

# Global financial crisis and its impact on india economics essay



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Financial crisis broadly refers to situations where some financial institutions or assets suddenly lose a large part of their value. In the 19th and 20th century financial crisis were associated with banking panics and many recessions coincided with these banking panics. Financial crisis is also synonyms with stock market crashes, bursting of financial bubbles, currency crisis and sovereign defaults. The financial collapse of 2007 refers to the freezing of financial markets in USA.

The financial collapse of 2007 has given birth to the Economic Recession of 2008; and This Recession is supposed to be the worst since THE Great Depression of 1929. If one was to name single most determinant factor of the 1929 mega event; it would definitely be lack of Aggregate Demand; something which brought Keynesian Economics to the forefront. And if we are to point out at the single most determinant factor of the 2007 collapse; it would be over deregulation of the system and over financial sophistication. To put in layman's words; it was greed and simply greed.

Impact on American economy and rest of the world

US financial sector bridged the gap between over consuming and overstimulated America and an under consuming and under stimulated rest of the world. This entire edifice rested on housing market. This market also created jobs, capital gains and property allowed to pay back earlier debts. Exports of other countries increased and their lending also increased (via borrowing mortgages) unknowingly or knowingly same money was financing US imports.

The rosy picture turned gloomy with Fed Reserve raising rates and the upward swing of house prices stopped. Short term creditors panicked and refused to refinance banks when their came due. Some banks failed, some were bailed out as whole system tottered on the brink of collapse. Economies went into a deep slump from which their slowly recovering. From this brief description some queries are still unanswered; Why do poor developing economies pay the price for over consuming rich economies like USA? Why were rates kept so low for so long? Why were loans given to people with no income, no jobs and no assets; the so - called NINJA loans?

### Financial Contagion

It is the spill over effect of financial crisis in one economy to others. To describe in simple words; just as a disease if not treated on time can spread to other body parts, similarly problems of financial deregulation and over sophistication if are not treated on time may lead to a domino effect of world's economies tumbling one after the other. A chief weapon of mass destruction is increased level of economic and financial integration. One can generalise and say that greater the degree of integration, greater will be the spill over effect.

Economies are connected together by imports and exports as well as inflow and outflow of capital. Lets now talk about the state of Indian Economy. First of all let me clear the air and positively state that India is not facing Recession. It is facing one of its worst economic slowdowns imported from the west at the cost of slowing exports, slowing inflows as well as because of its domestic home grown problems.

During the pre – crisis years from 2003 to 2008, India was the second fastest growing economies next to China. India had recorded a GDP growth of 8. 7%. India’s share in world GDP at purchasing power parity (PPP) is 5. 7%, but this statistics is overshadowed by the fact that it houses 17. 4% of global population. High growth enabled to increase GNI per capita to \$1025 US to be classified by World Bank as lower middle income country. Growth in GNI per capita has been slower in post crisis period. Inflation rate, fiscal deficit and current account deficit were well in proper shape. We will have a look at some key macroeconomic variables:

Year

GDP growth rate.

Savings(as proportion of GDP)

Capital Formation(as proportion of GDP)

2006-07

9. 6

34. 6

35. 7

2007-08

9. 3

36. 8

38. 1

2008-09

6. 7

32

34. 3

2009-10

8. 4

33. 8

36. 6

2010-11

8. 4

32. 3

35. 1

2011-12`

6. 9

31. 2

33. 6

During the pre-crisis years, India witnessed boom in terms of GDP growth rate. This growth rate was largely driven by service sector. India was amongst the fastest growing economies of the world second to China. The Indian growth story had got attention of the investors and entrepreneurs around the world. The GDP growth rate of 9.6 and 9.3% are testimony to that fact. One can also attribute era of political stability in the country

The global financial crisis of 2008 with its epicentre in USA cast a dark shadow over India's growth rate which slipped down to 6.7%. This was mainly on back of decrease in exports and inflow of capital. India's GDP growth recovered to 8.4% in both financial year 2010 and financial year 2011 before slipping to 6.9%. With the global outlook on economic growth looking green, the GDP forecast for India is 6.3%.

Saving as proportion of GDP and capital formation has witnessed more or less a constant trend in 30s. But capital formation has always been greater than savings which indicated that savings have also been used from sources abroad. This is also an indicator of trust that foreign investors have on India and its growth story.

This describes the crucial importance of foreign capital for an economy like India. Foreign capital enters the economy through FDI and FII. The FDI can be described as long term and stable in nature, while the FII is short term and unstable. FII inflows in India have been very volatile which are hungry for reforms. FDI is stuck due to policy paralysis in the economy where key bills are pending. Take the recent case of FDI in multi brand retail- this is one of the most awaited reforms which could bring in much needed foreign capital

which can help in bringing down current account deficit, increasing foreign exchange reserves and appreciation of rupee . Another issue of FDI in pensions, insurance is also pending

India's changing stance in terms of paying taxes on investment (capital gains tax) and controversial " GAAR " has hurt investor's sentiments and spread an environment of instability. The recent report on the panel of GAAR under the chairmanship of Dr. Parthasarthy Shome has many reasons to cheer from the point of view of foreign investors. Dr. Shome was a former IMF chief economist and also a winner of Brazil's highest civilian award for reforming tax system of Brazil.

The key recommendations included;

Implement GAAR only by 2016-17

Abolition of short term capital gains tax on listed securities which will increase incentive to invest directly in India and also treat investments from all countries as neutral

Initially 40% investments were routed through Mauritius to gain through tax advantage. But it also recommended a hike in securities transaction tax(STT). This move can cut margins of small retailers.

The recent move by SEBI has ensured the revival of investor sentiment. The moves are as follows

QFIF Scheme: Allows eligible foreign investors to invest directly in India.

Earlier foreign investors would invest in India only through FII. Individual

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investors and trust can invest in India through this scheme. The investors have to KYC complaint to become eligible to invest in India. They need to get a PAN. The investors feel PAN is more of psychological barrier. In 2011-12 budget, FM had opened QFI window in MF.

Investors/ FII's have to provide margin amount to be eligible to execute transactions. The amount depresses the overall return as it doesn't earn anything. The responsibility to provide margin rests with the custodians. Once the transaction is settled stock exchange release the margin of the custodians. Domestic investors have option of posting bonds, FD's or other earning assets as margin instead of cash. FII's were permitted to offer cash and other foreign sovereign securities with AAA rating or collateral for their transactions in derivative segments earlier but custodians still demand cash for logistic reasons. The move by SEBI is to relax Margin norms for FII's to bring them on par with domestic. Cash collateral is an issue because money is unproductively parked with no returns.

Deficit indicators

Year

Fiscal Deficit

Revenue Deficit

Primary Deficit

2006-07



3. 3

1. 9

-0. 2

2007-08

2. 5

1. 1

-0. 9

2008-09

6

4. 5

2. 6

2009-10

6. 5

5. 2

3. 2

2010-11

4. 8

3. 2

1. 8

2011-12

4. 6

3. 4

1. 6

Deficits are an indicator of health of an economy. In the current scenario, deficits aren't considered as a taboo for the economy, but too much of deficits pose a serious threat to the economy. As can be seen after the economic crisis, India's deficit indicators have moved northwards. India's fiscal deficit stands at 5. 9% of GDP and the budget for 2012-13 pegs it at 5. 1% at the end of FY 13, but going by the economic performance and pace of reforms, target of 5. 15 looks optimistic.

For the last 3 years, the budget has announced disinvestment target of Rs. 40, 000cr, but has never achieved it. The actual figure is 22144cr (2010-11) and 13894cr (11-12). For 5 months into FY13 so far no process has started. The Union Cabinet has given approval for the stake sale in BHEL, SAIL where Fin Ministry expects to garner 20% of disinvestment target. At present both the companies are trading at 52 week low. The programme has further hit a road block for opposition from Heavy industries, steel and power. They believe that govt will not get right market prices in current market scenarios. In addition, stake sales in NMDC, NALCO, NHPC, MIDL also.

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Current Account Deficit at 4.2% of GDP seems very dangerous and reminds us of 1991 crisis in India. CAD has widened mainly because of crude oil and gold. (India is largest importer of gold). Now increase in demand for gold indicates investor preference for the yellow metal as a safe investment bet vis a vis other financial assets.

The impact of financial crisis was felt through all channels- finance, real and more importantly confidence channel. Global investment dried up with a depreciating rupee; a clear signal of global risk aversion. Money and domestic credit markets came under pressure as domestic funds had to fill in the void left by external funds. Growth decreased due to agriculture and manufacturing and on expenditure side by private and government consumption as investment increased. Productivity growth slackened as reflected by increase in incremental output capital ratio(ICOR) at 4.8 from 3.9 during pre-crisis years. Inflation increased in post crisis years making RBI raise interest rates which further discouraged investment. Inflation with low growth had raised fears for stagflation. Part of the inflation was wage push as government spending on programmes like MGNREGA increased purchasing power of people. Government spending on subsidies on petroleum, fertilizers added to fiscal deficit of 5.9% of GDP. Increased government borrowing pushed up interest rates which led to crowding out of private investment.

To conclude, I would like to say that all is not so bad for India with its growth potential still intact. With a few positive steps, India's growth story can be back in the pre-crisis years. Finally it makes me wonder, after all the

economic ills - are developed economies more prone to financial crisis.  
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