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Global Economic Crisis: An Analysis for Indian Economy

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Abstract

The Global Economic Crisis or US Meltdown, one of the most out shaken turmoil in the history of financial innovation, has its origin late back in United States, but gradually extended over a period of time and eventually brought the entire world under its grip in year 2007-08. The present study looks upon the mechanism behind the crisis- How and in what way the crisis originates and engulfed most of the developed and developing economies of the world. India, not an exception, also affected by this although initially officials denied of this fact but over a considerable period of time they themselves ponder upon the ways to escape from this wave. The present study also makes an attempt to look upon the impact of global crisis on Indian economy in terms of selected economic indicators.

Key words: *Global economic crisis, Sub-prime, Slow down, Indian economy, Macroeconomic indicators.*

Introduction

The Global Financial Crisis of 2008 is the most severe financial- housing crisis ever in the history of Financial Innovation and Development. The ‘Financial Crisis of 2008’ , also known as US Meltdown, has its basic roots in the United States housing sector, finally brought the entire world under its seize.
The financial crisis characterized by contracted liquidity in the credit market and global housing, triggered by the failure of mortgage companies, investment banks and government institutions that had invested heavily in subprime loans. Though the crisis started in 2005-06, but has become more visible during 2007-08, when many of the prominent Wall Street firms collapsed.

Mechanism behind the Sub-prime crisis

The story started in USA with people or borrowers who have a poor credit history looking to buy a house and was prepared to pay a mortgage rate typically 2% higher than rates charged from people with good credit history. Sub prime loans, also called “B” loans or “second chance loans” were loans originated specially for borrowers who do not qualify for best market interest rates because of problems in their credit history. Borrowers, with poor credit history or those who scores below 620 points (on a scale from 380 to 850), were categorized as subprime borrowers. These types of loans are usually considered

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precarious for both borrower and lender. It is risky for the lender because borrowers usually have lower incomes and a poor credit history or record for paying debt that increases their default probability. It is also risky for borrowers as high interest rates are laborious for them, which further increases their likelihood of default.

Various varieties of subprime mortgages or loans were offered at that time e.g. “interest only mortgages”, which allow borrowers to only pay interest for a predetermined period of time and no principal amount, “pick a payment”, which gave the borrower the option on how to repay the loan and “initial fixed rate mortgages”, which convert to variable rate loans like “Adjustable Rate Mortgages” (ARM’s) etc, which helps in building market for subprime category.

Another important basis of crisis was speculation in real estate industry. It was observed by public in general that investment in housing sector yield high instant returns as compared to other traditional investment avenues. They turned to real estate, with the philosophy "Buy high--sell higher!" The higher price paid for a house the more profit would be made when it was resold in six or 12 months; prices were certain to keep going up and up. As a result investment in housing sector amplified.

The US Federal Reserve Bank started a series of interest rate hikes in 2002 till 2006, this led to increase in interest rate burden on the borrowers and they started to default. Earlier, due to high amounting loans taken up by sub prime borrowers the housing prices were at their peak as more money was chasing the same properties.

However, as soon as borrowers started to default due to higher monthly installments and lenders selling house properties, the relative supply of houses increased in the real estate market, leading to a fall in housing values and simultaneously housing based mortgage securities held by various lenders.

Original lenders of sub prime loans also knew about the riskiness of loans provided by them. To get rid of such type of risky loans they divided there total sub prime lending into different baskets according to their respective degree of riskiness i.e. default risk. The original lenders then sold the more risky debts baskets to other financial institutions by way of secondary debt market. Big banks and wholesale lenders such as HSBC Holdings bought the debt from original lenders and other lenders like banks and financial institutions etc, repackage them and sell them to Wall Street firms. Wall Street banks and investment houses further repackage these loans in “Mortgage-Backed securities (MBS)” and “Collateralized Debt Obligations (CDO)”. These structured products very often yield high rates of return and are sold to pension funds, hedge funds and institutions across the globe.

Securitization is a structured process in which assets, receivables or financial instruments are acquired, pooled together as collateral for the third party. Due to securitization, Mortgage Backed Securities (MBS) is created/ originated and distributed by the investment firms/banks. Initially Freddie Mae and Fannie Mac (quasi government agency) use to issue MBS but later private agencies also started issuing MBS on subprime loans. Moreover, most of the subprime loans were sold to big hedge funds, financial institutions and commercial banks across the world in the form of CDOs and when they defaulted, they had to face liquidity crisis. For fulfilling the liquidity needs they had to sell their respective investments and portfolios of investments that were in the form of shares of various companies across the world. Major selling of shares across the world put a high downward pressure on various countries stock market indexes.

Behind the Screen

Economists are blaming the crisis on "exuberant brokers" who lure borrowers into mortgage deals. These borrowers very often do not understand the types of loans or the contracts they sign, which denies the ability to asses true risk. The problem includes "appraisers" using inflated figures to value houses. Lack of government regulation on such brokers is also blamed as being the cause of the problem. To provide house at affordable price to all the people was the priority of both the Clinton and Bush administration. In 1974, President Carter passed the Community Reinvestment Act. This Act made mandatory for all the banks and saving institution to provide home loans to the lower income people in broad outlying areas where they had branch.

The U.S. Department of Housing and Urban Development's Mortgage policies fueled the trend towards issuing risky loans. Housing and Urban Development directed Freddie and Fannie to provide at least 42 per cent of their mortgage financing to borrowers with income below the median in their area. This target was increased to 52 per cent in 2005. The only way to achieve income loan target while dramatically increasing lending was to erode underwriting lending standards. Fannie Mae aggressively bought Alt-A loans, where these loans may require little or no documentation of a borrower's finances. Till November 2007 Fannie Mae held a total of $55.9 billion of subprime securities and $324.7 billion of Alt-A securities in their portfolios

Under new system of securitization, credit agencies played a very important role in rating these instruments. Investment firms/banks repackaged mortgages securities (MBS) into innovative financial products called CDOs (Collateral Debt Obligation), that promised to boost the return for investors. These CDOs were further divided into small financial units called 'tranches'. These tranches were rated on the basis of risk involved. The safest portion of the tranches received the highest rating of AAA, while riskier tranches received the medium quality BBB rating, just above the junk bonds. It has been observed that MBS and CDOs originated from subprime mortgages were distributed by the investment firms. Credit rating agencies are under scanner for giving investment-grade rating to securitization transactions based on subprime loans.

This housing bubble based on sub-prime loans burst in 2006-07. In the same year housing prices had declined after 15-16 years. It adversely affected the speculative investment made in housing sector. Those who had invested in houses to earn more profit, have to face losses. Therefore, they started to sell the houses but due to lack of demand, houses could not be sold. Huge over dues of housing loans were not repaid by the borrowers. Banks and financial institutions did not succeed in the recovery of these loans. The price of mortgage bonds started a steep fall resulting in loss for those who invested in mortgage bonds. Hence, the liquidity problem in America became very serious. The large banks like Lehman Brothers, Merrill Synch had declared bankrupt. Following this, over 20 subprime mortgage lenders failed or filed for bankruptcy, the most common one being a company by the name of New Century Financial Corporation, which was the nation's second biggest sub prime lender. Other well known lender includes Countrywide Financial Corp. and HSBC Holdings, which started unraveling problems in their sub prime portfolio. In USA, 19 large banks and 100 private financial institutions were declared bankrupt. Thus, the default in mortgage loans for housing is the primary reason for the financial crisis sweeping the world.

Impact of the Global Economic Crisis on India

The global economic crisis spread rapidly all over the world and various emerging economies through various channels. Though the epicentre of the economic crisis was US but its agitations was felt in financial markets all over the world. Though in the beginning Indian official

denied the impact of US meltdown on Indian economy but later on they themselves acknowledge the fact that US financial crisis will have some

cascading impact on the Indian economy. The US meltdown which shook the whole world had not too much drastic impact on India, as of India's strong fundamentalists approach and a lesser amount of exposure of Indian financial sector with the global financial market. Perhaps this approach has saved Indian economy from being swayed over instantly.

The global crisis affected the health of several sectors of Indian economy through distinct channels. The impact of financial crisis is already felt in terms of reduced export earning, drastic decline in industrial growth and employment, depreciation of rupee, reduction in foreign exchange reserves, down turn in stock markets and many other indicators. This section focuses upon some of the key sectors of Indian economy and analysing their condition before and after the crisis .

(A) India's Growth Story

The financial crisis in the US slowly snowballed into a huge economic crisis, hitting growth barometer of all economies.
Efforts had been taken by the US authorities to restore the fully functional markets, but there's an obvious time lag. Till then, the world economy has been pretentious by this deep economic crisis and India is not an exception. But still India's GDP, is a little less vulnerable than other economies.

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TABLE 1: Annual Growth Rate (GDP at factor Cost, at Constant Prices)

ERA	Year	Annual Growth Rate (Percent)
PRE CRISIS	2001-02	5.4
	2002-03	3.9
	2003-04	8.0
	2004-05	7.1
	2005-06	9.5
	2006-07	9.6
	2007-08	9.3
POST CRISIS	2008-09	6.7
	2009-10	8.6
	2010-11	9.3
	2011-12	6.2
	2012-13	5.0

Source: Handbook of Statistics on Indian Economy 2012-13, RBI

Looking at Table no. 1, this shows that pre crisis period of 2003-04 to 2007-08, India was able to maintain annual growth rate between 7% - 9.5%. Whereas afterwards, growth eventually slowed down to 6.7%, followed by slightly improved picture and again a steep fall from 9.3% to 5.0%. This shows that post crisis period actually shakes the basic fundamentals of Indian economy which in turn reflects in our growth projections. Looking at growth picture of Indian economy and its performance, one should consider about the growth of major sectors of any economy.

TABLE 2: Sectoral Growth of GDP (at factor Cost, at Constant Prices)

ERA	Year	Agriculture & allied activities	Industry	Manufacturing	Services
PRE CRISIS	2001-02	6.01	2.17	2.27	6.54
	2002-03	-6.60	6.86	6.87	7.12
	2003-04	9.05	5.63	6.34	8.56
	2004-05	0.18	7.52	7.38	9.10
	2005-06	5.14	8.55	10.10	11.15
	2006-07	4.16	12.90	14.32	10.09
	2007-08	5.80	9.25	10.28	10.34
POST CRISIS	2008-09	0.09	4.09	4.33	9.38
	2009-10	0.81	10.16	11.30	10.02

	2010-11	7.94	8.75	9.73	9.81
	2011-12	3.65	2.68	2.69	7.88
	2012-13	1.91	1.17	1.05	6.78

Source: Handbook of Statistics on Indian Economy 2012-13, RBI

This table mainly shows 4 sectors, one of these is agriculture and allied activities whose performance was badly hit because of crisis. Agriculture sector shows the uneven record for post crisis period, as the growth nearly goes down to 2% of the last year initially, followed by slow recovery. The Industry and Manufacturing sector revive after crisis for 2 years but they also not able to sustain this rate for long. The only least effected sector was service sector but eventually its growth rate is also slowing down year by year.

(B)India's Trade Picture

With U.S. and several European countries wending full blown recession, exports from India have faced difficult times since 2008. Manufacturing sectors like leather, textiles, gems and jewellery have been hit hard by falling demand in the U.S. and Europe. Moreover India enjoys trade surplus with U.S. and about 15 percent of its total exports in 2006-07 was directed to the U.S.. Indian exports fell by around 10% - 15% in 2008, as the impact of declining consumer demands in U.S. and other major world markets. Further, the trade balance always running in negative number points towards our dependency on other developed countries and this gap gets widened during post crisis period.

TABLE 3: India's Foreign Trade

ERA	Year	Exports		Imports		Trade Balance
		Rupees Billion	% Change	Rupees Billion	% Change	Rupees Billion
PRE CRISIS	2001-02	2090.18		2452.00		-361.82
	2002-03	2551.37	122.06	2972.06	121.21	-420.69
	2003-04	2933.67	114.98	3591.08	120.83	-657.41
	2004-05	3753.40	127.94	5010.65	139.53	-1257.25
	2005-06	4564.18	121.60	6604.09	131.80	-2039.91
	2006-07	5717.79	125.28	8405.06	127.27	-2687.27
	2007-08	6558.64	114.71	10123.12	120.44	-3564.48
POST	2008-	8407.55	128.19	13744.36	135.77	-5336.80

CRISIS	09					
	2009-10	8455.34	100.57	13637.36	99.22	-5182.02
	2010-11	11429.22	135.17	16834.67	123.45	-5405.45
	2011-12	14659.59	128.26	23454.63	139.32	-8795.04
	2012-13	16343.19	111.48	26691.62	113.80	-10348.43

Source: Handbook of Statistics on Indian Economy 2012-13, RBI

(C) Foreign Investment Inflows Scenario

The Foreign Investment Inflows in terms of Direct and Portfolio investment to India smack badly because of global crisis. The contagious financial crisis eroded much of the money from the Indian stock market which gets reflected in data relating to net portfolio investment, as seen from Table No. 4, year 2008-09 having negative inflows means great selling on part of Institutional Investors inspite of good growth fundamentals of India. This was followed by low investment in years ahead, as institutional investors also faces liquidity crisis due to global meltdown.

Due to global recession, FIIs made a huge withdrawal, whereas the inflow of foreign direct investment (FDI) not much affected by this, but over a period of time it also moves up and down. This shows lack of consistent rate of growth. In totally, global crisis shakes the whole investment scenario in India.

TABLE 4: Foreign Investment Inflows to India

ERA	Year	Net Foreign Direct Investment		Net Portfolio Investment		Total	
		Rupees Billion	% Change	Rupees Billion	% Change	Rupees Billion	% Change
PRE CRISIS	2001-02	226.30		92.90		319.20	
	2002-03	155.94	68.91	45.04	48.48	200.98	62.96
	2003-04	109.44	70.18	518.98	1152.26	628.42	312.68
	2004-05	167.45	153.01	413.12	79.60	580.57	92.39
	2005-06	134.25	80.17	553.57	134.00	687.82	118.47
	2006-07	349.10	260.04	318.81	57.59	667.91	97.11
	2007-08	637.76	182.69	1106.19	346.97	1743.95	261.11
POST CRISIS	2008-09	1000.00	156.80	-651.00	-58.85	349.00	20.01

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	2009-10	858.00	85.80	1540.00	236.56	2398.00	687.11
	2010-11	541.00	63.05	1394.00	90.52	1935.00	80.69
	2011-12	1021.37	188.79	851.26	61.07	1872.63	96.78
	2012-13	1078.60	105.60	1465.59	172.17	2544.19	135.86

Source: Handbook of Statistics on Indian Economy 2012-13, RBI

(D) Foreign Exchange Reserve Outlook

Foreign Exchange Reserves are the foreign assets held or controlled by the central bank of any country. The reserves are generally made of gold or a specific currency. They may be special drawing rights and marketable securities denominated in foreign currencies such as treasury bills, government bonds, corporate bonds and equities and foreign currency loans.

Reservations are held generally by countries to fulfill their international obligations to pay - terms of both short and long term, including sovereign and commercial debt, import financing, intervention in the currency markets in times of volatility also help increase market confidence in the ability of a country to meet its external obligations and absorb unexpected external shocks, contingencies or unexpected movements of capital.

TABLE 5: FOREIGN EXCHANGE RESERVES

ERA	End of Financial Year	Total (Rupees Billion)	% Change
PRE CRISIS	**2001-02**	2640.36	
	2002-03	3614.70	136.90
	2003-04	4901.29	135.59
	2004-05	6191.16	126.32
	2005-06	6763.87	109.25
	2006-07	8682.22	128.36
	2007-08	12379.65	142.59
POST CRISIS	**2008-09**	12838.65	103.71
	2009-10	12596.65	98.12
	2010-11	13610.13	108.05
	2011-12	15061.30	110.66
	2012-13	15884.20	105.46

Source: Handbook of Statistics on Indian Economy 2012-13, RBI

It is necessary for every country to maintain proper amount of foreign reserve to avoid any risk for economy and its survival. As seen from Table No. 5, the percentage increase in reserve was stagnated as result of depreciation of rupee, lower capital inflows, declining growth rate etc.

(E) Fiscal Deficit Situation

The government budget balance is also commonly known as the balance of the

general government, the government budget, fiscal balance or public, is the overall result of the general budget of the government of a country during an accounting period, usually one year. The gross fiscal deficit (GFD) is the excess of total expenditure including loans net of

recovery over revenue receipts (including external grants) and non-debt capital receipts.

Table No. 6 shows the Gross Fiscal Deficit's picture (as percentage of GDP) over a span of time. It clearly shows that Gross Fiscal Deficit gets doubled and even more than double post crisis period. The value lies between 3%-4% in pre crisis period, whereas it goes to around 5% - 6.5% for post crisis period. In the present scenario also, government faces a huge challenge to keep fiscal deficit at around 4% of GDP but because of different weakened macroeconomic drivers e.g. weaking rupee, lowering growth etc, it ends up in addition to rising value of fiscal deficit.

TABLE 6: Gross Fiscal Deficit

ERA	Year	Gross Fiscal Deficit (As perecentage of GDP)
PRE CRISIS	2001-02	5.98
	2002-03	5.72
	2003-04	4.34
	2004-05	3.88
	2005-06	3.96
	2006-07	3.32
	2007-08	2.54
POST CRISIS	2008-09	5.99
	2009-10	6.46
	2010-11	4.79
	2011-12	5.75
	2012-13	5.20

Source: Handbook of Statistics on Indian Economy 2012-13, RBI

Conclusion

The Global Economic Crisis can be attributed largely to prolonged periods of excessively loose monetary policy in the U.S. during the period 2002-06. Very low interest rates during this period encouraged an aggressive search for yield compression and substantial risk premiums worldwide. Abundant liquidity in advanced economies generated by the loose monetary policy found its way in the form of large capital flows to emerging market economies. It can be noted down that the 'Economic or Subprime Crisis' was the shear

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penalty cost of 'greed' and 'quick and big profit' on the part of Wall Street Firms and Investment Banks. This crisis also shows the breakdown of capitalist market economy. Though the Indian economy would be able to withstand the crisis without any major difficulty, but the crisis continues to wreak havoc around the world. To overcome from the after-effects of this crisis and to prepare ourselves as sturdy one, we should take care of each area of our economy. Example, more transparency in the process of setting the bank rate, repo rate, reverse repo rate, CRR, SLR etc. required. The link between monetary policy and financial stability need to be understood and more autonomy to the central bank should be given to maintain the enviable reputation earned by RBI. Monetary & fiscal policy both should therefore be co-ordinated for overall better performance of Indian economy. Black money should be tapped in time and corruption must be controlled. The ethical and moral standards should be improved. To accelerate the pace of economic development and to attract foreign direct investment in the Indian economy, there is an urgent need to ensure the protection of investors, their lives and money by keeping the law and the proper order. Entrepreneurship development in both rural and urban areas should be deal separately accordingly.

In fact, to achieve the target of higher sustained growth rate of 9 %+ in the coming years, that would require:

1. Revival and a vigorous pursuit of economic reforms at the center and in the states;
2. A major effort at raising the rate of domestic savings, refocusing on explicit and implicit subsidies, stricter control over non-
3. developmental expenditures, improvements in the tax ratio through stronger tax enforcement, and strengthening incentives for savings;
4. Larger investments in, and better performance of, infrastructural services, both in the public and private sectors; and
5. Greater attention to, and larger resources for, agriculture, social sectors and rural development programs to increase employment, reduce poverty and for creating a mass base in support of economic reforms.

The US meltdown in a form of contagion which shook the whole world had a considerable impact on India at the modest because of India's strong fundamental and less exposure of Indian financial sector with the global financial market, as Indian market is closely regulated by the SEBI, RBI and Government. In the final words we can say, India cannot flee itself totally from global crisis, as its economy has become more integrated with the rest of the world in the past two decades. But in order to safeguard itself from the ghastly effects of any such crisis, the package of integrated monetary and fiscal stimulus is indispensable.

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