# Financial Crises: A Cascading Effect on India

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## An Overview

A financial crisis refers to a loss of confidence in a country's currency or other financial assets causing international investors to withdraw their funds from the country. Financial crisis is applied broadly to a variety of situations in which some financial institutions or assets suddenly lose a large part of their value. In the 19th and early 20th centuries, many financial crises were associated with banking panics, and many recessions coincided with these panics. Other situations that are often called financial crises include stock market crashes and the bursting of other financial bubbles, currency crises, and sovereign defaults.

Economists have offered theories about how financial crises develop and how they could be prevented, however, financial crises are still a regular occurrence around the world. The current financial crises in the U.S. has originated in the indiscriminate lending of housing loans in that country's sub-prime mortgage market. Among the clients were the investors with poor credit histories or insufficient financial resources. Sub-prime lending has resulted in high levels of defaults. The banks were laying huge bets with each other over loans and assets. Complex transactions were designed to move risk and disguise the sliding value of assets. As the investors are risk averse, they realized the situation, losses occurred, and the market as a whole plummeted. This led to a deep credit crunch in the U.S., the effect of which was felt across the globe. Investor confidence has eroded. Lehman's collapse marked at the very least a powerful symbol of a new low in confidence, and the reverberations continued. America's financial system failed in its two crucial responsibilities: managing risk and allocating capital. It was all done in the name of innovation, and any regulatory initiative was fought away with claims that it would suppress that innovation. They were innovating, all right, but not in ways that made the economy stronger. Today we are all facing the repercussions of the crises.

## Financial Crises: Impact on India

***Indian Stock Market*:** An eventful week of great turbulence has begun in the global financial scenario as stock prices dipped across much of the globe on news that investment bankers, Lehman Brothers Holdings filed for bankruptcy and Merrill Lynch & Co's forced sale to Bank of America. The investments in Indian firms by these U.S. investment bankers are a major worry for Indian investors. Indian stock market has seen its worst time with the global financial crises. Mostly all the industrial sectors experienced a consistent low in their stock prices. The IT sector has been badly hit. Nearly half of the IT sector firms' revenues come from banking and financial institutions. The IT companies have these investment banks as their clients. With the effect of financial crises, IT companies are not able to enhance their business with these investment banks, and, in turn, started retrenching their employees. Apart from the financial crises, the employees' turnover is creating turmoil in the market as well. Job security is the biggest fear among people.

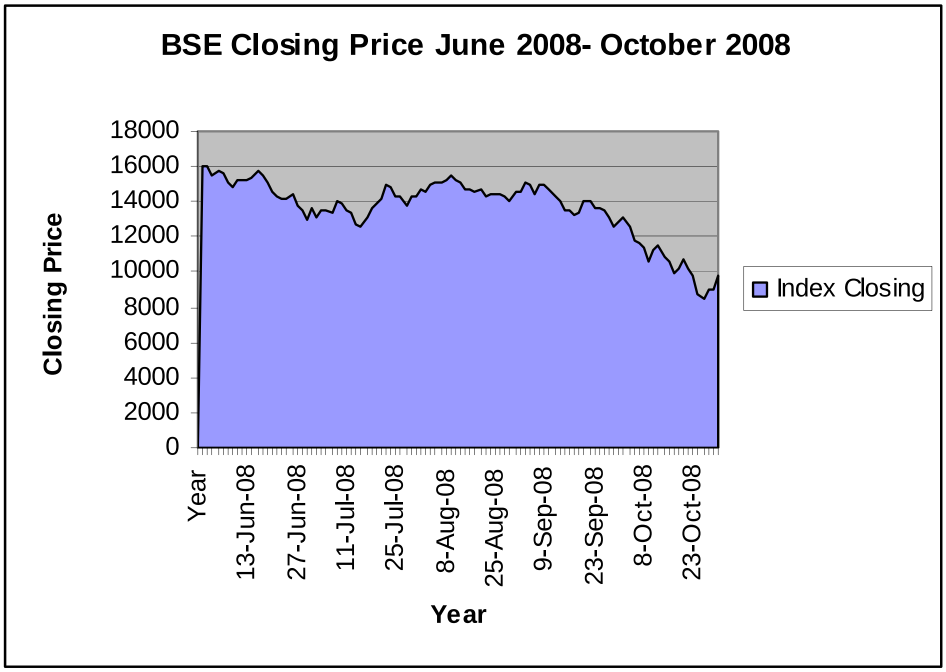


Figure 1.

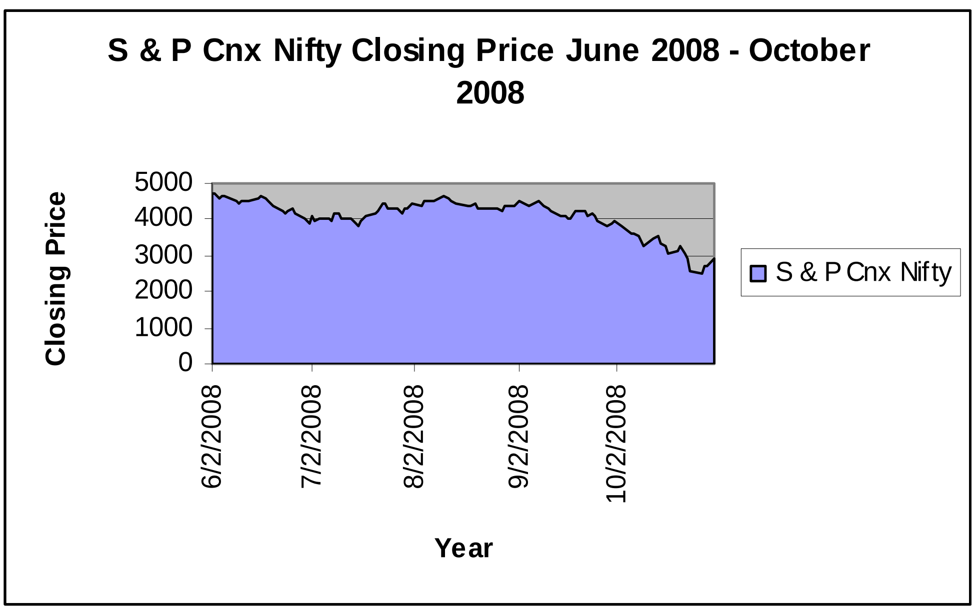


Figure 2.

***Banks*:** The ongoing crisis has an adverse impact on Indian banks. The large investment banks originally from the US, had invested substantially in the stocks of Indian banks. The banks, in turn, have invested in derivatives, which might have exposure to these investment bankers. Public sector banks, which have exposure towards derivatives, are the worst hit by the crisis

***Real estate***: Real estate is badly affected by the current financial downturn. The investment banks had given huge amounts of money to real estate companies for development projects. With the large investment banks going bankrupt, the projects have to be discontinued, leading to the slump in the real estate market as well.

***India's Exports*:** The worldwide financial crisis has caused up to 70 percent fall in India's exports. Handicrafts exports fell by 70 percent. Other sectors like tea and carpets were also down by 20 percent and 32 percent, respectively. The Indian government is now attempting lifting export curbs on steel and some agro products. Overall export growth went down to just over 10 percent from 26.9 percent. Two of India's largest markers, European Union and the US, are both in the throes of financial crisis. Bulk cargo shipping rates have also come down by nearly 50 percent.

***Rupee value:*** Rupee value against the US dollar has weakened dramatically. One reason might be the foreign fund inflow into India that was so prominent in the last couple of years, has turned negative. Financial institutional investors have deleveraged globally. Part of the reason has been the crunch they have faced in home markets, and part of it has been the flight to safety of US treasury paper. This net FII flow has been the single most important reason for the Rupee's fall. The Dollar has also strengthened against most currencies globally, not due to any strength of the US economy, but due to a 'flight to safety' of global capital. The US Dollar has been the world's reserve currency for several decades now. The Rupee's fall against other major currencies has been less pronounced, as seen in the Figure below.

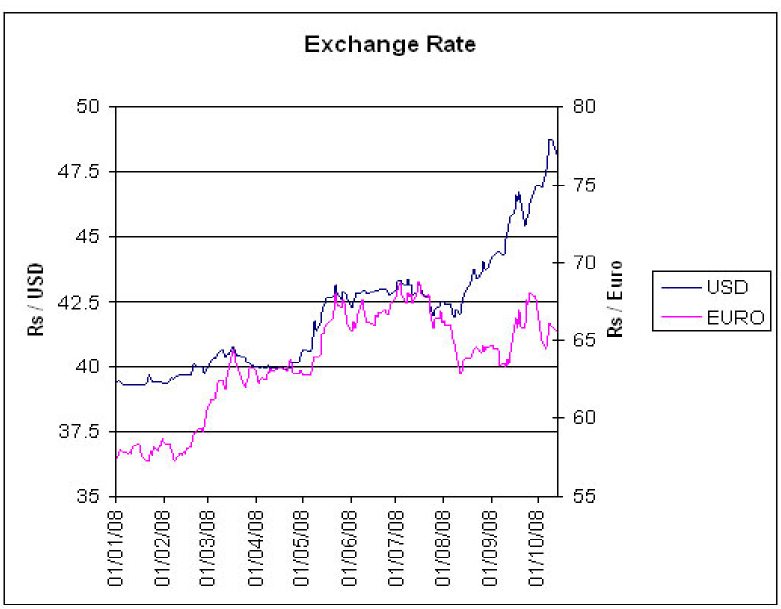


**Figure 3.**

**What is being done?**

On October 20, 2008, Prime Minister Manmohan Singh in the Lok Sabha stated that Indian banking system is not directly exposed to the sub-prime mortgage assets. Their exposure to other problem assets is also minimal. Banks both in the public sector and in the private sector are financially sound, well capitalized and well regulated. Moreover, banks are providing credit in line with anticipated credit targets; the global turmoil has led to a contraction in other forms of commercial credit. External commercial borrowings, which are used by the corporate sector, have dried up, as have international suppliers' credits. This has led to a reduction in overall credit availability in the economy even though credit from commercial banks has expanded satisfactorily. This contraction produced a liquidity crisis in the system. A number of steps have been taken to address this problem:

- Between October 6, 2008 to October 15, 2008, the RBI cut the Cash Reserve Ratio by a total of 250 basis points.

- The SLR (statutory liquidity ratio) requirements were relaxed initially by one percentage point and subsequently an additional window of 0.5 percentage points was introduced specifically to enable banks to draw funds to provide liquidity to mutual funds.

- As a result of these steps, the liquidity position in the financial system has improved considerably.

Government also arranged to provide, in advance, a sum of Rs.25,000 crore (Rs.250 billion) to the banking system under the Debt Waiver and Debt Relief Scheme. The limit of investment by Foreign Institutional Investors in corporate bonds was increased from $3 billion to $6 billion.

RBI announced a 100 basis points cut in the repo rate, which is the rate at which banks can borrow against surplus SLR securities. Government welcomes this decision. It will have a beneficial effect on the interest rate structure, and, in combination with the other steps to increase liquidity, will help to support economic activity and investment. It is broadly consistent with the objective to control inflation.

To maintain the adequate liquidity level, suitable advisories have been issued by the RBI and the Ministry of Finance to the banks to ensure that borrowers are provided adequate credit, including export credit and working capital. The government is conscious of the fact that it is not enough to infuse liquidity. The liquidity must translate into expanded flow of credit to industry, trade and business.

Reserve bank of India and the government are carefully monitoring the flow of credit and will ensure that the additional liquidity infused into the system translates into actual credit.

The capital adequacy ratios of banks are well above the Basel norm and above the RBI stipulated norm, Government has promised that it will help banks, which have lower ratios, to access funds to increase their capital risk weighted asset ratio to 12 percent.

The Prime Minister of India, Dr. Manmohan Singh set up a high-level panel to monitor the impact of the global financial crisis on domestic industry. The panel, headed by Dr. Singh, includes India's central Reserve Bank chief and finance and trade ministers who will advise the premier on steps needed to reassure Indian industry. .

The finance minister P. Chidambaram assured that Public sector banks had virtually no exposure to Lehman Brothers. Although the credit crunch globally will impact credit availability in the Indian market, there is no cause for any alarm that any Indian bank is vulnerable.

Securities & Exchange Board of India (SEBI) chairman, C B Bhave says, there is no panic in market. He calmed the fears of the US financial crisis affecting Indian markets, saying there was no panic as the capital market watchdog was monitoring the situation very closely. He also added that the Indian stock market is resilient and the clearing system has proved to its ability to deal with stock market fluctuation.

Currently, India is facing a challenge. It is not a new phenomenon as India has faced challenges in the past and has overcome them. Our nation has strength to overcome the current challenges. It is very essential that Indian public rise to the occasion and convert the challenge in to an opportunity to establish new highs. This is the time for unity of purpose and resolute action.

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