



India and the Global Financial Crisis: Impact and Responses

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Introduction

As the United States' subprime crisis morphed into a full-blown financial and economic crisis of historical proportions in the United States and much of the Western world, it was only a matter of time before the export-dependent emerging market economies such as Singapore and Malaysia were adversely impacted. Larger economies such as China, which also depended heavily on export growth to fuel economic growth, were also expected to be hit. However, most observers anticipated that India would remain insulated from this crisis. The bases for this belief were that (a) India's growth story was predominantly driven by domestic demand rather than external demand; and (b) the Indian financial system was fairly well-managed and capitalised with limited exposure to the 'toxic' assets and securities in the United States. To be sure, while it was anticipated that there would be a slight slow-

down in remittance inflows as well as exports, overall growth in India was expected to remain robust, if not as buoyant as the past few years, driven largely by domestic demand. However, grossly insufficient attention was paid to the impact on India via the international capital markets.

Financial Market Spillovers to India

The initial shock that the Indian markets witnessed was triggered by a precipitous fall in portfolio investments, predominantly due to massive outflows of foreign institutional investments (FIIs) from the Indian equity market. Massive FII infusions in the previous few years had propelled India's Bombay Stock Exchange (BSE) to a high of almost 20,000 points in end 2007 when it was less than 14,000 points a year earlier (January 2007). While net FII inflows were just over US\$20 billion in 2007-08 (April-March), there was a net withdrawal of over US\$11 billion between January and October 2008. This, in turn, pushed down the BSE index sharply to just below 14,000 points by October 2008, effectively giving back all the gains since January 2007. Limited foreign currency intervention by the Reserve Bank of India (RBI) also meant that the capital withdrawals caused a sharp depreciation of the rupee from about Rs39 to US\$1 in January 2008 to Rs48-49 to US\$1 by October 2008. During this period, there



was not much of a counter-cyclical response by the government or the RBI to tackle the downturn. This was because the expectation by Indian policymakers appeared to have been that the crisis was restricted to the asset markets – which in any case had experienced a sharp run-up in prices – and the RBI, in particular, was still concerned about commodity-driven inflation.

While this initial selling pressure was intense, much worse was to come for India and other emerging economies following the bankruptcy of the investment bank, Lehman Brothers, in mid-September 2008. The rather disorderly deleveraging associated with the bankruptcy led to a generalised rise in global risk aversion resulting in a spike in emerging market spreads and freezing of global credit markets as counterparty risk perceptions skyrocketed. Many Indian corporates had, in the last few years, availed themselves of “cheap” funding in the wholesale funding markets overseas to finance their rapid expansion. When credit markets froze, these institutions scrambled for funds in the domestic market, both from banks as well as non-banks (such as mutual fund withdrawals). These desperate efforts at refinancing led to a massive squeezing of credit in the domestic market, resulting in the call money rate in India peaking to almost 20 percent on 10 October 2008. The Indian equity market went into a freefall, with the BSE falling below 9,000 points by March 2009.

The financial contagion also inevitably had trade implications by curtailing both the final demand for, as well as potential supply of, goods produced in India and elsewhere as there was a sharp decline in trade financing in Asia and other parts of the world. The wealth destruction in India and globally due to sharp asset price declines as well as the increased cost of credit inevitably caused the country’s industrial production to decelerate and exports to collapse in October-November 2008. Overall real gross domestic product (GDP) growth slowed to 6.7 percent

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Policy Responses

As the gravity of the situation became apparent, Indian policymakers responded aggressively with a judicious mix of fiscal and monetary policy initiatives to cushion the impact of the global recession. A host of fiscal stimulus measures was adopted between December 2008 and February 2009 to buffer domestic demand. In a nutshell, these measures included a significant increase in planned expenditures, a reduction in indirect taxes, announcement of sector specific relief packages (textiles, housing, infrastructure and automobiles), and encouraging financial institutions to raise capital to fund infrastructure projects. The fiscal stimulus packages amounted to around three percent of the GDP.

In addition to the fiscal initiatives, the RBI intervened quite aggressively with a set of monetary initiatives to ease the liquidity crunch in both the rupee and the foreign exchange markets. With regards to domestic liquidity, the RBI reduced the key policy rates (the repo which is the rate at which RBI injects rupee liquidity in the banking system, and the reverse repo rate which is the rate at which RBI sucks excess rupee liquidity from the market), while the cash reserve requirement (CRR) [the minimum reserves each bank must hold to customer deposits and notes] and the statutory liquidity ratio (the ratio of total demand and time liabilities that a bank has to maintain in the form of cash, gold or other approved securities with the RBI) were aggressively brought down. The CRR, in particular, was reduced from nine percent in September 2008 to five percent by early January 2009, all of which helped to inject a significant amount of liquidity into the system. In addition to the macro-liquidity measures, the RBI took some targeted steps to ease the liquidity pressures on certain entities that were particularly hard-hit (such as micro, small and medium enterprises, real estate and export sectors). The RBI also tried to facilitate foreign exchange liquidity by loosening the restrictions on external commercial borrowings and short-term trade credits, while interest rate ceilings on non-resident deposits were raised in order to attract more foreign funds into the country.

Conclusion

The extent of India's de facto openness to the global economy was under-appreciated by many observers who paid attention almost solely to trade and tended to ignore the financial sector. Over the last few years, India has become extremely integrated with the Asian and global economies. While such integration has been a boon in helping India grow rapidly with the rest of the world, it also faced the downside of openness in terms of not being spared from the spillovers coming from the financial and economic crisis in the United States and the Western world. However, a strong and well-capitalised banking system and proactive efforts not only by the RBI in particular, but also the fiscal authority (that is, the government) have helped minimise the negative fallout of the global

turmoil on the real economy. After the sharp downturn in the latter part of 2008 and early 2009, the global and Asian economies appear to have stabilised.

As the global risk appetite has improved substantially, larger countries such as India which were impacted primarily due to the sudden stop in and reversals of international capital flows, as opposed to high dependence on export markets, have recovered much faster



than smaller export-dependent economies such as Singapore, where recovery is likely to be more tepid. ■