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GLOBAL SLOWDOWN AND INDIAN ECONOMY

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ABSTRACT

India's financial sector is not deeply integrated with the global financial system, which spared it the first round adverse effects of the global financial crisis and left Indian banks mostly unaffected. However, as the financial crisis morphed in to a full-blown global economic downturn, India could not escape the second round effects. The global crisis has affected India through three distinct channels: financial markets, trade flows, and exchange rates. The reversal in capital inflows, which created a credit crunch in domestic markets along with a severe deterioration in export demand, contributed to the decline of gross domestic product by more than 2 percentage points in the fiscal year 2008–2009. In line with efforts taken by governments and central banks all over the world, the Government and the Reserve Bank of India took aggressive countercyclical measures, sharply relaxing monetary policy and introducing a fiscal stimulus to boost domestic demand.
Keywords: *Integrated, global financial system , reversal in capital flows, gross domestic product .*

INTRODUCTIUON

The Indian economy looked to be relatively insulated from the global financial crisis that started in August 2007 when the sub-prime mortgage crisis first surfaced in the United States (US). In fact, the Reserve Bank of India (RBI) was raising interest rates until August 2008 with the explicit objective of cooling the economy and bringing down the gross domestic product (GDP) growth rate, which visibly had moved above the rate of potential output growth and was contributing to the buildup of inflationary pressures in the economy.1 But when the collapse of Lehman Brothers on 23 September 2008 morphed the US financial meltdown into a global economic downturn, the impact on the Indian economy was almost immediate. External credit flows suddenly dried up and the overnight money market interest rate spiked to above 20% and remained high for the next month. It is perhaps judicious to assume that the impacts of the global economic downturn on the Indian economy are still unfolding.

Severity of the current financial crisis:

Banking and financial crises have been a regular feature of modern economic history. According to one estimate, there have been 86 banking crises since the Great Depression that have spread beyond national borders. According to a World Bank study in 2001,2 the world has witnessed as many as 112 systemic banking crises from the late 1970s to early 2001. Most crises, including the current one, share some common features. Some general examples include a search for increasingly higher yields in financial markets, a lax regulatory regime, a mismatch in appetite for risk and the capacity for bearing it, and the consequent build up of asset bubbles, usually in the real estate sector, which for various reasons is overlooked by the regulators. The recent financial sector crisis shares most, if not all, of these features. However, what makes the current crisis exceptional is that it emerged at the very epicenter of global capitalism, the US, and its contagion spread very quickly to the entire global economy, unlike previous crises that were usually confined to a region or a small number of countries. Economies like India and the People's Republic of China (PRC), where the financial sectors were not as integrated with the global financial system, were spared the first round adverse effects of the current crisis and their banks were left mostly unaffected.

The severity of the current crisis can be gauged by the steep decline in the equity markets of advanced economies. The bursting of the sub-prime housing bubble caused Wall Street to lose a staggering US$8 trillion in market capitalization in a very short time (Brunnermier 2009). Interestingly, the loss in market capitalization and crash in equity prices has been significantly higher in periphery economies as compared to US markets

IMPACT OF CRISIS ON THE INDIAN ECONOMY

Global Integration of Indian Economy

In response to its balance of payments (BOP) crisis in the early 1990s, India implemented a series of trade, industry, and investment reforms. These reforms effectively liberalized the economy, ending a long period of relative isolation from global markets and financial and technology flows. Since then the Indian economy has become increasingly integrated with the world economy.6 Consequently, current account flows (receipts and payments of merchandise and invisibles) as a proportion of GDP increased from 20% in FY1990–1991 to 53% in FY2007–2008 (Figure 2). However, the most significant change can be witnessed in the capital account. Due to the rationalization of procedures and conditions for foreign investment, India has emerged as an attractive investment destination. This is reflected as an increase in foreign portfolio investment inflows from US$2 billion in FY2001–2002 to US$29 billion in FY2007–2008. Foreign direct investment (FDI) inflows have also gone up significantly in recent years, having risen to US$34.3 billion in FY2007–2008 from US$6.1

billion in FY2001–2002. At the same time, Indian corporations have also entered the global market for mergers and acquisitions, resulting in some capital account outflow from India. As a result, two-way flows of portfolio and direct foreign capital have gone up from a mere 12% of GDP in FY1990–1991, to 64% of the GDP in FY2007–2008, registering a fivefold increase. Interestingly, these ratios are significantly higher than those in the US, for which trade in goods and services constituted only 41% of GDP in 2007 and capital flows another 25% in the same year.

Impact on sector Growth:

Agriculture growth is 2..2 % for the quarter ending Dec. 08 against 6.9% in Dec. 07-02 % growth rate for manufacturing for quarter ending Dec. 08 against 8.6 % in Dec07.5.3 % GDP growth for quarter ending Dec. 08 against 8.6% in Dec 07. Fear of deeper economic slowdown grew stronger with the government reporting on Friday October. 10, 2008 the industrial growth plunged to 1.3 % in august from a robust 10.9 % in the same month last year. The plunge underscored the impact of rising interest rates and slacking demand, which has cascaded through almost rate of the six infrastructure industries – crude oil, refinery products, coal, power, cement and finished steel slumped to 1.4 percent, reflecting a decline in consumption triggered by the economic slowdown, finished product segments "consumer goods, consumer durables and consumer non-durables suffered contraction of 2.3 %, 3% and 2% respectively. The service sector which, contributes over 55 % to India's economy, has started showing market deterioration since October this year due to the global financial crisis, credit crunch and higher interest rates during recent months. The market slowdown that occurred from October 2008 compared with the cumulative growth rate for the period April Nov 2008 Compared with cumulative growth in April November 2007. These trends clearly indicated that the service sector that registered a robust growth in the year 2007-08 is being felt the impact of the ongoing economic turmoil and there are signs that in the month ahead further slowdown cannot be rules out.

Table- I

Trends in capital flows (figures in $ million)

Components	Period	2007-08	2008-09
FDI	April-August	8,536	16,733
FII	April- September	15,508	-6421
ECB	*April-June	6990	1559
STC	**April- June	1804	2173

ECB(Approvals)	April- August	13,375	8104
Forex (Variation)	April- September	48,583	-179

Source: RBI * External Commercial Borrowing

III- Impact on Financial sector: - The financial sector including the banking sector , equity markets, external commercial borrowings (ECB's) and remittances has not remained un scattered though fortunately, the Indian banking sector was not overly exposed to the sub-prime crisis . Only one of the larger banks, ICICI, was partly affected but managed to crisis because of its strong balance sheet and timely action by the Government, which virtually guaranteed its deposits. The equity markets have seen a near 60 percent decline in the index and a wiping off about USD 1.3 trillion in market capitalization since January 2008 when the Sensex had peaked at about 21000. This is primarily due to withdrawal of about USD 12 billion from the market by foreign 6 portfolio investors between September and December 2008. The foreign 6 portfolio investors withdrew these funds in order to strengthen the balance sheet of their parent companies. Commercial credit, both for trade finance and medium- term advances from foreign banks has virtually dried up. This has had to be replaced with credits lines from domestic banks but at higher interest cost and has caused the rupee to depreciate raising the cost and has caused the rupee to depreciate raising the cost of existing foreign loans, finally, while the latest number are not yet available, remittances from overseas Indians have reportedly fallen as oil producing economics in the Gulf and west Asian begin to suffer from decline in oil prices.

CONCLUSION:

Indian economy has been hurt by the global financial recession, but India may be in better position with quick recovery and for future growth than many of the other economics as Indian banks did not have significant exposure to sub- prime loans in the U.S. RBI's decision to appropriate use of a range of instruments such as CRR, Repo/ Reverse Repo rate, SLRMSS and LAF are in the right direction and taken in time. We would like to conclude the paper in the words of Dr. Rakesh Mohan, former Deputy Governor of RBI,"As the monetary and fiscal stimuli work their way though, and if calm and confidence are restored in the global markets, we can see economic turnaround later this year. Once calm and confidence are restored in the global markets, economic activity in India will recover sharply. Yet they will be period of painful recovery.

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