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Global Financial Crisis and Its Impact on India's Growth

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Abstract: *The global financial crisis surfaced around August 2007. Its origin lay in structured investment instruments (Collateralized Debt Obligations, synthetic CDOs) created out of sub-prime mortgage lending in the United States. The securitization process however was not backed by due diligence and led to large-scale default. In the last two decades (1990-2009) fluctuations in India's economic growth were not closely linked to the cycles in developed countries or high-income OECD countries. The upward jump in Indian growth between 2003-04 and 2008-09 however seems to coincide with a similar jump in global and OECD growth. The sharp decline in growth to 5.8 per cent in the second half of 2008-09 from 7.8 per cent in the first half of 2008-09, following the US and global financial meltdown in August 2008, seemed to support this perspective. Following the global recession, there was a view among global market analysts, that growth in emerging markets and developing countries was driven by the global excess liquidity/monetization, the associated capital flows from developed countries and the demand for commodities.*

Key Words: *Global Financial Crisis; Sub Prime Crisis; Gross Domestic Product; private final consumption expenditure (PFCE); gross fixed capital formation; government final consumption expenditure (GFCE).*

INTRODUCTION

Globalization implies integration; global economy implies the integration of all the economies of the world. Post globalization, the whole world is regarded as one and it functions through an economy popularly called the „global economy." The global economy also comprises of the global financial system. Global financial crisis however, is turmoil inthe world financial system caused due to some illogical reasons and mismanagement by the financial institutions. Today, the global financial system is under increasing strain and risks to financial stability have remained imminent. The modern world is an inter-connected world following a period of economic boom, a financial bubble which was global in scope finally bursted causing havoc which was global in nature. The global financial crisis brewing for a while really started to show its effects in the middle of 2007 and into 2008. The fall of the world stock markets, large financial institutions and the complexities of the global financial system indicated the height of the global financial crisis. A collapse of the US subprime mortgage market and the reversal of housing boom in other industrialized economies have had a ripple effect around the world. The global financial crisis clearly reflects a combination of three factors;

- Weakening balance sheets of financial institutions
- Continuous fall in asset prices
- The weakening global growth

GLOBAL FINANCIAL CRISIS

The global financial crisis surfaced around August 2007. Its origin lay in structured investment instruments (Collateralized Debt Obligations, synthetic CDOs) created out of sub-prime mortgage lending in the United States. The securitization process however was not backed by due diligence and led to large-scale default.

The complexity of the instruments and the role of credit rating agencies played a contributory role. The high ratings assigned to certain CDO trenches, which were then quickly reversed with the onset of the crisis, created a panic situation among investors and precipitated the crisis.

While the initial effect of the crisis was profound on the US financial institutions and to a lesser extent on European institutions, the effect on emerging economies was less serious. In the initial stages, the capital flows to the emerging economies actually increased, giving rise to what is termed as "positive shock" and the "decoupling' debate. In the case of India, for example, the net FII inflows during the five-month period from September 2007 to January 2008 was US$ 22.5 billion as against an inflow of US$ 11.8 billion during April-July 2007, which were the four months immediately preceding the onset of crisis.

The effect of the global financial crisis on emerging economies (including India) thereafter was mainly through reversal of portfolio capital flows due to unwinding of stock positions by FIIs to replenish cash balances abroad. Withdrawal of FII investment led to stock market crash in many emerging economies and depreciation or decline in the value of local currencies vis-a-vis US dollar as a result of supply-demand imbalances in domestic markets. In the case of India, the extent of reversal of capital flows was US$ 15.8 billion during five months (February-June, 2008) following the end of “positive shock” period in January 2008.

Following the collapse of Lehman Brothers in mid-September 2008, there was a full-blown meltdown of the global financial markets. It created a crisis of confidence that led to the seizure of inter-bank market and had trickle-down effect on trade financing in the emerging economies. Together with slackening global demand and declining commodity prices, it led to fall in exports, thereby transmitting financial sector crisis to the real economy. Countries with export-led model of growth, as in many South-East Asian countries, and that depended upon commodity exports, were more severely affected.

The impact on Indian economy was less severe because of lower dependence of the economy on export markets and the fact that a sizeable contribution to GDP is from domestic sources. India’s trade reforms since 1991 have moved progressively towards neutral regime for exports and imports, eschewing tax and other incentives for exports.

The direct impact of the crisis on financial sector was primarily through exposure to the toxic financial assets and the linkages with the money and foreign exchange markets. Indian banks however had very limited exposure to the US mortgage market, directly or through derivatives, and to the failed and stressed international financial institutions. The depending of the global crisis and subsequent deleveraging and risk aversion however affected the Indian economy leading to slowing of growth momentum.

The overall balance of payment situation however remained resilient despite signs of strain in the capital account that manifested in the net reversal of FII flows of US$ 15.0 billion during fiscal year 2008-09 and on current account through decline in exports. In 2008-09, the merchandise exports recorded a growth of 13.6 per cent reaching US$ 189 billion.

While export growth was robust till August 2008, it became low in September and became negative from October 2008 to July 2009. The rupee depreciated by 21.2 per cent against the US dollar during the fiscal year 2008-09. The US dollar however appreciated by 17 per cent against the broad index (FRB, New York) between March 2008 and March 2009, suggesting that only 5 percentage points of the rupee depreciation was due to India-specific factors.

Money and credit markets had been affected indirectly through the dynamic linkages. The drying up of liquidity, a fallout of repatriation of portfolio investments by FIIs, affected credit markets in second half of2008-09. This was compounded by the “risk aversion” of banks to extend credit in the face of general downturn.

The extent of the external financial and monetary shock on the Indian monetary financial system is best captured by the precipitous contraction in reserve money by more than 15 per cent between August 2008 and November 2008 (compared to 0.5 percent increase in the corresponding period of the previous year). Reserve money growth (y-o-y) collapsed from 26.9 per cent in August 2008 to 10.3 per cent in November 2008 and further to 6.4 per cent in March 2009.

The various monetary policy measures taken by RBI kept narrow money M1 and broad money M3 from falling as precipitously. Despite these, however, Ml growth decelerated from 19.4 per cent in August 2008 to 10.3 per cent in November 2008 and further to 8.2 per cent in March 2009, while M3 growth decelerated from 21 per cent in August 2008 to 18.7 per cent in March 2009. A series of unconventional measures actually helped to push up the rate of growth of bank credit from 25.4 per cent in August 2008 to 26.9 per cent in November 2008.

However, this only partly offset the effects on short-and long-term credit to Indian companies in the United States and EU markets, because of the freezing of financial markets. Subsequently, credit growth decelerated sharply to 17.1 per cent in March 2009, partly because of transmission of

OECD recession effects to Indian exporters and organized manufacturing.

Despite these developments, the macroeconomic impact of the global financial turmoil, particularly on the GDP growth, has been relatively muted due to the overall strength of domestic demand in India and the predominantly domestic nature of investment financing.

IMPACT OF GLOBAL FINANCIAL CRISIS ON INDIA'S GROWTH

In the last two decades (1990-2009) fluctuations in India's economic growth were not closely linked to the cycles in developed countries or high-income OECD countries. The upward jump in Indian growth between 2003-04 and 2008-09 however seems to coincide with a similar jump in global and OECD growth.

The sharp decline in growth to 5.8 per cent in the second half of 2008-09 from 7.8 per cent in the first half of 2008-09, following the US and global financial meltdown in August 2008, seemed to support this perspective. Following the global recession, there was a view among global market analysts, that growth in emerging markets and developing countries was driven by the global excess liquidity/monetization, the associated capital flows from developed countries and the demand for commodities.

Consequently, with the bursting of the bubble the initial impact would be a growth collapse, followed by a return in the medium term to growth rates that prevailed before 2004-05, because of the painful process of de-leveraging and collapse of capital flows. It was therefore concluded by some of these analysts belonging to World Bank and IMF that India's growth would collapse to around 4 per cent during the subsequent four to six quarters and thereafter it may- revert to around 5 to 5.5 per cent over the medium term. An analysis of the growth history of India during 2008-09 suggests that this superficial generalization of a plausible global analysis to India was erroneous.

The first half (H1) of 2008-09 saw the Indian economy recording a growth of 7.8 per cent in GDP, despite the build-up of uncertainty in the international commodity and financial markets. Among the domestic growth drivers, gross fixed capital formation (GFCF) retained some of its momentum from the preceding years with a growth of nearly 11 per cent.

Consumption – both private and government however declined significantly. The growth in private final consumption expenditure (PFCE) in of the first half 2008-09 was 3.3 per cent, which was less than half of the corresponding period in 2007-08. Similarly, government final consumption expenditure (GFCE) in the first half of 2008-09 grew at less than 1 per cent, or just one-third of the growth in first half of 2007-08.

In the second half (H2) of2008-09, GDP growth declined to 5.8 per cent, with a further decline in private consumption growth to 2.5 per cent and a significant moderation in growth rate of GFCF to about 6 per cent over the corresponding period of 2007-08.

However, with the roll-out of the fiscal stimulus, primarily in the shape of implementation of the Sixth Pay Commission recommendations in Q3, as well as the second round of fiscal expansion announced in Q4, the growth in government final consumption expenditure shot up by nearly 36 per cent, partly making up for the shortfall in other components of the domestic aggregate demand. The overall GDP growth for the fiscal 2008-09 at 6.7 per cent surpassed all estimates and forecasts, mostly ranging from 5.5 per cent to 6.5 per cent, made by international agencies and analysts.

As expected, outcome of the recession in countries to which India exports its goods has been the sharp fall in growth of Indian organised manufacturing. The trend in India's manufacturing sector started in the second quarter of calendar year 2007 with the slowing of the US economy and its imports of several products from India.

The trend was merely accelerated after the US meltdown and the onset of the global recession. Services sector growth of India was not expected to slow sharply because of its well-known insensitivity to demand cycles and relatively small contribution of service exports to GDP.

In fact, there was a sharp increase in the growth of community, social and personal services which includes GDP from government administration. It is also important to note that in 2009-10 the Indian economy recovered faster and GDP growth rate in 2009-10 was 8.6 per cent and in 2010-11 it was 9.3 per cent. This shows the resilience of the Indian economy against external shocks.

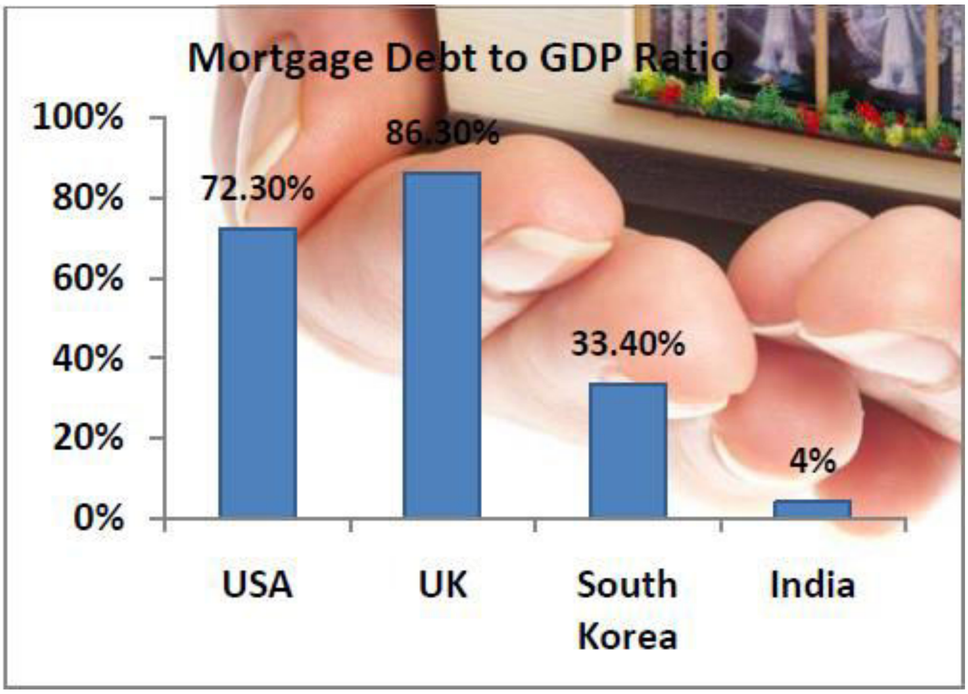
Table 1. Growth and Income in Asia

Period	Japan	Korea	Indonesia	China	India
	Average Annual GDP Percent Growth (2005 U.S. dollars)				
1960s	10.4	8.3	3.7	3.4	3.9
1970s	4.1	10.5	7.8	7.5	2.9
1980s	4.4	8.6	6.4	9.8	5.7
1990s	1.5	6.7	4.8	10.0	5.8
2000s	.6	4.7	5.1	10.3	6.9
2010-14	1.5	3.7	5.8	8.6	7.3
	Per Capita GDP (2005 U.S. dollars)				
1960s	10,576	1,335	290	108	245
1970s	17,782	2,895	416	169	278
1980s	24,620	5,749	644	328	334
1990s	32,779	11,618	1,026	746	463
2000s	35,250	18,350	1,258	1,761	724
2010-14	36,916	23,373	1,712	3,381	1,115

Note: GDP is gross domestic product.
Source: World Bank, World Development Indicators.

MAIN REASONS INDIA SURVIVED THE GLOBAL ECONOMIC RECESSION OF 2008

1. Less dependency on housing sector: Unlike US, Japan and Europe, private housing is not that big a part of the domestic economy. Even the concept of home mortgages from banks are barely 2 decades old. In early 1990s, all of Indian banks gave less than $1 billion in loans for housing and most of this is for government/bank employees.



2. Low base. At $1100/person as per-capita GDP there is way bigger room to grow up than go down. Contrary to popular myth, neither India nor China are the fastest growing countries. Some of the poorer countries do much better. The thing is, if the past is so shitty, you can even produce a triple digit growth rate. Here is last year's GDP growth rate of 12 fastest growing countries.

Rank	Country or Territory	Real GDP growth rate
1	Libya	121.9
2	Sierra Leone	21.3
3	Macau	20.7 (2011 est.)
4	Niger	14.5
5	Mongolia	12.7
6	Afghanistan	11.0
7	Iraq	10.2
8	Timor-Leste	10.0
9	Bhutan	9.9
10	Liberia	9.0
11	Panama	8.5
12	Laos	8.3

3. Strong central bank. India has a very good central bank, RBI, that is managed by some of the best finance guys. Both Subbarao and his predecessor YV Reddy are very prudent bankers. They applied brakes on banking loans even before the crisis.

4. General health of the economy. There is a colorful saying in the US that when tide goes away, you know who has been swimming naked. In the US and Europe, the housing crisis has just made their bad economy look even more bad. But, in most indicators (such as GDP growth, innovation), West has been sliding since 1990s. For Europe it is the lack of innovation, for Japan it is demographics and US it is healthcare. There is hardly any wage growth since that period. India and China have a sound fundamental economy that is ripe for boom.

5. Disconnected from the global economy. In 1990s India was opening up in a big way. As they were about to take the next round of reforms, the Asian financial crisis came up in 1997. It was the single worst event we discussed in our school. It took a decade for India to shakeout from that shock of just missing the trainwreck, and before it could make a round of currency reforms, this wreck happened. In either case, we were saved by luck of not connecting well with global economy. Global trade is a very small part of what we do.

FUNDAMENTAL REASONS

1) A high structural growth rate

In the run up to the recession, India had been growing at 8-9% per annum for a few years. A 5% hit to most economies would mean an outright recession, while for India, it meant 4% growth instead of 9%.

2) Quantity and product mix of exports

Indian exports account for a pretty small share of GDP.

The exports are in sectors like software, textiles, petroleum products, chemicals, iron & steel and gems. Of these the only industries that were severely hit were iron&steel and gems. The others held up fairly well.

3) A boring financial industry

India does not have a sophisticated financial services industry. Indian banks have a very small global footprint. They do boring work, largely catering to Indian customers. So, the collapse of international banks and conglomerates had a small impact on the banking sector.

OTHER REASONS

4) A high inflation rate

A recession is always accompanied by (some would say caused by) a huge fall in aggregate demand in the economy. This is accompanied by (some would say causes) a commensurate fall in business investment and a flight to low risk, liquid assets (typically cash and Government bonds)

Basically, a recession creates a situation where people want to save more than others are willing to borrow and invest.

In such a situation, the blow to the economy can be cushioned by goosing up business investment through a cut in the interest rate. It is the job of the country's central bank to do that. This is what people mean when they say "Monetary Stimulus". In the west, the inflation rate is low and therefore, the nominal interest rates tend to be low.

A low inflation rate is a good thing in normal times, however if the fall in aggregate demand is sufficiently large, one could find oneself in a situation where even cutting interest rates to zero doesn't deliver enough monetary stimulus to bring about a recovery. This is what happened in the US, Japan and much of Europe. They cut rates to zero but the economy did not recover.

However, this did not happen in India. The nominal interest rate was very high. So, there was enough room to cut and a stimulus big enough to avoid a recession was delivered.

5) Black money

Approximately 50% of India's GDP is estimated to come from the underground economy and this black money is disproportionately concentrated in the real estate market. Therefore, bank loans as a proportion of the value of property tend to be lower than they are in the west.

SUITABLE MEASURES TO OVERCOME THE CRISIS

The global financial crisis is a serious issue which needs to be checked. Appropriate measures should be put into practice so that there can be deterioration in the magnitude of the crisis. However, some rational measures would be to;

- The IMF has urged that monetary policy be the first line of defense in industrialized countries and the same should be followed in India
- The Reserve Bank of India has to provide liquidity and bring an ease in the monetary policies keeping the inflationary expectations under check.
- The central banks of the crisis initiating countries must continue to pay more attention to asset prices in future.
- The emerging economies should support policies to strengthen their domestic demand, including greater exchange rate flexibility to play a more dynamic role in economic growth.
- The Asian economies and especially Indian economy have a huge backlog to make up in basic infrastructure, which can be a powerful instrument for stimulating demand in Asia.
- The Indian economy should steer towards greater financial and economic independence.
- Likewise, reducing interest rates sounds like there would be fewer incentives for people to save money, when banks need to build up capital reserves. However, as the real economy starts to feel the pinch, reduced interest rates are an attempt to encourage people to take part in the economy.
- Tax reduction is something that most people favour, and yet during times of economic downtown, it would seem that a reduction in tax would result in reduced government revenues just when they need it and then spending on health, education etc would be at risk. However, because the higher taxes during downturns means more hardship for more people, increased borrowing is supposed to effect the reduction in taxes, hopefully affording people a better chance to overcome the economic storm.

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