IMPACT OF GLOBAL ECONOMIC CRISIS ON INDIAN ECONOMY

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Abstract

Indian economy is now relatively an open economy. Gross capital & current account flows in the Balance of Payments have increased to over 100 percent of GDP in 2009-10 from nearly 22 percent in 1980s. With this higher degree of openness, Indian economy is bound to be affected by the developments in international markets and the global shocks- real as well as financial. This paper provides an outlook for the Indian economy in the light of the extraordinary global financial crisis, that started in the US, but which has now transformed into the worst economic downturn since the Great Depression. The present study is focused upon the magnitude and causes of Global Financial Crisis and the response of India. The role of financial and real sector and monetary policy has been analyzed in analyzing the impact of global financial crisis on Indian economy.
Keywords: Indian economic growth, Economic outlook and conditions, financial crises

1. Introduction

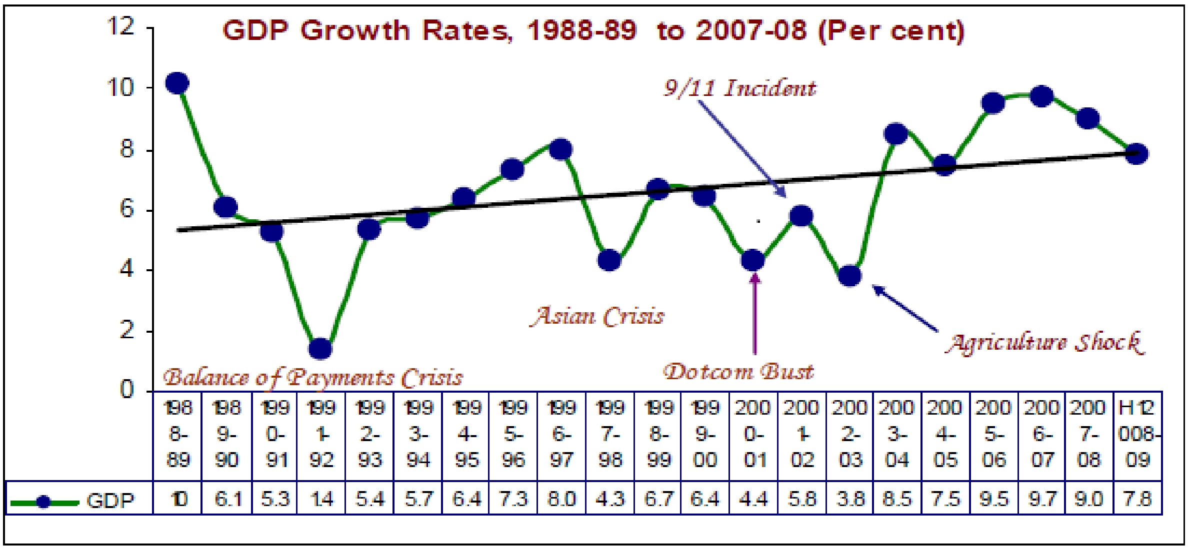
Global financial crisis is the variety of situations in which the financial assets and institutions suddenly lose a large part of their value. Global financial crisis have been associated with banking panics, global recessions, currency recessions, stock market crashes etc. In the era of globalization; financial crisis have been occurring with greater frequency and the impact of global financial conditions cannot be overlooked because of increased integration of domestic and global economies. Before the major crisis of 2008, there were crisis of Latin America (1980), Mexico, and Asia & Russia (1990s). The late 2000s financial crisis also known as Global Financial Crisis was considered to be the worst financial crisis since the Great Depression of 1930s. It resulted in the collapse of large financial institutions, bailout of banks by national governments and downturn in the stock market around the world. India experienced a classic external payments crisis in 1991 which included: high fiscal, current account deficits, rising debt servicing obligations, rising inflation and inadequate exchange rate adjustment. Integration of financial markets in India has been facilitated by various measures in the form of free pricing, widening of participation base in markets, introduction of new instruments and improvements in payment and settlement infrastructure. Financial integration represents strictly the “extent to which the prices of, and returns to, assets are equalized between different national financial markets”.

2. Indian Economy: Past Crises and Recent Developments

2.1 Past Crises

Using an averaging process of past crises as done in the seminal study of Reinhart and Rogoff (2008) we try to see the impact of the present global crisis on the nature, severity and duration of the economic downturn in India. The past crises that have been considered are the three major crises – 1991-92 balance of payment (BOP) crisis; 1997-98 fallout from the Asian financial crisis; and 2000-02 crisis caused by the worldwide bursting of the dotcom bubble and 9/11 incident.

Figure 1: Trends and Growth of Indian GDP



Source: Central Statistical Organization

2.2 *Indian Economy: Recent Developments*

India had been growing robustly at an annual average rate of 8.8 per cent for the past five years (2003-04 to 2007-08). This was higher than the potential growth rate of output as estimated both by the IMF and OECD (See IMF, 2007 and OECD, 2007). The strong Indian growth story, based on its structural strengths of a young population, skilled manpower, rising savings and investment rates, large unfulfilled domestic demand and globally competitive firms attracted significant investor attention in recent years. Recent high rates of economic growth have been the result of high levels of investment, rise in productivity supported by technological up-gradation and greater integration with global flows of trade, finance and technology. The challenge is to sustain these high growth rates while also preventing an unacceptable rise in income and spatial inequities and also eliminating absolute poverty in a given time frame. The answer to this challenge is in raising India's potential rate of output growth by removing the binding constraints. We have also estimated the potential growth rate for India during the last decade based on HP filter technique (Hodrick and Prescott, 1997) and found that in the last three years, India had been growing above its potential growth rate.

Impact of Global Financial Crisis on Indian Economy:

1. Real channel

US, European Union and Middle East accounting three quarters of India's goods & services suffered downturn. With deepening of recession services export was slowed down. Demand effects were particularly severe in housing, construction, consumer durables and IT sector.

Table: 1 Exports & GDP Inter-linkages

Year	Total Exports/All Commodities	%age Rise	GDP at Factor Cost	%age Rise
1990-91	32557.6	17.71	515032	16.49
1991-92	44041.8	35.27	594168	15.37
1992-93	53688.3	21.9	681517	14.7
1993-94	69751.4	29.92	792150	16.23
1994-95	82674.1	18.53	925239	16.8
1995-96	106353.3	28.64	1083289	17.08
1996-97	118817.1	11.72	1260710	16.38
1997-98	130100.6	9.50	1401934	11.2
1998-99	139753.1	7.42	1616082	15.28
1999-00	159561.4	14.17	1786526	10.55
2000-01	203571	27.58	1925017	7.75
2001-02	209018	2.68	2097726	8.97
2002-03	255137.3	22.06	2261415	7.8
2003-04	293366.8	14.98	2538170	12.24
2004-05	375339.5	27.94	2971464	17.07
2005-06	456417.9	21.6	3390503	14.1
2006-07	571779.3	25.28	3953276	16.6
2007-08	655863.5	14.71	4582086	15.91
2008-09	840755.1	28.19	5303567	15.75

The export slow-down is one of the primary suffer on real channel side; Growing trade integration is one of the route to affect real economy by deceleration in exports of goods & services, which earlier contribute to boom. Table 1 depicts that during the period of 1993-94 after LPG; when there was increase in exports from 69751.4 rupee crores, GDP also increased from 681517 to 792150, but the percentage increase in exports was much more than the percentage increase in GDP. However, due to financial turmoil in year 2008-09; exports declined from 28.19% to 0.57% however, GDP declined to 14.86% from 15.75%. This shows that during the phase of global financial crisis, exports declined to a large extent.

2. Impact on Stock Market

The stock markets of Indian were affected by global financial turmoil. SENSEX which reached to the mark of 21000 in the month of January 2008plungedtobelow10000inthemonthofOctober2008.Table2showsthesignificant relation between foreign investment in the economy and SENSEX movements. During 2007- 08 when total foreign investments (Portfolio Investment + Direct Investment) increased to 249921 Rupee crores, from 135080 in 2006-07; SENSEX value also rose to 16568.89 from 12277.33 in previous year. And during the year of financial crisis in 2008-09, exports reduced to 110123 Rupee crores and SENSEX value also declines to 12365.55.

Table 2: SENSEX & Foreign Investments

Year	**Direct investment**	**Portfolio investmen t**	**Total Foreign Investment**	**BSE Sensex (Base : 1978-79 =100)**
1990-91	174	11	185	1049.53
1991-92	316	10	326	1879.51
1992-93	965	748	1713	2895.67
1993-94	1838	11188	13026	2898.69
1994-95	4126	12007	16133	3974.91
1995-96	7172	9192	16364	3288.68
1996-97	10015	11758	21773	3469.24
1997-98	13220	6794	20014	3812.86
1998-99	10358	-257	10101	3294.78
1999-00	9338	13112	22450	4658.63
2000-01	18406	12609	31015	4269.69
2001-02	29235	9639	38874	3331.95
2002-03	24367	4738	29105	3206.29
2003-04	19860	52279	72139	4492.19
2004-05	27188	41854	69042	5740.99
2005-06	39674	55307	94981	8278.55
2006-07	103367	31713	135080	12277.33
2007-08	140180	109741	249921	16568.89
2008-09	173741	-63618	110123	12365.55

3. Financial Markets

As a consequence of the global liquidity squeeze the credit demand of Indian corporate and Banks was shifted to domestic banking sector from global finances leading to pressure on domestic capital and money market. Global deleveraging process lead to reversal of capital flows which put pressure on forex markets and leading downward trend of rupee. To manage volatility, Reserve bank's intervention in forex market added to liquidity tightening. There was rapid depreciation of exchange rate and surge in short-term interestrates.

4. Confidence Channel

Initially Indian markets continued to function in an orderly manner but immediately after Lehman failure in September 2008, the risk aversion of financial system increased and banks became cautious aboutlending. In 1991, two immediate external shocks contributed to the large current account deficit of 3.1 in 1990-91. First was the Gulf crisis in August 1990 which increased petroleum costs. The government had to bear the additional burden of rehabilitating 1,12,000 Indian workers from Middle East as remittances from that region declined. The second shock was the global recession: declined world growth to 2.25 percent in 1991 from 4.5 percent in 1988. Export growth in US turned negative in 1991. Large fiscal imbalances of 1980s and precipitated by the Gulf war; India's oil import bill swelled, exports slumped, credit dried up and investors took their own money out leading to fiscal deficit rise to 12.7 percent. All these lead to: Reduction in Capital Flows, Pressure on Balance of Payments, Monetary & Liquidity Impact, Reduction in flows from non-banks, Perceptions of credit crunch, Fiscal Stress: Oil, Fertilizer & Food subsidies, Pay Commission, Debt Waiver, NRE, Stimulus Packages, Large Increase in MarketBorrowings.

Conclusion

The Indian economy was on a cyclical slowdown after a five-year record boom and there was every hope that the economy will go for another strong growth phase after this brief slowdown. The global crisis has changed that outlook and instead will deepen and prolong Indian economy's slowdown. While the impact of global financial crisis is having a devastating impact on most economies of the world, but its impact on Indian economy is not that severe. The economic indicators in United States and European Union countries point to severe contraction in these countries, but the slowdown in emerging markets have been smaller. Fiscal and monetary expansionary steps at a time of extreme uncertainty worldwide will have limited impact. On the other hand, the sharp reversal of the steady fiscal improvement over the past five years or so would weaken public finances considerably and store up problems for the economy sooner than later.

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