Can the Indian economy emerge unscathed from the global financial crisis?

By Sridhar Kundu

The crisis in financial markets has spread at an alarming rate. Though the epicenter of the crisis was the US sub-prime mortgage market, its shockwaves are being felt in financial markets all over the world. As the financial sector is fully integrated with the real economy, the burgeoning crisis in the financial sector poses a threat to the real economy. Macro-economic fundamentals like growth, employment and prices are bound to be affected. The shock has been felt in India's financial market as well since we are far more exposed to international markets after our macro-economic reforms of 1991. Admittedly, the strength of our banks and other financial institutions coupled with conservative and sound regulation by the Reserve Bank of India has made us better equipped to face this challenge; nevertheless as problems spread to the real economy, policy makers will find their task cut out for them.

The present study will focus on the impact and analysis of the global financial crisis on India's financial market and the real economy and the desirable monetary and fiscal policy responses to the challenge before us.

But first, a look at the origin of the crisis and its impact on the financial sector and the real economy, globally.

The origins of the Global Financial Crisis

The crisis which began with the bursting of the housing bubble in the US and high incidence of defaults on sub-prime mortgages early last year has its origins in the loose monetary policy followed under former Chairman of the US Federal Reserve, Alan Greenspan. In a bid to counter the economic slowdown brought on by the dotcom bust of 2000, the US Fed steadfastly lowered interest rates to 1% during the period till 2004 before raising it to 5.25% in 2006. The combination of rising prosperity and low interest rates led to a sharp increase in demand for housing loans even as easy liquidity saw a run up in all asset values, including houses. This encouraged borrowers to assume expensive mortgages in the belief that they would be able to get refinance on more favourable terms. However, once interest rates began to rise and housing prices started to drop in many parts of the US in 2006-07, refinancing became more difficult. Defaults and foreclosures became commonplace once home prices stopped going up and then started falling.

What made matters worse was that banks and mortgage lenders that had securitised their loans by issuing mortgage-backed securities, based on underlying mortgage payments, suddenly found the value of these securities falling rapidly as defaults rose. Major banks and financial institutions, both in the US and in many other developed countries, that had borrowed and invested hugely in such securities lost heavily. Credit default swaps that were meant to act as insurance against the risk that borrowers will not pay back bank loans and make the financial system less risky (because they allow holders of securitised instruments to offset the risk of holding them) failed to provide the expected comfort. The fear now is that CDS issuers may not be able to fulfill their obligations in case of a default in which case there is a very real danger of the credit crisis worsening.

The first hint of trouble came from the collapse of two Bear Stearns hedge funds early last. Subsequently a number of other banks and financial institutions also began to show signs of distress. However, matters really came to a head with the bankruptcy of Lehman Brothers, an iconic investment bank, in September 2008.

The US government's failure to rescue Lehman destroyed what little confidence there was among market participants. As inter-bank lending seized up and banks refused to lend each other, funds flow to the larger economy became constrained. Stock markets across the world plummeted on account of rising risk aversion and the resultant flight to safety. Faced with the fear of productive sectors of the economy being denied credit, central banks and governments around the world announced various economic stimulus packages to spur growth and instill confidence in financial markets. These moves have as yet had limited impact in ameliorating the distress.

The meeting in Washington of the heads of state of the G20 on 15 November is the latest attempt at coordinated policy action to stave off what many regard as the most serious economic crisis since the Great Depression of the 1930s.

Impact of the Crisis on basic economic fundamentals

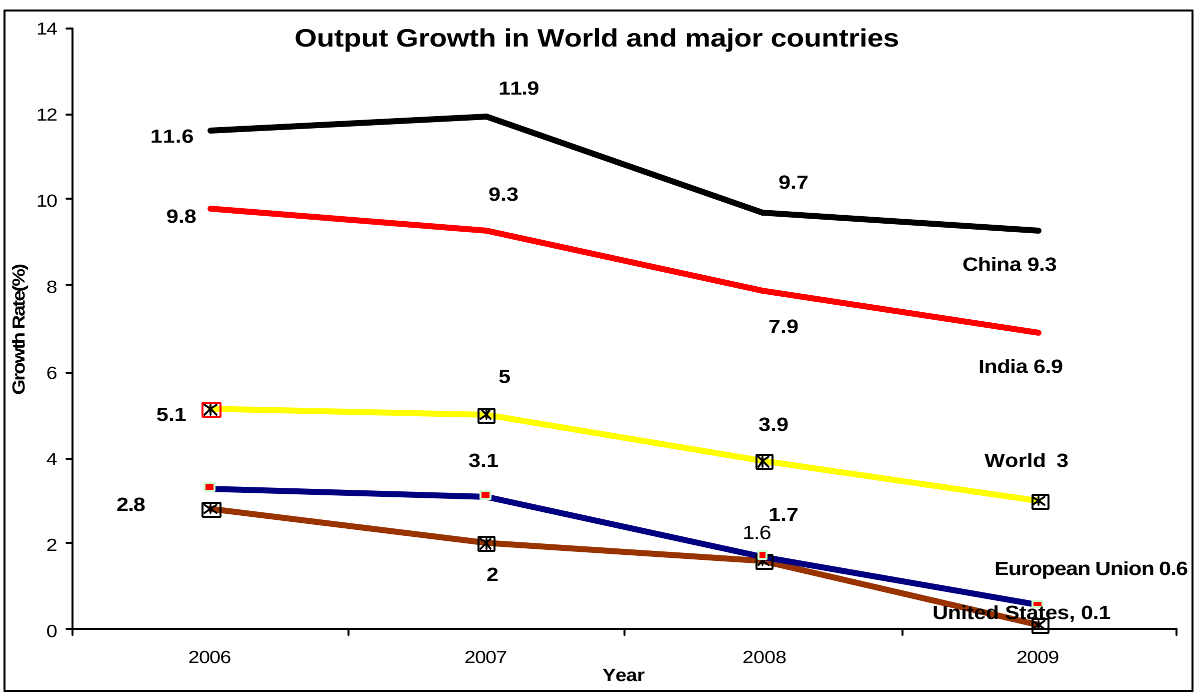
Economic Growth: The impact of the financial crisis is being felt on the growth of the major economies of the world and, in turn, on global commodity prices. The International Monetary Fund (IMF) expects advanced economies to contract 0.3 per cent on a full-year basis next year. In its most recent (November) revision of its World Economic Outlook 2008 it has slashed its global growth forecast to 2.2 percent, blaming the global credit crunch. Less than a month ago the IMF forecast growth of 0.5 percent in the advanced economies and 3 per cent worldwide.

As the epicenter of the crisis, the US is expected to experience a significant slowdown. According to the IMF the US economy will show positive growth for 2008, but at a tepid rate of 1.4 per cent, with the second-half contraction offsetting growth in the first six months of the year.

Growth in the eurozone is forecast to shrink drastically by half a point in 2009, the IMF said, instead of the 0.2 percent growth seen in its October Outlook.

The Chart below shows the present and estimated future output growth in world and major countries in the world.

Fig I



Source: World Economic Outlook, 2008

Inevitably, the slowdown of the major economies of the world has spilled over to economies like China and India thanks to their increasing integration into the world economy following the reforms of the 1980s and 1990s respectively. According to the IMF, China is expected to be relatively less impacted with its economy projected to grow at 9.7 and 8.5 per cent in 2008 and 2009 respectively, though this is lower than the average 11.5 percent in previous years. India is estimated to grow at 7.8 and 6.3 percent in 2008 and 2009 respectively as against its average growth rate of 8.7 percent since 2003-04.

Price Situation: The credit crunch in the market has had a dampening effect on world commodity markets. The price of major commodities in the world has fallen steadily, due to sluggish demand. Consumers are apprehensive about spending more; at the same time, increased market volatility and the liquidity crunch have increased uncertainty.

Table 1 shows world commodity prices during the past three months starting from October, 08. Prices of crude oil and natural gas fell by 45 and 39.3 per cent respectively between July and October while prices of vegetable oil like palm oil and coconut oil declined by 39.4 and 50 per cent respectively. Prices of essentials like rice and wheat also fell by 16.7 and 27.7 per cent respectively. In the metal groups copper and silver price fell over 40 per cent while gold and steel fell by 14.2 and 22.4 per cent respectively during the same period.

Table I

Major Commodity prices of world:

Commodity		July	August	September	October	Reduction% (Sept-Oct)	Reduction% (July-Oct)
Crude oil, Brent	$/bbl	133.9	113.8	99.06	72.84	26.5	45.6
Natural gas, US	*$/mmbtu*	11.1	8.3	7.69	6.73	12.4	39.3
Coconut oil	*$/mt*	1436	1188.8	1,104	870	21.2	39.4
Palm oil	*$/mt*	1128	884	760	564	25.8	50.0
Rice, Thailand, 5%	*$/mt*	731.8	693.5	686.3	609.3	11.2	16.7
Wheat, US, HRW	*$/mt*	328.2	329.3	294.5	237.4	19.4	27.7
Rubber, Singapore	c/kg	321.6	294.9	288.1	193.5	32.8	39.8
Aluminum	*$/mt*	3071.2	2764.4	2,526	2,121	16.0	30.9
Copper	*$/mt*	8414	7634.7	6,991	4,926	29.5	41.5
Gold	*$Itoz*	939.8	839	829.9	806.6	2.8	14.2
Iron ore	*c/dmtu*	140.6	140.6	140.6	140.6	0.0	0.0
Silver	*cItoz*	1806.4	1457.8	1,219	1,043	14.5	42.3
Steel	*$/mt*	980	1030	792.5	760.0	4.1	22.4

Source: World Bank Pink sheet

The fall in commodity prices is bound to temper the inflationary pressure that the world was facing only few months earlier. Average consumer price index inflation is expected to come down from 4.2

per cent in 2008 to 1.8 per cent in 2009. However that is the only silver lining in an otherwise bleak scenario with most of the world economy already into a recession.

Is this the 1929 Great Depression revisited?

Many have compared the present crisis with the 1929 Great Depression and though there are undoubtedly similarities there are a number of differences as well that give us reason to hope the distress will not be on the scale witnessed in the 1930s. In both cases the epicenter is the USA and the proximate cause, indiscriminate borrowing and spending by US citizens, is also the same.

The present credit crisis was caused by huge borrowing and spending on homes leading to inflated home values, while the crisis in 1929 was the outcome of increased spending (using borrowed money) on radios, cars and appliances. But there is a key difference. The present US economy is 20 per cent of the world economy; in 1929 it was only 3 per cent. The unemployment rate during 1929 was 5 per cent; it increased to 8.5 per cent in 1933 and further to 15 per cent 1940. However, the unemployment rate in the US is presently only 6.1 per cent and though it is expected to increase following the failure of several banks and financial institutions, the government has been far more proactive this time round. Policy makers have acted fast to offset the downward momentum with a series of dramatic steps: nationalising banks, guaranteeing deposits, increasing money supply, slashing interest rates. The present Chairman of the US Federal Reserve Ben Bernanke, who has done extensive research on the Great Depression, has been at the forefront of formulating far more aggressive policy interventions together with the US Treasury Secretary, Hank Paulson. The US Fed rate is down to 1%, the Bank of England cut its policy rate by an unprecedented 1.5 pecentage points early November while the European Central Bank reduced interest rates by 50 basis points. Hence it is reasonable to expect that the US, and hence the world economy, will have a softer landing this time.

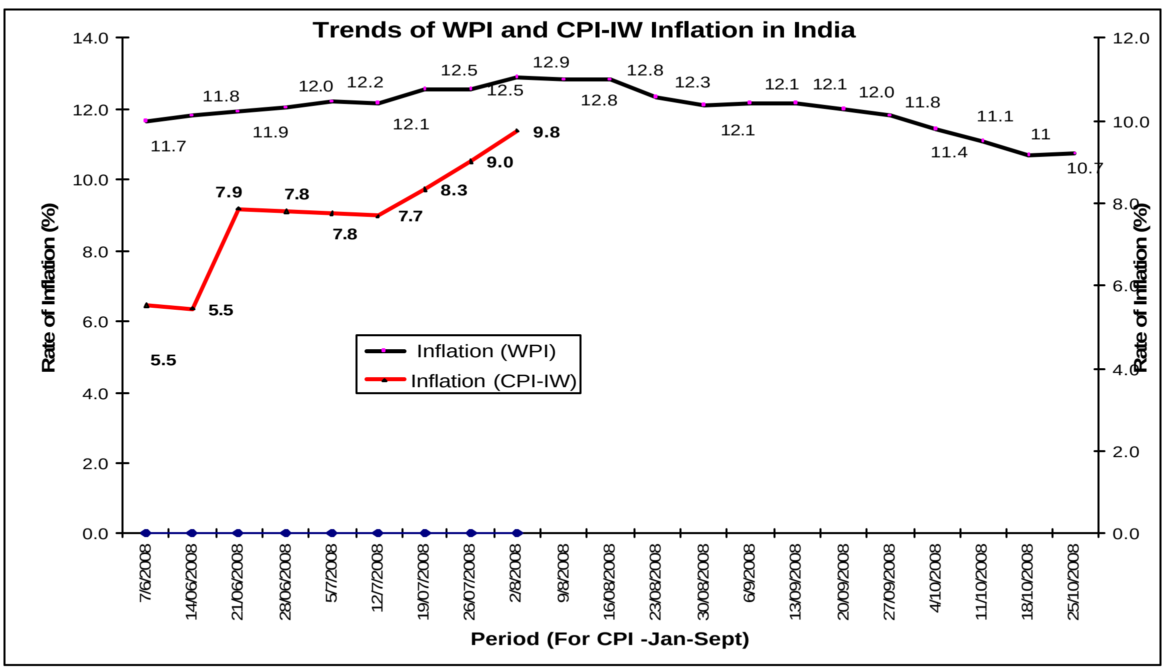
Impact of the Crisis on the Indian Economy

A. India's Real Economy

Economic Growth: Has the present global crisis affected India's domestic economy? To answer this it is necessary to look at our current macroeconomic fundamentals. Latest RBI estimates place India's growth rate during 2008-09 at 7.7 per cent. Most other estimates also place GDP growth for the year in the range of 7-8%. During the first quarter of 2008-09 (April-June) Indian economy grew at 7.9 per cent, though growth is expected to slow down in the subsequent quarters as the slowdown takes hold.

The first indication has already come from the index of industrial production (IIP). According to latest data, the IIP grew 4.8% in September 2008 as against 7% in the corresponding period last year. The cumulative growth during April-September 2008 was only 4.9% as against 9.5% during the corresponding period in previous year. While the September figure is an improvement over the dismal growth of 1.3% recorded for August 2008, it is too early to see it as a recovery from the previous low.

Price Situation: The rate of inflation, as measured by the wholesale price index (WPI) has gone down during recent few weeks and more encouragingly declined sharply during the week ended 1 November to 8.98%, down from the previous week's 10.68% and the peak of 12.9 percent in first week of August. However, food inflation remains high. Moreover, inflation as measured by the consumer price index (CPI IW) has not shown a decline. On the contrary, there is a steady rise in CPI-IW inflation from 7.7 per cent in June 2008 to 9.8 in September, 08. The combination of rising prices of consumer goods coupled and slowing growth does not bode well for the economy.



Source: WPI- Inflation calculated from the data obtained from Office of Economic Advisor, CPI-IW Inflation calculated from data obtained from Labour Bureau, GOI

B. Financial Sector

Banking Sector: The banking sector in India is largely (70%) dominated by the public sector. Partly as a result, India has not been witness to the kind of crisis of confidence seen in advanced countries. Additionally, strict regulation and conservative policies adopted by the Reserve Bank of India have ensured that banks in India are relatively insulated from the travails of their Western counterparts. However, this cannot be advanced as a reason either for continuance of public sector dominance or for resistance to further financial sector reform. The example of Canada where the private sector plays a major role in the banking sector and is, by and large, less affected by the present financial crisis is a case in point.

Indian banks are well-capitalised with a low level of non-performing assets (NPAs), though the level of NPAs is expected to go up as the slowdown begins to bite.

The Table below shows the capital adequacy ratio of the banks in India.

Capital Adequacy ratio of the Banks in India in 2007-08

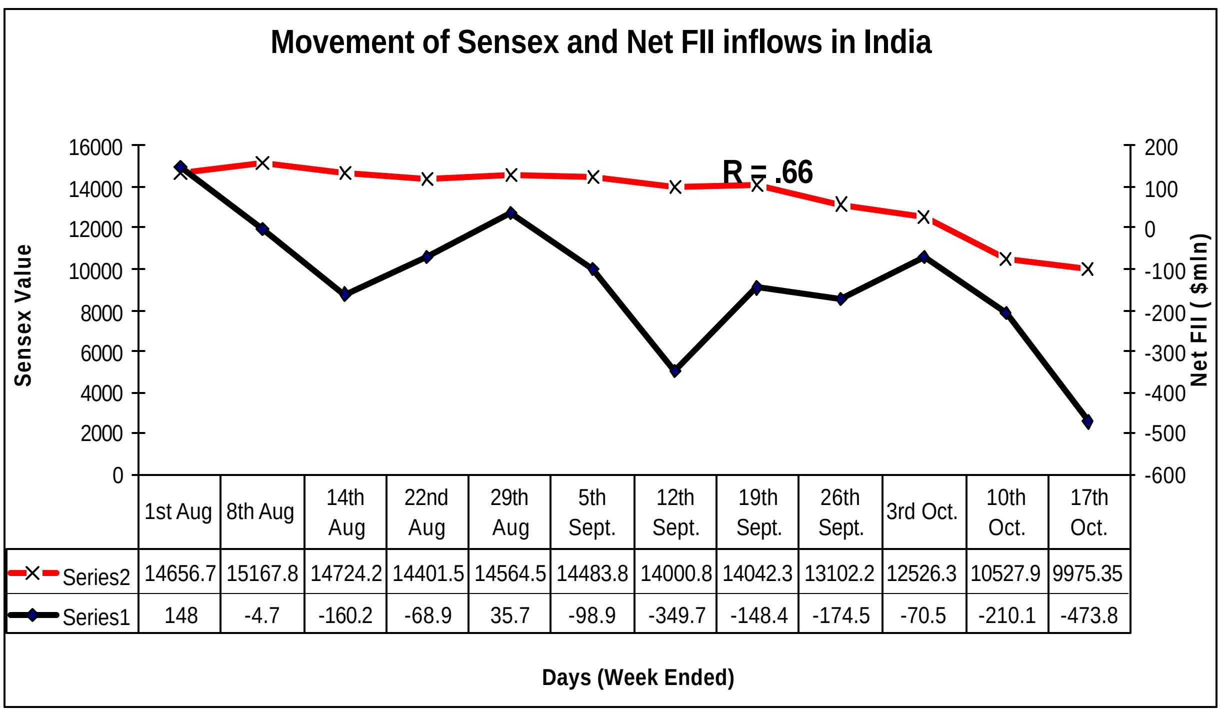
Banks	CRAR	Banks	CRAR
Federal Bank	22.5	Oriental Bank of Commerce	12.1
Barclays Bank	21.1	Corporation bank	12.1
Kotak Mahindra Bank	18.7	Allahabad Bank	12.0
JP Morgan Chase bank	17.7	Bank of India	12.0
ICICI bank	14.0	Citi Bank	12.0
Axis Bank	13.7	State bank of Hyderabad	12.0
HFDC bank	13.6	Indian Overseas bank	12.0
Yes Bank	13.6	IDBI Ltd.	12.0
Deautch Bank	13.6	IndusInd Bank	11.9
Canara Bank	13.3	United bank of India	11.9
Punjab National bank	13.0	Bank of Rajasthan	11.9
ABN Amro	12.9	BNP Paribas	11.8
Bank of Baroda	12.9	State bank of Mysore	11.7
Indian bank	12.9	Punjab & Sind bank	11.6
Jammu & Kashmir Bank	12.8	State bank of Indore	11.3
Lakshmi Vilas bank	12.7	Syndicate Bank	11.2
State bank of Travancore	12.7	Vijaya bank	11.2
State bank of India	12.6	Dena bank	11.1
Karur Vysya Bank	12.6	HSBC	10.6
State bank of Bikaner	12.5	Standard Chartered	10.6
Union Bank of India	12.5	Central Bank of India	10.4
State bank of Patiala	12.5	Bank of Maharashtra	10.3
State bank of Saurashtra	12.3	ING Vysya Bank	10.2
Karnataka Bank	12.2	UCO bank	10.1
Bank of America	12.1	Andhra bank	10.2

Source: Calculated from Banks profile, Reserve Bank of India

The Reserve Bank of India has initiated a series of steps to ease the liquidity problems being faced by banks. It has cut the cash reserve ratio to 5.5% and the repo rate at which the central bank pumps liquidity into the system to 7.5%. It has also reduced the SLR or statutory liquidity ratio to 24%, down from 25% earlier.

Capital market: After the macro-economic reforms in 1991, Indian economy has been increasingly integrated into the global economy. The financial institutions in India are exposed to the world financial market. Foreign institutional investment (FII) is largely open to the India's equity, debt market and market for mutual funds. The present crisis has significant impact on FII investment in India, as investors all over world lack confidence on the market. The crisis in confidence resulted in net outflow of \$10.1 billion from both the equity and debt market in India in the year 2008, till 22nd. Oct. This has significant impact on India's stock market and exchange rate. As higher FII outflows have a down pressure on the value of rupee at the same time a weaker rupee makes it costlier for FIIs and hedge funds to pull out of the market but decline in stock prices only adds to their woes. India's stock market index Sensex which touched above 21, 000 mark in the month of January, 2008 has plunged below 10, 000 during October. The movement of Sensex shows a positive and significant relation with the FII flows into the market which is represented in the Fig II. Data on Sensex at the weekend closing point and net FII in equity on the same day taken since 1st of August, 2008 till 17th Oct. figures a positive correlation of 0.66. The positive correlation establishes the fact that market capitalization of most of the companies including banking, finance and real estate sector has been depended on FII.

Fig II



	1st Aug	8th Aug	14th Aug	22nd Aug	29th Aug	5th Sept.	12th Sept.	19th Sept.	26th Sept.	3rd Oct.	10th Oct.	17th Oct.
Series2	14656.7	15167.8	14724.2	14401.5	14564.5	14483.8	14000.8	14042.3	13102.2	12526.3	10527.9	9975.35
Series1	148	-4.7	-160.2	-68.9	35.7	-98.9	-349.7	-148.4	-174.5	-70.5	-210.1	-473.8

Source: FII data collected from SEBI, Sensex from BSE India.

Citigroup's vulnerability index shows that India is among the most vulnerable Asian economies. In Asia (except Japan) China is the most resilient economy, while among Brazil, Russia, India and China (BRIC) nations India is at the lowest position. But the ratio mobile capital to forex reserve is not the right indicator of representing vulnerability, as mobility of capital generates wealth and its storage will lay off interest income. For many countries this ratio is high but they are not vulnerable.

Vulnerability Indicators

Country	Mobile capital/Forex reserves (%)	External financing/ Forex reserves (%)
Korea	208	95
Vietnam	34	64
India	59	21
Indonesia	237	13
Philippines	97	12
Thailand	54	0
Taiwan	88	-6
Singapore	Na	-9
Hong Kong	Na	-15
China	16	-19
Malaysia	71	-21

Source: Citigroup

Impact of capital outflows on domestic currency: Exchange rate volatility in India has increased in the year 2008-09 compared to previous years. The exchange rate of rupee vis-à-vis the dollar which stood at Rs 39.9/$ on 1 April 2008 has fallen steadily on account of net dollar outflows, driven predominantly by portfolio investors pulling out of the country. It breached the Rs 50 to the dollar mark, falling to Rs 50.29 to the dollar on 27 October 2008 before recovering to Rs 48-49 to the dollar in subsequent trading.

The higher volatility is reflected in the higher co-efficient of variance of 3.58 per cent in the period up to September 2008, as against 2 per cent in 2007-08 and 1.9 per cent in 2006-07.

Period	Co-efficient of Variation (CV) of Daily Exchange rate
2004-05	2.304791
2005-06	1.796839
2006-07	1.966165
2007-08	2.069177
2008-09 (till Sept,08)	3.583151

Source: Exchange rate data collected from RBI

Exchange rate volatility and India's external trade: After registering an export growth of 29.02 per cent and import growth of 35.4 per cent during 2007-08, growth merchandise export growth fell 15%

in dollar terms in October 2008. This is the first time in five years that exports have actually shown a dip, reflecting the growing adverse impact of the global slowdown. If the present trend continues there is a danger that India will not achieve the export target of $ 200 bn for the current fiscal.

Government's policy to deal with the Crisis: The government has adopted a multi-pronged approach to deal with the crisis. While the Reserve Bank of India has acted decisively to ease liquidity by cutting the Cash Reserve Ratio (CRR), Statutory Liquidity Ratio (SLR), Repo rate etc, the government has announced its determination to follow through with additional measures if necessary. But infusion of liquidity through these measures is counterbalanced by selling pressure of foreign exchange in the spot market to stabilize the value of domestic currency. In the month of October net sale of foreign exchange in the spot market was $7.6 bln while the rate cut policy can increase the liquidity by $17.3bln into the market. The recent External Commercial borrowing (ECB) liberalisation policy of the Government can be helpful for increasing capital inflows into the country.

Conclusion:

The Indian economy has shown considerable resilience in the face of the present global financial crisis. The financial sector has emerged without much damage thanks in part to our strong regulatory framework and in part on account of state ownership of most of the banking sector. However, it would be naïve to expect the real economy to be completely unaffected by the global slowdown. The immediate impact of the crisis is the drying up of dollar liquidity as FIIs pull out their money from the stock market and sources of overseas credit and trade credit dry up. While large corporates will no doubt be affected, the worst affected are likely to be the exports and SMEs (small and marginal enterprises) that contribute significantly to employment generation.

RBI's efforts to ease the downward pressure on the rupee (by selling dollars) have added to the domestic liquidity crunch in a scenario where corporates are increasingly turning to the domestic banking sector to make up for the drying up of external sources of finance and the IPO (initial public offering) market. Despite robust growth of 30% in bank credit (year-on-year), corporates are complaining of a credit crunch. The only silver lining is the decline in inflation – latest numbers show inflation at 8.98 % for the week ended 1 November 2008.

Unfortunately, the scope for fiscal measures that could be targeted at the genuinely needy is limited thanks to the government's large fiscal deficit. The net result is that economic activity is bound to slow down. And though the precise extent of the slowdown is hard to predict, the fact that even the most conservative estimates do not place GDP growth at less than 6% provides some solace.