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Global Financial Crisis and Its Impact on India

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ABSTRACT The global financial crisis originated in United States of America. During booming years when interest rates were low and there was great demand for houses, banks advanced housing loans to people with low credit worthiness on the assumption that housing prices would continue to rise. Later, the financial institutions repackaged these debts into financial instruments called Collateralized Debt Obligations and sold them to investors world-wide. In this way the risk was passed on multifold through derivatives trade. Surplus inventory of houses and the subsequent rise in interest rates led to the decline of housing prices in the year 2006-07 which resulted in unaffordable mortgage payments and many people defaulted or undertook foreclosure. The house prices crashed and the mortgage crisis affected many banks, mortgage companies and investment firms world-wide that had invested heavily in sub-prime mortgages. Different views on the reasons of the crisis include boom in the housing market, speculation, high-risk mortgage loans and lending practices, securitization practices, inaccurate credit ratings and poor regulation of the financial institutions. The financial crisis has not only affected United States of America, but also European Union, U.K and Asia. The Indian Economy too has felt the impact of the crisis to some extent. Though it is difficult to quantify the impact of the crisis on India, it is felt that certain sectors of the economy would be affected by the spill-over effects of the financial crisis.

INTRODUCTION

The current global financial crisis is rooted in the subprime crisis which surfaced over a year ago in the United States of America. During the boom years, mortgage brokers attracted by the big commissions, encouraged buyers with poor credit to accept housing mortgages with little or no down payment and without credit checks. A combination of low interest rates and large inflow of foreign funds during the booming years helped the banks to create easy credit conditions for many years. Banks lent money on the assumption that housing prices would continue to rise. Also the real estate bubble encouraged the demand for houses as financial assets. Banks and financial institutions later repackaged these debts with other high-risk debts and sold them to world- wide investors creating financial instruments called CDOs or Collateralized Debt Obligations (Sadhu 2008). In this way risk was passed on multifold through derivatives trade.

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Surplus inventory of houses and increase in interest rates led to a decline in housing prices in 2006-2007 resulting in an increased defaults and foreclosure activity that collapsed the housing market (Sengupta 2008). Consequently, a large number of properties were up for sale affecting mortgage companies, investment firms and government sponsored enterprises which had invested heavily in sub prime mortgages.

Since the collateral debt instruments had been globally distributed, many banks and other financial institutions around the world were affected. Major Banks and other financial institutions around the world have reported losses of approximately US $ 435 billion as on 17th July, 2008 (Onaran 2008). Thus with the failure of a few leading institutions in United States, the entire financial system in the world has been affected.

METHODOLOGY

The present study focuses on

- The origin and causes of global financial crisis and
- The impact of the crisis on the Indian economy.

The data for the study has been collected from secondary sources.

RESULTS AND DISCUSSION

Reasons for Financial Crisis

The first hint of the trouble came from the collapse of two Bear Stearns hedge funds early 2007. Subsequently a number of other banks and financial institutions also began to show signs of distress. Matters really came to the fore with the bankruptcy of Lehman Brothers, a big investment bank, in September 2008.

The reasons for the crisis are varied and complex. Some of them include boom in the housing market, speculation, high-risk mortgage loans and lending practices, securitization practices, inaccurate credit ratings and poor regulation.

1. Boom in the Housing Market: Subprime borrowing was a major contributor to an increase in house ownership rates and the demand for housing. This demand helped fuel housing price increase and consumer spending. Some house owners used the increased property value experienced in housing bubble to re-finance their homes with lower interest rates and take second mortgages against the added value to use the funds for consumer spending. Increase in house purchases during the boom period eventually led to surplus inventory of houses, causing house prices to decline, beginning in the summer of 2006. Easy credit, combined with the assumption that housing prices would continue to appreciate, had encouraged many subprime borrowers to obtain adjustable-rate mortgages which they could not afford after the initial incentive period. Once housing prices started depreciating moderately in many parts of the U.S, re-financing became more difficult. Some house owners were unable to re-finance their loans reset to higher interest rates and payment amounts. Excess supply of houses placed significant downward pressure on prices. As prices declined, more house owners were at risk of default and foreclosure.

2. Speculation: Speculation in real estate was a contributing factor. During 2006, 22 per cent of houses purchased (1.65 million units) were for investment purposes with an additional 14 per cent (1.07 million units) purchased as vacation homes. In other words, nearly 40 per cent of house purchases were not primary residences. Speculators left the market in 2006, which caused investment sales to fall much faster than the primary market.

3. High- Risk Mortgage Loans and Lending Practices: A variety of factors caused lenders to offer higher-risk loans to higher-risk borrowers. The risk premium required by lenders to offer a subprime loan declined. In addition to considering high-risk borrowers, lenders have offered increasingly high-risk loan options and incentives. These high-risk loans included “No Income, No Job and No Assets loans.” It is criticized that mortgage underwriting practices including automated loan approvals were not subjected to appropriate review and documentation.

4. Securitization Practices: Securitization of housing loans for people with poor credit- not the loans themselves-is also a reason behind the current global credit crisis. Securitization is a structured finance process in which assets, receivables or financial instruments are acquired, pooled together as collateral for the third party investments (Investment Banks). Due to securitization, investor appetite for mortgage-backed securities (MBS), and the tendency of rating agencies to assign investment-grade ratings to MBS, loans with a high risk of default could be originated, packaged and the risk readily transferred to others.

5. Inaccurate Credit Ratings: Credit rating process was faulty. High ratings given by credit rating agencies encouraged the flow of investor funds into mortgage-backed securities helping finance the housing boom. Risk rating agencies were unable to give proper ratings to complex instruments (Gregorio 2008). Several products and financial institutions, including hedge funds, and rating agencies are largely if not completely unregulated.

6. Poor Regulation: The problem has occurred during an extremely accelerated process of financial innovation in market segments that were poorly or ambiguously regulated – mainly in the U.S. The fall of the financial institutions is a reflection of the lax internal controls and the ineffectiveness of regulatory oversight in the context of a large volume of non-transparent assets. It is indeed amazing that there were simply no checks and balances in the financial system to prevent such a crisis and “not one of the so-called pundits” in the field has sounded a word of caution. There are doubts whether the operations of derivatives markets have been as transparent as they should have been or if they have been manipulated.

Impact on India

Due to globalization, the Indian economy cannot be insulated from the present financial crisis in the developed economies. The development in the U.S financial sector has affected not only America but also European Union, U.K and Asia. The Indian economy too has felt the impact of the crisis though not to the same extent. It is premature to try to quantify the consequences of the crisis on the Indian economy. However the impact will be multi-fold.

1. Information Technology: With the global financial system getting trapped in the quicksand, there is uncertainty across the Indian Software industry. The U.S. banks have huge running relations with Indian Software Companies. A rough estimate suggests that at least a minimum of 30,000 Indian jobs could be impacted immediately in the wake of happenings in the U.S. financial system.

Approximately 61 per cent of the Indian IT Sector revenues are from U.S financial corporations like Goldman Sachs, Washington Mutual, Citigroup, Bank of America, Morgan Stanley and Lehman Brothers. The top five Indian players account for 46 per cent of the IT industry revenues. The revenue contribution from U.S clients is approximately 58 per cent. About 30 per cent of the industry revenues are estimated to be from financial services (Atreya 2008). The software companies may face hard days ahead.

2. Exchange Rate: Exchange rate volatility in India has increased in the year 2008-09 compared to previous years. Massive selling by Foreign Institutional Investors and conversion of their holdings from rupees to dollars for repatriation has resulted in the rupee depreciating sharply against the dollar. Between January 1 and October 16, 2008, the Reserve Bank of India (RBI) reference rate for the rupee fell by nearly 25 per cent, from Rs.39.20 per dollar to Rs.48.86 (Chandrasekhar and Gosh 2008). This depreciation may be good for India's exports that are adversely affected by the slowdown in global markets but it is not so good for those who have accumulated foreign exchange payment commitments.

3. Foreign Exchange Outflow: After the macro-economic reforms in 1991, the Indian economy has been increasingly integrated with the global economy. The financial institutions in India are exposed to the world financial market. Foreign institutional investment (FII) is largely open to India's equity, debt markets and market for mutual funds. The most immediate effect of the crisis has been an outflow of foreign institutional investment from the equity market. There is a serious concern about the likely impact on the economy because of the heavy foreign exchange outflows in the wake of sustained selling by Foreign Institutional Investors in the stock markets and withdrawal of funds by others. The crisis resulted in net outflow of $ 10.1billion from the equity and debt markets in India till 22nd Oct, 2008 (Kundu 2008). There is even the prospect of emergence of deficit in the balance of payments in the near future.

4. Investment: The tumbling economy in the U.S is going to dampen the investment flow. It is expected that the capital inflows into the country will dry up. Investments in mega projects, which are under implementation and in the pipeline, are bound to buy more time before injecting funds into infrastructure and other ventures. The buoyancy in the economy is absent in all the sectors. Investment in tourism, hospitality and healthcare has slowed down. Fresh investment flows into India is in doubt.

5. Real Estate: One of the casualties of the crisis is the real estate. The crisis will hit the Indian real estate sector hard (Sinha 2008). The realty sector is witnessing a sudden slump in demand because of the global economic slowdown. The recession has forced the real estate players to curtail their expansion plans. Many on-going real estate projects are suffering due to lack of capital, both from buyers and bankers. Some realtors have already defaulted on delivery dates and commitments. The steel producers have decided to resort to production cuts following a decline in demand for the commodity.

6. Stock Market: The financial turmoil affected the stock markets even in India. The combination of a rapid sell off by financial institutions and the prospect of economic slowdown have pulled down the stocks and commodities market. Foreign institutional investors pulled out close to $ 11 billion from India, dragging the capital market down with it (Lakshman 2008). Stock prices have fallen by 60 per cent. India's stock market index—Sensex—touched above 21,000 mark in the month of January,2008 and has plunged below 10,000 during October 2008 (Kundu 2008).The movement of Sensex shows a positive and significant relation with Foreign Institutional Investment flows into the market. This also has an effect on the Primary Market. In 2007-08, the net Foreign Institutional Investment inflows into India amounted to $20.3 billion. As compared to this, they pulled out $11.1 billion during the first nine-and-a-half months of the calendar year 2008, of which $8.3 billion occurred over the first six-and-a-half months of the financial year 2008-09 (April 1 to October 16).

7. Exports: The crisis will sharply contract the demand for exports adversely affecting the country's growth prospects. It will have an impact on merchandise exports and service exports. The decline in export growth may sharply affect some segments of the Indian Economy that are export-oriented. The slowdown in the world economy has affected the garment industry. The orders for factories which are dependent on exports, mainly to the U.S have come down following deferred buying by big apparel brands. Rising unemployment and reduced spending by the Americans have forced some of the leading brands in the U.S to close down their outlets, which in turn has affected the apparel industry here in India. The U.S accounts for 55 per cent of all global apparel imports (Bageshree and Srivatsa 2008). The global recession will undermine other major export sectors of the Indian economy like sea foods, gems and jewellery.

8. Increase in Unemployment: One danger is of a dip in the employment market. The global financial crisis could increase unemployment. Layoffs and wage cuts are certain to take place in many companies where young employees are working in Business Process Outsourcing and Information Technology sectors (Ratnayake 2008). With job losses, the gap between the rich and the poor will be widened. It is estimated that there would be downsizing in many other fields as companies cut costs. The International Labor Organization predicted that millions of jobs will be lost by the end of 2009 due to the crisis - mostly in "construction, real estate, financial services, and the auto sector." The Global Wage Report 2008-09 of International Labour Organization warns that tensions are likely to intensify over the issue of wages. There would also be a significant drop in new hiring (The Hindu 2008) All these will change the complexion of the job market.

***9. Banks**:* The ongoing crisis will have an adverse impact on some of the Indian banks. Some of the Indian banks have invested in derivatives which might have exposure to investment bankers in U.S.A. However, Indian banks in general, have very little exposure to the asset markets of the developed world. Effectively speaking, the Indian banks and financial institutions have not experienced the kind of losses and write-downs that banks and financial institutions in the Western world have faced (Venkitaramanan 2008). Indian banks have very few branches abroad. Our Indian banks are slightly better protected from the financial meltdown, largely because of the greater role of the nationalized banks even today and other controls on domestic finance. Strict regulation and conservative policies adopted by the Reserve Bank of India have ensured that banks in India are relatively insulated from the travails of their western counterparts (Kundu 2008).

CONCLUSION

While the developed world, including the U.S, the Euro Zone and Japan, have plunged into recession, the Indian Economy is being affected by the spill-over effects of the global financial crisis (Chidambaram 2008). Great savings habit among people, strong fundamentals, strong conservative and regulatory regime have saved Indian economy from going out of gear, though significant parts of the economy have slowed down and there is a wide variance of opinion about how long it will continue. It is expected that growth will be moderate in India.

The most important lesson that we must learn from the crisis is that we must be self-reliant. Though World Trade Organization (WTO) propagates free trade, we must adopt protectionist measures in certain sectors of the economy so that recession in any part of the globe does not affect our country.

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