

# Economy Bounce-Back Post 2008 Recession in India

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**ABSTRACT:** The effects of the global financial crisis have been more severe than initially forecast. By virtue of globalization, the moment of financial crisis hit the real economy and became a global economic crisis; it was rapidly transmitted to many developing countries. The crisis emerged in India at the time when Indian economy was already preoccupied with the adverse effects of inflationary pressures and depreciation of currency. The crisis confronted India with daunting macroeconomic challenges like a contraction in trade, a net outflow of foreign capital, fall in stock market, a large reduction in foreign reserves, slowdown in domestic demand, slowdown in exports, sudden fall in growth rate and rise in unemployment. The government of India has been highly proactive in managing this ongoing crisis with a slew of monetary and fiscal measures to stabilize the financial sector, ensure adequate liquidity and stimulate domestic demand. As a result of this combining with many several structural factors that have come to India's aid, India's economic slowdown unexpectedly eased in the first quarter of 2009. The present paper makes an attempt to assess the impact of global financial crisis on the Indian economy and discuss the various policy measures taken by government of India to reduce the intensity of impacts. The paper also highlights recovery of Indian economy from crisis and in the end of paper concluding remarks are given towards.

**KEYWORDS:** globalization, India, economic, crisis, government, recovery, currency, intensity, impact

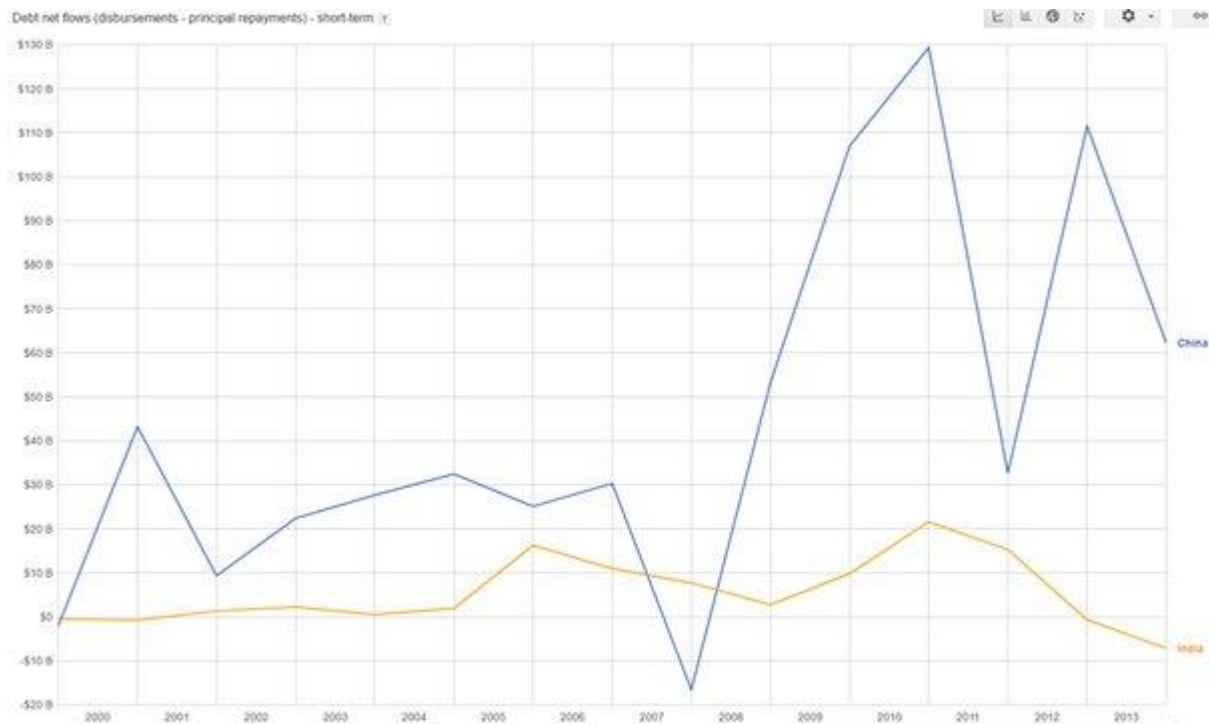
## I. INTRODUCTION

The present financial crisis which has its deep roots in closing year of the 20th century became apparent in July 2007 in the citadel of global neoliberal capital, the United States, when a loss of confidence by investors in the value of securitized mortgages resulted in a liquidity crisis.<sup>1</sup> But the crisis came to the forefront of business world and media in September 2008, with the failure and merging of many financial institutions. The crisis's global effects differentiate it from the earlier crisis like Asian 1997-98 crisis,<sup>2</sup> which spread, only to Russia and Brazil or from the debt crisis of the early 1980s that affected the developing world. It is different from the recession of 1973-75 and 1979-81 because they did not propagate as fast and hardly affected Soviet Union, China, and India. Added to this, in previous times of financial turmoil,<sup>2</sup> the pre-crisis period was characterized by surging asset prices that proved unsustainable; a prolonged credit expansion leading to accumulation of debt; the emergence of new types of financial instruments; and the inability of regulators to keep up. The immediate cause or trigger of the present crisis was the bursting of United States housing bubble<sup>3</sup> (Also known as Sub-prime lending crisis), which peaked in approximately 2006-07. In March 2007, the United States' sub-prime mortgage industry collapsed to higher-than-expected home foreclosure rates, with more than 25 sub-prime lenders declaring bankruptcy, announcing significant losses, or putting themselves up for sale. As a result, many large investment<sup>4</sup> firms have seen their stock prices plummet. The stock of the country's largest sub-prime lender, New Century Financial plunged 84%.<sup>5</sup> Liquidity crisis promoted a substantial injection of capital into the financial markets by the U.S. Federal Reserve. In 2008 alone, the U.S. government allocated over \$900 billion to special loans and rescues related to the U.S. housing bubble, with over half going to the quasi-government agencies of Fannie Mae, Freddie Mac, and the Federal Housing Administration. Bailout of Wall Street<sup>6</sup> and the financial industry moral hazard also lay at the core of many of the causes. Initially, it was thought that other major world economies would not be significantly affected.



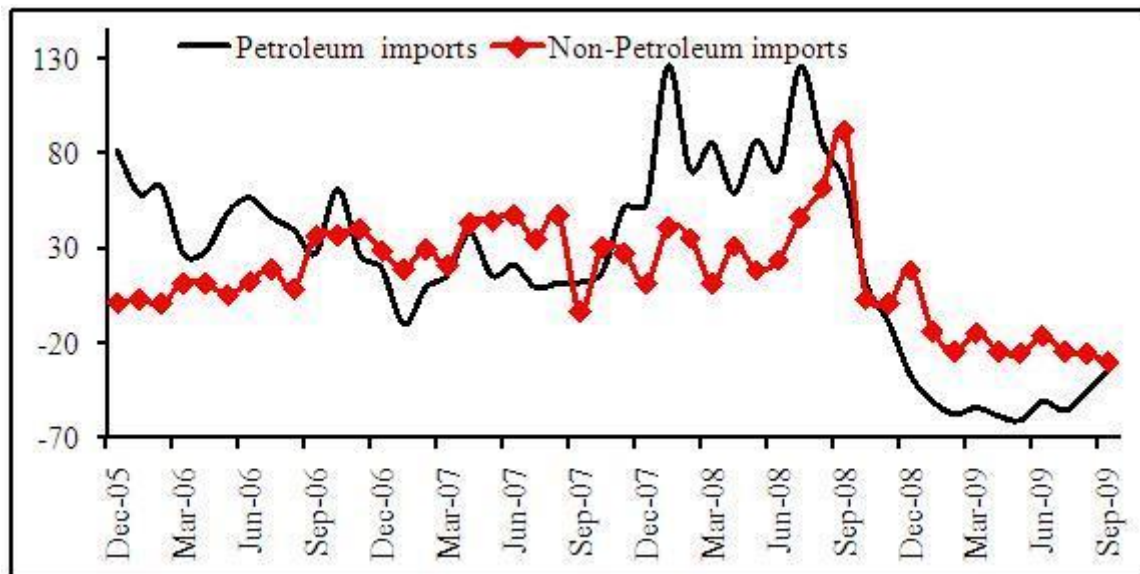
But, the crisis of U.S. quickly became a global problem affecting major economies worldwide both directly and indirectly. The sub-prime crisis in the U.S., following the collapse of the housing sector boom, has sent ripples through the economies of many countries. The crisis has brought about a slump in economic growth in most countries and has been called the most serious financial crisis since the Great Depression, with its global effects characterized by the failure of key businesses<sup>7</sup>, decline in the consumer wealth estimated in the trillion of U.S. dollars, rapid decrease in international trade, slowdown in foreign investments, steep falls in industrial productions, substantial financial commitments incurred by the governments, and significant decline in the economic activity.<sup>8</sup>

Well-developed financial systems was initially mostly affected by cross broader financial linkages through capital flows, stock market investors and exchange rate. Under developing and poor countries have been mostly insulated from the first round effects of the financial crisis owing partly to sound macroeconomic management, but also because of the underdeveloped nature of the financial markets and are not well connected to international markets. In the present paper an attempt has been made to study the impact of global financial crisis on the Indian economy.<sup>9</sup> The paper has been divided into 4 sections. Section 2 discusses the impact of global financial crisis on various segment of Indian economy. Section 3 highlights the policy option adopted by Indian government to overcome the situation of crisis. Section 4 highlights the recovery of Indian economy from economic slowdown and in the end of paper concluding remarks are given. India's economy has been one of the stars of global economies in recent years,<sup>10</sup> growing 9.2% in 2007 and 9.6% in 2006 and has seen a decade of 7 plus per cent growth. Growth had been supported by markets reforms, huge inflows of FDI, rising foreign exchange reserves, both an IT and real estate boom, and a flourishing capital market. But, in the middle of 2008, price increases of global commodity, especially those of oil, metal, and food took a toll on India. Inflation reached at 12.91 per cent, the highest level seen for a decade. With this growth softened, budget deficits widened and trade balances worsened. Before the India could recover from the adverse impact of high commodity prices, the global financial crisis has come knocking. Initially, it was argued that India would be relatively immune to this crisis,<sup>11</sup> because of the 'strong fundamentals' of the economy and the supposedly well-regulated banking system. But, a crisis of this magnitude was bound to affect globalized economy like India and it has. Economy began to slow down from the middle of 2007-08.<sup>12</sup> After a long spell of growth, the Indian economy is experiencing a downturn. Industrial growth is faltering, inflation remains at double-digit levels, the current account deficit is widening, foreign exchange reserves are depleting and the rupee is depreciating.<sup>13</sup>



The most immediate effect of that crisis on India has been an out- flow of foreign institutional investment from the equity market. Foreign institutional investors, who need to retrench assets in order to cover losses in their home countries and are seeking havens of safety in an uncertain environment, have become major sellers in Indian markets. FIIs have pulled out an estimated U.S.\$ 13 billion from Indian stock market in 2008 . Almost immediately after the crisis surfaced FII registered a steel fall between October and November 2007, from \$ 5.7 billion to minus 1.6 billion. Since then the downward trend of FII has remained unabated . FDI investment during 2008-09 was volatile but overall remained stable. <sup>14</sup>

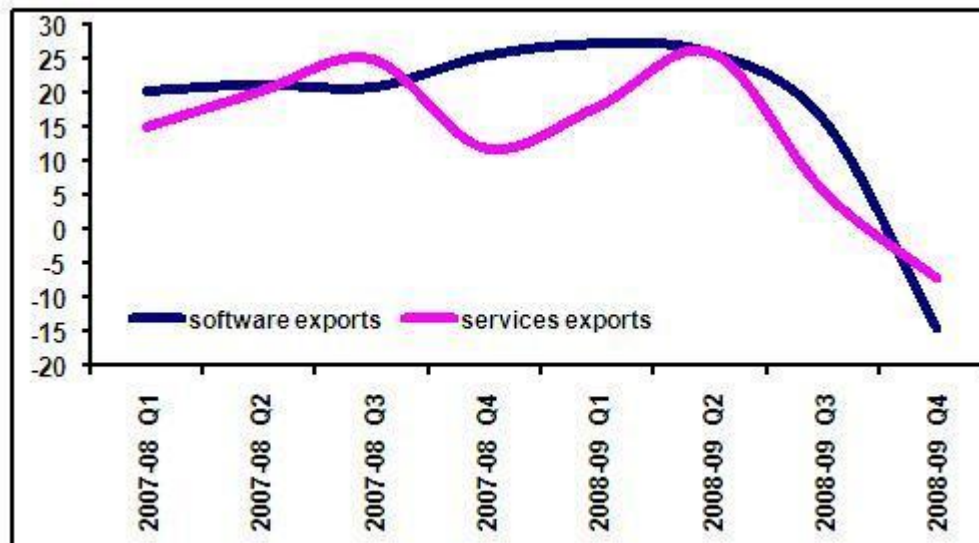
slightly higher than the FDI received in 2007-08 . A significant difference in the total investments of 2008-09 and 2007-08 has been on due to the inflow and outflow of foreign investment observed in 2007-08 and 2008-09 respectively. Remittances are another source of inward foreign capital flows<sup>8</sup> that in the past have helped to balance India's large trade account deficit and keep the current account deficit at a reasonable level. The remittances from overseas Indians started feeling the impact of the global crisis during the third quarter of FY2008-2009<sup>15</sup> when, on a year-on- year basis, they declined by 0.5%. The impact becomes more evident in the fourth quarter of FY2008-2009 when the inflow of remittances declined by more than 29% as compared to the same period in previous year. With the poor economic outlook for oil producing economies in the Gulf and West Asia, coupled with rising pressure against immigration in advanced countries, it is expected that remittances will further decline in the coming quarters. The financial crisis has also created a shortage of money supply and India is also facing a credit crunch especially in terms of foreign ex- change and the Indian Banking sector and forex markets are facing tight liquidity situations each passing day for the past quite some time<sup>16</sup>.



As is to be expected, FII outflows might also have had a negative impact on domestic investment. Given the relative thinness of the Indian share market, the sharp fall in FII followed by their withdrawal contributed, albeit with some lag, to the bursting of the India's stock market bubble<sup>17</sup>. However, Indian stock markets are never free from falling big and the market crash in 2008 was an anticipated one, but a fall of this extent was never anticipated by even the big of the bear. Curiously enough, though IIP growth had started declining since March 2007, the share market boom continued until early 2008; between March and December 2007, the Bombay Stock Exchange (BSE) index, fuelled in part by substantial FII inflows, went up from 12,858 to 19,827. The bullish sentiments prevailed for a short while even after the downward drift in FII began in November 2007.<sup>18</sup>

## II. DISCUSSION

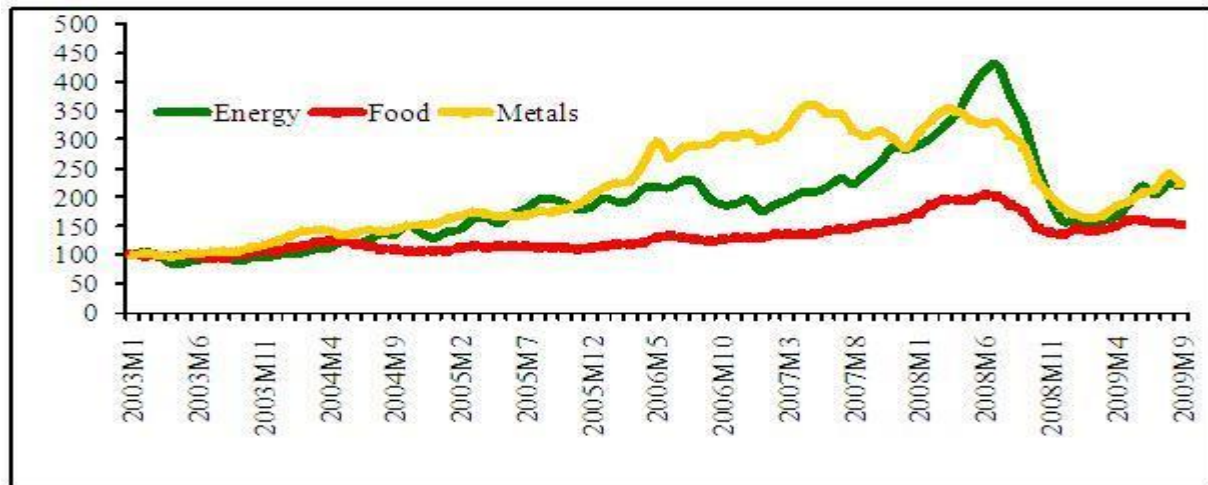
Second, the global financial crisis and credit crunch have slowed India's economic growth. GDP started decelerating in the first quarter of 2007-08, nearly six months before the outbreak of the U.S. financial crisis and considerably ahead of the surge of recessionary tendencies in all developed countries from August-September 2008. That was just the beginning of slowdown impact on India's GDP growth. GDP growth for 2008-09 was estimated at 6.7 % as compared to the growth of 9.0% posted in the previous year. All the three segments of the GDP namely agriculture, forestry and fishing, industry and services sector were seen to post growth of 1.6%, 3.8%, and 9.6% respectively in 2008-09 against the growth of 4.9%, 8%, and 10.8% respectively in 2007-08. Poor agricultural growth is also attributed to low monsoon in major parts of India clearly shows that due to shrinkage in demand in the markets,<sup>19</sup> it is not only manufacturing industry but also the services sector that is getting hit. The government came up with a set of stimulus measures on three occasions to aid the ailing industry compromising on the deficits. These measures have however have led to widening of fiscal deficits. Further, India's industrial output fell at its fastest annualized rate in 14 years, despite tax cuts and fresh spending programme announced by the government of India in December and January to boost domestic demand.



Data released by CSO showed that the factory output shrank by 1.2 per cent in February, on week global and domestic demand. This is against growth rate of 9.5 per cent during the same month India's exports fell the most in at least 14 years as the worst global recession since the Great Depression slashed demand for the nation's jewellery, clothing, and other products. It must be noted this growth contraction has come after a robust 25%-plus average export growth since 2003. A low-to-negative growth in exports may continue for some-time until consumption revives in the developed economies. The slow-down in the trade sector post April 2008 is more explicit. Exports have declined continuously since July 2008 except the month of December. They declined from U.S.\$ 17,095 million in July 2008 to U.S.\$ 11,516 million in March 2009, which accounts for almost 33 % decline. India's export of steel fell by a whopping 35 per cent to 3.2 million tonnes during the current fiscal buoyed by healthy domestic demand, Centre for Monitoring Indian Economy (CMIE). Automotive tyre exports from India also suffered a setback in the first quarter of current financial year, according to latest Tyre Manufacturing Association of India. During the period exports registered a 22 per cent drop against that the in the same period of 2008-09.<sup>20</sup>

The Automotive Components Manufacturing Association has warned that if the slump in auto sales continues, exports could also be negative this year. Apparel exports from India have fallen sharply by 24 per cent since August 2008 due to declining sales in the U.S. and the European Union while those from Bangladesh, Indonesia, and Vietnam are on an upswing. The current global meltdown has hit the country's cashew farmers. Official reports with the Cashew Export Promotional Council of India (CPECI) show that cashew kernel exports have dropped marginally from 11.5 lakh tonnes in 2006-07 to only 11 lakh tonnes in 2007-08. Indian seafood export during 2007-08 has also recorded a fall of 11.58 per cent in terms of quantity and 8.9 per cent in terms of rupee. The domestic tea industry, which was showing some signs of recovery in 2008 after a long spell of recession since 1999, has been pushed back into gloomy the ongoing financial crisis. Software services receipts also declined by 12.7 per cent during Q 4 of 2008-09. However, when compared with the performance in the first three quarters of 2008-09, software exports at U.S.\$ 11.2 billion during Q4 of 2008-09 was almost in line with an average software exports of U.S.\$ 11.9 billion recorded in the first three quarters of 2008-09. Initially, the commerce ministry had set an export target of \$200 billion for 2008-09, which was subsequently revised downwards to U.S.\$ 175 billion in January this year. But the latest numbers reveal that India has missed even the revised target. While, imports fell 36.6 per cent in April from a year earlier and the trade deficit narrowed to U.S.\$ 5 billion from U.S.\$ 8.7 billion in the same month in 2008. Oil imports slid 58.5 per cent to U.S.\$ 3.6 billion, while non-oil purchases dropped 24.6 per cent to \$12.11 billion. The sharp decline in both exports and imports during Q4 of 2008-09 led to a lower trade deficit (Table 4). The trade deficit on a BoP (Balance of Payment) basis in Q4 of 2008-09 (U.S.\$ 14.6 billion) was less than half of the average trade deficit (U.S.\$ 34.9 billion) recorded in the first three quarters of 2008-09. The trade deficit during Q4 of 2008-09 was much lower than that of Q4 of 2007-08 (U.S.\$ 22.3 billion). A decelerating export growth has implications for India, even though our economy is far more domestically driven than those of the East Asia. Still, the contribution of merchandise exports to GDP has risen steadily over the past six years- from about 10% of GDP in 2002-03, to nearly 17% by 2007-08. If one includes service exports, the ratio goes up further.<sup>21</sup>





The current crisis parallels the 2001-2002 bust especially for India's outsourcing (BPOs and KPOs) sector. The outsourcing sector is heavily dependent on demand from the U.S. and Europe, which are currently going through a deep recession. This is going to have a strong negative impact on Indian IT groups. Approximately 61% of the Indian IT sector's revenues are from U.S. clients and 20% from U.K., the rest comes from other European countries, Australia, etc. Just take the top five India players who account for 46 % of the IT industry's revenues, the revenue contribution from U.S. clients are approximately 58%. The outsourcing arm of Infosys Technologies, India's second-biggest software maker, and iGate Global Solutions, both based in Bangalore, lost a major client when GreenPoint Mortgage was shut down by parent Capital One Financial Corp. About 30% of the industry revenues are estimated to be from financial services. After exports, there seems to be bad news in store for the domestic IT and BPO market in 2009 which is expected to grow only 13.4 per cent being the slowest growth since 2003. This will largely on the back of slower IT consumption in some key verticals including retail and financial services. Large Indian firms such as TCS, Infosys, Wipro, Satyam, Cognizant, and HCL Technologies collectively referred as SWITCH vendors are now forced to reconcile to a lower growth rate as their larger banking and auto clients became victims of the financial crisis. The SWITCH vendor account for over half of the country's soft-ware exports. The industry, which grew by 30 per cent on a compound annual basis over the past five years, is likely to see its growth rate halve this year as the economic turmoil intensifies. In fact, the Indian IT and BPO market is slated to see 16.4 per cent CAGR in the coming five years leading to 2012, compared with 24.3 per cent growth recorded between 2003 and 2008<sup>22</sup>

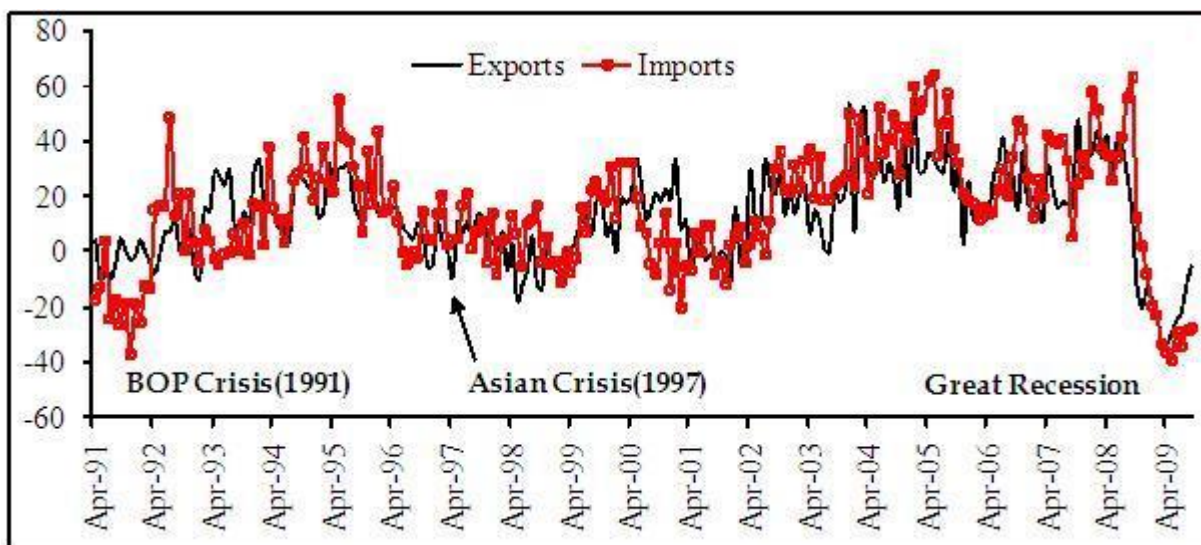
### III. RESULTS

India's travel and tourism sector has been hit by global financial crisis. The Indian tourism industry, valued at Rs 333.5 billion, earns most of its forex revenues from the U.S., U.K., and European visitors. As per the industry, on account of recent crisis, the sector may lose as much as 40% of annual revenues.<sup>16</sup>



Even as per the estimates of the Tourism Committee of The Associated Chambers of Commerce and Industry of India (ASSOCHAM) on account of the global slowdown, the growth in tourism sector is likely to fall by a minimum of 10% and stay at around 5% YoY for FY09. Of the tourist visiting India, corporate travelers account of the majority chunk. This segment was already getting affected since the start of the year on account of the global credit and subprime crisis. With companies cutting down travel budgets, this segment exercised caution. While the recent terror attacks will affect this segment on a temporary basis, it is more likely to suffer due to the prolonged economic crisis. Hotels in the metros which largely cater to corporate tourists have witnessed a sharp dip in occupancy rates in the past few weeks, in some cases as much as 25% to 30%.

Last but not the least, the prices of food articles has increased by more than one-fifth in this one-year. This, obviously, affects household budgets, especially among the poor for whom food still accounts for more than half of total household expenditure. Meanwhile, non-food primary product prices have hardly changed. The prices of fibres mainly cotton, jute and silk have barely increased at all.<sup>21</sup>



Oilseed prices have fallen by more than five per cent. This, immediately, affects all the producers of cash crops, who will be getting the same or less for their products even as they pay significantly more for food. They are also paying more for fertilizer and pesticides, prices of which have increased by more than five per cent. Another major item of essential consumption has also increased in price- that of drugs and medicines, up by 4.5 per cent. This obviously impacts upon the entire population, but especially the bottom half of the population who may find it extremely difficult if not impossible to meet such expenditures in times of stringency.<sup>20</sup>

On the monetary policy front, the policy responses in India since September 2008<sup>17</sup> have been designed largely to mitigate the adverse impact of the global financial crisis on the Indian economy. In mid September 2008, severe disruptions of international money markets, sharp declines in stock markets across the globe and extreme investor aversion brought pressures on the domestic money and forex markets. The RBI responded by selling dollars consistent with its policy objective of marinating conditions in the foreign exchange market. Simultaneously, it started addressing the liquidity pressures through a variety of measures. A second repo auction in the day under the Liquidity Adjustment Facility (LAF)<sup>18</sup> was also introduced in September 2008<sup>21</sup>. The repo rate was cut in stages from 9 per cent in October 2008 to rate of 5 per cent. The policy reverse repo rate under the LAF was reduced by 250 basis points from 6.0 per cent to 3.5 per cent. The CRR (Cash Reserve Ratio) was also reduced from 9 per cent to 5 per cent over the same period, whereas the SLR (Statutory Liquidity Ratio) was brought down by 1 per cent to 24 per cent. To overcome the problem of availability of collateral of government securities for availing of LAF,<sup>18</sup> a special re-finance facility was introduced in October 2008 to enable banks to get refinance from the RBI against declaration of having extended bona fide commercial loans, under a pre-existing provision of the RBI Act for a maximum period of 90 days. These policy measures of the RBI since mid September resulted in augmentation of liquidity of nearly U.S.\$ 80<sup>16</sup>

#### IV. CONCLUSIONS

Slowdown in the economy and rapid decline in global commodity prices toned down the overall inflation to below 0 levels for the first time in 35 years.<sup>22</sup> However, it was found that prices of some of the items of mass consumption were still rising<sup>31</sup> (Rakshit 2009). While, the average overall inflation numbers for the month of June 2009 turned negative however, food articles falling within the category of primary commodities continue

to rise by 8.6% in June 2009 on YoY terms compared to 6 % in the previous year. Further food articles were also seen to get dearer (m-o-m basis) over May 2009. In June 2009 prices of non food articles, fuel leather and basic metals dropped by 2%, 12.6%, 1%, and 14 % respectively from positive growth of 17 %, 16%, 1.6%, and 21% seen in the previous year. The annual inflation rate, as measured by the wholesale price index (WPI), fell to 0.27 per cent for the week ended March 14 this year, compared with 8.02 per cent in the corresponding week last year<sup>14</sup>



The appreciation or depreciation of the rupee,<sup>37</sup> as the case may be, is more influenced by the weakness or strength of the U.S. dollar. This means that factors affecting the dollar against a host of other international currencies need to be closely monitored. A string of economic reports released by the U.S. and Euro regions, statements made by central banks in these regions, inflationary concerns, and the GDP growth of these economies play a direct role in determining the value of a particular currency. For instance, the appreciation of the rupee to 47 levels (from 53 levels) in the second quarter of 2009 was also attributed to the weakness of the Dollar Index against major currencies, such as the euro and the pound and positive sentiment on the back of the euro—a composite currency of 15 nations—gaining strength.<sup>13</sup>

This, apart from inflating stock market bubble, led to a significant strengthening of Indian rupee and posed a serious hurdle to the country's export growth. The Indian economy suffers from an extended period of high interest rates, high prices consequent to supply constraints that are more domestic in origin than global and declining business confidence that was ignored by policy players fixated on inflation and blinded by GDP numbers. But, in nutshell, macro and micro policies adopted by RBI have ensured financial stability and resilience of the banking system.<sup>23</sup> The timely prudential measures instituted during the high growth period especially in regard to securitization, additional risk weights and provisioning for specific sectors measures to curb dependence on borrowed funds, and leveraging by systematically important NBFCs have stood us in good stead. Added to these, at the policy front there is need to focus on creating as much additional fiscal space as possible to prop up the domestic economy while preventing macroeconomic stability. Expenditure priority should be defined rationally.<sup>24</sup> Public spending that creates jobs especially for poor is essential. Ongoing efforts to increase effectiveness and efficiency of the banking system must continue. At organizational level, efforts to raise domestic productivity and competitiveness in international market become critical factors for protecting export market shares. Last but not the least, a close coordination and integration between government of India, financial institutions and organizations is needed to deal with the crisis and restore the growth momentum.<sup>25</sup>

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