IMPACT OF GLOBAL FINANCIAL CRISIS ON THE INDIAN ECONOMY
AND PROSPECTS FOR INDIA

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ABSTRACT

The world’s advanced economies – the US, the EU, Japan and others – entered a phase of negative growth in the second and third quarters of calendar 2008. Most people estimate that this will continue into the first half of 2009; the more pessimistic guess is that negative growth will blight the third quarter and even the entirety of the second half of the year. The trouble, we may recollect, began in late summer 2007, when the problem with sub-prime mortgage assets first surfaced in the public domain and the entire market based on such underlying assets, very rapidly turned from being as liquid as treasuries to rapidly becoming illiquid.

Keeping in view all of these factors, the Council is of the view that economic conditions in the advanced economies may continue to be recessionary in the first half of 2009, but growth would re-surface in the third quarter of the year. Emerging economies, such as India and perhaps China, would have a difficult time in the first part of the year, but should be able to show a pick-up in growth in the last quarter of 2009, if not earlier.

KEYWORDS

Global, Economic, Recession, International Capital Market, Bond Market Index, External Commercial Borrowing (ECB)
INTRODUCTION

The world’s advanced economies – the US, the EU, Japan and others – entered a phase of negative growth in the second and third quarters of calendar 2008. Most people estimate that this will continue into the first half of 2009; the more pessimistic guess is that negative growth will blight the third quarter and even the entirety of the second half of the year. The trouble, we may recollect, began in late summer 2007, when the problem with sub-prime mortgage assets first surfaced in the public domain and the entire market based on such underlying assets, very rapidly turned from being as liquid as treasuries to rapidly becoming illiquid.

In retrospect, other parts of the international capital market did not seem to view the problem with sub-prime assets as being intractable. Either the markets did not appreciate the magnitude of the problem or they reposed excessive faith in the ability of the regulatory authorities to “cure” it or more likely it was a combination of both factors. Immediately after the sub-prime problem broke into the media space in early August, the world’s stock markets lost ground. However, by late September 2007, confidence returned and most stock indices hit all time highs by the end of October or early November; a few did so in December and some others in January 2008 – including that of India. Brazil and Russia, both commodity exporters, benefited from the spurt in the prices of their exports and their equity markets hit highs in May and June 2008 respectively. Most other equity markets, including that of India, weakened considerably through the first and second quarters of 2008.

The flush of liquidity and change in investing styles had led to a generalised decline in risk premium since 2002. Thus the Emerging Bond Market Index (EMBI), a proprietary index of JP Morgan, reported that credit premium (for a basket of emerging economies) had fallen from over 700 basis point (bps) in January 2003 to below 180 bps at the end of December 2006. The progressive discounting of risk was also evident in cross-country comparison of equity valuation, which showed a decline in the spread between conventional metrics of equity valuation in advanced and emerging economies. A similar narrowing of the credit spread was also evident within markets as between government treasuries and corporate bonds. The outing of the sub-prime mortgage issue (which essentially was about the egregious mispricing of risk) in 2007, saw a sharp reversal in the declining trend in credit risk premium.

The risk spread on the leading public sector bank in India rose from a little over 50 bps to 100 bps in August 2007, but did not rise much further, with the year ending at a spread of less than 120 bps. More serious problems began to emerge in January 2008 in both the US and European financial sectors, leading to the arranged takeover of Bear Stearns by JP Morgan Chase in March 2008. By that time the credit spread for the leading public sector Indian bank had risen to 230 bps. This was part of a generalised
increase in risk premium. The credit spread for the leading US and European banks roughly doubled between January and March 2008.

The absence of a further calamity in the subsequent months saw equity markets regain some ground and the credit spreads falling a bit. However, as crude oil soared and approached $150 per barrel, and inflation across countries reached unacceptable levels, the economic and financial outlook worsened and spreads rose. By this time, large international commercial banks, brokerages and other financial institutions had already posted over $500 billion in losses and the appetite for emerging market and corporate debt had diminished. However, Indian companies were able to raise $6.8 billion in External Commercial Borrowings (ECB) in the July to September quarter of 2008. This was indicative of the fact that raising debt was still possible, but at a significantly higher price and effort than it had been before.

A significant part of the funding for new asset creation by Indian companies had come from ECB. An equally important part had come from fresh issuance of equity with the balance obtained from the reinvestment of profits. Roughly, on an aggregate basis, about 35 to 40 per cent of the funding needs were met from reinvested profits, with the balance being split between domestic debt, ECB and fresh equity infusion. Conditions in the equity market were not conducive after February 2008 for the raising of fresh equity. This was perhaps initially due to the unwillingness of companies to seek lower listing prices, but as the markets weakened thereafter, appetite for fresh issuance also declined. Hence, in the first six months (Apr–Sept) of 2008/09, the total of share issuance (domestic and overseas) by Indian companies was, according to Securities and Exchange Board of India (SEBI), down to Rs. 12,484 crore from Rs. 42,724 crore in the same period of last year - a decline of 71 per cent.

Equity and debt are not good substitutes. In the difficult situation where equity and ECB debt had become hard to come by, Indian companies have sought loans from the domestic banking system, presumably as a temporary measure. As a result, in the first quarter (April–June) of 2008/09, bank credit to the commercial sector increased by Rs. 68,000 crore more than it had in the corresponding period of 2007/08. In the second quarter (Jul–Sep), the increase in credit off-take was more by about Rs. 13,000 crore again compared to the same period of last year.

In other words, Indian companies had borrowed over Rs. 80,000 crore more in the first half of 2008/09 than they had in the first half of last year. While part of it was to meet the needs of higher levels of economic activity, another part was due to the financing of large working capital needs of public sector oil marketing companies and outstanding subsidies due to fertiliser companies; a very large part of it also flowed from the need to find alternate financing in lieu of what may have been planned to be raised through equity and overseas debt offerings.
Prospects for 2009/10 in India

Keeping in view all of these factors, the Council is of the view that economic conditions in the advanced economies may continue to be recessionary in the first half of 2009, but growth would re-surface in the third quarter of the year. Emerging economies, such as India and perhaps China, would have a difficult time in the first part of the year, but should be able to show a pick-up in growth in the last quarter of 2009, if not earlier.

Recollecting the transmission channels that was discussed at the outset, the expected economic recovery in the second half of 2009, is likely to ease the capital market constraints, earlier than it may ease the export market constraints. The widely held view is that the recovery in the advanced economies when it comes in 2009, is unlikely to be robust and thus the limitations on the recovery of the export market may continue into 2010. However, capital market conditions are expected to recover earlier – given the greater extent of weakening that they have undergone. By recovery is meant that the markets become functional once again in terms of being able to allocate capital. That is, companies should be able to place debt and equity – albeit neither as easily nor at such attractive prices as were prevalent in 2006 and 2007. It is likely that loan market conditions will improve before the summer of 2009, although equity market conditions may not do so till the third or even fourth quarters of 2009. As earlier stated, in its forthcoming Update likely to be released late in January 2009, the IMF may further reduce the growth outlook for advanced economies and also for most emerging economies as well. In the case of India this is likely to see a reduction from the November 2008 estimate of 6.3 per cent to somewhere below 6 per cent. International banks and other private agencies, as mentioned earlier, are placing growth in the Indian economy in 2009/10 in the region of 5.0 to 5.8 per cent.

The Council is of a different view with an expectation that in 2009/10, the Indian economy is likely to remain relatively weak in the first quarter (April–June) and slowly pick up thereafter; that the economy would show fairly strong recovery in growth in the second half of the fiscal (Oct 2009 to Mar 2010) assuming an improvement in international economic and financial conditions in the second half of 2009. Overall, the Council assesses that growth in 2009/10 would be between 7.0 and 7.5 per cent or somewhat above that, with the first half of the year averaging growth close to 7.0 per cent and the second half with average growth of close to 7.5 per cent or higher. This outcome factors in the impact of monetary easing, fiscal stimulus and other administrative measures to keep the growth engine running in the economy.