GLOBAL ECONOMIC AND FINANCIAL CRISIS:
IMPACT ON INDIAN ECONOMY AND POLICY RESPONSES

The impact of the economic crisis has percolated to all major sectors of the economy, although the magnitude of the impact varies from sector to sector. The depth and size of the downturn depends on the extent of integration of these sectors with the world economy. The impact of the global crisis has been transmitted to the Indian economy through three distinct channels, namely: the financial sector, exports and exchange rates. The other significant channel of impact is the fall in business and consumer confidence leading to decrease in investment and consumer demand. We explain below some important effects of global financial crisis on the Indian economy.

4.1 IMPACT ON INDIA

4.1.1 IMPACT ON GDP GROWTH:

After a long spell of growth, the Indian economy was experiencing a downturn. Chart 4.1 shows that in 2006-07, the GDP growth rate was 9.6% which became 9.3% in 2007-08 and due to the impact of global financial crisis and global recession, the growth rate of Indian economy became declining. In 2008-09, it reduced to 6.8% but increased up to 8.4% in the successive two years during 2009-10 and 2010-11. (Central Statistical Organization, Government of India).
4.1.2 INDUSTRIAL GROWTH:

The declining trend in GDP has affected adversely the industrial activity, especially, in the manufacturing, infrastructure and in service sectors mainly in the construction, transport and communication, trade, hotels etc. During recession, industrial growth was also falling. India’s industrial sector has suffered from the depressed demand conditions in its export markets, as well as from suppressed domestic demand due to the slow generation of employment. As per the index of industrial production (IIP) data released by CSO, the overall growth in 2008-2009 was 3.2 percent compared to a growth of 8.7 percent in 2007-08.\textit{(Chart4.2).} (Central Statistical Organization, Government of India).
4.1.3 NET INVESTMENT OF FIIS:

The most immediate effect of the crisis on India has been an outflow of foreign institutional investment from the equity market. Foreign Institutional Investment (FIIs), which need to retrench assets in order to cover losses in their home countries and were seeking havens of safety in an uncertain environment, have become major sellers in Indian markets. As FIIs pull out their money from the stock market, the large corporate no doubt have affected, the worst affected was likely to be the exports and small and marginal enterprises that contribute significantly to employment generation. In 2007-08, net FIIs inflows into India amounted to $16040 million. But in April-November 2008 it was negative to $8857 million. *(Chart 4.3).* *(Central Statistical Organization, Government of India)*
4.1.4 STOCK- MARKET CRASH:

Following the eruption of financial crisis, when the Wall Street of the US and Stock markets of the European countries crashed, its effect spilled over to India and our stock market (Dalal Street) was also badly hit. To meet the liquidity requirement or liabilities of their parent companies, FIIs started selling the shares of the Indian companies held by them. The selling pressure by FIIs brought about crash in Dalal Street. In the last few years, FIIs had invested on a massive scale in the equity shares of several Indian companies operating in various industries from consumer infrastructure industries. As a result of the buying spree of shares of Indian companies by FIIs, share prices rose to new heights. Due to this, there was a collapse in stock prices. As a result, the Sensex fell from its closing peak of 20873 on January 2008 to nearly 8000 in 1999-2000

<table>
<thead>
<tr>
<th>Year</th>
<th>Amount (US $ Million)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1999-00</td>
<td>2339</td>
</tr>
<tr>
<td>2000-01</td>
<td>2160</td>
</tr>
<tr>
<td>2001-02</td>
<td>1846</td>
</tr>
<tr>
<td>2002-03</td>
<td>562</td>
</tr>
<tr>
<td>2003-04</td>
<td>9949</td>
</tr>
<tr>
<td>2004-05</td>
<td>10272</td>
</tr>
<tr>
<td>2005-06</td>
<td>9332</td>
</tr>
<tr>
<td>2006-07</td>
<td>6707</td>
</tr>
<tr>
<td>2007-08</td>
<td>16040</td>
</tr>
<tr>
<td>2008-09*</td>
<td>-8857</td>
</tr>
</tbody>
</table>

Source: Central Statistical Organization, Government of India
October-November 2008. Chart 4.4 shows that in the last trading day of 2008-09, the BSE Sensex was 9708.5.(SEBI Bulletin June 2010, Vol. 8, No. 06).

**Chart 4.4**

<table>
<thead>
<tr>
<th>Year</th>
<th>BSE Sensex</th>
</tr>
</thead>
<tbody>
<tr>
<td>2008-09</td>
<td>9708.5</td>
</tr>
<tr>
<td>2009-10</td>
<td>17527.8</td>
</tr>
<tr>
<td>2010-11**</td>
<td>17558.7</td>
</tr>
<tr>
<td>May-10</td>
<td>16944.6</td>
</tr>
</tbody>
</table>

* As on the last trading day of respective financial year
** As on April 30, 2010

Source: SEBI Bulletin June 2010, Vol. 8, Number-06

4.1.5 FOREIGN EXCHANGE RESERVES:

The foreign exchange market came under pressure because of reversal of capital flows as part of the global decelerating process. Foreign exchange reserves were depleting. It was $ 309.7 billion in 2007-08 and came down to $252.0 billion in 2008-09, which shows the direct impact of the financial crisis on India’s foreign exchange reserves. (Economic Survey of India 2010-11).
4.1.6 FOREIGN EXCHANGE RATE:

In addition to the withdrawal by the FIIs and corporate, converting the funds raised locally into foreign currency to meet their external obligations led to sharp depreciation of the rupee. Between April 2008 and November 2008, the RBI reference rate for the rupee fell by nearly 25 percent, rupees per unit dollar gone up from Rs.40.02 in April 2008 to Rs.49.00 in November 2008.

### Table 4.1
FOREIGN EXCHANGE RATE

<table>
<thead>
<tr>
<th>Month</th>
<th>Rupees per unit of Dollar</th>
<th>Appreciation/Depreciation</th>
</tr>
</thead>
<tbody>
<tr>
<td>March 2008</td>
<td>40.36</td>
<td>-</td>
</tr>
<tr>
<td>April 2008</td>
<td>40.02</td>
<td>+0.85</td>
</tr>
<tr>
<td>May 2008</td>
<td>42.13</td>
<td>-4.2</td>
</tr>
<tr>
<td>June 2008</td>
<td>42.82</td>
<td>-5.74</td>
</tr>
<tr>
<td>July 2008</td>
<td>42.84</td>
<td>-5.79</td>
</tr>
<tr>
<td>Aug 2008</td>
<td>42.91</td>
<td>-5.95</td>
</tr>
<tr>
<td>Sep 2008</td>
<td>45.56</td>
<td>-11.42</td>
</tr>
<tr>
<td>Oct 2008</td>
<td>48.66</td>
<td>-17.05</td>
</tr>
<tr>
<td>Nov 2008</td>
<td>49.00</td>
<td>-17.64</td>
</tr>
<tr>
<td>Dec 2008</td>
<td>48.63</td>
<td>-17.01</td>
</tr>
</tbody>
</table>

*Source: Monthly Economic Report, Ministry of Finance, Government of India*
4.1.7 STRAIN ON BALANCE OF PAYMENTS:

The shrinking of aggregate in the world market as a consequence of the crisis has hurt the exporting manufacturing industries in the country. The growth rate of export and import also declined to 13.3 percent and 20.7 percent from 29.0 and 35.5 percent respectively during 2007-8 and 2008-09. In 2009-10 the export growth rate was -3.5 percent and import growth rate was -5.0 percent. The balance of payment was $ -109622. (Table 4.2) This shows that India’s exports were adversely affected by the slowdown in global markets. This is already evident in certain industries like the garments industries where there have been significant job losses with the onset of the crisis. This along with a squeeze in the high-income service sectors like financial services, hospitality and tourism etc. led to a reduction in consumption spending and overall demand with the domestic economy. A direct consequence of this was a simultaneous loss of informal employment and lower generation of new non-farm employment in the economy. The depreciation of rupee could not positively affect the exports bill of India. (DGCI&S, Kolkata, India).

Table 4.2
INDIA’S FOREIGN TRADE IN US $ MILLION

<table>
<thead>
<tr>
<th>Year</th>
<th>Export % Growth</th>
<th>Import % Growth</th>
<th>Balance of Trade</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005-06</td>
<td>103091(23.4)</td>
<td>149166(33.8)</td>
<td>-46075</td>
</tr>
<tr>
<td>2006-07</td>
<td>126414(22.6)</td>
<td>185735(24.5)</td>
<td>-59321</td>
</tr>
<tr>
<td>2007-08</td>
<td>162904(29.0)</td>
<td>251439(35.5)</td>
<td>-88535</td>
</tr>
<tr>
<td>2008-09</td>
<td>185295 (13.3)</td>
<td>303696(20.7)</td>
<td>-118401</td>
</tr>
<tr>
<td>2009-10</td>
<td>178751(-3.5)</td>
<td>288373(-5.0)</td>
<td>-109622</td>
</tr>
<tr>
<td>2010-2011*</td>
<td>105064(29.5)</td>
<td>161051(19.0)</td>
<td>-55987</td>
</tr>
</tbody>
</table>

*Data for 2010-11 are provisional
Source: DGCI&S, Kolkata, India
4.1.8 RATE OF INFLATION (WPI) IN INDIA:

Since November 2008, inflation rate has generally shown declining trend in especially of manufactured products. Rate of inflation which had peaked at 12.6 in September 2008 came down to 8.9 percent in the week ending Nov 15, 2008 and further to 8.4 percent at the end of November 2008 and in the end march 2009, inflation rate had fallen to 0.4 percent. It has been seen that the rate of inflation has gone down to 8.98% in the last week of November 2008 from the peak of 12.9 % in first week of August and further sharply declined during successive few weeks.
4.1.9 INCREASE IN UNEMPLOYMENT:

A reliable aggregate estimate to the extent of increase in unemployment is not available from the official statistical system. Recognizing that unemployment is on the rise, the government did make an attempt to estimate the impact of the downturn on employment. The Labor Bureau conducted a sample survey covering eight sectors (mining, textile, metals, automobile, gems & jewelery, construction, transport, information technology/business process outsourcing industry) to reach at an approximation of the job loss. The survey was designed to cover a sample of units employing 10 or more workers, with the sample being drawn from 20 centers in 11 states and union territories. On the basis of this limited sample, the total employment in all the sectors covered by the survey is estimated to have declined from 16.2 million during September 2008 to 15.7 million during December, 2008. The actual decline in employment during this period is likely to have been much higher. (Chandrasekhar, C. P, 2009).

In India, the impact of the crisis has been deeper than what was estimated by our policy makers; although it is less severe than in other emerging market economies. The extent of impact has been restricted due to several reasons such as-

- Indian financial sector, particularly our banks have no direct exposure to tainted assets and its off-balance sheet activities have been limited. The
credit derivatives market is in an embryonic stage and there are restrictions on investments by residents in such products issued abroad.

- India’s growth process has been largely domestic demand driven and its reliance on foreign savings has remained around 1.5 per cent in this period.

- India’s comfortable foreign exchange reserves provide confidence in our ability to manage our balance of payments not withstanding lower export demand and dampened capital flows.

- Headline inflation, as measured by the wholesale price index (WPI), has declined sharply. Consumer price inflation too has begun to moderate.

- Rural demand continues to be robust due to mandated agricultural lending and social safety-net programmes.

- India’s merchandise exports are around 15 per cent of GDP, which is relatively modest.

Despite these mitigating factors, India too has to weather the negative impact of the crisis due to rising two-way trade in goods and services and financial integration with the rest of the world. (Subbarao Duvvuri, 2008).
4.2 **HOW THE GOVERNMENT AND RBI RESPONDED?**

The government of India and RBI responded to the challenge strongly through its fiscal and monetary policies. These are described as follows:

### 4.2.1 MONETARY POLICY MEASURES

Our response to the global financial turmoil has been essentially monetary. The RBI, which for several months before had been increasing cash reserve ratio and interest rates to fight against inflation reversed its monetary policy from October 2008. The RBI took several steps to prevent fast depreciation of Indian rupee due to massive capital outflows by FIIs by selling billions of dollars in the foreign exchange market from its reserves. But for RBI intervention, the value of rupee would have gone much below Rs 52 for a US dollar.

The problem raised by global financial crisis was diagnosed as the lack of liquidity in the money market which adversely affected the flow credit to industries. Therefore, to increase liquidity of the banking system, RBI cut cash reserve ratio four times in October 2008 to January 2009 by 40 basis points from 9% to 5%. Besides RBI reduced SLR from 25% to 24% which enabled banks to get Rs. 20,000 Crore from RBI. With the fusion of this adequate liquidity in the system through various measures, the banks can provide credit to the industries for financing working capital and fixed investment projects.
This was expected to boost industrial growth, which had slackened in the last few months.

Repo rate, at which banks borrow from RBI for a short time and used as a policy signal- was cut five times by 4 percentage point from 9 percent to 5 percent in October 2008. As a result of this, various Indian banks including SBI reduced their prime lending rate (PLR) around 12 to 12.5 percent and were expected to reduce further.

4.2.2 FISCAL POLICY MEASURES

At G-20 Summit held in Washington DC in October 2008, Prime Minister Manmohan Singh emphasized giving a fiscal stimulus to overcome recession and slowdown in economic growth. The fiscal stimulus is in keeping with Keynesian macroeconomics as Keynes emphasized increase in government expenditure to get rid of depression in the nineteen thirties.

(I) FIRST FISCAL STIMULUS PACKAGE

The Indian Government announced the first fiscal stimulus package on December 6, 2008 to stimulate growth, so as to ensure 7 percent growth rate in 2008-09. This fiscal package, involving Rs.30700crores comprises both the increase in Government expenditure and cut in taxes, and was meant to increase both the consumption demand and investment in the economy. This fiscal package was expected to help the growth of infrastructure projects,
growth of exports, textiles, housing, automobiles and small and medium enterprises. We explain below the various items of this fiscal stimulus package:

(a) INCREASE IN FISCAL EXPENDITURE:

The fiscal package provided for the increase in plan expenditure by Rs 30,000 crores in the next four months (December 2008 to March 2009) under plan and non-plan expenditure. This huge government expenditure was expected to lead to the large increase in domestic demand for goods and services; and help in stimulating economic growth.

(b) FINANCING INFRASTRUCTURE DEVELOPMENT:

The first fiscal package provided for allowing Indian Infrastructure Finance Company Limited (IIFCL) to raise Rs 10,000 crore through issue of tax free bonds. IIFCL is a financial institution that gives funds to refinance long-term loans provided by the banks for infrastructure projects relating to highways, power and ports. With this fund-raising, the government hoped to implement the infrastructure projects worth Rs 100,000 crores under public-private partnerships (PPP) schemes. It may be noted that development of infrastructure projects has important linkages through which it could boost demand for steel, cement and other items. It would also provide fresh employment opportunities for lakhs of unemployed.
(c) **4% CUT IN CENTRAL EXCISE DUTY I.E. (CENVAT):**

Instead of adopting a selective approach in the cutting excise duty, 4 percent reduction in CENVAT was made on all commodities on which excise duty is levied. This uniform cut in excise duty was expected to bring about fall in prices of goods which would raise demand for them. This was expected to give a boost to the demand for cars and consumer durable goods. However cut in excise duty would raise demand for goods, if manufacturers would pass on this benefit to buyers of these products by lowering prices. The across- board 4% cut in excise duty was estimated to result in revenue loss Rs 8,700 crores to the government.

(d) **BOOST THE TEXTILES & HOUSING SECTOR:**

 In a bid to boost textile sector, an additional allocation of Rs 1400 was made to clear the entire backlog in the technology upgradation fund scheme that allows the reimbursement to textile companies investing in technological upgradation. Its impact was to make textile firms stung by shrinking export orders to become more competitive in the international market by lowering cost through upgrading their technology.

In a bid to give to the labour intensive housing sector, it was provided that RBI will give Rs 4000 crore to National Housing Board (NHB) to lend to housing finance companies. In addition to the first fiscal
stimulus, public sector banks would have to announce a package of home loans in two categories- upto Rs 5 lakh loans and between 5 lakh to 25 lakh. This was expected to lead to greater demand for housing which has multiplier effect on the economy.

(e) EXPORT PROMOTION:

To counter the slump in exports due to financial crisis, the first fiscal package provided for subsidizing interest costs of exporters. According to this, the government was to bear 2 percentage points of interest on the loans taken by the exporters, subject to minimum rate of 7 percent per annum. It was hoped that lower interest cost of exporters would make the Indian exports more competitive. This was expected to greatly help sectors such as handlooms, textiles, etc. and SMEs. In order to give further boost to the exports, an additional fund of Rs. 1,100 had also been provided to ensure full refund of duties service tax paid on inputs.

(II) THE SECOND FISCAL STIMULUS PACKAGE

The first stimulus package along with monetary measures taken by RBI was expected to revive demand in the economy and thereby to ensure 7% rate of economic growth. Therefore further expansionary fiscal measures were required to ensure 7% growth of the Indian economy in the fiscal year 2008-09. Therefore, on Jan. 2, 2009 the Central Government announced the
second fiscal stimulus package to boost demand and increase income across the real economy. The measures taken under fiscal stimulus package have been described below:

(a) In the second fiscal stimulus package, housing sector and infrastructure received special attention as to raise demand for goods in sectors such as cement and steel and increase consumption demand through greater income and additional employment generation.

(b) Increase in expenditure on infrastructure was sought by providing finance to non-banking finance companies (NBFCs) dealing exclusively with infrastructure finance. For this purpose the public sector company-Indian Infrastructure Finance Company (IIFC) was allowed to borrow 30,000 crore from the market by issuing tax-free bonds that would be used to assist in funding of projects worth Rs. 75000 crore.

(c) State governments whose tax collection had fallen due to slowdown in the economy were allowed to borrow in 2008-09 an additional 0.5 % of their State Gross Domestic Product from the market through issue of bonds. This was expected to increase expenditure, which would help in boosting demand. Besides an extra line of credit to non banking financial companies for purchase of Commercial Vehicles and assistance by it, for purchase of houses for urban transport system remain under Governmental Urban Renewal Scheme.
(d) In order to ensure that Indian Corporate sector get cheaper funds from abroad in the second stimulus package, the government increased the limit on investment by foreign institutional investors (FIIs) in rupee denominated corporate bonds, issued by the Indian companies.

(e) The government also permitted real estate companies to utilize ECB funding for development of integrated townships. These ECB option will help the Indian Corporate Companies to fund their activities. It was hoped that the above measures would result in additional supply of Rs 56000 crore.

(f) THIRD FISCAL STIMULUS PACKAGE

A week after presenting interim budget for 2009-10, the Central Government announced on January 24, 2009 the third fiscal stimulus package. In this package, the government sought to boost demand by cutting general excise duty, service tax and custom duty. This was estimated to cost the exchequer Rs 29,100 crores. The measures announced in this fiscal stimulus were:

(a) Central excise duty was slashed by 2% from 10 % to 8%. Along with this, the earlier 4% cut in central excise duty announced in December 2008 was extended beyond March 31, 2009. If this cut in excise duty was actually passed on to the customers by manufacturers, this would
lead to the reduction in prices and therefore stimulate demand for goods.

(b) As a further measure to boost demand, service tax was also cut across the board by 2 % point from 12% to 10%.

(c) To provide relief to the power sector, Naptha imported for generation of electricity was fully exempted from basic custom duties beyond March 2009.

4.3 KEY DIFFERENCES IN POLICY RESPONSE: INDIA VIS-À-VIS THE ADVANCED ECONOMIES

- In the process of liquidity injection, the counter-parties were banks unlike non-banks in case of advanced economies. Even liquidity measures for mutual funds, NBFCs and housing finance companies were largely channelled through the banks.

- There was no compromise on collateral standards for injecting liquidity. Unlike the mortgage securities and commercial papers in the advanced economies, the range of collaterals was not expanded beyond government securities.
• Despite large liquidity injection, the Reserve Bank’s balance sheet did not show unusual increase because of release of earlier sterilised liquidity.

• Availability and flexible use of multiple instruments facilitated better sequencing of monetary and liquidity measures.

• The use of pro-cyclical provisioning norms and counter-cyclical regulations ahead of the global crisis helped safeguard financial stability.

• Fiscal stimulus was geared to address deficiency in aggregate demand rather than supporting the financial sector as was the case in advanced economies.

4.4 INDIA BACK TO HIGH GROWTH

During the financial crisis, India was less affected than others solely on the back of the rural sector and due to the domestic demands, strict banking rules and the mindset of the people. The banking system in India is so regulated and it did not blindly follow the USA. So we did not face any problems with mortgage issues as USA. Thanks to the IT and other sectors who have started exploring the European countries and are less dependent to USA.
India’s economic performance in 2009-10 shows that the recovery from the slowdown during the global financial crisis is well underway. Now in 2010-11, GDP growth rate is 8.6 percent on the basis of a resurgent industrial sector. In particular, agricultural sector growth was better than feared with slightly positive growth rate despite the worst monsoon shortfall in three decades. On the demand side, much higher investments replaced government stimulus. Food inflation, declined. Global commodity prices have rebounded after the financial crisis but price pressures are remained under control. *Chart 4.5* shows that in 2009-10, the foreign exchange reserves increased. The trade and external sector of the country also witnessed heightened momentum due to the growth in exports, increase in capital inflows and addition in the foreign exchange reserves. The UNCTAD World Investment Report (WIR) 2010, in its analysis of the global trends and sustained growth of Foreign Direct Investment (FDI) inflows, has also reported that India today rated as one of the most attractive destinations across the globe and is to be the second most attractive location for FDI for 2010-2012.
REFERENCES


2. Central Statistical Organization, Government of India


8. SEBI Bulletin June 2010, Vol. 8, Number-06