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Impact of the Global Economic and Finance Crises on India: An Analysis

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Absract:
Over a decade the world economy is facing severe financial and economic crisis due to structural reforms. Globalization leads to economic transformation throughout the world which necessitates structural reforms. The Indian economy is a fast growing economy and it holds highly strong position in global hub as Indian economy registers high growth figures of economy when globally there was a heavy financial meltdown. In the early nineties, the Indian economy faced a severe Balance of Payment crisis which becomes a bottleneck for the overall progress of the nation. In such adverse situations, the policy makers decided to adopt a more liberal and global approaches in order to overcome that. Even still now it is in hard time, the rupee value was declined drastically. The solution to overcome this financial crisis is to liberalize its economic policies to widen its operations globally. But Liberalization, Privatization and Globalization brought remarkable impact on Indian economy. The recent Global Financial Crisis (2008) affected adversely and it has spared any of the countries or market sectors and has devastated all the economies, even traditionally strong economies in the world. On this backdrop, an attempt is made to analyze the impact of Global crisis on the Indian economy.

Key words: *Crisis, Global, Structural reforms, Global imbalance, Turbulence, Stability*

1. Conceptual Fallacy

The world has witnessed several financial crises over the past few decades, such as the OPEC Oil crisis (1970), the United States Savings and Loan crisis (1980), the prolonged economic downturn in the Japanese economy (1990), the Asian financial crisis (1990), and the problems following the crash of the Dot Com Bubble in the early part of the last decade. Each of these events had been accompanied by shocks to the economies of one or more markets or regions and it took several years of concerted economic and regulatory policy adjustments for the affected markets to return to stability. While it is normal for financial crises to occur frequently and the affected economies to recover subsequently, it nevertheless results in economic losses for the countries involved and for the people, businesses and institutions in those countries. Among the financial crisis of the past hundred years, only the Great Depression of the 1930s had a more severe and protracted effect on the world economy compared to the current economic upheaval. The excessively loose monetary policy in major developed economies transformed into global imbalances and a full-blown financial and economic crisis for all the economies of the world.

1.1. Causes and Magnitude of the Crisis

In the beginning of 1990s, major countries in the world had been following relatively loose monetary policies which continued in the period following the dot com bubble. During this period, the United States faced a growing current account deficit which was financed by capital flows from exporting countries. This global imbalance contributed to the low interest rates in the United States and the resulting real estate asset bubble. In addition, lenders relaxed their standards for mortgage loans and financial innovations allowed them to mask the risk of their portfolios. Beginning in 2004, the United States Federal Reserve Bank started tightening the credit markets by raising interest rates in response to rising inflation, which caused the crisis in the sub-prime mortgage market. This quickly spread to the entire banking sector in the United States and other advanced economies, resulting in the liquidation of several major banks. The banking sector in the advanced economies is estimated to have lost up to $2.8 trillion between 2007 and 2010. The contagion in the banking sector caused a near shutdown of the credit markets and the United States economy went into a severe recession which was reflected in the securities markets. The crisis was not limited to the United States market – it quickly spread to all other markets, including emerging markets, through both financial channels (i.e., flow of funds) and real channels (i.e., foreign trade).

Over a decade, Indian economy is facing severe financial crisis which becomes a bottleneck for the overall progress of the nation. Developing countries like India always need financial support in order to achieve stability in the economy. Hence Since 1991 the Government of India has focused on liberalization of policies to welcome foreign players as it has been a key driver for accelerating the economic growth through technology transfer, employment generation, and improved access to managerial expertise, global capital, product markets and distribution network. It also enables financial stability, growth and development to

sustain and compete in the global economy. The effect of the crisis on the Indian economy was not significant in the beginning. The initial effect of the subprime crisis was, in fact, positive, as the country received accelerated Foreign Institutional Investment (FII) flows during September 2007 to January 2008. There was a general belief at this time that the emerging economies could remain largely insulated from the crisis and provide an alternative engine of growth for the world economy. But the argument proved to be wrong as the global crisis intensified and spread to the emerging economies through capital and current account of the balance of payments. The net portfolio flows to India soon turned negative as Foreign Institutional Investors rushed to sell equity stakes in a bid to replenish overseas cash balances. This had a knock-on effect on the stock market and the exchange rates through creating the supply demand imbalance in the foreign exchange market. The current account was affected mainly after September 2008 through slowdown in exports. Despite setbacks, however, the BoP situation of the country continues to remain resilient.

2. Review of Literature

There is a robust modern literature on financial crises that policy makers in the newly affected countries can potentially draw from. The existing literature has yet to fully account for the large size of the crises and the long run effects, but still there are a number of findings that may help guide policy in the context of the current crisis. This study is an attempt to draw the main lessons from this literature, with a special focus for the macro-economic impact of financial crises.

Berkmen et al. (2009) examines the impact of global financial crisis on developing and some of the emerging economies of the world and views that the financial crisis can transmit to the developing and emerging economies via a number of ways such as trade and financial linkages. Furceri, D. and Zdzienicka, A. (2010) studies the impact of financial crises on output in Eleven European Transition Economies (CEECs) and finds that financial crises have a significant and permanent impact, reducing the long term output by 12 to 17 percent, which is more in smaller countries in where there is more financial disequilibria. They argue that fiscal policy is the most efficient tool in dealing with financial crises whereas monetary policy is considered to be modest. Viswanathan (2010), in his study entitled *Global Financial Crisis and Its Impact on India,* states that shocks of global financial crisis have been transmitted to Indian economy through various channels such as trade, finance and business confidence and highlights various policy responses taken to control the impact of crisis on Indian economy. During the crisis, India adopted various proactive measures such as injecting adequate liquidity, stabilizing interest rate and inflation. At the same time, fiscal stimulus was also provided. Brambila-Macias et al. (2011) says that the global economic downturns have negative and significant impact on export flows of developing countries, and especially of Latin American and Sub Saharan African countries. King and Levine (1993) and Rajan and Zingales (1999) provide empirical evidence that countries with highly developed financial markets grow faster and that financial development is particularly helpful in enhancing the growth of industries that, for technological reasons, rely heavily on external funds to enable their investment. In short, financial markets are important to the well-being of the real economy, especially businesses and enterprises.

Carmen and Kenneth (2008) say the first major financial crisis of the 21st century as well as the newest one is the U.S. sub-prime mortgage financial crisis. According to Lucjan (2008), the crisis has five stages, the beginning is the housing bubble in the U.S. increases the inflated by subprime mortgage lending and then spread into other types of assets like investment banks. And the third important effect is that it turns into the global liquidity crisis when the lots pullout of liabilities from the banks, like Lehman Brothers, spread into the global scale. Fourth, the collapse of collateralised debt obligations which also caused the bubble effects in the commodity futures market. Finally, lots of fund shifts in risk-free securities, the Lehman Brothers filed for bankruptcy protection the whole U.S. investment banking system crashed. The whole world was alarmed by the bankruptcy of Lehman Brothers and also alarmed by the U.S. financial crisis. Shah (2008) also views the same that the global financial meltdown will affect the livelihoods of almost everyone in an increasingly interconnected world, the crisis not only affect one country's people also affect the livelihoods of others. Eichen Green, Rose and Wyplosz (1997) used the Probit model to estimate the probabilities of a financial crisis occur and indicated that the financial crisis is easier to spread between the counties with the trade connections. Masson (1998) confirmed that as under the environment of integration with the global economy, the commodity trade is the main channel for financial crisis spread. Coughlin and Pollard (2000) estimated how much the financial crisis affects the different countries, found that the countries rely on the Asian countries' export have had the worst influences. According to Fernald, Edition and Loungani (1999) studies, the Asian crisis made the export of China decreasing badly, because the financial crisis made the other Asian countries' needs of import decreased so much. Niu, Li and Lai (2000) also said that, when the counties have the financial crisis, the import needs will decrease which will cause China's export decrease.

According to Gunawardana (2005) the influence of the financial crisis has the positive correlation with the counties' real GDP and GDP per population, and the negative correlation with the real exchange rate when the rate following down. Mckibbin and Stoeckel (2009) say that the financial crisis has a combined effect from the three shocks, a drop in GDP, stock market value and consumption. Chandy, Gertz, and Linn (2009) reports that because the crisis, the global output has negative 1.3 per cent growth, in the U.S., there has 2.8 per cent negative growth and Germany with 5.6 per cent negative growth. The worst negative growth countries are Japan and Russia which with 6.2 per cent and 6.0 per cent negative growth rate respectively. Only China and India had positive growth in 2009.

3. Database and Methodology

The need to analyze the impact of the global crisis on the Indian economy arises because of its adverse impact on all sectors of the economy and the reforms undertaken by the Government of India (GOI) by liberalizing its' trade and economic policies. Given the fact that India has adopted overwhelming reforms in economic policies, an analysis like this would provide first-hand empirical evidence on whether further efforts in overcoming the crises are warranted. The study analyzed the causes and

magnitude of the crisis and also the impact on Indian economy. The general objective of this study is to analyze the economic reforms undertaken by the GOI in overcoming the financial crises and accelerating the fast growth of the economy.
Many researchers have undertaken the study on different aspects of Global crises, formulated conclusions and recommended various suggestions to overcome it. Even then certain gaps still remained as it is a wide and powerful concept. In order to fill the uncovered gaps, the present study is undertaken to make the study more meaningful and purposeful. With this background the present study "*IMPACT OF THE GLOBAL FINANCE AND ECONOMIC CRISIS ON INDIAN ECONOMY: AN ANALYSIS*" has been formulated with the following objectives:

- To analyze various forms of Global crises
- To analyze the causes and magnitude of the Global crises
- To analyze the impact of the crises on the Global economy
- To compare the current crises with the initial global crises
- To analyze the impact of it on Indian economy
- To review the challenges to be faced by the policy makers
- To evaluate the changes in economy after introduction of various reforms

For accomplishing the objectives of the study, secondary data have been utilized which has been collected from various published sources and websites. Interpretation of data is based on rigorous exercises aiming at the achievement of the study objectives and findings of the existing studies. Interpretation of the data is more on qualitative terms than on quantitative terms.

4. Analysis

The effect of the crisis on the Indian economy was not significant in the beginning. The initial effect of the subprime crisis was, in fact, positive, as the country received accelerated Foreign Institutional Investment (FII) flows during September 2007 to January 2008. There was a general belief at this time that the emerging economies could remain largely insulated from the crisis and provide an alternative engine of growth to the world economy. The net portfolio flows to India soon turned negative as Foreign Institutional Investors rushed to sell equity stakes in a bid to replenish overseas cash balances. This had a knock-on effect on the stock market and the exchange rates through creating the supply demand imbalance in the foreign exchange market. The current account was affected mainly after September 2008 through slowdown in exports. Despite setbacks, however, the BoP situation of the country continues to remain resilient.
Most of the crises over the past few decades have had their roots in developing and emerging countries resulting from abrupt reversals in capital flows, and from loose domestic monetary and fiscal policies. In contrast, the current ongoing global financial crisis has had its roots in the US due to the sustained rise in asset prices, particularly house prices, on the back of excessively accommodative monetary policy and lax lending standards during 2002-06 coupled with financial innovations. Given the growing financial globalization, banks and financial institutions in other major advanced economies, especially Europe, have also been adversely affected by losses and capital write-offs. Inter-bank money markets nearly froze and this was reflected in very high spreads in money markets. There was aggressive search for safety, which has been mirrored in very low yields on Treasury bills and bonds.
The deep and lingering crisis in global financial markets, the extreme level of risk aversion, the mounting losses of banks and financial institutions, the elevated level of commodity prices and their subsequent collapse, and the sharp correction in a range of asset prices, all combined, have suddenly led to a sharp slowdown in growth momentum in the major advanced economies. Global growth for 2009, which was seen at a healthy 3.8 per cent in April 2008, is now projected to contract by 1.3 per cent (IMF, 2009c). Major advanced economies are in recession and the EMEs – which in the earlier part of 2008 were widely viewed as being decoupled from the major advanced economies – have also been engulfed by the financial crisis-led slowdown. Global trade volume (goods and services) is also expected to contract by 11 per cent during 2009 as against the robust growth of 8.2 per cent during 2006-2007. Private capital inflows (net) to the EMEs fell from the peak of US $ 617 billion in 2007 to US $ 109 billion in 2008 and are projected to record net outflows of US $ 190 billion in 2009. The sharp decline in capital flows in 2009 will be mainly on account of outflows under bank lending and portfolio flows. Thus, both the slowdown in external demand and the lack of external financing have dampened growth prospects for the EMEs much more than that was anticipated a year ago.
As a developing country, India always tries to integrate the world economy and as one part of the world financial system. As it is an export country which highly dependent on the international market, the global financial crisis has also affected the India's economic and trade market. The export trade is the one of the major sources for economic growth. Because of the global financial crisis, U.S., Japan and other Europe countries economic status got worse, studying the effects of global financial crisis on Indian economy is an important empirical issue to be investigated.
Developing countries were severely hit by the global financial crisis, which originated in developed countries in late 2007. Economic growth in emerging and developing economies dropped dramatically from 13.8 per cent in 2007 to 6.1 per cent in 2008, and it fell to 2.1 per cent in 2009 (IMF, 2009a, and 2010). Some regions experienced strong economic growth transformed into negative growth in 2009, while others experienced significant slowdowns. The financial and real channels through which the global financial crisis spread to developing countries are mainly four: private capital flows, remittances, trade and foreign aid. The World Bank estimates that as a result of the crisis, 89 million people will be living in extreme poverty (below $1.25 a day) by the end of 2010. According to the ILO (2010), the global number of unemployed will increase by 34 million in 2009 compared with 2007. National governments implemented a number of policy responses including fiscal, monetary and social policy.

	2005	2006	2007	2008	2009	2010
GDP (annual % change) World	4.48	5.09	5.17	3.00	-0.80	3.10
Advanced economies	2.63	2.99	2.72	0.56	-3.20	1.32
Emerging and developing economies	7.09	7.94	8.31	5.99	2.10	5.08
Developing Asia	9.03	9.83	10.59	7.50	6.50	7.35
Germany	0.73	3.18	2.52	1.25	-4.80	0.34
United Kingdom	2.17	2.85	2.56	0.74	-4.80	0.91
United States	3.05	2.67	2.14	0.44	-2.50	1.52

Table 1: Economic Indicators for Selected Markets: 2005-2010
Source: World Bank

The volume of trade in goods and services across the world was fell to 2.95 percent in 2008, and shrank by 12.3 percent in 2009. Contraction in trade volume across countries can exacerbate global imbalances and cause financial distress in firms that depend on international trade for selling their output and for sourcing their resources. This is also reflected in the unemployment numbers reported for the different markets. The unemployment rate for the advanced economies was projected to rise to 8.20 percent in 2009, and 9.29 percent in 2010. Such high unemployment rates for protracted periods in the US and the UK are unprecedented in the post-world war period. The unemployment rates among EMEs also deteriorated, but to a lesser extent. For example, the unemployment rate for India increased from 10.4 percent to 10.7 percent between 2008 and 2009. In China and Russia, the corresponding increases were from 4.2 percent to 4.3 percent and 6.5 percent to 8.9 percent, respectively.

4.1. Effect of Global Financial Crisis on Indian Economy

As a big developing country, India always tries to integrate the world economy and as one part of the world financial system. India as an export country which highly dependent on the international market, the global financial crisis has also affected the India's economic and trade market. The challenges that confronted the Indian economy in 2008-09 and continue to do so fall into two categories - the short-term macroeconomic challenges of monetary and fiscal policy and the medium-term challenge of attaining and sustaining high rates of economic growth. The former covers issues such as the trade-off between inflation and growth, the use of monetary policy versus use of fiscal policy, their relative effectiveness and coordination between the two. The latter includes the tension between short- and long-term fiscal policy, the immediate longer term imperatives of monetary policy and the policy and institutional reforms necessary for restoring high growth.

The global financial crisis which originated in the advanced economies, spread to India and other EMEs through financial and real channels. Given the strength of its economy, India should have been able to withstand the adverse effects of the financial crisis and avoid any serious and long-term consequences for its economic growth. However, its increasing dependence on bilateral trade with other countries and on financing from external markets makes it vulnerable to economic shocks in the global economy. Although India was not immune to the contagion effects of the global financial crisis, it was one of the few countries to recover quickly from the slowdown in the economy and appears to be back on the growth trajectory it was on prior to the crisis. In its latest report, the IMF estimates that India's GDP will grow by 7.7 percent in 2010 and by 7.8 percent in 2011. This compares very favourably with IMF's estimates for the world output to grow by 3.9 percent in 2010 and 4.3 percent in 2011. To understand India's response to the crisis and the resiliency of the Indian economy, it is helpful to analyze the channels through which the real and financial shocks are transmitted from the advanced economies to India.

The contagion effects of the financial crisis spread from the advanced economies to the Indian market in three distinct channels – the financial channel, the real or trade channel, and the confidence channel.

	Us$ Million				**% Change (Y-O-Y)**	
	2007-08	**2008-09**	**1st Half 2008-09**	**2nd Half 2008-09**	**1st Half 2008-09**	**2nd Half 2008-09**
Exports	166163	175184	98107	77077	35.1	-17.6
Imports	257789	294587	168208	126379	45.2	-11
Trade Balance	-91626	-119403	-70101	-49302	-62.2	-1.9
% of GDP	**-7.8**	**-10.4**	**-6.1**	**-4.3**		
Invisible receipts	148604	162556	84635	77921	32.5	-84.1
Invisible Payments	74102	72970	36065	136905	14	-12.9
Invisibles.net	74592	89586	48570	41016	50.6	-3.1
% of GDP	**6.4**	**7.8**	**4.2**	**3.6**		
Current account	-17034	-29817	-21531	-8286	-96.1	-36.8
% of GDP	**-1.5**	**-2.6**	**-1.9**	**-0.7**		
Capital account (net)	109198	9737	19032	-9295	-63	-116.1

% of GDP	9.3	0.9	1.7	-0.8		
Foreign Direct Investment	15401	17496	13867	3629	185.1	-65.6
Portfolio Investment	29556	-14034	-5521	-8513	-129.9	-176.6
External Commercial Borrowings	22633	8158	3157	5001	-71.7	-56.4
Short-term Trade Credit	17183	-5795	3689	-9484	-44	-189.5
External Assistance	2114	2638	869	1769	22.6	25.9
NRI Deposits	179	4290	1073	3217	1475.6	1151.8
Other Banking Capital	11578	-7687	3747	-11434	-35.4	-298
Other Flows	10554	4671	-1849	6520	-147.1	-1.7
Change in Reserves (-Increase/+decrease)	**-92164**	**20080**	**2499**	**17581**	**106.2**	**134**

Table 2: India's Balance of Payments: 2008-09
Source: Reserve Bank of India

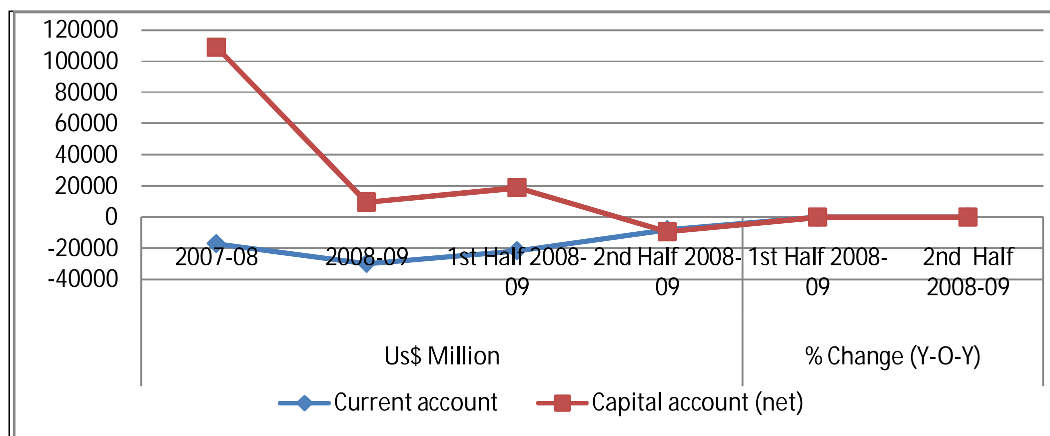

Figure 1: Current & Capital account balances as % of GDP
Source: Reserve Bank of India

Above table depicts that India's balance of payments in 2008-09 captured the spread of the global crisis to India. The current account deficit during 2008-09 shot up to 2.6 percent of GDP from 1.5 percent of GDP in 2007-08. Figure 1 shows the highest level of current account deficit for India since 1990-91. The capital account surplus dropped from a record high of 9.3 percent of GDP in 2007-08 to 0.9 percent of GDP. And this is lowest level of capital account surplus since 1981-82. The year ended with a decline in reserves of US$ 20.1 billion (inclusive of valuation changes) against a record rise in reserves of US$ 92.2 billion for 2007-08.

The challenges that confronted the Indian economy in 2008-09 and continue to do so fall into two categories - the short-term macroeconomic challenges of monetary and fiscal policy and the medium-term challenge of attaining and sustaining high rates of economic growth. The former covers issues such as the trade-off between inflation and growth, the use of monetary policy versus use of fiscal policy, their relative effectiveness and coordination between the two. The latter includes the tension between short- and long-term fiscal policy, the immediate longer term imperatives of monetary policy and the policy and institutional reforms necessary for restoring high growth.

The global financial crisis began to affect India from early 2008 through a withdrawal of capital from India's financial markets. This is shown in India's balance of payments as a substantial decline in net capital inflows in the first half of 2008-09 to US$ 19 billion from US$ 51.4 billion in the first half of 2007-08, a 63 percent decline. This is seen from a large outflow of portfolio investment (as equity disinvestment by foreign institutional investors); and lower external commercial borrowings, short-term trade credit, and short-term bank borrowings. Inflows under foreign direct investment, external assistance and NRI deposits, by contrast, surged during the first half of 2008-09. In the second half of 2008-09, net capital flows turned negative as there were huge outflows of portfolio investment, short-term trade finance and banking capital. Capital flows under foreign direct investment and external commercial borrowings recorded sharp declines of 66 percent and 56 percent respectively over the same period of 2007-08. However, inflows under external assistance and NRI deposits continued to rise considerably during the second half of 2008-09.

While capital account suffered right from the beginning of 2008-09, the impact of the global crisis on the current account was felt only in the second half of 2008-09. In the first half of 2008-09, merchandise exports in fact grew strongly at 35 percent and invisible receipts by 32 percent. Merchandise imports grew by 45 percent and invisible payments by 14 percent in the first half of 2008-09. Net invisible earnings grew strongly at the rate of 51 percent in the first half of 2008-09. Things turned adverse dramatically in the second half of 2008-09 as global crisis took its toll on external trade.

Merchandise exports declined by about 18 percent in the second half of 2008-09 over the same period of 2007-08, and imports declined by 11 percent. Invisible receipts declined more sharply at 84 percent and invisible payments by 13 percent. As a result, net invisible receipts declined by 3 percent in the second half of 2008-09 over the same period of 2007-08 in contrast a steep rise of 51 percent in the first half of 2008-09.

The two major items of invisible receipts for India have been software exports and private transfers (remittances). Net receipts from software exports rose by 19 percent in 2008-09 to US$ 44 billion from US$ 37 billion in 2007-08. Remittances also amounted to US$ 44 billion in 2008-09, a rise of 5 percent from US$ 42 billion in 2007-08.

Despite the negative impact of the liquidity crisis on its financial markets, India was able to contain the effects and implement a quick recovery, as shown in the Table 3. The net Foreign Institutional Investment for the first three quarters of 2009-10 has exceeded that of any of the prior fiscal years. As noted previously, IMF estimates the growth rates in GDP and industrial production to rebound in the near future to levels that existed prior to the crisis. The optimism in the Indian economy is also reflected in the BSE Index, which rose by 79.88 percent in the first three quarters of the last fiscal year.

Fiscal Year	**2000-01**	**2001-02**	**2002-03**	**2003-04**	**2004-05**	**2005-06**	**2006-07**	**2007-08**	**2008-09**	**2009-10***
Foreign Direct Investment (US$ millions)	4029	6130	5035	4322	6051	8961	22826	34835	35180	26506
Growth in FDI (% change from year to year)	+87	+52	-18	-14	+40	+48	+146	+53	+1	0[P]
Net Foreign Institutional Investment (in US$ millions)	1847	1505	377	10918	8686	9926	3225	20328	15017	20518
Change in BSE Sensex Index (% change from year to year)	-27.9	-3.7	-12.1	+83.37	+16.13	+73.73	+15.89	+19.68	37.94	+79.88

Table 3: Flow of External Funds in India during 2000 – 2010

Source: Securities and Exchange Board of India (SEBI) Annual Reports, SEBI Handbook of Statistics, and Reserve Bank of India Annual Report

Note: The fiscal calendar year in India starts in April and ends in March of the following year

[*] 2009-2010 fiscal year data is for the period ending in December 2009.

[P] Computed using prorated FDI based on the first nine months of the fiscal year.

Several factors contributed to the quick recovery of the financial markets in India. Although the economic liberalization policies were initiated in 1991, the transformations in the markets have been implemented cautiously, and the markets are still highly regulated relative to the standards of advanced economies. Stringent regulation of banks has limited their exposure to complex derivatives and off-balance sheet activities. The exposure of the banks in India to the United States subprime mortgage and credit default swaps markets was negligible and indirect.

4.2. India’s Policy Response to the Crisis

Subbarao, Misra and Thorat present the various monetary and fiscal policy initiatives implemented by the Indian government and its agencies in response to the global financial crisis and its effects on the domestic economy. In its role as the principal regulator of the financial markets in India, the primary responsibility of the Reserve Bank of India (RBI) is to ensure the orderly functioning of the credit and foreign exchange markets in India. The monetary policy response of the RBI was aimed at containing the contagion effects of the financial crisis from the advanced economies by ensuring sufficient liquidity in the credit markets. On the fiscal side, the government’s policy responses were aimed at protecting businesses and groups that were directly affected by the crisis. This was accomplished through relaxation of some onerous restrictions, tax subsidies and strengthening of social safety-nets.

- **Monetary Policy Responses**: The goals of the monetary policy initiatives were three-fold: to provide sufficient liquidity in the domestic market, to provide dollar liquidity for businesses financing in the external markets, and to ensure flow of credit to those industry sectors that were productive.
- **Fiscal Policy Responses**: The focus of the fiscal policy responses of the Indian government to the financial crisis was to stimulate demand for the country’s output and to bailout those industries and groups that were most vulnerable to the crisis. Starting in December 2008, the government introduced three stimulus packages in the span of four months that lowered tax rates and increased tax subsidies, increased capital expenditures and government spending, and provided incentives that encouraged growth in consumption and demand. Specifically, the government announced plans for

additional public spending in capital expenditure projects, provided government guarantees for infrastructure spending, and expanded credit for SMEs and exporters.

Starting in 1991, India had been implementing economic reforms that were aimed at moving from a centrally-planned economy to a market based economy. In the process, it had been cautious in opening up its markets and allowing risky innovations in the financial markets. While encouraging the private sector to play a more dominant role in the economy, it was also in the process of strengthening and streamlining the regulation of markets. The banking sector, which plays a pivotal role in the savings and capital formation functions in India, was heavily regulated to limit overly risky behaviour by the participants. Consequently, while the global financial crisis is having a protracted and devastating effect on most of the economies of the world, its impact on the Indian economy is not that severe. The strength of the Indian economy along with the timely and appropriate monetary and fiscal policy responses by the government helped manage the adverse effects of the crisis. Mohan estimates the monetary policy responses to the crisis injected liquidity that amounted to about INR 4,900 billion or 9 percent of GDP. On the fiscal side, the spending initiatives amounted to INR 2,928 billion, and tax subsidies cost INR 1,600 billion. These policy responses stabilized the financial markets and facilitated a quick recovery of the economy. One negative consequence of the various stimulus packages is that the fiscal deficit is at 11 percent of GDP and will continue to be at this level for some time. This limits the policy options available to the RBI to manage future shocks to the economy in the near term.

5. Conclusion

Recent economic history has explained that financial crises that simultaneously affect several economies occur frequently, and that prudent policies and appropriate responses by monetary authorities help in managing the crises. However, the task of containing the adverse effects becomes more challenging when all the economies of the world are affected by the crisis. The current global financial crisis, which started in 2008, has been adversely affecting all the world economies and the magnitude of its impact is exceeded only by that of the Great Depression of 1930s. In response to the crisis, the various National Monetary Authorities and International Financial Organizations have implemented fiscal and monetary policy initiatives to alleviate the problems and soften the impact on the affected sectors. While all economies were adversely affected by the crisis, the impacts were not uniform across countries. Consequently, the responses by the governments in individual countries varied.

The global financial crisis has had a more severe impact on the advanced economies compared to the rest of the world. This paper detailed the impacts of the global financial crisis on the Indian economy, and the responses of the Indian government in managing the crisis. India could not insulate itself from the adverse developments in the international financial markets. To counter the negative fallout of the global slowdown on the Indian economy, the Federal Government responded by providing three focused fiscal stimulus packages in the form of tax relief to boost demand and increased expenditure on public projects to create employment and public assets. The Reserve Bank of India (RBI) took a number of monetary easing and liquidity enhancing measures to facilitate flow of funds from the financial system to meet the needs of productive sectors.

The proactive policies of the RBI have ensured the availability of adequate liquidity in the markets. In the credit and consumer markets, interest rates and inflation rates have stabilized. In the foreign exchange market, the Indian Rupee has rebounded against currencies of the major trading partners. The fiscal stimulus provided by the government has helped cushion the decline in private investment and consumption in the real sector. Although preliminary estimates of the nonperforming assets of banks have been rising, they are still at manageable levels. In the meantime, industries that were facing rising unemployment in 2008-09 have been reversing the trend. The stock market, which is an indicator of the strength of the economy, has risen by 80 percent in the first three quarters of the current fiscal year (2009-10), after falling by 38 percent in the previous year. The current figures for the Purchasing Managers' Index, the RBI's Business Expectations Index and the Neilsen Global Consumer Confidence Index for India indicate optimism about the economy on the part of businesses and consumers in India. Finally, IMF's consensus estimate for the GDP of 7.7 percent and 7.8 percent for 2010 and 2011, respectively, is evidence that India has recovered from the global financial crisis and is back on the growth trajectory.

Although India has been liberalizing its markets since 1991, it has adopted a cautious approach by opening up its markets slowly and implementing reforms after studying their effects on the domestic market. Unlike many other emerging economies, the banking sector in India is still highly regulated and continuously monitored. The Reserve Bank of India has at its disposal a number of tools to control the money supply and to infuse liquidity as needed. The size of its foreign reserves allows India to intervene effectively in the foreign exchange market to support its currency. Consequently, businesses can manage their exchange rate risk when trading with foreign countries and when borrowing in the external markets. Although India has expanded its foreign trade sector, which is now a major component of its GDP, the domestic sector is large enough to cushion any shocks in the real sector of the global economy. This contrasts with several EMEs that have implemented strategies to expand their external trade sector at the expense of the domestic markets, making them vulnerable to external shocks. Finally, the government in India has been expanding investments in social safety-nets to soften the impact on the groups most vulnerable to economic shocks and contagion in free markets.

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