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Impact of Global Economic Crisis in India

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Abstract

The perception that the current global economic crisis is primarily a financial crisis resulting from excessive exuberance and inadequate regulation of the financial sector is at best superficial, if not downright misleading. Globalization has ensured that the Indian economy and financial markets cannot stay insulated from the present financial crisis in the developed economies. The debate, therefore, can only be on the extent of impact and how resilient India is to withstand the storm with minimal damage. In the light of the fact that the Indian economy is linked to global markets through a full float in current account (trade and services) and partial float in capital account (debt and equity), and there is the need to analyze the impact based on three critical factors: Availability of global liquidity; demand for India investment and cost thereof and decreased consumer demand affecting Indian exports.

Keywords: *ECB, FDI, Forex, FRBM, GDP, Global Financial Crisis, Global outlook, Monetary Policy, NASSCOM, NBFCs, Reserve Bank of India.*

Introduction

The concerted intervention by central banks of developed countries in injecting liquidity is expected to reduce the unwinding of India investments held by foreign entities, but fresh investment flows into India are in doubt.

The impact of this will be three-fold: The element of GDP growth driven by off-shore flows (along with skills and technology) will be diluted; correction in the asset prices which were hitherto pushed by foreign investors and demand for domestic liquidity putting pressure on interest rates.

While the global financial system takes time to "nurse its wounds" leading to low demand for investments in emerging markets, the impact will be on the cost and related risk premium. The impact will be felt both in the trade and capital account.

Indian companies which had access to cheap foreign currency funds for financing their import and export will be the worst hit. Also, foreign funds (through debt and equity) will be available at huge premium and would be limited to blue-chip companies. The impact of which, again, will be three-fold: Reduced capacity expansion leading to supply side pressure; increased interest expenses to affect corporate profitability and increased demand for domestic liquidity putting pressure on the interest rates.

Consumer demand in developed economies is certain to be hurt by the present crisis, leading to lower demand for Indian goods and services, thus affecting the Indian exports.

The impact of which, once again, will be three-fold: Export-oriented units will be the worst hit impacting employment; reduced exports will further widen the trade gap to put pressure on rupee exchange rate and intervention leading to sucking out liquidity and pressure on interest rates.

The impact on the financial markets will be the following: Equity market will continue to remain in bearish mood with reduced off-shore flows, limited domestic appetite due to liquidity pressure and pressure on corporate earnings; while the inflation would stay under control, increased demand for domestic liquidity will push interest rates higher and we are likely to witness gradual rupee depreciation and depleted currency reserves. Overall, while RBI would inject liquidity through CRR/SLR cuts, maintaining growth beyond 7 per cent will be a struggle.

The banking sector will have the least impact as high interest rates, increased demand for rupee loans and reduced statutory reserves will lead to improved NIM while, on the other hand, other income from cross-border business flows and distribution of investment products will take a hit.

Banks with capabilities to generate low cost CASA and zero cost float funds will gain the most as revenues from financial intermediation will drive the banks' profitability.

Given the dependence on foreign funds and off-shore consumer demand for the Indian growth story, India cannot wish away from the negative impact of the present global financial crisis but should quickly focus on alternative remedial measures to limit damage and look inwards to sustain growth!

Impact of the Crisis on India – Current Literature

While the overall policy approach has been able to mitigate the potential impact of the turmoil on domestic financial markets and the economy, with the increasing integration of the Indian economy and its financial markets with rest of the world, there is recognition that the country does face some downside risks from these international developments. The risks arise mainly from the potential reversal of capital flows on a sustained medium-term basis from the projected slow down of the global economy, particularly in advanced economies, and from some elements of potential financial contagion. In India, the adverse effects have so far been mainly in the equity markets because of reversal of portfolio equity flows, and the concomitant effects on the domestic forex market and liquidity conditions. The macro effects have so far been muted due to the overall strength of domestic demand, the healthy balance sheets of the Indian corporate sector, and the predominant domestic financing of investment. As might be expected, the main impact of the global financial turmoil in India has emanated from the significant change experienced in the capital account in 2008-09 so far, relative to the previous year. Total net capital flows fell from US$17.3 billion in April-June 2007 to US$13.2 billion in April-June 2008. Nonetheless, capital flows are expected to be more than sufficient to cover the current account deficit this year as well. While Foreign Direct Investment

(FDI) inflows have continued to exhibit accelerated growth (US$ 16.7 billion during April-August 2008 as compared with US$ 8.5 billion in the corresponding period of 2007), portfolio investments by foreign institutional investors (FIIs) witnessed a net outflow of about US$ 6.4 billion in April- September 2008 as compared with a net inflow of US$ 15.5 billion in the corresponding period last year.

Similarly, external commercial borrowings of the corporate sector declined from US$ 7.0 billion in April-June 2007 to US$ 1.6 billion in April-June 2008, partially in response to policy measures in the face of excess flows in 2007-08, but also due to the current turmoil in advanced economies. With the existence of a merchandise trade deficit of 7.7 per cent of GDP in 2007-08, and a current account deficit of 1.5 per cent, and change in perceptions with respect to capital flows, there has been significant pressure on the Indian exchange rate in recent months. Whereas the real exchange rate appreciated from an index of 104.9 (base 1993-94=100) (US$1 = Rs. 46.12) in September 2006 to 115.0 (US$ 1 = Rs. 40.34) in September 2007, it has now depreciated to a level of 101.5 (US $ 1 = Rs. 48.74) as on October 8, 2008.

With the volatility in portfolio flows having been large during 2007 and 2008, the impact of global financial turmoil has been felt particularly in the equity market. The BSE Sensex (1978-79=100) increased significantly from a level of 13,072 as at end-March 2007 to its peak of 20,873 on January 8, 2008 in the presence of heavy portfolio flows responding to the high growth performance of the Indian corporate sector. With portfolio flows reversing in 2008, partly because of the international market turmoil, the Sensex has now dropped to a level of 11,328 on October 8, 2008, in line with similar large declines in other major stock markets.

As noted earlier, domestic investment is largely financed by domestic savings. However, the corporate sector has, in recent years, mobilized significant resources from global financial markets for funding, both debt and non-debt, their ambitious investment plans. The current risk aversion in the international financial markets to EMEs could, therefore, have some impact on the Indian corporate sector's ability to raise funds from international sources and thereby impede some investment growth. Such corporate would, therefore, have to rely relatively more on domestic sources of financing, including bank credit. This could, in turn, put some upward pressure on domestic interest rates. Moreover, domestic primary capital market issuances have suffered in the current fiscal year so far in view of the sluggish stock market conditions. Thus, one can expect more demand for bank credit, and non-food credit growth has indeed accelerated in the current year (26.2% on a year-on-year basis as on September 12, 2008 as compared with 23.3% a year ago). The financial crisis in the advanced economies and the likely slowdown in these economies could have some impact on the IT sector. According to the latest assessment by the NASSCOM, the software trade association, the current developments with respect to the US financial markets are very eventful, and may have a direct impact on the IT industry and likely to create a downstream impact on other sectors of the US economy and worldwide markets.

Global Outlook

- The global economic outlook deteriorated sharply over the last quarter. In a

sign of the ferocity of the down turn, the IMF made a marked downward revision of its estimate for global growth in 2009 in purchasing power parity terms – from its forecast of 3.0 per cent made in October 2008 to 0.5 per cent in January 2009. In market exchange rate terms, the downturn is sharper – global GDP is projected to actually shrink by 0.6 per cent. With all the advanced economies – the United States, Europe and Japan - having firmly gone into recession, the contagion of the crisis from the financial sector to the real sector has been unforgiving and total. Recent evidence suggests that contractionary forces are strong: demand has slumped, production is plunging, job losses are rising and credit markets remain in seizure. Most worryingly, world trade – the main channel through which the downturn will get transmitted on the way forward – is projected to contract by 2.8 per cent in 2009.

- Policy making around the world is in clearly uncharted territory. Governments and central banks across countries have responded to the crisis through big, aggressive and unconventional measures. There is a contentious debate on whether these measures are adequate and appropriate, and when, if at all, they will start to show results. There has also been a separate debate on how abandoning the rule book driven by the tyranny of the short-term, is compromising medium-term sustainability. What is clearly beyond debate though is that this Great Recession of 2008-09 is going to be deeper and the recovery longer than earlier thought.

Emerging Economies

Contrary to the 'decoupling theory', emerging economies too have been hit by the crisis. The decoupling theory, which was intellectually fashionable even as late as a year ago, held that even if advanced economies went into a downturn, emerging economies will remain unscathed because of their substantial foreign exchange reserves, improved policy framework, robust corporate balance sheets and relatively healthy banking sector. In a rapidly globalizing world, the 'decoupling theory' was never totally persuasive. Given the evidence of the last few months – capital flow reversals, sharp widening of spreads on sovereign and corporate debt and abrupt currency depreciations - the 'decoupling theory' stands totally invalidated. Reinforcing the notion that in a globalized world no country can be an island, growth prospects of emerging economies have been undermined by the cascading financial crisis with, of course, considerable variation across countries.

Questions that will be Addressed

India too has been impacted by the crisis – and by much more than it was suspected earlier:

i. Why has India been hit by the crisis?

ii. How has India been hit by the crisis?

iii. How have we responded to the challenge?

iv. What is the outlook for India?

Why has India been hit by the crisis?

There is, at least in some quarters, dismay that India has been hit by the crisis. This dismay stems from two arguments.

1. The first argument goes as follows. The Indian banking system has had no direct exposure to the sub-prime mortgage assets or to the failed institutions. It has very limited off-balance sheet activities or securitized assets. In fact, Indian banks continue to remain safe and healthy. So, the enigma is how can India be caught up in a crisis when it has nothing much to do with any of the maladies that are at the core of the crisis.
2. The second reason for dismay is that India's recent growth has been driven predominantly by domestic consumption and domestic investment. External demand, as measured by merchandize exports, accounts for less than 15 per cent of our GDP. The question then is, even if there is a global downturn, why should India be affected when its dependence on external demand is so limited?

The answer to both the above frequently-asked questions lies in globalization. First, India's integration into the world economy over the last decade has been remarkably rapid. Integration into the world implies more than just exports. Going by the common measure of globalization, India's two-way trade (merchandize exports plus imports), as a proportion of GDP, grew from 21.2 per cent in 1997-98, the year of the Asian crisis, to 34.7 per cent in 2007-08. Second, India's financial integration with the world has been as deep as India's trade globalization, if not deeper. If an expanded measure of globalization is taken into consideration, that is the ratio of total external transactions (gross current account flows plus gross capital flows) to GDP, this ratio has more than doubled from 46.8 per cent in 1997-98 to 117.4 per cent in 2007-08.

Importantly, the Indian corporate sector's access to external funding has markedly increased in the last five years. Some numbers will help illustrate the point. In the five-year period 2003-08, the share of investment in India's GDP rose by 11 percentage points. Corporate savings financed roughly half of this, but a significant portion of the balance financing came from external sources. While funds were available domestically, they were expensive relative to foreign funding. On the other hand, in a global market awash with liquidity and on the promise of India's growth potential, foreign investors were willing to take risks and provide funds at a lower cost. In the year 2007-08, India received capital inflows amounting to over 9 per cent of GDP as against a current account deficit in the balance of payments of just 1.5 per cent of GDP. These capital flows, in excess of the current account deficit, evidence the importance of external financing and the depth of India's financial integration. So, the reason India has been hit by the crisis, despite mitigating factors, is clearly India's rapid and growing into the global economy.

How has India been hit by the crisis?

The contagion of the crisis has spread to India through all the channels – the financial channel, the real channel, and importantly, as happens in all financial crises, the confidence channel.

The financial channel: India's financial markets - equity markets, money markets, forex markets and credit markets - had all come under pressure from a number of directions. First, as a consequence of the global liquidity squeeze, Indian banks and corporates found their overseas financing drying up, forcing corporates to shift their credit demand to the domestic banking sector. Also, in their frantic search for substitute financing, corporates withdrew their investments from domestic money market mutual funds putting redemption pressure on the mutual funds and down the line on non-banking financial companies (NBFCs) where the MFs had invested a significant portion of their funds. This substitution of overseas financing by domestic financing brought both money markets and credit markets under pressure. Second, the forex market came under pressure because of reversal of capital flows as part of the global deleveraging process. Simultaneously, corporates were converting the funds raised locally into foreign currency to meet their external obligations. Both these factors put downward pressure on the rupee. Third, the Reserve Bank's intervention in the forex market to manage the volatility in the rupee further added to liquidity tightening.

The real channel: Here, the transmission of the global cues to the domestic economy has been quite straight forward – through the slump in demand for exports. The United States, European Union and the Middle East, which account for three quarters of India's goods and services trade, are in a synchronized down turn. Service export growth is also likely to slow in the near term as the recession deepens and financial services firms – traditionally large users of outsourcing services – are restructured. Remittances from migrant workers too are likely to slow as the Middle East adjusts to lower crude prices and advanced economies go into a recession.

Beyond the financial and real channels of transmission as above, the crisis also spread through the confidence channel. In sharp contrast to global financial markets, which went into a seizure on account of a crisis of confidence, Indian financial markets continued to function in an orderly manner. Nevertheless, the tightened global liquidity situation in the period immediately following the Lehman failure in mid-September 2008, coming as it did on top of a turn in the credit cycle, increased the risk aversion of the financial system and made banks cautious about lending.

The purport of the above explanation is to show how, despite not being part of the financial sector problem, India has been affected by the crisis through the pernicious feedback loops between external shocks and domestic vulnerabilities by way of the financial, real and confidence channels.

How have we responded to the challenge?

The failure of Lehman Brothers in mid-September was followed in quick succession by several other large financial institutions coming under severe stress. This made financial markets around the world uncertain and unsettled. This contagion, spread to emerging economies, and to India too. Both the government and the Reserve Bank of India responded to the challenge in close coordination and consultation. The main plank of the government response was fiscal stimulus while the Reserve Bank's action comprised monetary accommodation and counter cyclical regulatory forbearance.

Monetary Policy Response:

The Reserve Bank's policy response was aimed at containing the contagion from the outside - to keep the domestic money and credit markets functioning normally and see that the liquidity stress did not trigger solvency cascades. In particular, targeted three objectives are targeted: first, to maintain a comfortable rupee liquidity position; second, to augment foreign exchange liquidity; and third, to maintain a policy framework that would keep credit delivery on track so as to arrest the moderation in growth. This marked a reversal of Reserve Bank's policy stance from monetary tightening in response to heightened inflationary pressures of the previous period to monetary easing in response to easing inflationary pressures and moderation in growth in the current cycle. The measures to meet the above objectives came in several policy packages starting mid-September 2008, on occasion in response to unanticipated global developments and at other times in anticipation of the impact of potential global developments on the Indian markets.

Indian policy packages included, like in the case of other central banks, both conventional and unconventional measures. On the conventional side, India reduced the policy interest rates aggressively and rapidly, reduced the quantum of bank reserves impounded by the central bank and expanded and liberalized the refinance facilities for export credit. Measures aimed at managing forex liquidity included an upward adjustment of the interest rate ceiling on the foreign currency deposits by non-resident Indians, substantially relaxing the external commercial borrowings (ECB) regime for corporates, and allowing non-banking financial companies and housing finance companies access to foreign borrowing.

The important among the many unconventional measures taken by the Reserve Bank of India are a rupee-dollar swap facility for Indian banks to give them comfort in managing their short-term foreign funding requirements, an exclusive refinance window as also a special purpose vehicle for supporting non-banking financial companies, and expanding the lendable resources available to apex finance institutions for refinancing credit extended to small industries, housing and exports.

Government's Fiscal Stimulus:

Over the last five years, both the central and state governments in India have made a serious effort to reverse the fiscal excesses of the past. At the heart of these efforts was the Fiscal Responsibility and Budget Management (FRBM) Act which mandated a calibrated road map to fiscal sustainability. However, recognizing the depth and extraordinary impact of this crisis, the central government invoked the emergency provisions of the FRBM Act to seek relaxation from the fiscal targets and launched two fiscal stimulus packages in December 2008 and January 2009. These fiscal stimulus packages, together amounting to about 3 per cent of GDP, included additional public spending, particularly capital expenditure, government guaranteed funds for infrastructure spending, cuts in indirect taxes, expanded guarantee cover for credit to micro and small enterprises, and additional support to exporters. These stimulus packages came on top of an already announced expanded safety-net for rural poor, a farm loan waiver package and salary increases for government staff, all of which too should stimulate demand.

Impact of Monetary Measures:

Taken together, the measures put in place since mid-September 2008 have ensured that the Indian financial markets continue to function in an orderly manner. The cumulative amount of primary liquidity potentially available to the financial system through these measures is over US$ 75 billion or 7 per cent of GDP. This sizeable easing has ensured a comfortable liquidity position starting mid-November 2008 as evidenced by a number of indicators including the weighted-average call money rate, the overnight money market rate and the yield on the 10-year benchmark government security. Taking the signal from the policy rate cut, many of the big banks have reduced their benchmark prime lending rates. Bank credit has expanded too, faster than it did last year. However, Reserve Bank's rough calculations show that the overall flow of resources to the commercial sector is less than what it was last year. This is because, even though bank credit has expanded, it has not fully offset the decline in non-bank flow of resources to the commercial sector.

Evaluating the Response:

In evaluating the response to the crisis, it is important to remember that although the origins of the crisis are common around the world, the crisis has impacted different economies differently. Importantly, in advanced economies where it originated, the crisis spread from the financial sector to the real sector. In emerging economies, the transmission of external shocks to domestic vulnerabilities has typically been from the real sector to the financial sector. Countries have accordingly responded to the crisis depending on their specific country circumstances. Thus, even as policy responses across countries are broadly similar, their precise design, quantum, sequencing and timing have varied. In particular, while policy responses in advanced economies have had to contend with both the unfolding financial crisis and deepening recession, in India, the response has been predominantly driven by the need to arrest moderation in economic growth.

What is the outlook for India?

The outlook for India going forward is mixed. There is evidence of economic activity slowing down. Real GDP growth has moderated in the first half of 2008-09. The services sector too, which has been our prime growth engine for the last five years, is slowing, mainly in construction, transport and communication, trade, hotels and restaurants sub-sectors. For the first time in seven years, exports have declined in absolute terms for three months in a row during October-December 2008. Recent data indicate that the demand for bank credit is slackening despite comfortable liquidity in the system. Higher input costs and dampened demand have dented corporate margins while the uncertainty surrounding the crisis has affected business confidence. The index of industrial production has shown negative growth for two recent months and investment demand is decelerating. All these factors suggest that growth moderation may be steeper and more extended than earlier projected.

In addressing the fall out of the crisis, India has several advantages. Some of these are recent developments. Most notably, headline inflation, as measured by the wholesale price index, has fallen sharply, and recent trends suggest a faster-than-expected reduction in inflation. Clearly, falling commodity prices have been the

key drivers behind the disinflation; however, some contribution has also come from slowing domestic demand. The decline in inflation should support consumption demand and reduce input costs for corporates. Furthermore, the decline in global crude prices and naphtha prices will reduce the size of subsidies to oil and fertilizer companies, opening up fiscal space for infrastructure spending. From the external sector perspective, it is projected that imports will shrink more than exports keeping the current account deficit modest.

There are also several structural factors that have come to India's aid. First, notwithstanding the severity and multiplicity of the adverse shocks, India's financial markets have shown admirable resilience. This is in large part because India's banking system remains sound, healthy, well capitalized and prudently regulated. Second, India's comfortable reserve position provides confidence to overseas investors. Third, since a large majority of the Indians do not participate in equity and asset markets, the negative impact of the wealth loss effect that is plaguing the advanced economies should be quite muted. Consequently, consumption demand should hold up well. Fourth, because of India's mandated priority sector lending, institutional credit for agriculture will be unaffected by the credit squeeze. The farm loan waiver package implemented by the Government should further insulate the agriculture sector from the crisis. Finally, over the years, India has built an extensive network of social safety-net programmes, including the flagship rural employment guarantee programme, which should protect the poor and the returning migrant workers from the extreme impact of the global crisis.

RBI's Policy Stance

Going forward, the Reserve Bank's policy stance will continue to be to maintain comfortable rupee and forex liquidity positions. There are indications that pressures on mutual funds have eased and that NBFCs too are making the necessary adjustments to balance their assets and liabilities. Despite the contraction in export demand, it is possible to manage the balance of payments. It is the Reserve Bank's expectation that commercial banks will take the signal from the policy rates reduction to adjust their deposit and lending rates in order to keep credit flowing to productive sectors. In particular, the special refinance windows opened by the Reserve Bank for the MSME (micro, small and medium enterprises) sector, housing sector and export sector should see credit flowing to these sectors. Also the SPV set up for extending assistance to NBFCs should enable NBFC lending to pick up steam once again. The government's fiscal stimulus should be able to supplement these efforts from both supply and demand sides.

When the "Turnaround" Comes?

Over the last five years, India clocked an unprecedented 9 per cent growth, driven largely by domestic consumption and investment even as the share of net exports has been rising. This was no accident or happenstance. True, the benign global environment, easy liquidity and low interest rates helped, but at the heart of India's growth were a growing entrepreneurial spirit, rise in productivity and increasing investments and exports slow. Clearly, there is a period of painful adjustment ahead of us. However, once the global economy begins to recover, India's turn around

will be sharper and swifter, backed by our strong fundamentals and the untapped growth potential. Meanwhile, the challenge for the government and the RBI is to manage the adjustment with as little pain as possible.

Government and the RBI are to manage the adjustment with as little pain as possible.

Conclusion

The longer term implication of the current global crisis is that it puts an end to the triumphalism that until recently characterized neoliberal defenders of market fundamentalism. The notion that nothing much needs to change except for somewhat more stringent regulation of the financial sector is being promoted by the rich countries. Further, in the name of global regulation, further erosion of national sovereignty and the autonomy of policy-making in the developing world is on the anvil. A good starting point for thinking constructively about the global economic crisis and how to deal with it is to discuss and implement the recommendations of the U.N.-appointed Stiglitz committee on the Global Financial Crisis – an opportunity that was missed at the recent G 20 conclave, with India lining up faithfully behind the G 7 for the most part.

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