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IMPACT OF THE GLOBAL FINANCIAL CRISIS ON INDIAN ECONOMY

Seyed Saadat Masoumi[1] **and Shivaji Borhade**[2]

[1]Research Scholar, Department of Commerce , BharatiVidyaPeeth University, YashwantraoMohite College, Pune.
[2]Associate Professor,Department of Commerce , BharatiVidyaPeeth University, YashwantraoMohite College, Pune.

Abstract:-The global financial crisis, brewing for a while, really started to show its effects in the middle of 2007 and into 2008. Around the world stock markets have fallen, large financial institutions have collapsed or been bought out, and governments in even the wealthiest nations have had to come up with rescue packages to bail out their financial systems.This paper analyses the impact of the global financial crisis on Indian economy. The study argues the recession and the crisis in the world economy and effect of the crisis on the developing countries.So economy would not be safe from negative and destructive.However, this crisis contains opportunities for Indian's economic potential, but it has threats to gradually bring the economy to a record.

Keywords: Financial crisis, recession, opportunities, threats.

INTRODUCTION

Financial crisis is a situation in which the supply of money is outpaced by the demand for money. This means that liquidity is quickly evaporated because available money is withdrawn from banks, forcing banks either to sell other investment to make up the shortfall or to collapse. A financial crisis is manifested in a chronic budget deficit, which causes inflation and impairs state credit and the tax system. Such crisis is the inevitable result of the growth of militarism and the unceasing arms race. The chronic budget deficit is also related to the expenditures of the state budget for regulating the capitalist business cycle.The financial crisis started in the United States in 2007 and involved financial institutions in many OECD countries. It was only when the crisis turned into a global economic recession that developing and emerging-market economies were affected, mainly through the trade channel, and in some cases through workers' falling remittances. In many developing countries, the economic consequences of these indirect effects were as severe as the direct effects were on developed countries (Dullien, et al, 2010).

In 2007 and 2008, the world experienced a remarkable Global Financial Crisis (GFC) that started in the U.S.A. and quickly spread to affect the global economy (Foster and Magdoff, 2009). Several factors were perceived as drivers of this crisis (Goodhart, 2008), however its dynamic and long-term consequences, in particular its impact on natural resources, remain largely unknown. The GFC is known to have affected developing countries through a decrease in commodities demand, reduced exports and investments, and unstable economic scenarios (World Bank, 2009). Importantly, economic downturns and environmental degradation have been shown to be consequential (Nilsson, 2009).

LITERATURE REVIEW:

Walia (2012) planned a study on impact of global economic crisis on Indian economy: An analysis. This paper aimed to analyze the impact of the global economy on Indian economy which is one of the fast growing economies of the world. To analyze the impact of global slowdown for the Indian economy, a comparative analysis was made between the growth rates of sectoral GDP during pre-meltdown and meltdown years. The paper confirmed that various sectors of Indian economy are affected by global recession, to a certain extent.

Long, Li,et al (2012)conducted a study on impact of US financial crisis on different countries: based on the method of functional analysis of variance. This paper made a comparative analysis on the economic development process and the degrees crisis-affected in financial crisis of five categories countries. In this paper, the method of

Functional Analysis of Variance (FANOVA) was applied to make a comparative study on the economic development process of different types of countries, including the differences on the economic growth rate, the time of the economic recession, the extent of the recession and the recovery situation of the economy. Moreover, the paper performs a dynamic test on the significance of the difference on the economic growth rate during the whole stage.

Dornean, et al (2012) undertook a study on the impact of the recent global crisis on foreign direct investment. Evidence has been taken from central and eastern European countries. This paper aimed to analyze the relationship between the financial crisis and FDI in CEE Countries for Central and Eastern European countries (EU members). The crisis had a major impact on capital flows to the region, although the magnitude of the impact differed notably, depending on the type of capital inflows and the receiving country. In order to highlight this, the paper used a regression model and panel data methodology, trying to find if there is some difference between the analyzed countries. The results showed that the financial crisis affects directly the level of FDI.

Capraru and Ihnatov (2012) studied the interest rate transmission and exchange rate arrangements in the Central and Eastern European countries: evidence from the current international financial crises. The purpose of this study was to analyze which are the consequences of the euro interest rate movements over the interest rates in 16 CEE selected countries' money markets outside euro zone during the current international financial crises period, in a framework of different exchange rate regimes. The study adopted a methodology derived from the one used by Frankel et al. (2004). It was found that the sample countries do not develop an independent monetary policy in relation with ECB on the long run. Also, there were significant differences between the official declared exchange rate regimes and the real behavior of the monetary authority, especially those with pure floating exchange rate regimes.

OBJECTIVE OF STUDY:

To investigate the effect of the global financial crisis on Indian economy

FINANCIAL CRISIS IN INDIA:

India looked to be relatively insulated from the global financial crisis which started in August 2007 when the 'sub-prime mortgage' crisis first surfaced in the US. In fact the RBI was raising interest rates until July 2008 with the view to cooling the growth rate and contains inflationary pressures. But as the financial crisis, morphed in to a global economic downturn with the collapse of Lehman Brothers on 23 September 2008, the impact on the Indian economy was almost immediate. Credit flows suddenly dried-up and, overnight, money market interest rate spiked to above 20 percent and remained high for the next month. It is, perhaps, judicious to assume that the impacts of the global economic downturn, the first in the center of global capitalism since the Great Depression, on the Indian economy are still unfolding.

Experience of recent financial crisis shows that with increased openness of Indian economy the 'decoupling theory' does not hold. Global crisis spilled over in India through financial as well as real channels. Because of negligible exposure of Indian banks to distressed assets, India was not directly affected by the financial crisis, but the indirect effects through trade and capital flows were severe. After record inflow of capital, sudden reversal in trends affected Indian economy through various channels, stock market heavily dependent on FII investments crashed, Indian companies found it difficult to raise money in international market, Rupee depreciated by 23 percent in just 11 months and to contain deprecation RBI increased dollar liquidity leading to reduction in its foreign exchange reserve. Similarly recession in the world economy hampered the growth of exports. Detailed analysis of effects of the crisis on the Indian economy is following. (Arora&Rathinam and Khan, 2010).

Drop in Foreign Institutional Investment

Data compiled by Securities and Exchange Board of India (SEBI) shows that after receiving record $ 45.07 billion between 2004 and 2007, Indian economy witnessed reversal in FII equity flows in 2008 with an outflow of $12.03 billion because of global financial crisis. Global investors hit by financial sector meltdown started selling their holdings in Indian companies in order to ease liquidity conditions given huge losses in home markets and to look for safer investment in an uncertain environment.

Reaction of India's Stock Exchange

Being dominant player in free float portion of listed companies, trading behavior of Foreign Institutional Investors (FIIs) is bound to impact the Indian share market. Cumulative investment of $67.12 billion till December by FIIs in equity market played a crucial role in astonishing rise (from3000 in 2003 to 21000 in 2007) of Sensex. However, with the emergence of crisis in US market FIIs started divesting their shares holding in order to ease liquidity problem. Reversal in FII flows led to a steep fall in BSE index in 2008. Beginning from January, 8, 2008 in

just 26 trading days BSE dropped by 23.43 percent (from 20873 on 8-Jan-08 to16608 on 12-Feb-08) because of huge withdrawal of FIIs. Biggest single day fall of 1408 pts was recorded in this period. Between March 2008 and August 2008 Sensex fluctuated around 15000 points.

Drop in External Commercial Borrowings

Financial sector reform since 1991, on the one hand has resulted in downfall of Developmental Financial Institutions (DFIs) and on the other hand led to massive borrowings from external sector by corporate houses in the form of External Commercial Borrowings (ECBs). Between 2003-04 and 2007-08 net medium term and long term commercial borrowings by Indian Companies $41 billion.However, twin effect of financial crisis led to considerable fall of $18 billion (from $22.7 billion in 2007-08 to $6.93 billion in 2008-09) in borrowings. First, recession which followed the financial crisis reduced the demand for goods and services, with pessimistic outlook all-around, companies deferred their investment plans. Second, facing liquidity problem after the collapse of Lehman Brothers, financial sector was reluctant to lend and lending rates touched record high. In fact in many cases lending rates were above the limit prescribed by the Reserve Bank of India (RBI). Concerned about the falling ECBs, RBI liberalized its policies by expanding the list of eligible borrowers, easing all-in-cost ceilings and relaxations in end-use-stipulations etc.

Exchange Rate Appreciation and decline in Foreign Exchange Reserve

After the financial globalization India has been grappling with the problem of foreign exchange management. The problem that policy makers have been facing is that movements in exchange rate is influenced more by capital inflow or outflow than with the fundamentals in real sectors. Financial crisis and subsequent reversal in capital flows led to substantial downward pressure on Rupee. In this period rate of dollar in terms of rupee increased from Rs. 40 to Rs. 52, a depreciation of 23 per cent. However, impact of the falling rupee may not have been as severe on the economy as magnitude of fall suggests, because of appreciation of dollar vis-a-vis other currencies in same period.

Export Growth

India's export registered more than 20 percent growth for 6 consecutive years since 2002-03, however the financial crisis and subsequent recession in the world economy decelerated the export growth to 3.4 percent in 2008-09. Major commodities that experienced negative growth in first quarter of 2009-10 include iron ore (45 percent), gems &jewellery (45.2 percent), iron & steel (65.7 percent), machinery & instruments (30.1 percent) basic chemicals, pharmaceuticals & cosmetics (21.1 percent) and petroleum products (46.5 percent).

CONCLUSION:

In this paper, we argue that, the negative and destructive effects of the financial crisis and recession in the global economy would be spared harmful effects and the financial crisis has reduced the competitiveness of domestic products, the ability to create wealth and reduce the national economy. This study showed India was not directly affected by the financial crisis, but the indirect effects through trade and capital flows were severe.

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Seyed Saadat Masoumi
Research Scholar, Department of Commerce , BharatiVidyaPeeth University, YashwantraoMohite College, Pune.

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