Impact of Financial Crisis on Emerging Economies

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Abstract:
This paper talks about financial crisis of 2008 which had hit all the nations of the world. This crisis had most affected the developed nations of United States and United Kingdom. But it has been observed that impact of this crisis was not identical for emerging nations like India. This study does an empirical investigation into the case of Indian economy to measure the impact or insulation story of this economy.

Keywords: *Crisis of finance, Economics, Impact, Emerging economies*

1. Introduction

There have been numerous debates to whether the emerging economies or the developing nations have remained insulated to the financial crisis 2008 or they were equally disadvantaged by the dismal condition of the financial markets of the US. There are three transmission channels that work in stretching the crisis to developing nations. First, banking failures and reductions in domestic lending, directly, banks in developing countries may be affected to the extent to which they hold assets contaminated by subprime mortgages. However, many developing-country banks had limited interrelationships with international banks. There is, however, a more serious indirect threat through declines in stock market prices and housing prices. In such cases it is likely that banks will reduce lending which will reduce investment which will lower growth & increase unemployment which in turn leads to a further reduction in demand lowering growth even further. Secondly, reduction in export earnings, the expected declines will come through a combination of a decline in commodity prices, a decline in demand for their goods from advanced economies and a decline in tourism. A significant proportion of US imports are from developing countries. Many of these imports are also imports of services, not just goods. An example is of India's software sector, which exports IT services to the United States which registered slow growth during this period. Thirdly, the reduction in financial flows to developing countries; as a group, developing countries require financial inflows from the rest of the world to facilitate and accelerate economic growth, trade and development. These flows include official development assistance (ODA), investment flows (portfolio and foreign direct investment (FDI), trade credits and flows of remittances. All of these were negatively affected during the crisis period.

2. Policies for the Future

The purpose of any policy in the short run should be two-fold, dampening the bank runs and asset purchases and recapitalization. Policies should be directed towards decreasing leverage of the financial system which can be done via regulation & using monetary policy effectively. The irony is that many existing tax rules favor such leverage, from the tax deductibility of mortgage interest payments by households, to the tax deductibility of interest payments by firms. A major task of regulators will be to monitor, and, if needed, to react to increases in systemic risk.

Immediate responses to the crisis include guarantees on deposits and interbank loans, provision of liquidity to financial institutions ('lender of last resort' facilities) and forbearance on meeting regulatory requirements. An essentially private sector-based financial system, characterized by sufficient competition but with strong oversight and sufficient capital adequacy, remains the best option for developing countries. Nationalizing banks may be a short-term emergency measure to prevent banks from failing, it creates a number of longer-term difficulties such as moral hazard, opportunities for rent-seeking, and directed/distorted lending, all of which compromise economic efficiency. Long term responses include reform of the international financial system. A large literature has emerged in recent years on proposals to improve aid effectiveness, which include finding innovative sources of development finance (such as a carbon tax), increasing the share of multilateral aid (most current aid is bilateral), improving the management of aid, pushing forward with aid for trade initiatives and facilitating mechanisms for encouraging private sector aid.

3. Indian Economy's Insulation Story

India could not insulate itself from the adverse developments in the international financial markets, despite having a banking and financial system that had little to do with investments in structured financial instruments carved out of subprime mortgages, whose failure had set off the chain of events culminating in a global crisis. This argument has been cited in the paper "Global Financial Crisis, its impact on India and the policy response" by Nirupam Bajpai. They claim that economic growth decelerated in 2008-09 to 6.7 percent. This represented a decline of 2.1 percent from the average growth rate of 8.8 percent in the previous five years (2003-04 to 2007-08). Per capita GDP growth grew by an estimated 4.6 percent in 2008-09.

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 argument soon proved unfounded 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. The challenges that confronted the Indian economy in 2008-09 and continue to do so in 2009-10 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.

Due to the global crisis the economy experienced extreme volatility in terms of fluctuations in stock market prices (refer to fig.6 in appendix), exchange rates and inflation levels during a short duration necessitating reversal of policy to deal with the emergent situations. Before the onset of the financial crisis, the main concern of the policymakers was excessive capital inflows, which increased from 3.1 percent of GDP in 2005-06 to 9.3 percent in 2007-08. While this led to increase in foreign exchange reserves from US$ 151.6 billion at end-March 2006 to US$ 309.7 billion at end-March 2008, it also contributed to monetary expansion, which fuelled liquidity growth. WPI inflation reached a trough of 3.1 percent in October 2007, a month before global commodity price inflation zoomed to double digits from low single digits. The rising oil and commodity prices, contributed to a significant rise in prices,

with annual WPI peaking at 12.8 percent in August 2008. The monetary policy stance during the first half of 2008-09 was therefore directed at containing the price rise.

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 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.

This fiscal accommodation led to an increase in fiscal deficit from 2.7 percent in 2007-08 to 6.2 percent of GDP in 2008-09. The difference between the actual figures of 2007-08 and 2008-09 constituted the total fiscal stimulus. This stimulus at current market prices amounted to 3.5 percent of GDP for 2008-09. These measures were effective in arresting the fall in the growth rate of GDP in 2008-09 and India achieved a growth rate of 6.7 percent.

3.1 Developments in the exchange rate arena

A major factor, which affected the emerging economies almost simultaneously, was the unwinding of stock positions by the FIIs to replenish cash balances abroad. The decline in rupee became more pronounced after the fall of Lehman Brothers in September 2008, requiring RBI intervention to reduce volatility. The rupee stabilized after October 2008, with some volatility with signs of recovery and return of foreign institutional investment (FII) flows after March 2009. The movement of the exchange rate in the year 2009/10 indicated that the average monthly exchange rate of the rupee against the US dollar appreciated by 9.9 percent from Rs 51.23 per US dollar in March 2009 to Rs 46.63 per US dollar in December 2009, mainly on account of weakening of the US dollar in the international market.

3.2 Developments in the monetary policy arena

The outflow of foreign exchange, as a fall out of the crisis, also meant tightening of liquidity situation in the economy. To deal with the liquidity crunch and the virtual freezing of international credit, the monetary stance underwent an abrupt change in the second half of 2008/09. The RBI responded to the emergent situation by facilitating monetary expansion through decreases in the CRR, RR and R-RR rates, and the statutory liquidity ratio (SLR).

The credit policy measures by the RBI broadly aimed at providing adequate liquidity. At the same time, it was necessary to ensure that the financial contagion arising from the global financial crisis did not permeate the Indian banking system. These measures were therefore supplemented by sector-specific credit measures for exports, housing, micro and small enterprises and infrastructure.

The step-up in India's growth rate over much of the last two decades was primarily due to the structural changes in industrial, trade and financial areas, among others, over the 1990s as the reforms in these sectors were wide and deep and hence contributed significantly to higher productivity of the economy. Indeed, there is potential for still higher growth on a sustained basis of 9+ percent in the years ahead.

On contrary to the above said argument is the explanation provided in the paper "Global Financial Crisis and Key Risks: Impact on India and Asia" by Rakesh Mohan who supports the fact that Indian economy was insulated against the crisis. The Indian current account has been opened fully, though gradually, over the 1990s, a more calibrated approach has been followed to the opening of the capital account and to opening up of the financial sector.

Capital account convertibility is a feature of a nation's financial regime that centers on the ability to conduct transactions of local financial assets into foreign financial assets freely and at country

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determined exchange rates. But free mobility of capital leaves countries open to both sudden and huge inflows as well as outflows, both of which can be potentially destabilizing unless there are financial institutions capable of dealing with such huge flows leading to even a crisis like situation. *Current account convertibility* allows free inflows and outflows for all purposes other than for capital purposes such as investments and loans. In other words, it allows residents to make and receive trade-related payments - receive dollars (or any other foreign currency) for export of goods and services and pay dollars for import of goods and services, make sundry remittances, access foreign currency for travel, studies abroad, medical treatment and gifts etc.

The Reserve Bank had already put in place steps to mitigate liquidity risks at the very short-end, risks at the systemic level and at the institution level as well. Some of the important measures by the Reserve Bank in this regard include, *first*, restricting the overnight unsecured market for funds to banks and primary dealers (PD) as well as limits on the borrowing and lending operations of these entities in the overnight inter-bank call money market; *second,* large reliance by banks on borrowed funds can exacerbate vulnerability to external shocks. This has been brought out quite strikingly in the ongoing financial crisis in the global financial markets. Accordingly, in order to encourage greater reliance on stable sources of funding, the Reserve Bank had imposed prudential limits on banks on their purchased inter-bank liabilities and these limits were linked to their net worth. *Third,* asset liability management guidelines for dealing with overall asset-liability mismatches took into account both on and off balance sheet items. *Finally,* guidelines on securitization of standard assets had laid down a detailed policy on provision of liquidity support to Special Purpose Vehicles (SPVs).

Active liquidity management is a key element of monetary policy. Liquidity modulation through a flexible use of a combination of instruments such as CRR, OMO has, to a significant extent, cushioned the impact of the international financial turbulence on domestic financial markets by absorbing excessive market pressures and ensuring orderly conditions.

Credit policy reforms, better structuring of banking sector debt and improved fiscal positions have also played their role making the EMEs resilient from the crisis. In addition, large foreign exchange reserves, particularly in Asia, also provide a degree of protection against possible sudden stops. Another factor that could be of relevance for this favourable situation is the relatively smaller presence of foreign banks in the Asian banking sector.

The Government’s fiscal deficit has been high by international standards but is also largely internally financed through a vibrant and well developed government securities market, and thus, despite large fiscal deficits, macroeconomic and financial stability has been maintained. Derivative instruments have been introduced cautiously in a phased manner, both for product diversity and, more importantly, as a risk management tool. All these developments have facilitated the process of price discovery in various financial market segments.

In view of the accelerated exposure observed to the real estate sector, banks were advised to put in place a proper risk management system to contain the risks involved. In view of the rapid increase in loans to the real estate sector raising concerns about asset quality and the potential systemic risks posed by such exposure, the risk weight on banks' exposure to commercial real estate was increased from 100 per cent to 125 per cent in July 2005 and further to 150 per cent in April 2006.

In brief, the Indian approach has focused on gradual, phased and calibrated opening of the domestic financial and external sectors, taking into cognizance reforms in the other sectors of the economy. Financial markets are contributing to efficient channeling of domestic savings into productive uses and, by financing the overwhelming part of domestic investment, are supporting domestic growth. These

characteristics of India's external and financial sector management coupled with ample foreign exchange reserves coverage and the growing underlying strength of the Indian economy reduced the susceptibility of the Indian economy to global turbulence.

4. Econometric Testing

We have tried to do a very brief testing of whether the financial markets of India affected by that of the US, which shall bring to forefront the ideas behind the two contrary arguments. For this we have regressed the SENSEX (Stock Price Index for India) on S&P500 (Stock Price Index for US) to verify if the Indian stock price index is being guided by the American stock price index. We have used monthly average values for the two stock price indices for the period beginning January 2004 to December 2011.

$$SENSEX = \mu 1 + \mu 2.SP500 + e$$

The estimated equation is:

$$SENSEX = 2315.603 + 8.864453.SP500 + e$$

(3378.734) (2.760144) ……..parentheses contain the standard errors

The results show that the constant term is highly insignificant, so we re-run the regression dropping the constant term.

$$SENSEX = 10.73831.SP500 + e$$

(.3766264) ……..parentheses contain the standard error

It can be analyzed that the resulting value of the coefficient is statistically significant at all levels of significance. So, it can be inferred from this result that the SENSEX is definitely guided by the S&P500 index and hence Indian financial markets were highly effected by the US financial crisis.

5. Trends Analysis

On the contrary to the above said result, if we analyze the trends in the two stock price indices, we can bring an interesting inference. The S&P500 trend reflects that this stock price index averaged in the range of 1100 points at the beginning of the year 2004 and in the boom period it crossed the 1500 points level by end of year 2007, which roughly comes up as a 36% rise in the index over these four years span. Then the crisis hit the US economy and it started declining to reach a low range of 750 points by the first quarter of 2009 which is roughly a 50% decline in the index. Then it gradually picked up the range of 1100 points in 2010 and 1200 points in 2011.

But if look at the performance of the SENSEX the story appears to be different. The SENSEX began its journey from the range of 5000 points in January 2004 and reached an unexpected high of 20,000 points by December 2007 which is clearly a 300% increase over this boom period of four years. There on there was a negative market sentiment developed by the news of the crisis in US, so the index dropped sharply to 8891 points in February 2009 but soon gained momentum and crossed 15000 points mark by mid-2009. So, two implications are there (i) the decline in the Indian stock price index was short-lived (ii) the decline was there but it was well above the 2004 level unlike US.

It may appear that such an unanticipated increase in the SENSEX was mainly due to the speculative activity in the financial market by the big bullish players. But the strength maintained by the financial

markets in the period of recession could explain the Indian economy's insulation story. The point being conveyed here is that, had the rise in SENSEX been totally speculative then a bearish sentiment could have pulled it down to the 2004 level or even below as in case of US where the stock prices were much lower than 2004 levels. Also the catch up period for Indian stock price index is very short unlike US which has not yet seen the initial high levels. Thus, this trend analysis attempts to support the fact that the Indian economy was insulated against the financial crisis 2008.

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Appendix