RECESSION & ITS IMPACT ON INDIAN ECONOMY

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ABSTRACT

The world is presently facing economic crisis due to which economics world over are considered to be entering into prolonged slowdown in economic activities. The intensity of present economic crisis is so high that 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 economics recession and its impact on Indian economy, in this paper, I tries to explain the impact of three distinct channels, that is, the capital flows, sectoral growth and financial sector. The global economic recession has taken its toll on the Indian economy that has led to multi-crore loss in business and export orders, tens of thousands of job losses, especially in key sectors like the IT, automobiles, industry and export-oriented firms. Indian economy also passed through these stages during the year 2008. The economic growth rate, which was above 8% for consecutive period of three years since 2006, suddenly plunged to an average of 5.5%. Developed world is under the fear that recession may not turn out to be continuous process resulting into great depression. Generally recessions are for two quarters, but depression is a severe economic downturn that lasts several years. Earlier India was affected less by external world depressions as it relied more on internal consumption, saving and import substitutions. However, after 1991 India opened up its economy to global players, share of exports, both goods and services, in GDP grew significantly. The effects of the global financial crisis have been more severe than initially forecast. By virtue of globalization, the moment of financial crisis hit the real economy and became a global economic crisis; it was rapidly transmitted to many developing countries. India too is weathering the negative impact of the crisis. There is, however, an important difference between the crisis in the advanced countries and the developments in India. While in the advanced countries the contagion traversed from the financial to the real sector, in India the slowdown in the real sector is affecting the financial sector, which in turn, has a second-order impact on the real sector. The paper is an attempt to analyze the variables responsible for India's recent growth, impact of world recession on these variables and their significance. It needs to validate whether India's economy has shifted away from consumption and saving to external sector dependence.

INTRODUCTION

Every day the main headline of all newspapers is about our falling share markets, decreasing industrial growth and the overall negative mood of the economy. The global financial crisis originated in United States of America. During booming years when interest rates were low and there was great demand for houses, banks advanced housing loans to people with low credit worthiness on the assumption that housing prices would continue to rise. Later, the financial institutions repackaged these debts into financial instruments called Collateralized Debt Obligations and sold them to investors world-wide. In this way the risk was passed on multifold through derivatives trade. Surplus inventory of houses and the subsequent rise in interest rates led to the decline of housing prices in the year 2006-07 which resulted in unaffordable mortgage payments and many people defaulted or undertook foreclosure. The house prices crashed and the mortgage crisis affected many banks, mortgage companies and investment firms world-wide that had invested heavily in sub-prime mortgages. Different views on the reasons of the crisis include boom in the housing market, speculation, high-risk mortgage loans and lending practices, securitization practices, inaccurate credit ratings and poor regulation of the financial institutions.

Global economic meltdown has affected almost all the countries of the world. Strongest of American, European and Japanese companies are facing severe crisis of liquidity and credit. This global financial and economic crisis keeps on getting worse. Recession in the United States is a very bad news for our country. Recession is the result of reduction in the demand of products in the Global market. Recession can also be associated with falling prices known as deflection due to lack of demand of products. Again it could be the result of inflation or a combination of increasing prices & segment economic growth in the west.

Almost everybody today seems to be discussing about the US recessionary trend and its impact on emerging countries, more particularly Indian Economists, Industrialists and the common man on the streets seem to have been horrified by the very thought of recession in India. Decreasing industrial production, inflation, decreasing job opportunities, cost cutting, reducing purchasing power parity, etc. all are the aspects discussed among them through every possible mode like articles, talks & walks and places like washrooms, canteens, etc.

WHAT IS A RECESSION?

A drastic slowing of the economy, where gross national or domestic product has fallen in two consecutive quarters. A recession would be indicated by a slowing of a nation's production, rising unemployment and falling interest rates, usually following a decline in the demand for money.

A recession is a decline in a country's Gross domestic product (GDP) growth for two or more consecutive quarters of a year. A recession is also preceded by several quarters of slowing down. An economy, which grows over a period of time, tends to slow down the growth as a part of the normal economic cycle. An economy typically expands for 6-10years and tends to go into a recession for about six months to 2 years. A recession normally takes place when consumers lose confidence in the growth of the economy and spend less. This leads to a decreased demand for goods and services, which in turn leads to a decrease in production, lay-offs and a sharp rise in unemployment. A recession occurs when a decline – however initiated or instigated – occurs in some measure of economic activity and causes cascading declines in the other key measures of activity. Thus, when a dip in sales causes a drop in production, triggering declines in employment and income, which in turn feed back into a further fall in sales, a vicious cycle results and a recession ensues. This domino effect of the transmission of economic weakness from sales to output to employment to income, feeding back into further weakness in all of these measures in turn, is what characterizes a recessionary downturn.

A popular distinction between recession and depression is:

'Recession is when your neighbors lose his job; depression is when you lose yours.

WHAT CAUSES IT?

I. An economy which grows over a period of time tends to slow down the growth as a part of the normal economic cycle.

II. A recession normally takes place when consumers lose confidence in the growth of the economy and spend less.

III. This leads to a decreased demand for goods and services, which in turn leads to a

IV. decrease in production, lay-offs and a sharp rise in unemployment.

V. Investors spend less as they fear stocks values will fall and thus stock markets fall Background of the Global Financial Crisis.

IMPACT ON INDIAN ECONOMY

The most worrying aspect of a recession is the sustained drop in demand leading to deflation that is often caused by a drop in the supply of money or credit. It is also caused by a contraction in spending, by government or people. Deflation tends to raise unemployment, causing a vicious spiral. Just to avoid the deflation trap nations are pumping money into their economies disregarding the deficit they are accumulating. This is to stimulate spending and to keep the inflation from falling below a certain level as to become a disincentive to produce.

In India, the impact of the crisis has been deeper than what was estimated by our policy makers although it is less severe than in other emerging market economies. The extent of impact has been restricted due to several reasons such as- Indian financial sector particularly our banks have no direct exposure to tainted assets and its off-balance sheet activities have been limited. India's growth process has been largely domestic demand driven and its reliance on foreign savings has remained around 1.5 per cent in recent period. India's merchandise exports are around 15 per cent of GDP.

A. Stock Market

The economy and the stock market are closely related as the buoyancy of the economy gets reflected in the stock market. Due to the impact of global economic recession, Indian stock market crashed from the high of 20000 to a low of around 8000 points. Corporate performance of most of the companies remained subdued, and the impact of moderation in demand was visible in the substantial deceleration during the current fiscal year. Corporate profitability also exhibited negative growth in the last three successive quarters of the year.

B. Forex Market

In India, the current economic crisis was largely insulated by the reversal of foreign institutional investment (FII), external commercial borrowings (ECB) and trade credit. Its spillovers became visible in September-October 2008 with overseas investors pulling out a record USD 13.3 billion and fall in the nominal value of the rupee from Rs. 40.36 per USD in March 2008 to Rs. 51.23 per USD in March 2009, reflecting at 21.2 per cent depreciation during the fiscal2008-09.Hence, sharp fluctuation in the overnight forex rates and the depreciation of the rupee reflects the combined impact of the global credit crunch and the deleveraging process underway in Indian forex market.

C. Money Market

The money market consists of credit market, debt market and government securities market. All these markets are in some or other way related to the soundness of banking system as they are regulated by the Reserve Bank of India. According to the Report submitted by the Committee for Financial Sector Assessment (CFSA), set up jointly by the Government and the RBI, our financial system is essentially sound and resilient, and that systemic stability is by and large robust and there are no significant vulnerabilities in the banking system. Yet, NPAs of banks may indeed rise due to slowdown as Reserve Bank has pointed out. But given the strength of the bank's balance sheets, that rise is not likely to pose any systemic risks, as it might in many advanced countries.

D. Slowing GDP

In the past 5 years, the economy has grown at an average rate of 8-9 per cent. Services which contribute more than half of GDP have grown fastest along with manufacturing which has also done well. But this impressive run of GDP ended in the first quarter of 2008 and is gradually reduced. Even before the global confidence dived, the economy was slowing.

E. Reduction in Import-Export

During 2008-09, the growth in exports was robust till August 2008. However, in September 2008, export growth evidenced sharp dip and turned negative in October 2008 and remained negative till the end of the financial year. For the first time in seven years, exports have declined in absolute terms in October 2008.. Similarly, imports growth also witnessed a deceleration during October- November 2008, before turning negative thereafter.

F. Reduction in Employment

Employment is worst affected during any financial crisis. So is true with the current global meltdown. This recession has adversely affected the service industry of India mainly the BPO, KPO, IT companies etc. According to a sample survey by the commerce ministry1,09,513 people lost their jobs between August and October 2008, in export related companies in several sectors, primarily textiles, leather, engineering, gems and jewelry, handicraft and food processing.

G. Taxation

The economic slowdown has severely dented the Centre's tax collections within direct taxes bearing the brunt. The tax-GDP ratio registered a steady increase from 8.97 per cent to 12.56 per cent between 2000-01 and 2007-08. But this trend has been reversed as the tax-GDP ratio has fallen to 10.95 per cent during current fiscal year mainly on account of reduction in Customs and Excise Tax due to effect of economic slowdown.

IS INDIA HEADED FOR A RECESSION IN 2012?

Euro state recently reported that Q2 2012 GDP growth was (0.2%) for the entire Euro zone, which was a decline from the 0.0% growth reported in Q1 2012. With the 17 countries that make up the Euro zone accounting for 25% of global GDP, it's clear that Europe has been an ongoing drag on global growth. Additionally, with the US reporting a deceleration in GDP growth to 1.5% in Q2 2012 a large number of Indian investors are beginning to wonder what a global recession would mean for the Indian economy and Indian stocks.

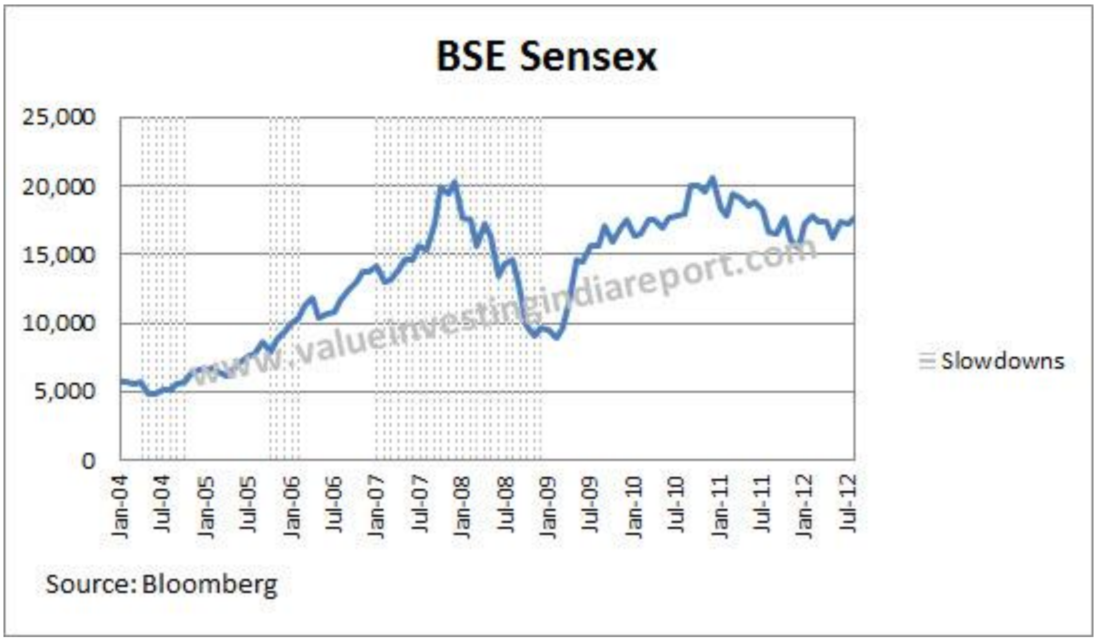
Before we can determine whether India is headed for a recession, we need to define the meaning of a recession. Many financial journalists and investors mistakenly believe that two negative quarters of GDP growth is the technical definition of recession. I think this rule has become popular because of its simplicity, but that doesn't make it correct or accurate.

A decline in GDP is not enough to make a recession call. It has to be coupled with declines in employment, sales and income. Based on Ms. Dua's research, the Indian economy has only experienced two short recessions, which occurred from March 1991 to September 1991 and from May 1996 to November 1996, since liberalization began in the 90s.

Despite the recent malaise that has negatively impacted the Indian economy, mid-single digit GDP growth can in no way be interpreted as a recession. Interestingly, during the 2008 crisis India didn't experience a recession either but rather a milder outcome called a slowdown, which is simply a deceleration in growth. There are a number of reasons that have resulted in the recent trend of declining growth including a negative attitude toward foreign retail investment, a persistent budget deficit, poor energy infrastructure and continued price controls on natural gas and coal. Ultimately, the underlying problem remains a failure to continue down the path of economic reforms and greater liberalization. The risk of a further deceleration in growth is very real.

Although the Indian economy hasn't entered a recession since the 90s there have been four distinct slowdowns – March 2000 to July 2001, April 2004 to October 2004, October 2005 to March 2006 and January 2007 to January 2009 – according to Pami Dua's research.

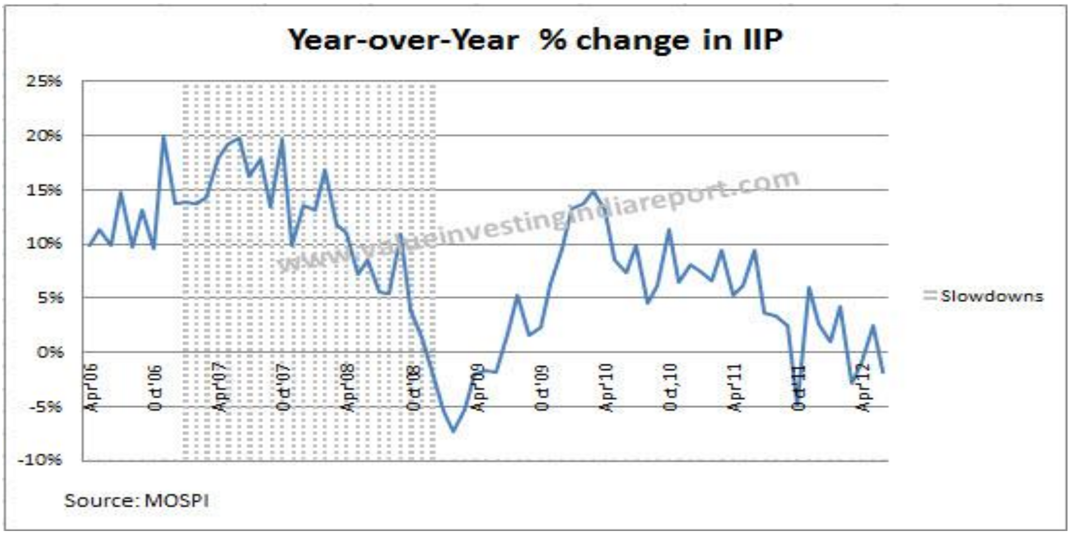
The next logical question for investors is what does a slowdown mean for the stock market? In the chart below we can see that in the spring 2004 slowdown the market was essentially flat and in the fall 2005 slowdown the market actually rallied 31%. But the 2008 experience is what should keep you awake at night. From its peak in January 2008 to the low in March 2009, the Sensex lost 61% of its value. Why was there such a huge difference in the performance in the index in 2008 relative to the prior slowdowns?



The answer is that, In 2008 there was an unprecedented global contagion. As the crisis progressed, Foreign Institutional Investors were forced to repatriate capital and reduce risk as their domestic economies weakened. With Europe already in a recession and the US economy also slowing, another slowdown in India will likely lead to a similar experience to that of 2008 for Indian stock investors.

THE NEXT QUESTION IS MOST LIKELY IS INDIA IN ANOTHER SLOWDOWN?

We can see below that it's a coincident indicator and basically turned down in terms of y-o-y growth just as the 2008 slowdown began and didn't turn positive until the slowdown ended. As of June 2012 the y-o-y growth rate in the index was negative (1.8%). Clearly, the IIP is sending a signal that the Indian economy is slowing down along with the global economy. Thus, investors in the Indian stock market need to be aware that there are significant risks ahead.



Seeing the above Graph we can imagine the market position and risk in Indian market. Till now, Indian market is in search of stability.

MEASURES TO TACKLE THE RECESSION

The following measures can be adopted to tackle the recession:

1. Tax cuts are generally the first step any government takes during slump.
2. Government should hike its spending to create more jobs and boost the manufacturing sectors in the country.
3. Government should try to increase the export against the initial export.
4. The way out for builders is to reduce the unrealistic prices of property to bring back the buyers into the market. And thus raise finances for the incomplete projects that they are developing.
5. The falling rupees against the dollar will bring a boost in the export industry. Though the buyers in the west might become scares.
6. The oil prices decline will also have a positive impact on the importers.

India has adopted certain measures to combat recession. Since October, 2008 The Reserve Bank of India has cut the repo rate and the CRR by 350 and 400 basis points respectively. The reverse repo rate has been cut by 200 basis points over the same period. This in turn has made credit cheaper and has increased the overall liquidity in the system. Further, the PSU banks of the country have decreased the home loan rates. This is expected to induce more buyers and boost the real estate sector.

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 economics as Indian banks did not have significant exposure to Sub-prime loans in the U.S. RBI's decisions to appropriate use of a range of instruments such as CRR, Repo/Reverse Repo rate, SLR MSS and LAF are in the right direction and taken in time. There is currently a high level of activity amongst the business support community with a key focus on ensuring businesses survive the downturn. A challenging and critical focus on the basics, or fundamentals of businesses, is likely to give local companies the best chance of survival over the next year.

After watching so many positive points we Indians can ourselves that we are quite in a safer place in comparison to many developed countries economy. To conclude let's hope for a stronger India by rectifying all its economic weaknesses after this so called financial crunch. Hence, the growth of the public sector and the narrow reliance on financial services for growth needs to change, with manufacturers and exporters having particular attention paid to them. After watching so many positive points we Indians can ourselves that we are quite in a safer place in comparison to many developed countries economy.

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