

Impact of the Banking Crisis on Indian Economic Sectors

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Abstract: India's monetary quarter isn't always deeply included with the worldwide monetary system, which spared it the primary spherical unfavorable outcomes of the worldwide monetary disaster and left Indian banks in general unaffected. However, because the monetary disaster morphed in to a full-blown worldwide monetary downturn, India couldn't break out the second one spherical outcome. The worldwide disaster has affected India via 3 wonderful channels: monetary markets, change flows, and change rates. The reversal in capital inflows, which created a credit score crunch in home markets at the side of a excessive deterioration in export demand, contributed to the decline of gross home product with the aid of using extra than 2 percent factors with inside the financial 12 months 2008–2009. In line with efforts taken with the aid of using governments and relevant banks all around the world, the Government and the Reserve Bank of India took competitive countercyclical measures, sharply enjoyable economic coverage and introducing a financial stimulus to reinforce home demand. However, this paper argues that with very restricted financial maneuver ability and the restricted traction of economic coverage, coverage measures to repair the Indian gross home product increase returned to its capability price of 8–9% should cognizance on addressing the structural constraints which can be protecting down personal funding demand.

Keywords: India, financial, economic, product, monetary.

I. INTRODUCTION

The Indian economy seemed relatively insulated from the global financial crisis that began in August 2007 when the subprime mortgage crisis first erupted in the United States. In fact, the Reserve Bank of India (RBI) raised interest rates until August 2008 with the express objective of cooling the economy and slowing the gross domestic product (GDP) growth rate, which was clearly above potential output growth.¹ However, when the US financial crisis turned into a global economic downturn with the collapse of Lehman Brothers on September 23, 2008, the impact on the Indian economy was felt almost immediately. External credit flows suddenly dried up, and overnight money market rates rose to over 20% and remained elevated for a month thereafter. It is reasonable to assume that the impact of the global economic downturn on the Indian economy is still ongoing. In this backdrop, this paper analyses the impact of the global financial crisis on the Indian economy and suggests policy measures to get the economy back on track. This paper is broadly divided into six sections. After summarizing the severity of the current crisis in section 2, section 3 deals with the impact of the crisis on the Indian economy. Section 4 discusses the monetary and fiscal policy responses to the crisis and section 5 provides a critical appraisal of the policy response. The final section recommends some policy measures required to reverse the economic downturn.

Severity of the Current Financial Crisis

Banking and economic crises were a ordinary function of cutting-edge financial history. According to at least one estimate, there were 86 banking crises because the Great Depression which have unfold past countrywide borders. According to a World Bank observe in 2001,² the global has witnessed as many as 112 systemic banking crises from the past due Seventies to early 2001. Most crises, consisting of the cutting-edge one, proportion a few not unusual place



features. Some well known examples consist of a look for an increasing number of better yields in economic markets, a lax regulatory regime, a mismatch in urge for food for danger and the capability for bearing it, and the ensuing increase of asset bubbles, commonly with inside the actual property quarter, which for diverse motives is not noted through the regulators. The current economic quarter disaster stocks most, if now no longer all, of those features. However, what makes the cutting-edge disaster great is that it emerged on the very epicenter of world capitalism, the US, and its contagion unfold right away to the whole worldwide economy, not like preceding crises that had been commonly restrained to a area or a small quantity of nations. Economies like India and the People's Republic of China (PRC), wherein the economic sectors

had been now no longer as included with the worldwide economic system, had been spared the primary spherical unfavorable consequences of the cutting-edge disaster and their banks had been left commonly unaffected. However, those large economies and their Asian friends couldn't get away the 2nd spherical consequences that significantly impacted their exchange flows because of the fall apart of output and exchange in superior economies. The severity of the cutting-edge disaster may be gauged through the steep decline with inside the fairness markets of superior economies. The bursting of the sub-high housing bubble precipitated Wall Street to lose a magnificent US\$eight trillion in marketplace capitalization in a completely brief time (Brunnermeyer 2009). Interestingly, the loss in marketplace capitalization and crash in fairness expenses has been notably better in outer edge economies compared to US markets. The economic disaster quickly morphed in to a full-fledged worldwide financial downturn as credit markets froze, mixture call for in all superior economies fell, and commodity expenses crashed, forcing exporters to shelve expenditure and lay off employees in massive numbers. Consequently, business manufacturing collapsed worldwide. In the closing sector of the calendar yr 2008, superior economies and massive economies like India and the PRC witnessed a contraction of their business manufacturing. In a number of the foremost export-orientated nations like Japan, Germany, and Brazil, business output shriveled greater than 10% for the duration of the 0.33 and fourth quarters of monetary yr (FY) 2008. The decline in business output made hard work retrenchment and surging unemployment nearly inevitable. According to the International Labour Organization's (2009) Global Employment Trends Report greater than 50 million human beings are predicted to lose their jobs because of the disaster.

Essentially, the current crisis is truly global in nature and may be described as the worst crisis since the Great Depression. Fortunately, in contrast to the experience during the Great Depression, the severity of the crisis was recognized early and, more importantly, governments in both developed and emerging countries have coordinated their policy responses. Governments around the world have announced various stimulus packages and central banks have injected huge amounts of liquidity into the system. Some countries, such as South Africa and China, have announced large stimulus packages equivalent to about 24.0% and 8% of their respective GDPs⁴. In absolute terms, the United States announced bailout and stimulus packages worth \$8.1 trillion. Adding these together, the total amount of stimulus packages from the nine selected countries amounts to about \$10 trillion, which is equivalent to about 20% of the world's GDP, as shown in Table 3. Given these efforts, it is expected that the world economy will recover quickly and the recession will not last as long as the 1929 recession.

Impact of the Crisis on the Indian Economy

In response to the balance of payments crisis in the early 1990s, India implemented a series of trade, industrial and investment reforms. These reforms effectively liberalized the economy, ending a long period of relative isolation from global markets and financial and technological flows. Since then, the Indian economy has become increasingly integrated into the global economy.⁶ As a result, the current account (inflows and outflows of goods and intangible goods) as a share of GDP increased from 20 percent in fiscal year 1990-91 to 53 percent in fiscal year 2007-08 (Figure 2). However, the most significant change has been seen in the capital account. With procedures and conditions for foreign investment streamlined, India has emerged as an attractive investment destination. This is reflected in the increase in foreign portfolio investment from \$2 billion in 2001-02 to \$29 billion in 2007-08. Foreign direct investment (FDI) has also increased significantly in recent years, from \$6.1 billion in 2001-02 to \$34.3 billion in 2007-08. At the



same time, Indian companies have also entered the global mergers and acquisitions market, resulting in capital outflows from India. As a result, bilateral portfolio and foreign direct capital flows have increased five-fold, from just 12 percent of GDP in 1990-91 to 64 percent of GDP in 2007-08. Interestingly, these ratios are significantly higher than in the United States, where trade in goods and services was only 41% of GDP in 2007, and capital flows were an even smaller 25% in the same year.

Contagion of the Crisis to the Indian Economy

Given India's closer linkage with the global economy, we cannot expect India to remain immune to the global crisis or to be isolated from it. While it is true that the Indian banking sector has been largely unaffected due to its very limited operations outside India or exposure to subprime mortgages from foreign investment banks, the global crisis has impacted India through three different channels. These channels are financial markets, trade flows, and exchange rates. The financial sector includes the banking sector, the stock market, corporate investments, FDI, and external commercial credit (ECB) which facilitates remittances. The global crisis has impacted these different subsectors of the financial sector differently. Thanks to wise regulation and proactive regulators⁷, the Indian banking sector was more or less unaffected by the global crisis, at least directly. RBI imposition of higher provisioning requirements on commercial bank lending to the real estate sector helped contain the growth of the real estate price bubble. This is one of the few examples globally of counter-cyclical capital reserve requirements by a central bank. In general, Indian banks do not have excessive exposure to subprime mortgages. Only one of the large private banks, ICICI Bank, was partially affected, but managed to avert the crisis due to its strong balance sheet and timely government action that virtually guaranteed its deposits. The overall banking sector balance sheet is healthy at 4,444. In fact, Indian banks reported encouraging performance in the third quarter of fiscal 2008, which was a nightmare for many large financial institutions across the globe. In contrast to the absolute decline in profitability of non-financial 4,444 companies, the banking sector recorded a 43% increase in profitability (Figure 3). The ban on complex structures such as synthetic securitizations, coupled with strict monitoring of appropriate lending standards by the RBI, ensured an improvement in the quality of bank assets. The proportion of non-performing assets to total loans remained well within prudential norms (Figure 4). Moreover, with an average risk-weighted capital-to-asset ratio (CRAR) of 13%, Indian banks are well capitalized and well positioned to weather an economic downturn.

However, the indirect impact of the crisis has hit Indian banks hard. The liquidity crunch in global markets following the collapse of Lehman Brothers forced Indian banks and corporates to shift their loan demand from external to the domestic banking sector. This move significantly squeezed domestic market liquidity, resulting in an abnormal increase in short-term lending rates. The overnight interbank rate rose to 20% in October 2008 and remained high for a month thereafter (Figure 5). This credit crunch, combined with the loss of confidence following the Lehman Brothers incident, increased risk aversion among Indian banks, ultimately damaging credit growth in the domestic market. Bucking this trend, credit expansion in the non-food sector started declining in November 2008 and was negative in January 2009 (Figure 6). The magnitude of the impact of the crisis can be seen from the fact that credit expansion in the non-food sector declined by more than 68% in the last five months of the fiscal year 2008-2009 compared to the same period of the previous fiscal year.

II. CONCLUSION

Other areas that require policy attention and would help address some of the remaining structural bottlenecks in boosting potential GDP growth include removing entry barriers for business investment in education and vocational training, improving the delivery of public goods and services, and expanding physical infrastructure. This includes a major effort to improve connectivity in rural areas. These measures represent a second generation of structural reforms and would enable the Indian economy to exit the downturn in the growth cycle and subsequently extend the upturn longer than in the previous cycle. Two other areas that require attention and have been heavily debated are urgent improvements in physical infrastructure and the provision of public services, particularly urban utilities and public



safety. Adhering to these reforms would be much more effective and would have a more lasting positive impact in boosting India's potential growth. This is essential if India is to achieve its goals of poverty reduction and rapid and sustainable growth, and improve the overall level of welfare of its people.

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