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CRISIS PHONIX

(Analytical Study of U.S. Recession and its impact on Indian Economy)

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Abstract

The Global Financial Crises are an indication of failure of our Financial Planning and Financial Strategies. Current Global Financial Crisis is the worst since the Great Depression of 1930s and has a devastating effect on all economies, sectors, companies and individuals. Economic activity in India has drastically suffered in the last few months. The impact of the global crisis has been transmitted to the Indian economy through distinct channels. This paper is mainly dealt with causes of the Global Financial Crises and its impact on Indian economy. The paper suggests a set of policy measures to get the Indian economy back on the path of sustained rapid and inclusive growth.

Recession

A Recession is a contraction phase of the business cycle. According to National Bureau of Economic Research (NBER) recession is : "significant decline in economic activity lasting more than a few months, which is normally visible in real GDP, real income, employment, industrial production, and wholesale-retail sales". Some economists also suggest that a recession occurs when the natural growth rate in GDP is less than the average of 2%. Typically, a normal economic recession lasts for approximately 1 year.

Cause of U.S. Recession

The Economic crises began with the bursting of US housing bubble and high default rates on sub prime and adjustable rate mortgages (ARM) beginning from 2005-2006. Higher risk lending practices by lenders and high loan incentives such easy initial payments waivers of first few installments encouraged borrowers to take more loans. Defaults and fore closures increased once easy payment terms were over because of their inability to pay back banks and investment institutes borrowed funds from all over the world and invested in housing loans and correspondingly not increased their equity base The growing rate of defaults of borrowers mounted losses on banks with liquidity crunch and triggered collapsing of financial structures of more then 100 years, such as Lehman brothers spreading global financial meltdown. It is the loan offered to an individual who does not qualify for a loan at the prime rate due to their bad credit history. Lenders offer them a sub prime loan with higher rate as risk is greater.

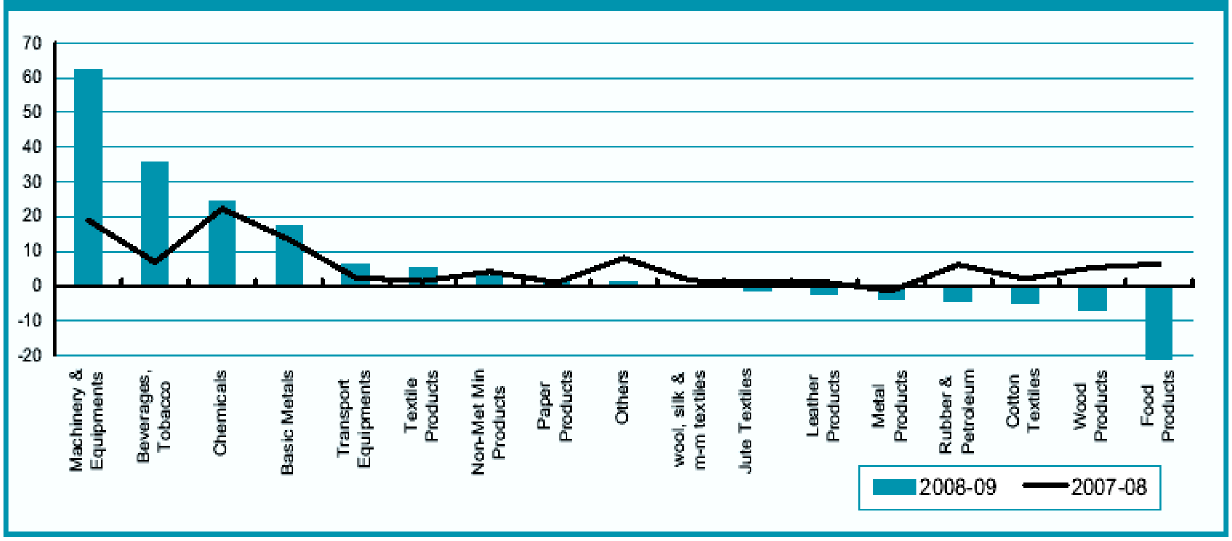
Impact on India

The impact of the global crisis has been transmitted to the Indian economy through various channels, viz., the financial sector, exports, and exchange rates. On the financial front, the Indian banking sector was not overly exposed to the sub-prime crisis. While exports of both goods and services, still account for only about 22 percent of the Indian GDP, their multiplier effect for economic activity is quite large as the import content is not as high as for example in the case of Chinese exports. Therefore, an export slump will bring down GDP growth rate in this year. The third transmission channel is the exchange rate, as the Indian Rupee has come under pressure. The detail impact of recession on Indian economy discussed as below

Industrial sector

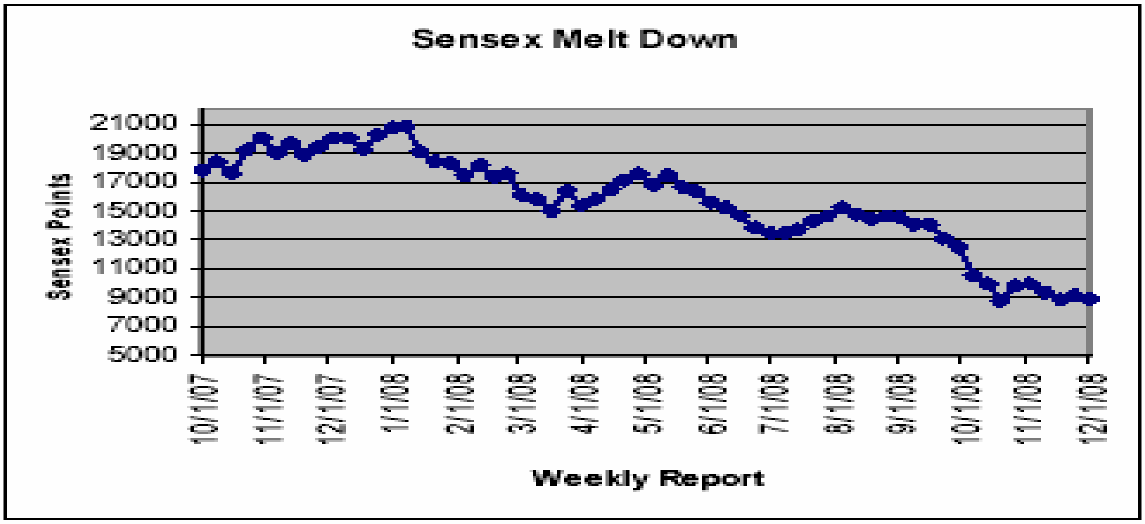
Index of Industrial Production index declined from 9.9% in H1 2007 to 4.1% in H1 2008. Oct 08: Negative growth of 0.4% (first time in 15 years) vers 12.2% in Oct 07. Manufacturing IIP index (weightage of 80% in IIP . calculation) declined from 10.6% to 4.2%. During same period Oct 08: Negative 1.2% vers 13.8% in Oct 07. Mainly due to slow down in both domestic and export demand and tight liquidity /Credit squeeze.

Figure 8.5 : Percentage contribution of product groups to manufacturing growth



Share Market

More people have sold the shares in the Indian share market than they bought in the recent weeks. This has added to the fall of sensex to lower points. Foreign investors have pulled out from stock markets leading to heavy losses in stocks and mutual funds.



Stock broking houses are laying-off people. Because of such uncertainty many people have started saving money in banks rather than investing. In 2007-08, net FII (Foreign Institutional Investments) inflows into India amounted to $20.3 billion. As compared with this, they pulled out $11.1 billion during the first nine-and-a-half months of calendar year 2008, of which $8.3 billion occurred over the first six-and-a-half months of financial year 2008-09 (April 1 to October 16). This has had two effects: in the stock market and in the currency market.

Information Technology Sector

A recent study by Forrester reveals that 43% of Western companies are cutting back their IT spend and nearly 30 percent are scrutinizing IT projects for better returns. Some of this can lead to off shoring, but the impact of overall reduction in discretionary IT spends, including offshore work, cannot be denied. The slowing U.S. economy has seen 70 percent of firms negotiating lower rates with suppliers and nearly 60 percent are cutting back on contractors. With budgets squeezed, just over 40 percent of companies plan to increase their use of offshore vendors. However, there are some offsetting factors softening the revenue slowdown - favorable Rupee- Dollar exchange rate, growth de-risking through Europe, growth in non-financial verticals, and growth through counter cyclical new business (counter cyclical to US slowdown).

Banking Sector

The US sub prime market crisis, which has so far caused losses worth $181 billion to the world's top 45 banks by the end of FY08, has now started hitting Indian banks too. India's largest private sector bank ICICI Bank was the first bank to announce a loss of about Rs. 1056 crores owing to the sub prime crisis of US in the FY08 results. The public sector banks have had a limited position in the structured products and therefore the impact is expected to be minimal. However negative sentiments will hit harder. Punjab National Bank, Bank Of India, State Bank of India, Bank of Baroda was major banks having an exposure to the instruments issued by Lehman Merrill Lynch. However the banking sector in general will have to face tight liquidity conditions apart from further mark-to-market losses. The net non performing assets of entire banking sector are less than 2% and it is well capitalized. The capital adequacy ratio is around 13% as against the statutory requirement of 8 to 9%.

Unemployment

Hundreds of workers have lost jobs in diamond jewellery, textiles and leather industry. Companies in IT industry have lower manpower need. Firms attached to the capital market are laying off people and large companies are putting their future expansion plans on hold.

Jet airways attempted to lay off around 1900 employees. Independent mortgage lender in the US, Indy Mac Bancorp, has decided to cut down staff with its temporary and outsourcing vendors by 27%, mainly in India. Various Soft Ware and IT industries are slowing down in their recruitment processes by cutting down on the Campus selection drives. An employment survey conducted by Ma Foi Management Consultants, a human resources services provider, has predicted a 30% dip in the creation of fresh jobs in the organized sector of the Indian Domestic market during the year in the wake of the global financial meltdown. Buying power of the consumers has drastically come down. Various companies and organizations are adopting cost cutting measures to its present employees. Indian stock markets are experiencing an all time low due to the crisis. **Export**

Corrective Steps to Check Recession

1. RBI needs to neutralize the outflow of FII money by unwinding the market stabilization securities that it had used to sterilize the inflows when they happened.
2. This will mean drawing down the dollar reserves which is important at this hour.
3. In the IT sector, there should be correction in salary offerings rather than job cutting
4. Public should spend wisely and save more
5. Taxes including excise duty and custom duty should be reduced to lighten the adverse effect of economic crunch on various industries In real estate the builders should drop prices, so as to bring buyers back into the market.
6. Also, the government should try and improve liquidity, while CRR and SLR must be cut further

7. Indian Companies have to adopt a multi-pronged strategy, which includes diversification of the export markets, improving internal efficiencies to maintain cost competitiveness in a tight export market situation

Conclusion

Over the past couple of months, fears of a slowdown in the United States of America have increased. The impact of the sub prime crisis along with a slowdown in mortgages has led to a significant lowering of growth estimates. Since the United States dominates the global economy, any slowdown there would have an impact on most of the global economic variables.

For India, it could mean a further appreciation in the rupee Vis--Vis the US dollar and a darkening of business outlook for sectors dependent on US companies. The overall impact of a US slowdown on India would, however, be minimal as the factors driving growth here are more local in nature. Unlike the rest of Asia, India is a strong domestic demand story, so any slowing in the US is likely to have a more muted impact on India. Strong growth in domestic consumption and significant spending on infrastructure are the two pillars of India's growth story. No sector has a dominant influence on earnings growth and risks to our estimate are limited. Corporate India is also learning to master the art of efficient capital management, reduction in costs and delivery of value-added services to sustain profit margins. Further, interest rates are expected to be stable primarily due to control over inflation and proactive measures undertaken by the RBI.

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