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Impact Of Global Financial Crisis On The Indian Economy

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Abstract

The Global Financial Crisis (GFC) started to appear in mid-2007. The crisis actually began in the US high risk, subprime home loan market and has spread into a global credit squeeze, bringing down the world growth. The world economy was just trying to recover from this that it had to encounter one more serious global economic slowdown which erupted in Europe. The Indian economy is not immune to this; all these factors had their impact on the Indian economy and the various sectors of the economy. The present paper is an attempt to analyse the impact of global economic slowdown on the Indian economy in terms of growth rates of real Gross Domestic Product (GDP). The sector wise impact of the crisis on the economy has also been analysed. Techniques like Tables and Trend graphs have been used to present the impact. Time Series data for almost ten years from the year 2000-01 has been used to analyze the impact.

Key Words: Global Financial Crisis; Sub Prime Crisis; Gross Domestic Product; Trend Graphs.

Introduction

Globalization implies integration; global economy implies the integration of all the economies of the world. Post globalization, the whole world is regarded as one and it functions through an economy popularly called the 'global economy.' The global economy also comprises of the global financial system. Global financial crisis however, is turmoil in the world financial system caused due to some illogical reasons and mismanagement by the financial institutions. Today, the global financial system is under increasing strain and risks to financial stability have remained imminent.

The modern world is an inter-connected world following a period of economic boom, a financial bubble which was global in scope finally bursted causing havoc which was global in nature. The global financial crisis brewing for a while really started to show its effects in the middle of 2007 and into 2008. The fall of the world stock markets, large financial institutions and the complexities of the global financial system indicated the height of the global financial crisis. A collapse of the US subprime mortgage market and the reversal of housing boom in other industrialized economies have had a ripple effect around the world.

The global financial crisis clearly reflects a combination of three factors;

- Weakening balance sheets of financial institutions
- Continuous fall in asset prices
- The weakening global growth

The crisis actually began in the US high risk, subprime home loan market and has spread into a global credit squeeze, bringing down the world growth. While the US remains the focal point, financial institutions in other countries have also been affected, reflecting the unreliable global financial conditions and weaknesses in risk management systems and prudential supervision.

The present Global Financial Crisis (GFC) started to appear in mid-2007, When the US economy witnessed a decline in real GDP for more than four months everyone suspected an ensuing slowdown. Officially the bubble got burst with the failure of Lehman Brothers one of the leading financial institutions in United States of America. Though economic fluctuations follow different trends, the occurring recession is regarded as a black swan because of it being a low probability event, an outlier, outside realm of reasonable expectations and carrying an extreme impact. The experience of Great Depression of 1930s is still afresh to understand the drastic effects of such a crisis.

The crisis actually began in the US high risk, subprime home loan market and has spread into a global credit squeeze, bringing down the world growth. While the US remains the focal point, financial institutions in other countries have also been affected, reflecting the unreliable global financial conditions and weaknesses in risk management systems and prudential supervision.

Some of the immediate causes for the global financial bubble to burst are:

- The banks borrowed even more money to lend out so that they could create more securitization.
- The investment banks like Lehman Brothers got into mortgages.
- Some banks loaned even more to have an excuse to securitise those loans.
- Banks started lending loans to the poor out of the anxiety of 'to whom to lend loans.' These sub-prime and self-certified loans were highly riskier loans.
- Some banks resorted to buying of securities from others
- The investment banks, not content with buying, selling and trading risk, got into home loans, mortgages etc, without the right controls and management.
- The soaring commodity prices were also responsible
- The increasingly restrictive monetary policies in many countries
- The stock market volatility

The International Monetary Fund (IMF) and the Organization for Economic Cooperation and Development (OECD) had warned about the crisis and threatening stagflation in the financial system and the required measures to be taken to shore up investors' confidence. The IMF had warned that the global economy was being hit by a serious slowdown and it also indicated that the total losses related to US risky loans could reach dollar one trillion.

The financial crisis unfortunately coincided with the decline of the dollar, rising inflation and booming commodity prices. The US central bank ignored this and paid more attention to the rate cuts to minimize financial meltdown. But with the passage of time the global financial crisis has gradually taken the form of recession. Although a recession is generally defined as two consecutive quarters of declining activity. It is a contraction of Gross Domestic Product (GDP) for two successive quarters.

"A recession is a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in production, employment, real income and other indicators."

A recession begins when the economy reaches a peak of activity and ends when the economy is in expansion. However, the Business Cycle dating committee of the National Bureau of Economic Research opined that the U.S. economy has been in recession since December 2007. The committee said that it identified December 2007 as the peak month, after determining that the subsequent decline in economic activity was large enough to qualify as a recession. However, they also opined that the peak marks the end of the expansion that began in November 2001 and the beginning of a recession. The expansion of the 1990's lasted for 120 months.

What triggers a financial crisis?

The current turmoil in the US financial market and its spilling over to financial markets overseas has led us to analyze as to what triggers a financial crisis. There are two factors which are responsible, first, the prevalence of high stakes in the financial markets under uncertainty with risks involved in holding assets often disproportionately high as compared to their realized returns.

The second factor which contributed to trigger the recent financial crisis relates to financial innovations in de-regulated financial markets. By generating derivative instruments which aimed to protect asset values in uncertain markets, derivatives also made it possible to invest and acquire assets much more easily.

Review of Literature

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Mohanty (2010) in his speech has commented about the impact of global financial crisis of 2008 on the Indian economy, he comments as the crisis showed that while increasing globalization and trade integration have brought enormous economic and financial benefits to the Emerging Market Economies (EMEs), they have also widened the channels through which a slowdown in economic activity in advanced economies could spread to the EMEs. Mohan (2009) in his speech has commented about the impact of global financial crisis on the various sectors of the Indian economy. Prasad and Reddy (2009) have assessed the impact of financial crisis on India; they say that the impact of the crisis on the Indian economy relatively has been less when compared to USA, UK and European Union. Sengupta (2008) has observed that surplus inventory of houses and increase in interest rates led to a decline in housing prices in 2006-07 resulting in an increased defaults and foreclosure activity that collapsed the housing market. Onaran (2008) has viewed that due to the failure of a few leading institutions in US, the entire financial system in the world has been affected.

Objectives Of The Study

The following are the objectives of the paper:

- To analyze the impact of global financial crisis on Indian economy in terms of growth rates of real Gross Domestic Product (GDP).
- To examine the sector-wise impact of the crisis in the Indian economy.

Hypotheses

The following are the hypotheses of the study

- The annual growth of GDP of Indian economy has been affected due to Global Financial Crisis.
- The impact of Global Financial Crisis on various sectors is not uniform.

Impact Of The Global Financial Crisis

The global financial turbulence has its impact on almost all the economies of the globe. A crisis of this magnitude is bound to affect the working of the economy of both a developed country as well as a developing country. The global financial crisis has impacted the corporates, banks and investor sentiments. Many economists have regarded this crisis as a crisis of confidence. The renowned Nobel economist Amartya Sen in a recent interview regarded this crisis as a 'crisis of confidence.'

However, the impact of the present global financial crisis has been different for different countries. With an increasingly inter-connected world, things like a credit crunch can ripple through the entire economy. In a wide economy, many sectors may feel the credit crunch and higher costs of borrowing will lead to job cuts. As people will cut back on consumption to try and weather this economic storm, yet other businesses will struggle to survive leading to further fears of job losses. The real economy in many countries is already feeling the effects. Many industrialized nations are sliding into recession if they are not already there.

The impact of the US housing crisis is not only widespread, but the disturbance it has created is still deepening across the world financial systems. In Europe, a number of major financial institutions failed, others needed rescuing.

The crisis however is not limited to Europe alone, but has affected markets of several developing countries as well. India and China are also seeing lower housing prices after a period of steady increases. For the developing world, the rise in food prices as well as the knock on effects from the financial instability and uncertainty in industrialized nations is having a compounding effect. High fuel costs, soaring commodity prices together with the fear of global recession are worrying many developing country analysts. Today, the most common problem for many emerging and developing economies is to contain inflation and addressing the vulnerabilities remains a key priority.

With regards to Asia and the financial crisis, many believed that Asia was sufficiently decoupled from the western financial systems. Asia has not had a subprime mortgage crisis like many nations in the west have. However, this crisis has shown that in an increasingly inter-connected world means there are spread over effects and as a result, Asia had more exposure to problems stemming from the west. Many Asian countries are also global and a slowdown in wealthy countries means increased chances of a slowdown in Asia and the risk of the losses and associated problems like social unrest.

The African countries will not be affected from the crisis, at least not initially. The African countries however could face increasing pressure for debt repayment. The Latin American countries are also expected to have a slower growth rate due to the crisis.

The global financial crisis has also led to a crisis of poverty. Almost daily, some half of humanity or more, suffer a daily financial, social and emotional crisis of poverty. The global food crisis is also fast affecting the poorest. The development process of the poor nations has also suffered set back due to lack of finance for their development projects. The countries which are less dependent on foreign credit, investment and trade are much safer.

7. Results And Discussion:

The following are the results and discussion of the study:

Table 1: Annual Growth Rate of Real Gross Domestic Product

Year	GDP at Factor Cost in (%)
2000-01	4.3
2001-02	5.5
2002-03	4.0
2003-04	8.1
2004-05	7.0
2005-06	9.5
2006-07	9.6
2007-08	9.3
2008-09	6.7
2009-10	8.4
2010-11	8.4
2011-12	6.9

Source: Economic Survey 2011-2012

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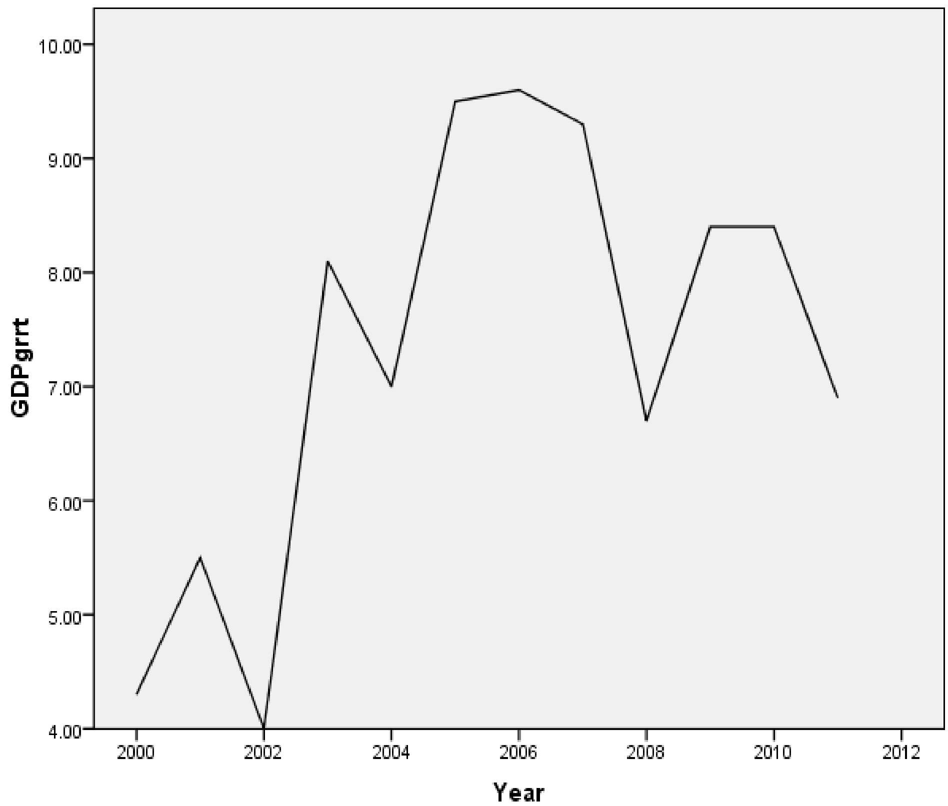
Graph 1: **Annual Growth Rate of Real Gross Domestic Product**



The above Table-1 and Graph-1 present the annual growth rates of real gross domestic product over the years starting from 2000 to 2012. In the graph, the x- axis specifies the years selected for the study and the y – axis represents the GDP growth rate for the selected years. The GDP which had a very moderate growth has shown an increasing trend during 2003-2004, this trend has continued till 2007-2008, but it decreased during 2008-09 due to the impact of global financial crisis. It recovered thereon due to the efforts of the

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Reserve Bank and the Government but again faced a falling trend due to the poor performance of the manufacturing sector in the total GDP.

Table 2: Annual Growth Rate of Real Gross Domestic Product Sector wise

Year	Agriculture & Allied Activities	Manufacturing, Construction, Electricity, Gas & Water Supply	Trade , Hotels, Transport& Communication	Financing, Insurance, Real Estate &Business Services	Public Administration & Defence and other Services
2000-01	0.3	6.5	6.4	4.5	4.6
2001-02	5.5	2.7	8.6	7.1	4.1
2002-03	-4.9	7.1	8.5	7.7	3.9
2003-04	8.2	7.9	11.1	5.8	5.4
2004-05	1.1	10	9.7	8.7	4.9
2005-06	4.6	10.7	12	12.6	7.1
2006-07	4.6	12.7	11.6	14	2.8
2007-08	5.5	10.3	10.9	12	6.9
2008-09	0.4	4.7	7.5	12	12.5
2009-10	1.7	8.6	10.3	9.4	12
2010-11	6.8	7.4	11.1	10.4	4.5
2011-12	1.9	4.5	11.2	9.1	5.9

Source: Central Statiscal Organisation

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The sector wise annual growth rate of real gross domestic product in India over the years has been presented in the Table -2. The contribution of agriculture and manufacturing sector has been unconvincing and the impact of the global financial crisis on these sectors is evident by their poor performance.

The following graphs present the annual growth rate of agriculture and allied activities, manufacturing and related activities and trade and other related activities to the real gross domestic product in India and from these graphs the impact of global financial crisis on the GDP figure has been analyzed using the trend graph. In the graph – 2 the x-axis shows the years selected for study and the vertical axis represents mean agricultural growth rate. The annual growth rates of the manufacturing sector and trade and a related activity have been represented in the graph – 3 and graph – 4 respectively. All the illustrations show a steep fall of the annual growth rates during the year 2008.This clearly implies that the prominent sectors of the Indian economy are not immune to the impact of global financial crisis.

Graph 2: Annual Growth rate of Agriculture and Allied Activities

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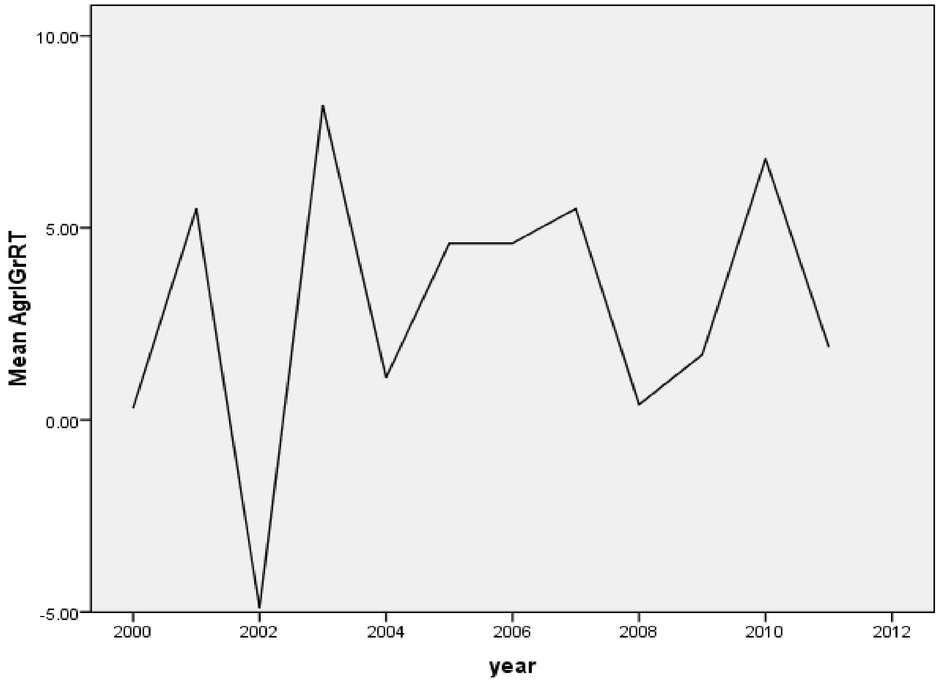

Graph 3: Annual Growth rate of Manufacturing & Related Activities

International Journal of Business Quantitative Economics and Applied Management Research
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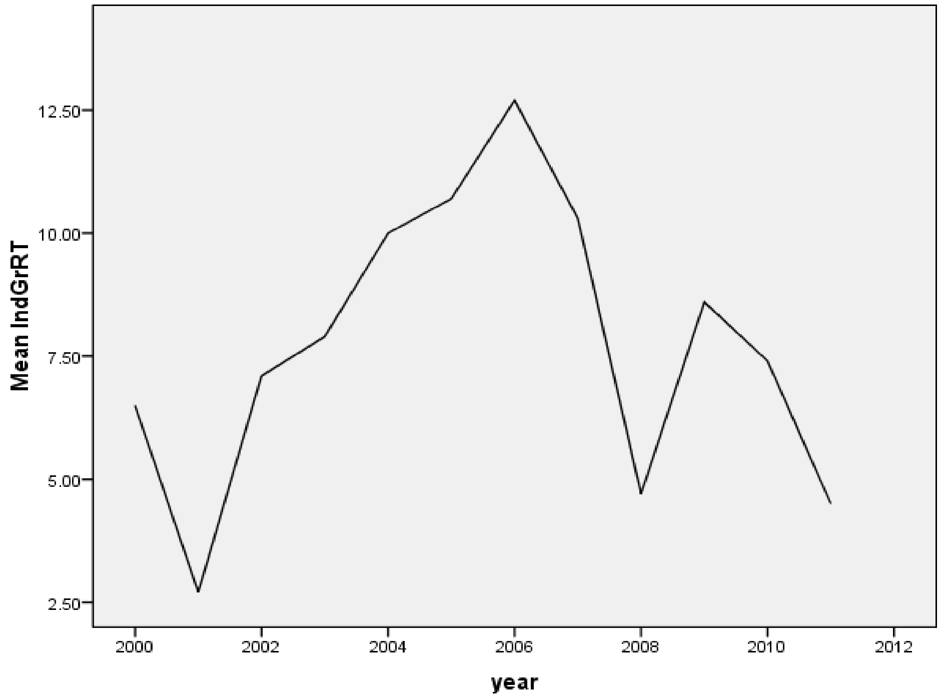
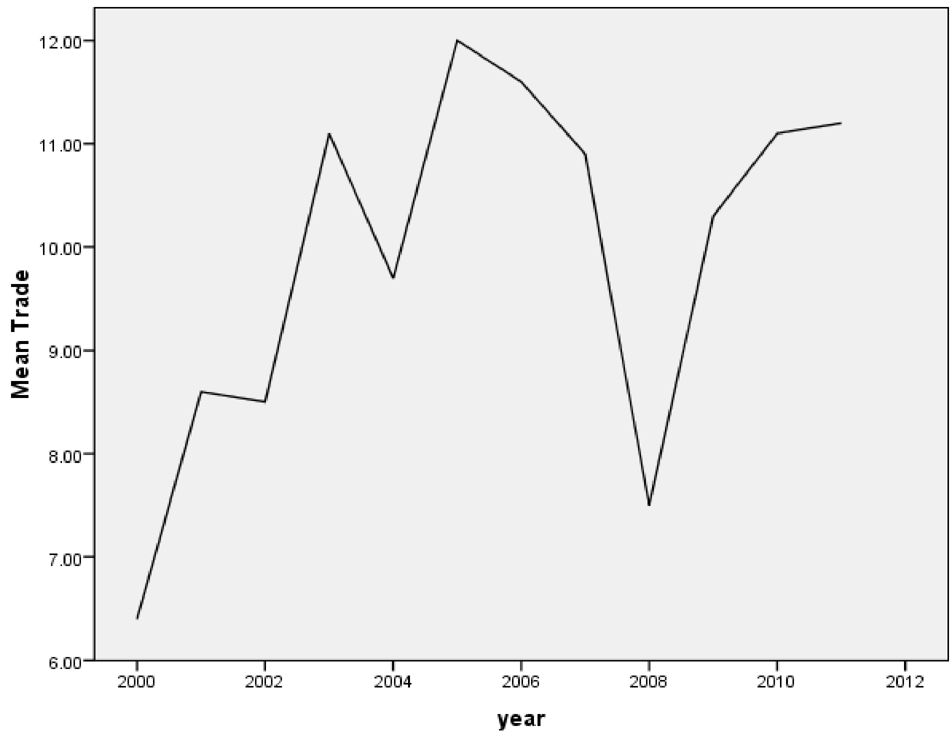


Graph 3: Annual Growth rate of Trade and Related Activities



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India's engagement with the global economy became deeper from the 1990s. The deepening global integration of India has made it vulnerable to global financial crisis. The global financial crisis has negatively impacted the Indian economy and it is very much evident in the real GDP growth performance. Global financial crisis has impacted almost all the economies, and India is not an exception to it. However the impact of the crisis has been different on different sectors of the economy.

8. Suitable Measures To Overcome The Crisis:

The global financial crisis is a serious issue which needs to be checked. Appropriate measures should be put into practice so that there can be deterioration in the magnitude of the crisis. However, some rational measures would be to;

- The IMF has urged that monetary policy be the first line of defense in industrialized countries and the same should be followed in India
- The Reserve Bank of India has to provide liquidity and bring an ease in the monetary policies keeping the inflationary expectations under check.
- The central banks of the crisis initiating countries must continue to pay more attention to asset prices in future.
- The emerging economies should support policies to strengthen their domestic demand, including greater exchange rate flexibility to play a more dynamic role in economic growth.
- The Asian economies and especially Indian economy have a huge backlog to make up in basic infrastructure, which can be a powerful instrument for stimulating demand in Asia.
- The Indian economy should steer towards greater financial and economic independence.
- Likewise, reducing interest rates sounds like there would be fewer incentives for people to save money, when banks need to build up capital reserves. However, as the real economy starts to feel the pinch, reduced interest rates are an attempt to encourage people to take part in the economy.

- Tax reduction is something that most people favor, and yet during times of economic downtown, it would seem that a reduction in tax would result in reduced government revenues just when they need it and then spending on health, education etc would be at risk. However, because the higher taxes during downturns means more hardship for more people, increased borrowing is supposed to effect the reduction in taxes, hopefully affording people a better chance to overcome the economic storm.
- Most importantly, it is at this time that public infrastructure work, which can potentially employ many people, is palatable.
- Finally, it is high time that we rethink about reforming the international financial system. The IMF and the World Bank often regarded as 'Bad Samaritans' should stop their step motherly treatment towards less wealthier nations. The poor countries and developing countries like India must be given more voice and power, which typically have little say in how the global economy is shaped.

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