IMPACT OF GLOBAL FINANCIAL CRISIS ON THE INDIAN ECONOMY

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ABSTRACT
The global financial crisis has originated in the sub-prime mortgage crisis in USA during 2007. The Government India has been concerned about the impact of the global financial crisis on the Indian economy and a number of steps have been taken to cope up with this problem. This paper presents a brief overview of the factors that led to the collapse of the financial markets around the world. It examines the Government of India's response to the financial crisis through stimulus packages. It also discusses the steps taken by Reserve Bank of India to deals with the problem of global financial meltdown. It analyzed the impact of all these steps taken by Government and RBI on different macroeconomic variables in India during the crisis time period. The Indian economy has proved relatively resilient in the face of the global economic crisis. India's large domestic market, along with government fiscal measures, a number of social programmes and a strong banking system have helped to mitigate the impact of the drop in demand in export markets.

Keywords: Financial crisis; Sub-prime mortgage; Stimulus package; India
JEL Classification Codes: F3, G1

I. Introduction:

The current global financial crisis is rooted in the subprime crisis which surfaced over a year ago in the United States of America. During the boom years, mortgage brokers attracted by the big commissions, encouraged buyers with poor credit to accept housing mortgages with little or no down payment and without credit checks. A combination of low interest rates and large inflow of foreign funds during the booming years helped the banks to create easy credit conditions for many years. Banks lent money on the assumption that housing prices would continue to rise. Also the real estate bubble encouraged the demand for houses as financial assets. Banks and financial institutions later repackaged these debts with other high-risk debts and sold them to world- wide investors creating financial instruments called Collateralized Debt Obligations. In this way risk was passed on multifold through derivatives trade. Surplus inventory of houses and increase in interest rates led to a decline in housing

prices in 2006-2007 resulting in an increased defaults and foreclosure activity that collapsed the housing market. Consequently, a large number of properties were up for sale affecting mortgage companies, investment firms and government sponsored enterprises which had invested heavily in subprime mortgages.

We have divided this paper into three sub sections. In first section we have discuss different reasons for the origin and growth of financial crisis across the globe. In second section we have provided brief description about various steps taken by Government of India and Reserve Bank of India to cope up with the problem of global financial meltdown and India's response towards it. In the third section we have analyzed the impact of financial crisis on some of leading macroeconomic indicators of India. The organization of the paper as follows. Section I discusses the origin and growth of the financial crisis. Section II analyzes the impact of global financial crisis on Indian Economy. The impacts of various steps to tackle the crisis are assessed in Section III. Section IV summarizes.

II. Section - I

We discuss the origin and growth of the financial crisis in the section.

(i) Sub-prime mortgage

The global economic crisis has originated in the sub-prime mortgage crisis in USA during 2007. With easy availability of credit at low interest rates, real estate prices in US had been rising rapidly since the late 1990s and investment in housing had assured financial return. The boom in housing sector made both banks and home buyers believe that the price of a real estate would keep going up. Banks went out of their way to lend to sub-prime borrowers who had no collateral assets. Low income individuals who took out risky sub-prime mortgages were often unaware of the known risks inherent in such mortgages. While on the one hand, they were ever keen to become house-owners, on the other, they were offered easy loans without having any regard to the fact that they were not in a position to refinance their mortgages in the event of the crisis. But the housing bubble burst in 2007. Home prices fell between 20 per cent and 35 per cent from their peak and in some areas more than 40 per cent; mortgage rates also rose. Sub-prime borrowers started defaulting in large numbers.

(ii) Securitization and Repackaging of Loans

The mortgage market crisis that originated in the US was a complex matter involving a whole range of instruments of the financial market that transcended the boundaries of sub-prime mortgage. An interesting aspect of the crisis emanated from the fact that the banks/ lenders or the mortgage originators that sold sub-prime housing loans did not hold onto them. They sold them to other banks and investors through a process called securitization. Securitization, as a financial process, has gained wide currency in the US in the last couple of decades. Indeed, as recently as 1980 only 10 per cent of US mortgages were securitized compared to 56 per cent in 2006[1].

(iii) Excessive Leverage

The main problem came from excessive leverage. Investors bought mortgage-backed securities by borrowing. Some Wall Street Banks had borrowed 40 times more than they were worth. In 1975, the Securities Exchange Commission (SEC) established a net capital rule that required the investment banks who traded securities for customers as well as their own account, to limit their leverage to 12 times. However, in 2004 the Securities and Exchange Commission (SEC) allowed the five largest investment banks– Merrill Lynch, Bear Stearns, Lehman Brothers, Goldman Sachs and Morgan Stanley – to more than double the leverage they were allowed to keep on their balance sheets, i.e. to lower their capital adequacy requirements. This was far too risky. The system went into reverse gear after the middle of 2007. US housing prices fell at their fastest rate in 75 years. Sub-prime borrowers started missing their payment schedules. Initially started as a liquidity problem, it soon precipitated into a solvency problem, making them search for capital that was not readily available. Bear Stearns was sold to the commercial bank J.P. Morgan Chase in mid-March 2008; Lehman Bros filed for bankruptcy in mid-September 2008; Merrill Lynch was sold to another commercial bank, Bank of America and finally Morgan Stanley and Goldman Sachs signed a letter of intent with US Federal Reserve on September 22, 2008 to convert themselves into bank holding companies. The year 2008 will go as the worst year in the history of modern finance wherein the sun of powerful and iconic Wall Street investment banks set in.

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[1]Global Economic Outlook, 2008 (http://www.imf.org/external/pubs/ft/weo/2008/02/pdf/text.pdf)

(iv) Role of Credit-Rating Organizations

Specialist credit rating organizations, which have the mandate to inform investors how safe a security really is, did not, apparently, do their job well enough. Credit Rating Organizations (CROs) awarded credit ratings to the high value asset-backed securities as investment grade, suggesting that they were safe even when the underlying collateral was all sub-prime. Even many regulatory agencies, investors and bond insurers rely on CRO credit ratings to substitute for their own due diligence[2] . But it was hard to understand as to why the CROs created the ambience of security by assigning AAA ratings to the toxic CDOs, if they were aware of the ground realities.

(v) Diversity among Financial Innovation and Regulation

It is not surprising that governments everywhere seek to regulate financial institutions to avoid crisis and to make sure a country's financial system efficiently promotes economic growth and opportunity. Financial innovation inevitably exacerbates risks, while a tightly regulated financial system hampers growth. When regulation is either too aggressive or too lax, it damages the very institutions it is meant to protect. It is important to understand that the goal of financial regulation and supervision is not to reduce risk-taking of the financial institutions, but to manage the safety net. This goal implied that supervisors have a duty to see that risks can be fully understood and fairly priced by investors. The crisis has taken by surprise everyone, including the regulators. The regulators failed to see the impact of the derivative products which clouded the weaknesses of the underlying transactions.

(vi) Defective understanding of the Implications of Derivative Products

Derivative products are a natural consequence of financial development. They are financial instruments that are used to reduce financial risk. Derivatives are a way to "hedge" against various unintended risks. The investor in the derivatives believes that he can diversify risk by combining one loan in one place with another loan of the same type at another place under one common instrument and then sells it to another investor. This combination reduces the risk and the

[2] "The 2007 Meltdown in Structured Securitization: Searching for Lessons, Not Scapegoats", Policy Research Working Paper 4756, The World Bank, October, 2008 (http://ideas.repec.org/p/wbk/wbrwps/4756.html)

investor believes that what he holds has a balanced risk. Experts have held that the derivatives have the potential to benefit the investors, provided there is thorough understanding of the varied facets of the derivative products including transparent dealings with the borrowers. If the derivate products become too complex to discern, where risk lies, they become sources of concern[3]. Even as the authorities deal with the immediate problems arising from the crisis, the regulators need to pay attention to how to deal with derivatives.

(vii) Fair value accounting rules

The broad aim of fair value accounting is to enable investors, financial system participants, and regulators to better understand the risk profile of securities in order to better assess their position. In order to achieve this, financial statements must, in the case of instruments for which it is economically relevant, be sensitive to price signals from markets, which reflect transaction values. Investors and regulators hold that the fair value accounting standard should not be weakened because it is a key component of accurate and fully transparent financial statements, which in turn are the bedrock of financial activity. But the asset holders maintain that accounting standard should be reformed to fully reflect the reality of financial activities.

(viii) Characteristics of US financial system

The financial system of USA has changed dramatically since the 1930s. Many of America's big banks moved out of the "lending" business and into the "moving business". They focused on buying assets, repackaging them, and selling them, while establishing a record of incompetence in assessing risk and screening for creditworthiness. Hundreds of billions have been spent to preserve these dysfunctional institutions. Nothing has been done even to address their perverse incentive structures, which encourage short-sighted behavior and excessive risk taking. With private rewards so markedly different from social returns, it is no surprise that the pursuit of self-interest led to such socially destructive consequences. Not even the interests of their own shareholders have been served well.[4]

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[3] C. Rangarajan, ''The financial crisis and its ramifications'', The Hindu, November 8, 2008

[4] Joseph E. Stiglitz, "The Triumphant Return of John Maynard Keynes", Guatemala Times, December 5, 2008

In the United States, the crisis was shaped by typical nature of the US financial system having a complex mortgage financing value chain with opaque securitization structures, a large 'shadow financial system' involving various poorly regulated intermediaries viz. investment banks, hedge funds, structured investment vehicles etc. and instruments like credit default swaps. Prudential oversight was lax, allowing poor lending standards, the proliferation of non-transparent securitization structures, poor risk management throughout the securitization chain, and the build-up of excessive leverage by financial institutions.

(ix) Failure of Global Corporate Governance

One of the reasons for crisis in the advanced industrial countries related to the failures in corporate governance that led to non-transparent incentive schemes that encouraged bad accounting practices. There is inadequate representation and in some cases no representation of emerging markets and less developed countries in the governance of the international economic institutions and standard setting bodies, like the Basle Committee on Banking Regulation[5]. The international economic organization such as IMF has been wedded to particular economic perspectives that paid little attention to the inherent risks in the policies pursued by the developed countries.

(x) Complex Interplay of multiple factors

It may be said with a measure of certainty that the global economic crisis is not alone due to sub-prime mortgage. There is a congregation of factors that led to a crisis of such an enormous magnitude. The declaration made by the G-20 member states at a special summit on the global financial crisis held on 15th November 2008 in Washington, D.C. identified the root causes of the current crisis and put these in a perspective. Policy-makers, regulators and supervisors, in some advanced countries, did not adequately appreciate and address the risks building up in financial markets, keep pace with financial innovation, or take into account the systemic ramifications of domestic regulatory actions. Major underlying factors to the current situation were, among others, inconsistent and insufficiently coordinated macroeconomic policies, inadequate structural

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[5] Presentation by Joseph Stiglitz at the Interactive Panel of the UN General Assembly on the Global Financial Crisis at UN Head Quarter, October 30, 2008

reforms, which led to unsustainable global macroeconomic outcomes. These developments, together, contributed to excesses and ultimately resulted in severe market disruption[6].

III. Section - II

We examine the impact of Global financial crisis on the Indian economy in the section.

The Government India has been concerned about the impact of the global financial crisis on the Indian economy and a number of steps have been taken to deal with this problem.

The first priority was to re-assure the people of the stability of the financial system in general and of the safety of bank deposits in particular. To this end, steps were taken to infuse liquidity into the banking system and also to address problems being faced by various non-bank financing companies. These steps have ensured that the financial system is functioning effectively without suffering the kind of loss of confidence experienced in the industrialized world.

Having assured stability of the system, the Government has focused its attention on countering the impact of the global recession on India's economic growth. On the monetary side, the RBI has sought to pump sufficient liquidity into the banking system to enable bank credit to meet the expanded requirements of the economy keeping in mind the contraction in credit from non-bank sources. Banks have been provided adequate liquidity through a series of reductions in the CRR and additional flexibility in meeting the SLR requirement. Interest rate reductions have also been signaled by reductions in the repo and reverse repo rates, the most recent of which was announced on Saturday when both the repo rate and the reverse repo rate were cut by 100 basis points. Access to external commercial borrowings has also been liberalized so that borrowers capable of accessing funds from abroad are allowed to do so. The banks are being encouraged to counter what might otherwise become self-fulfilling negative expectations by enhanced lending to support economic activity.

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[6] The Statement from G-20 Summit on "Financial Markets and the World Economy" held in Washington on 15th November 2008

These measures in the area of money and credit are being supplemented by fiscal measures designed to stimulate the economy. In recognition of the need for a fiscal stimulus, the government had consciously allowed the fiscal deficit to expand beyond the originally targeted level because of the loan waivers, issue of oil and fertilizer bonds and higher levels of food subsidy. In addition, the Government of India has announced four stimulus packages to cope up with the problem of global financial meltdown.

The first stimulus package of US$4 billion in December 2008 was followed by a second package in January 2009, totaling US$4.2 billion, to prevent a further slowdown of the economy. A third stimulus package, which at about US$800 million was much smaller than the earlier two, was announced in February 2009. Overall, the stimulus packages totaled about US$9 billion, less than 1 per cent of GDP.

Following is the brief details of various financial stimulus package declared by Government of India and Reserve Bank of India.

First Stimulus Package:

1. Plan Expenditure

In order to provide a contra-cyclical stimulus via plan expenditure, the Government has decided to seek authorization for additional plan expenditure of up to Rs 20,000 crore in the current year. In addition, steps are being taken to ensure full utilization of funds already provided, so that the pace of expenditure is maintained. The total spending programme in the balance four months of the current fiscal year, taking plan and non-plan expenditure together is expected to be Rs. 300,000 crore.

The economy will continue to need stimulus in 2009-2010 also and this can be achieved by ensuring a substantial increase in plan expenditure as part of the budget for next year.

2. Reduction in Cenvat

As an immediate measure to encourage additional spending, an across-the-board cut of 4% in the ad valorem Cenvat rate will be effected for the balance part of the current financial year on all products other than petroleum and those where the current rate is less than 4%.

3. Measures to Support Exports

Pre and post-shipment export credit for labour intensive exports, i.e., textiles (including handlooms, carpets and handicrafts), leather, gems & jewellery, marine products and SME sector is being made more attractive by providing an interest subvention of 2 percent up to 31/3/2009 subject to minimum rate of interest of 7 percent per annum.

4. Housing

Housing is a potentially very important source of employment and demand for critical sectors and there is a large unmet need for housing in the country, especially for middle and low income groups. The Reserve Bank has announced that it will shortly put in place a refinance facility of Rs. 4000 crore for the National Housing Bank. In addition, one of the areas where plan expenditure can be increased relatively easily is the Indira Awas Yojana. As a further measure of support for this sector public sector banks will shortly announce a package for borrowers of home loans in two categories: (1) up to Rs. 5 lakhs and (2) Rs 5 lakh-Rs 20 lakh. This sector will be kept under a close watch and additional measures would be taken as necessary to promote an accelerated growth trajectory.

5. MSME Sector

The Government attaches the highest priority to supporting the medium, small and micro enterprises (MSMEs) sector which is critical for employment generation. To facilitate the flow of credit to MSMEs, RBI has announced a refinance facility of Rs. 7000 crore for SIDBI which will be available to support incremental lending, either directly to MSMEs or indirectly via banks, NBFCs and SFCs.

6. Textiles

(a) An additional allocation of Rs. 1400 crore will be made to clear the entire backlog in TUF Scheme.

(b) All items of handicrafts will be included under 'Vishesh Krishi & Gram Udyog Yojana'.

7. Infrastructure Financing

A large number of infrastructure projects are now being cleared for implementation in the Public Private Partnership mode. These projects may experience difficulty in reaching financial closure given the current uncertainties in the financial world. In order to support financing of such projects, Government has decided to authorize the India Infrastructure Finance Company Limited (IIFCL) to raise Rs. 10,000 crore through tax-free bonds by 31/3/2009. These funds will be used by IIFCL to refinance bank lending of longer maturity to eligible infrastructure projects, particularly in highways and port sectors. In this way it is expected that IIFCL resources used for refinance can leverage bank financing of double the amount. Depending on need, IIFCL will be permitted to raise further resources by issue of such bonds. In particular, these initiatives will support a PPP programme of Rs. 100,000 crore in the highways sector.

Second Stimulus Package:

The government and the Reserve Bank of India announced a second stimulus package for the economy that includes a further easing of liquidity and liberalization of various rules and regulations, to give a boost to spending and investment.

In order to further ease liquidity and credit flow, the Reserve Bank of India also reduced the repo rate under the liquidity adjustment facility (LAF) by 100 basis points from 6.5 per cent to 5.5 per cent. It also reduced the reverse repo rate by 100 basis points from 5.0 per cent to 4.0 per cent with immediate effect.

RBI also announced a reduction in the cash reserve ratio (CRR) of scheduled banks by 50 basis points from 5.5 per cent to 5.0 per cent from the fortnight beginning 17 January 2009.

The government had taken a number of steps since 7 October to minimize the impact of the global financial crisis on the Indian economy. These included:

- Additional plan expenditure of up to Rs20,000 crore in the current year, mainly for critical rural, infrastructure and social security schemes such as Pradhan Mantri Gram Sadak Yojana (PMGSY), Jawaharlal Nehru National Urban Renewal Mission (JNNURM), National Rural Employment Guarantee Scheme (NREGS), Indira Awas Yojana, Accelerated Irrigation Benefit Programme and National Social Assistance Programme (NSAP).

- An across-the-board cut of 4 per cent in ad-valorem Central value-added tax (CENVAT) rate except for petroleum products

- The Reserve Bank of India and the government had announced several other measures to support exports, housing, micro, small and medium enterprises (MSME) and the textile sectors.

- The government had also authorizing India Infrastructure Finance Company Limited (IIFCL) to raise Rs. 10,000 crore to refinance bank lending for infrastructure projects.

- Subsequently, other measures have also been taken such as removal of ban on export of cement.

Third Stimulus Package:

Major points of package are—

- Service Tax Rates reduction by 2%. Now the Service Tax shall be charged at 10% instead of 12%. This will give relief to Service Sector like telephone, airlines ticket, tour packages, health clubs, beauty parlors, drycleaners, cyber cafes, outdoor catering, transport of goods by air, packaging, maintenance and repairs packages, insurance, banking sector, etc. that constitutes 50% of country's GDP.

- Central Excise Rate reduced by 2%. Now the Central Excise Tax shall be levied at 8% instead of 10%. This reduction shall boost demand of colour television sets, washing machines, refrigerators, air-conditioners, soaps, detergents, hybrid cars and commercial vehicles.

- Government announced that 4% across the board cut in Excise Duty which was announced in the First Stimulus Package (in December, 2008) will be valid even beyond March 31, 2009.

- Customs duty exemption on naphtha imports for generation of electric energy has also been extended beyond March 31, 2009.

- The Government slashed excise duty on bulk cement by 2% to 8%, or Rs. 60 per metric tons to Rs. 230 PMT. This will bring down the cost of housing and construction companies and give a fillip to demand in the

cement industry reeling under a slowdown. The 2% cut in excise duty will also bring down the cost of steel for this sector.

- GOI has extended the flexibility to states to deviate from fiscal consolidation targets by 0.5% beyond March 31, 2009, to boost infrastructure and enable them to generate more employment.

Fourth Stimulus provided through Foreign Trade Policy

- Duty Credit Scrips under Duty Entitlement Pass Book (DEPB) Scheme to be issued without waiting for realization of export proceeds.
- Special Package of Rs. 325 crores for Leather and Textiles sector.
- State Trading Corporation Ltd. (STCL), Diamond India, Metal Scrap Trading Co. (MSTC), Gem & Jewellery Export Promotion Council and Star Trading Houses added as nominated agencies for import of precious metals.
- Threshold limit for recognition as Premier Trading Houses reduced to Rs. 7500 crores.
- Under Export Promotion Capital Goods Scheme (EPCG), export obligation extended till 2009-10 for exports during 2008-09.
- Re-credit of 4% Special Additional Duty (SAD) for Vishesh Krishi & Gram Udhyog Yojana (VKGUY), Focus Product Scheme (FPS) and Focus Market Scheme (FMS) allowed.
- A new office of Director General of Foreign Trade (DGFT) to be opened at Srinagar.
- Value cap under Duty Entitlement Pass Book (DEPB) revised for two products.

Measures for Easing Difficulties of Micro, Small Sector Enterprises during Current Economic Down-Turn (other than Government of India)

A. Measures announced by Reserve Bank of India

- Reserve Bank of India has provided finance facility of Rs. 7000 crores to SIDBI to support incremental lending either directly to MSEs or indirectly through Banks, Non-Banking Finance Companies (NBFC) and State Financial Corporations.

- To boost collateral free lending of Banks by extending credit guarantee cover, Credit Guarantee Trust for Micro, Small Enterprises (CGTMSE) has increased the loan ceiling to micro and small entrepreneurs from Rs. 50 lakhs to Rs. 1 crore with guarantee cover of 50%. CGTMSE has also reduced the lock-in period for invoking claims in credit guaranteed accounts from 24 months to 18 months.

- The Reserve Bank of India has enhanced export credit refinance limit for scheduled commercial Banks from 15 to 50% of the outstanding export credit eligible for refinance to export oriented units and advised Banks to use the special refinance facility up to 1% of each bank's Net Demand and Term Liability (NDTL) for the purpose of extending finance to micro and small enterprises.

B. Measures announced by Indian Banks' Association

- Public Sector Banks to grant need based ad hoc Working Capital Demand Loans up to 20 percent of the existing fund based limits in respect of units having overall fund based credit facility up to Rs. 10 crore.

- Interest rates for borrowings by Micro Industries to stand reduced by 100 basis points for all existing and new loans with immediate effect.

- In addition, RBI will be providing finance facility of Rs. 7000 crore to SIDBI to support incremental lending either directly to MSEs or indirectly through banks, NBFCs and SFCs. This is in addition to Rs. 3600 crore already allotted to SIDBI this year for refinance from the shortfall of scheduled commercial banks in the priority sector lending.

- To boost collateral free lending, SIDBI has decided to extend the current guarantee cover under credit guarantee scheme for loans to micro and small entrepreneurs from Rs. 50 lakh to Rs. 1 crore with guarantee cover of 50 percent. Further, SIDBI has also reduced the lock

in period for invoking claims in respect of loans covered under credit guarantee scheme to 18 months from 24 months.

Above were the various stimulus packages announced by Government of India and various steps taken by Reserve Bank of India to deals with global financial crises problem in India.

IV. Section - III

We will assess the impact of these various steps on macroeconomic indicator in India. They are as follows:

Contribution to Growth:

GDP growth of 8.8% in the first quarter of FY2010 (ending March 2011) and 8.6% in the last quarter of FY2009 signaled a strong and durable recovery, primarily led by a healthy expansion in industry and buoyancy in services. Moreover, the performance of agriculture was reasonable in the first quarter, after a negligible expansion in FY2009 due to a poor summer monsoon. The subsectors that registered impressive growth included mining and quarrying; manufacturing; electricity, gas, and water supply; construction; and trade, hotels, transport, and communications. From the demand perspective, investment took over as the major driver of growth in the second half of FY2009, from government consumption expenditure in the first. Indeed, investment contributed nearly one-half of GDP growth for the second half of the fiscal year. This revival was primarily due to an improved overall business outlook and the desire for greater production capacity following slow investment the previous year.

Inflation

Persistent high inflation somewhat mars the economic landscape. The year-on-year rate picked up to 11.0% in April 2010, and subsequently moderated to 8.5% in August. While initially bumped up by a surge in food prices reflecting a poor harvest, high food inflation appeared to be seeping through to wages and then to prices for manufactured goods, where inflation climbed to 6.4% in April, but subsequently slowed to 4.8% in August as monetary tightening gained traction. Food price inflation stayed high at 14.6% in August 2010—despite record levels of government food stocks and a good spring harvest— adding further to popular discontent over continued high prices. (A June revision in domestic prices of

petrol, diesel, cooking gas, and kerosene, while a welcome step in reducing high subsidies, has also nudged up overall inflation.) Still, the government expects inflation to moderate in the second quarter of FY2010 and beyond because this year's summer monsoon rainfall has been above average and a bumper agricultural outturn is expected to bring down food prices. The Reserve Bank of India (RBI), the central bank, expects that overall inflation will moderate to 6% year on year by end-March 2011.

Monetary Policy Indicators

In the context of the strong domestic recovery and inflation pressures, the RBI began a gradual withdrawal from its earlier expansionary monetary policy stance. It raised both the repo and the reverse repo rates by 125 and 175 basis points, respectively, from January to mid-September this year. It lifted the cash-reserve ratio by 100 basis points in the same period. In announcing the September decision to adjust rates (the first mid-quarterly policy review undertaken to better guide market participants), the central bank noted that India's recovery was rapidly converging to its trend rate of growth.

Strong momentum in industrial production, buoyant services sector indications, a favorable outlook for agriculture, and fiscal consolidation on its targeted path underpinned this assessment. Inflation remained the dominant concern and the upward rate adjustment would contain it and anchor inflationary expectations without disrupting growth.

On the external front, the central bank noted that the continued sluggishness of the global economy was constraining export growth, while the strong domestic recovery was pushing imports and the trade deficit higher. However, improved global investor sentiment was resulting in increased capital inflows and, if it continued, it would abate concerns even if exports remained sluggish.

In its statement, the RBI also indicated that policy adjustments over the year had brought back the high expansionary stance of policy to a more neutral position. With normalization largely complete, adaptations in central bank policies would now essentially be oriented to changing current and expected macroeconomic conditions.

Balance of Payment Indicators

The key features of India's balance of payments during FY2009 were a slightly lower trade deficit (though it expanded over the year as the return to rapid growth sucked in imports); a weakening in the invisibles account surplus (because of slower growth in business processing services); and a marked widening in the current account deficit to $38.4 billion (to 2.9% of GDP).

An encouraging development was the burgeoning of net capital inflows during the year, as risk appetite returned with the upswing in growth in major industrial economies. The capital surplus more than covered the current account deficit and helped to rebuild foreign exchange reserves following the large loss in FY2008. India's external debt, as of31 March 2010, was at $261.4 billion (18.9% of GDP).

International Reserve [$ billion]

Foreign exchange reserves fell slightly in the first fiscal quarter but subsequently advanced to show roughly a $4 billion gain over the first 5 months of FY2010, to total about $258 billion at end-August. This increase in reserves (though less than the $20 billion in the period a year earlier), suggests that, in the face of a growing trade deficit, net capital inflows stayed strong. Indeed, portfolio investment by foreign institutional investors amounted to $12.2 billion in the first 5 months of FY2010, some 20% above the prior-year level.

Exchange Rates

Despite some moderation in capital inflows in the first quarter of FY2010 (especially in May), and consequent nominal depreciation of the rupee against the dollar, the pressure on the rupee to appreciate has reemerged due to strong capital inflows in the second quarter. Indeed, the Indian currency appreciated by more than 11% in real terms between August 2009 and August 2010. This was mainly attributable to high inflation (relative to trading partners). The authorities are keen to push growth to 9%–10% over time, and so may want to resist any appreciation in the exchange rate and to this end the expected reduction in inflation over the coming months will be beneficial. Given the volatile nature of capital inflows in reaction to external events, striking the right balance among growth, inflation, and competitiveness objectives will be a delicate maneuver. A continued stable recovery in the industrial world should sustain positive global investor sentiment, and hence capital inflows to India.

Amid uncertainties about global recovery, the central government's FY2010 budget deficit was set to decline to 5.5% of GDP, about a 1.2 percentage point reduction as part of a multiyear plan for winding down the large fiscal stimulus provided earlier. Receipts from the sale of bandwidth for mobile telephony and wireless broadband in auctions turned out to be almost three times the budgeted amount; however, the additional funds were largely offset by an Rs.546 billion supplement to the budget that raised total expenditure by about 5%. Data through August show buoyant revenue collection, such that the deficit target should be readily met.

The June 2010 the government's decision to decontrol gasoline (petrol) prices—allowing them to adjust to global prices—as well as raising administered prices for diesel, cooking gas, and kerosene was a step in the right direction. While further actions are needed, the changes were an important start to reducing excessive subsidies and rationalizing incentives for energy use and production.

The introduction of a comprehensive, integrated (federal and state) goods and services tax (GST) to replace a myriad of indirect taxes is also a crucial reform both for achieving fiscal consolidation as well as minimizing distortions in the economy. It was expected to take effect from April 2011; however, it has been delayed as procedural requirements were not completed in time. Moreover, the revised version of the direct tax codes, approved by the Cabinet recently, appears to be a missed opportunity for fundamental reforms in the direct tax system. That version, too, will not take effect in April 2011 as originally planned.

Despite renewed buoyancy in revenue stemming from higher growth, greater rationalization in expenditure will be needed to achieve the fiscal consolidation roadmap proposed by the 13th Finance Commission. That document envisaged the central budget deficit shrinking to 3.0% by FY2013 and the general government debt to 68% of GDP (from 80% at end-FY2009).

Stock Price Indices 01/01/2007 to 16/11/2010 (Jan 2007=100)

The Sensex, the main index of the Bombay Stock Exchange, saw a remarkable run up from March 2009 that has continued through August 2010. The upturn was part of a general worldwide rally in stock prices. The Sensex has substantially outperformed a general index of emerging Asian stock markets—the Morgan Stanley Capital International All Country Asia Pacific (excluding Japan)—whereas they had often moved in virtual lockstep before.

V. Conclusion:

Indian Economy is being affected by the spill-over effects of the global financial crisis. Great savings habit among people, strong fundamentals, strong conservative and regulatory regime have saved Indian economy from going out of gear, though significant parts of the economy have slowed down. It is expected that growth will be moderate in India.

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Table 1: Stimulus Packages Announced by Government of India

Stimulus Package	Date of Announcement	Amount in US $
First Stimulus Package announced by Government of India	07-12-2008	4 billion
Second Stimulus Package announced by Government of India	02-01-2009	4.2 billion
Third Stimulus Package announced by Government of India	24-02-2009	800 million
Fourth set of Stimulus provided through Foreign Trade Policy by Government of India (A.) Measures announced by Reserve Bank of India (B.) Measures announced by Indian Banks' Association	26-02-2009	-

Source: Details on Stimulus Packages announced by Government of India is available on http://rajyasabha.nic.in/rsnew/publication_electronic/glob_eco_crisis2009.pdf

Table 2: Contribution to Growth [percentage Points, year on year]

Fiscal quarters	GDP	Agriculture	Industry	Services
Q1 2007	**9.3**	0.5	3.0	5.8
Q2 2007	**9.4**	0.5	3.1	5.7
Q3 2007	**9.7**	1.8	2.6	5.3
Q4 2007	**8.5**	0.4	2.2	5.9
Q1 2008	**7.8**	0.5	1.9	5.3
Q2 2008	**7.5**	0.3	1.7	5.5
Q3 2008	**6.1**	-0.3	0.4	5.9
Q4 2008	**5.8**	**0.5**	**0.6**	**4.6**
Q1 2009	**6.0**	**0.3**	**1.3**	**4.4**
Q2 2009	8.6	0.1	2.3	6.2
Q3 2009	6.5	-0.3	2.9	3.9
Q4 2009	8.6	0.1	3.6	4.8
Q1 2010	8.8	0.4	2.9	5.5

Source: Ministry of Statistics and Program Implementation, GOI, http://www.mospi.nic.in

Table 3: Balance of Payment Indicators

Year	Trade balance	Invisibles balance	Current account balance	Capital account balance	Change in reserves including valuation changes
FY2007	-91.5	75.7	-15.7	106.6	105.3
FY2008	-118.7	89.9	-28.7	7.2	-62.5
FY2009	-117.3	78.9	-38.4	53.6	27.4

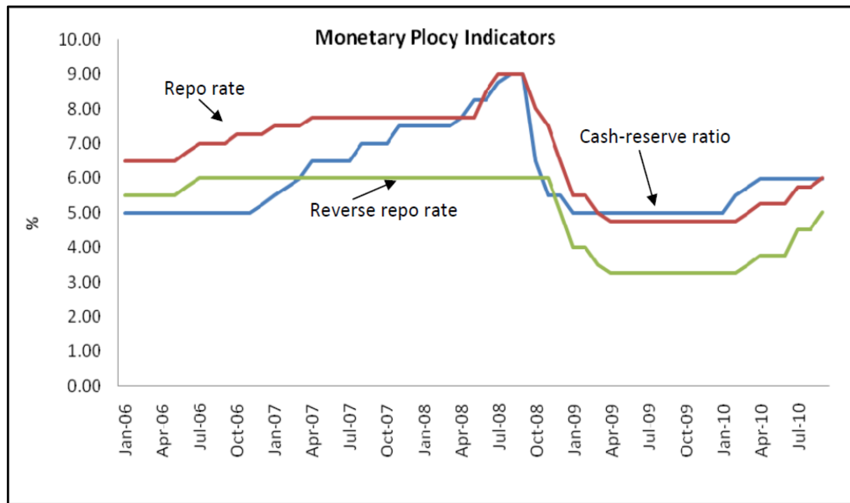
Source: Reserve Bank of India, www.rbi.org

Table 4: Central Government Budget Indicators as % of GDP

Year	Revenue	Expenditure	Deficit
2006	10.7	14.1	-3.5
2007	11.8	14.4	-2.6
2008	9.8	15.9	-6.0
2009	9.7	16.4	-6.6
2010	11.4	16.9	-5.5

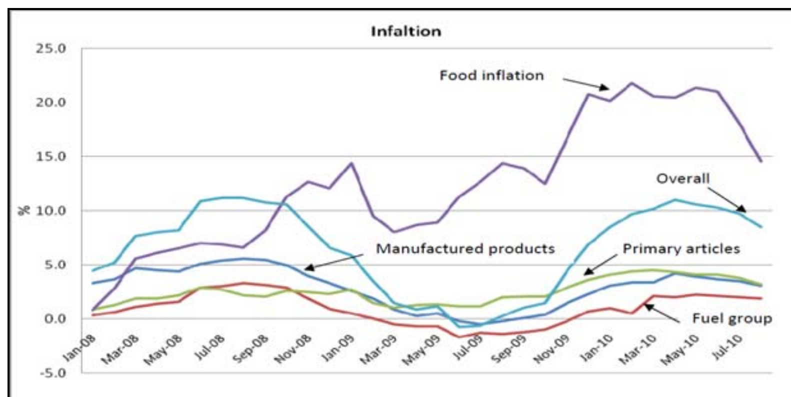
Source: Ministry of Finance, GOI, http://indiabudget.nic.in

Figure 1: Inflation



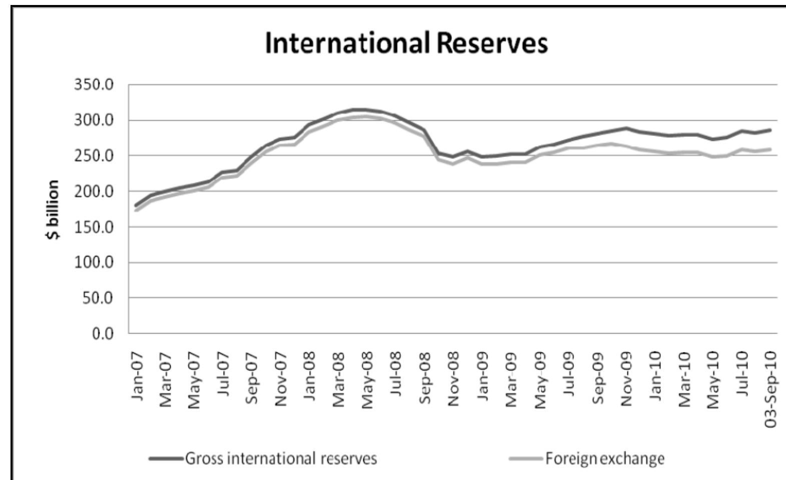
Source: Ministry of Industry and Commerce, GOI, http://eaindustry.nic.in

Figure 2: Monetary Policy Indicators



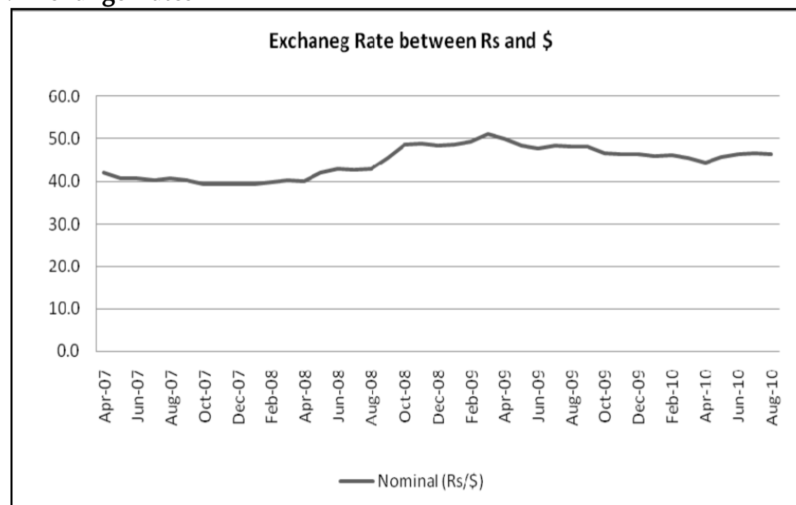
Source: Reserve Bank of India, www.rbi.org

Figure 3: International reserves



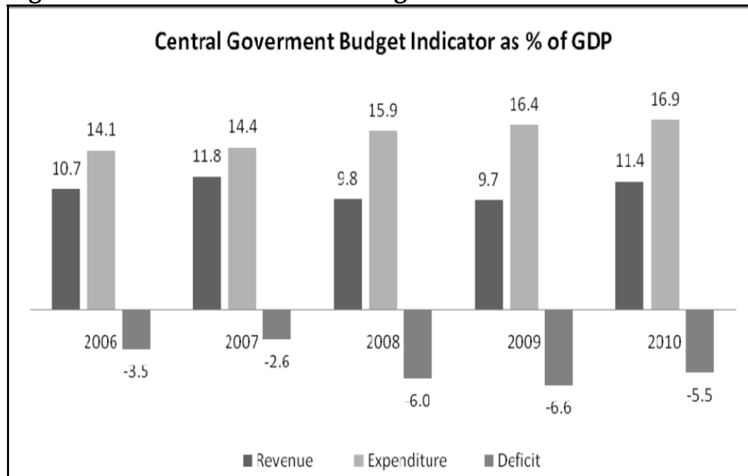
Source: Reserve Bank of India, www.rbi.org

Figure 4: Exchange Rates



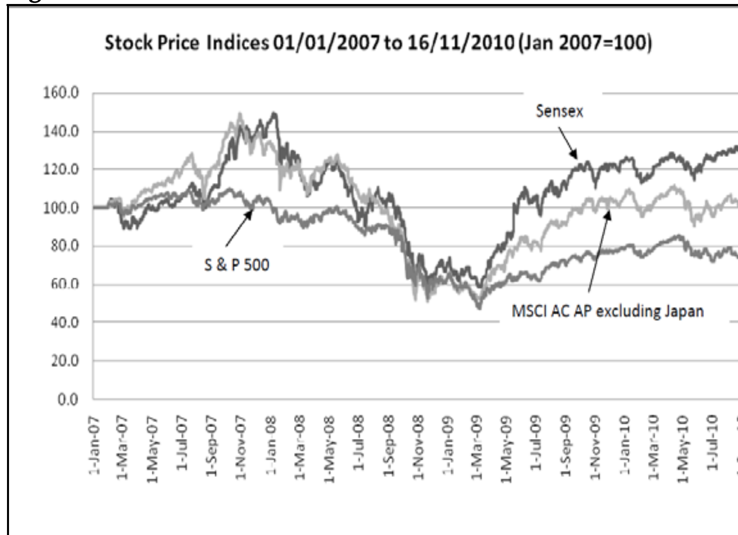
Source: Reserve Bank of India, www.rbi.org

Figure 5: Central Government Budget Indicator as % of GDP



Source: Ministry of Finance, GOI, http://indiabudget.nic.in

Figure 6: Stock Price Indices



Source: Bloomberg

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