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Global Economic Meltdown and Its Impact on Indian Economy

Minal
Faculty, Institute of Business Management,
Mangalayatan University, Aligarh-Mathura
Highway, Beswan, Aligarh (U.P.) - 202145, India
E-mail: drminalaggarwal@gmail.com

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Abstract

The world is presently facing economic crisis due to which economies world over are considered to be entering into prolonged slowdown in economic activities. The intensity of present economic meltdown is so high that it is being compared with the global economic recession in 1873, great depression of 1930s and East Asian crisis of 1990s. The current economic slowdown is considered to be subprime mortgage crisis in the financial sector of United States. Global economic meltdown and its impact on Indian economy, in this paper it has been tried to explain the impact of three distinct channels, that is, the capital flows, sectoral growth and financial sector.

Keywords: Global financial recession, Capital flows, Sectoral growth, Financial sector

Introduction

The current Global Meltdown has engrossed the world economy these days. Every day we hear about our falling share markets, decreasing industrial growth and the overall negative mood of the economy. For many people an economic recession has already arrived whereas for some it is just round the corner. In our opinion the recession has already arrived and it has started showing its effect on Indian economy. In India, the impact of the recession has been deeper than what was estimated by our policy makers although it is less severe than in other emerging market economies. Despite these, the impact of the global recession has been transmitted to the Indian economy through three distinct channels, viz. the capital flows, sectoral growth and financial sector.

1. Impact on Capital Flows

An outflow of foreign Institutional investment (FII) from the equity market has been the most immediate effect of this meltdown on India. During the first nine and half months of calendar year 2008, Foreign Institutional Investment pulled out $11.1 billion. A sharp decline in FII inflows aggravated the downward pressure with the rupee plunged to 50.D against dollar on November 21, 2008. There are two main factors driving the rupee down. Firstly, the dollar has been gaining strength against major currencies. Secondly, there is pressure on the capital account side as the country is witnessing outflows of dollars. If the US stock market continues to remain under pressure will persist on the foreign institutional investors leading to capital outflow and weakening rupee. The BSE sensex (1978-79= 100) increased significantly from a

level of 13,072 as end March 2007 to its peak of 20,875 on January 8, 2008 with portfolio flow reversing in 2008, partly because of international financial crisis, the sensex has now dropped to a level of 8,891 on March 6, 2009. Due to the significant change in the capital account in 2008-09, the total net capital flows fell from US $ 17.3 billion in April – June – 07 to 13.3 billion in April-June-08. Portfolio investment by FIIs witnessed a net outflow of about US $ 6.4 billion in April-Sep-08 as compared with net inflows of US $ 15.5 billion in the corresponding period of last year. While FDI inflows increased from US $ 8.5 billion in April-August-07 to 16.7 billion in the corresponding period of 08, foreign exchange reserve dropped from $ 15.5 billion to $ 258.4 billion on 31st Oct. 08. This indicates that RBI sold dollar to stem the currency's decline.

2. Impact on Sectoral Growth

The growth rate for agriculture is – 2.2% for the quarter ending Dec.08 against 6.9% in Dec. 07, -0.2% growth rate for manufacturing for quarter ending Dec. 08 against 8.6% in Dec. 07. 5.3% GDP growth rate for quarter ending Dec. 08 against 8.6% in Dec.07. The fear of deeper economic slowdown grew stronger with the government reporting on Oct. 10, 2008, the industrial growth plunged to 1.3% in August from a robust 10.9% in the same month last year. The plunge underscored the impact of rising interest rates and slackening demand, which has cascaded through almost rate of the six infrastructure industries-crude oil, refinery products, coal, power, cement and finished steel slumped to 1.4 percent, reflecting a decline in consumption triggered by the economics slowdown, finished product segments "consumer goods, consumer durables and consumer non-durables suffered contraction of 2.3%, 3% and 2% respectively. The service sector, which contributes over 55% to India's economy, has started showing a market deterioration since October this year due to the global financial crisis, credit crunch and higher interest rates during recent months. The market slowdown that occurred from October, 2008 compared with the cumulative growth rate for the period April-November 2008 compared with the cumulative growth in April-November 2007. These trends clearly indicated that the service sector that registered a robust growth in the year 2007-08 is being felt the impact of the ongoing economic turmoil and there are signs that in the months ahead further slowdown cannot be ruled out.

Table-1: Trends in Capital Flows (figures in $ million)

Components	Period	2007-08	2008-09
FDI	April-August	8,536	16,733
FII	April-September	15,508	-6,421
ECB	*April-June	6,990	1,559
STC	**April-June	1,804	2,173
ECB(approvals)	April-August	13,375	8,104
Forex(variations)	April-September	48,583	-179

Source : RBI * External Commercial Borrowing
* * Short Term Trade

3. Impact on Financial Sector

The financial sector including the banking sector, equity markets, external commercial borrowings (ECB's) and remittances has not remained unscathed though fortunately, the Indian banking sector was not overly exposed to the sub-prime crisis. Only one of the larger banks, ICICI, was partly affected but managed to thwart a crisis because of its strong balance

sheet and timely action by the government, which virtually guaranteed its deposits. The equity markets have seen a near 60 percent decline in the index and a wiping off of about USD 1.3 trillion in market capitalization since January 2008 when the sensex had peaked at about 21,000. This is primarily due to the withdrawal of about USD 12 billion from the market by foreign 6 portfolio investors between September and December, 2008. The foreign investors withdrew these funds in order to strengthen the balance sheet of their parent companies. Commercial credit, both for trade finance and medium-term advances from foreign banks has virtually dried-up. This has had to be replaced with credit lines from domestic banks but at higher interest costs and has caused the Rupee to depreciate raising the cost of existing foreign loans, finally, while the latest numbers are not yet available, remittances from overseas Indians have reportedly fallen as oil producing economics in the Gulf and West Asia begin to suffer from decline in oil prices.

Table-2: GDP Growth Trends over last year (%)

	2007-08	2008-09		
	Q 3	Q1	Q2	Q3
Agriculture	6.9	3	2.7	-2.2
Mining	4.3	4.8	3.9	5.3
Manufacturing	8.6	5.6	5	-0.2
Electricity	3.8	2.6	3.6	3.3
Construction	9	11.4	9.7	6.7
Trade, Hotels, Transport, Communications, Finance, Insurance, Real Estate	11.6	11.2	10.8	6.8
Business services	11.9	9.3	9.2	9.5
Community, Social & Personal services	5.5	8.4	7.6	17.3
GDP at Factor cost*	8.9	7.9	7.6	5.3

Source : Economic Times , February 28 , 2009 * at 1999-2000 prices.

Conclusion

Indian economy has been hurt by the global financial recession, but India may be in better position with quick recovery and for future growth than many of the other economies as Indian banks did not have significant exposure to Sub-prime loans in the U.S. The RBI's decisions to appropriately use a range of instruments such as CRR, Repo/Reverse Repo rate, SLR, MSS and LAF are in the right direction and taken in time. We would like to conclude the paper in the words of Dr. Rakesh Mohan, former Deputy Governor of RBI, "As the monetary and fiscal stimuli work their way through, and if calm and confidence are restored in the global markets, we can see economic turnaround later this year. Once calm and confidence are restored in the global markets, economic activity in India will recover sharply."

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