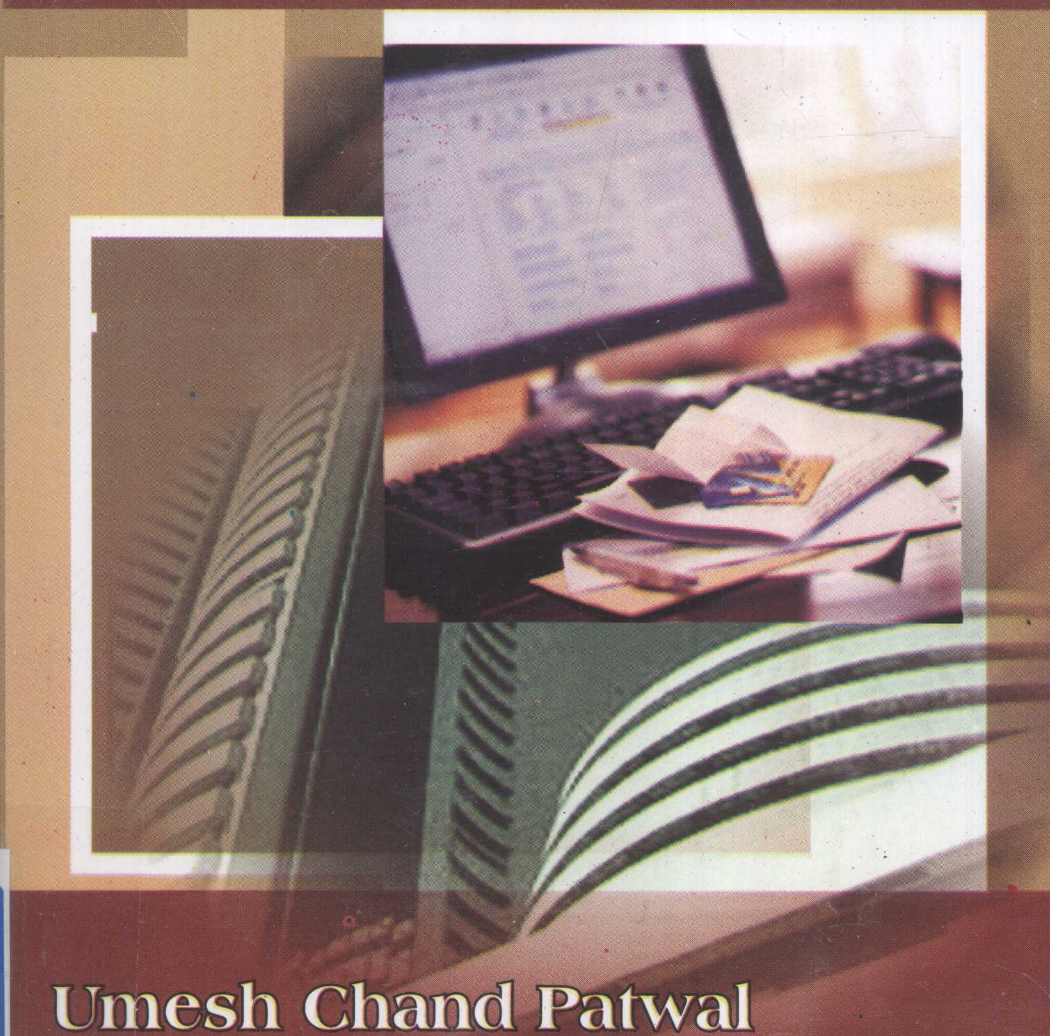
India's Emerging Financial Market

A Flow of Fund Model



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A Flow of Fund Model

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Preface

Investing in emerging markets is considered very risky. The financial markets of developing countries are typically small, with a short operating history. Emerging markets exist in undeveloped regions of the world, which are very volatile and therefore have great growth potentials but also pose significant risks. Corruption, political instability, illiquidity, and currency collapse are just some of the significant risks of emerging regions. Argentina's economic collapse is the latest example of the risk involved in emerging countries.

Emerging markets are those countries or geographic regions in which a previously untapped potential for U.S. exports or investment might be anticipated. Nations typically characterized under this banner are often developing countries, but they may also be economically formidable countries with markets that are increasingly open to exports. "The BEMs big emerging markets share certain characteristics," wrote Mark Tran in *Working Woman*. "They have large territories and populations, and they are undertaking extraordinary development projects that call for new infrastructure, such as power-generating plants and telecommunications systems. And, of course, with development comes increased demand for consumer goods, like computers and washing machines. These countries have pursued economic policies leading to faster growth and expanding trade and investment with the rest of the world. They aspire to be technological leaders. Their economic growth would have enormous spillover into their respective regions, and they all have political clout."

Economies in countries noted for some amount of liquidity, stability, infrastructure, a unified currency, and other positive features, but not to the same extent as exists in the developed world. That is, emerging markets are economies that have increasingly important roles in the international stage and may one day become principal players, but they have not yet arrived at that level. Political factors may help or encumber emerging markets as they attempt to gain wealth and prominence.

– Umesh Chand Patwal

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Chapter 1

Global Recession and Its Impact on Indian Financial Markets

Introduction

The economic slowdown of the advanced countries which started around mid-2007, as a result of sub-prime crisis in USA, led to the spread of economic crisis across the globe. Many hegemonic financial institutions like Lehman Brothers or Washington Mutual or General Motors collapsed and several became bankrupt in this crisis.

According to the current available assessment of the IMF, the global economy is projected to contract by 1.4 per cent in 2009.Even as recently as six months ago, there was a view that the fallout of the crisis will remain confined only to the financial sector of advanced economies and at the most there would be a shallow effect on emerging economies like India.

These expectations, as it now turns out, have been belied. The contagion has traversed from the financial to the real sector; and it now looks like the recession will be deeper and the recovery longer than earlier anticipated. Many economists are now predicting that this 'Great Recession' of 2008-09 will be the worst global recession since the 1930s.

Meaning Of Recession

A recession is a decline in a country's gross domestic product 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 6-10 years 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. Investors spend less; as they fear stocks values will fall and thus stock markets fall on negative sentiment. Risk aversion, deleveraging and frozen money markets and reduced investor interest adversely affect capital and financial flows, import-export and overall GDP of an economy. This is exactly what happened in US and as a result of contagion effect spread all over the world due to high integration in the global economy.

Impact On Indian Economy

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. The credit derivatives market is in an embryonic stage and there are restrictions on investments by residents in such products issued abroad.
- 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 comfortable foreign exchange reserves provide

confidence in our ability to manage our balance of payments notwithstanding lower export demand and dampened capital flows.

- Headline inflation, as measured by the wholesale price index has declined sharply. Consumer price inflation too has begun to moderate.
- Rural demand continues to be robust due to mandated agricultural lending and social safety-net programmes.
- India's merchandise exports are around 15 per cent of GDP, which is relatively modest.

Despite these mitigating factors, India too has to weather the negative impact of the crisis due to rising two-way trade in goods and services and financial integration with the rest of the world. Today, India is certainly more integrated into the world economy than ten years ago at the time of the Asian crisis as the ratio of total external transactions gross current account flows plus gross capital flows to GDP has increased from 46.8 per cent in 1997-98 to 117.4 per cent in 2007-08. Although Indian banks have very limited exposure to the US mortgage market, directly or through derivatives, and to the failed and stressed financial institutions yet Indian economy is experiencing the knock-on effects of the global crisis, through the monetary, financial and real channels all of which are coming on top of the already expected cyclical moderation in growth.

I. 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. Indian stock market has tumbled down mainly because of 'the substitution effect' of:

- Drying up of overseas financing for Indian banks and Indian corporates;
- Constraints in raising funds in a bearish domestic capital market; and
- Decline in the internal accruals of the corporates.

Thus, the combined effect of the reversal of portfolio equity flows, the reduced availability of international capital both debt and equity and the perceived increase in the price of equity with lower equity valuations has led to the bearish influence on stock market.

II. Forex Market

In India, the current economic crisis was largely insulated by the reversal of foreign institutional investment, external commercial borrowings 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 fiscal 2008-09. The annual average exchange rate during 2008-09 worked out to Rs. 45.99 per US dollar compared to Rs. 40.26 per USD in 2007-08 which is the biggest annual loss for the rupee since 1991 crisis. Moreover, there is reduction in the capital account receipts in 2008-09 with total net capital flows falling from USD 17.3 billion in April-June 2007 to USD 13.2 billion in April-June 2008.

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.

III. 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 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 banks' balance sheets, that rise is not likely to pose any systemic risks, as it might in many advanced countries.

Nevertheless, the call money rate went over 20 per cent immediately after the Lehman Brothers' collapse and banks' borrowing from the RBI under daily liquidity adjustment facility overshot Rs. 50,000 crore on several occasions during September-October 2008 under tight liquidity situation.

IV. 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. According to the revised estimates released by the CSO for the overall growth of GDP at factor cost at constant prices in 2008-09 was 6.7 per cent as against the 7 per cent projection in the midyear review of the Economy presented in the Parliament on December 23, 2008. The growth of GDP at factor cost at constant 1999-2000 prices at 6.7 per cent in 2008-09 nevertheless represents a deceleration from high growth of 9 per cent and 9.7 per cent in 2007-08 and 2006-07 respectively. The RBI annual policy statement 2009 presented on July 28, 2009 projects GDP growth at 6 per cent in 2009-10 in 2009-10. The slowdown in growth of GDP is more clearly visible from the growth rates over successive quarters of 2008- 09. In the first two quarters of 2008-09, the growth in GDP was 7.8 and 7.7 respectively which fell to 5.8 per cent in the third and fourth quarters of 2008-09. The third quarter witnessed a sharp fall in the growth of manufacturing, construction, trade, hotels and restaurants. The last quarter was an added deterioration in manufacturing due to the deepening impact of the global crisis and a slowdown in domestic demand.

Hence, the slowdown in Indian economy is evident from the low GDP growth with deceleration in the industrial activity, particularly in the manufacturing and infrastructure sectors and moderation in the services sector mainly in the construction, transport and communication, trade, hotels and restaurants.

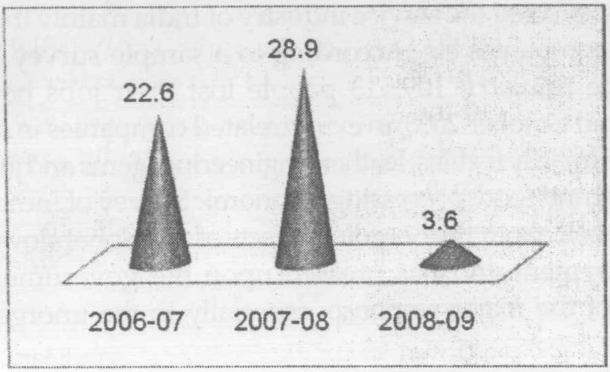
V. Strain On Balance Of Payments

The overall balance of payments situation remained resilient in 2008-09 despite signs of strain in the capital and current accounts, due to the global crisis. During the first three quarters of 2008- 09, the current account deficit was US $ 36.5 billion as against US $ 15.5 billion for the corresponding period in 2007-08. The capital account balance declined significantly to US $ 16.09 billion in 2008-09 as compared to US $ 82.68 billion during the corresponding period in 2007-08. As at end-March 2009 the foreign exchange reserves stood at US $ 252 billion.

VI. Reduction In Import-Export

During 2008-09, the growth in exports was robust till August 2008. However, in September 2008, export growth evinced a 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.

Chart 1: Export Growth Year Wise



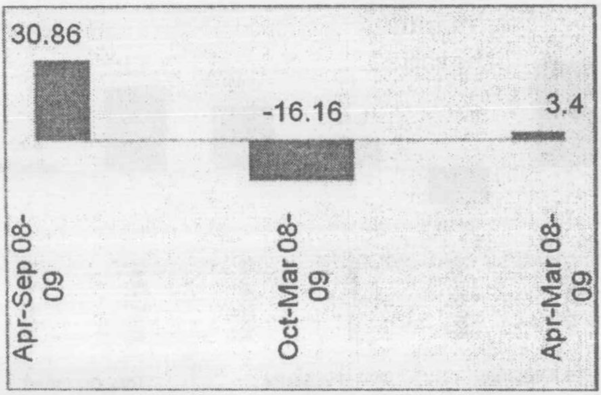


Chart 2: Quarterly Export Growth in 2008-09

Source: Economic Survey 2009, Government of India

The above chart show that the exports have declined since October 2008 due to contraction in global demand due to the synchronised global recession. Similarly, imports growth also witnessed a deceleration during October-November 2008, before turning negative thereafter. The merchandise trade deficit declined during 2009-10 over the corresponding period of the previous year, reflecting the sharper decline in the imports in relation to exports.

VII. 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 ministry 109,513 people lost their jobs between August and October 2008, in exportrelated companies in several sectors, primarily textiles, leather, engineering, gems and jewelry, handicraft and food processing. Economic Survey of India gives alarming bell about the on-going effects of the global slowdown on employment and has pressed upon the government the urgency of the major response, especially in the unorganized sector.

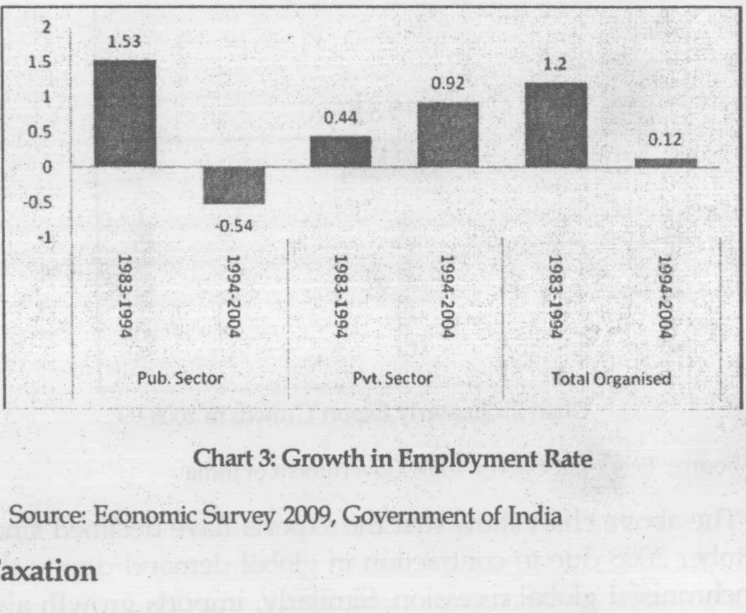


Chart 3: Growth in Employment Rate

Source: Economic Survey 2009, Government of India

Taxation

The economic slowdown has severely dented the Centre's tax collections with indirect 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.

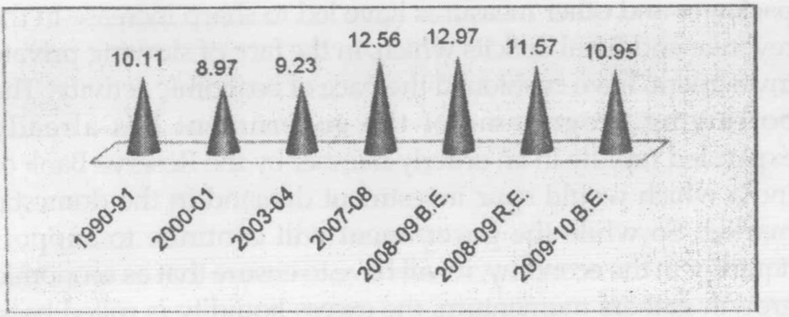


Chart 4: Reduction in Tax-GDP ratio

Source: Central Statistical Organisation

Response To The Crisis

The future trajectory of the economic meltdown is not yet clear. However, the Government and the Reserve Bank responded to the challenge strongly and promptly to infuse liquidity and restore confidence in Indian financial markets. The Government introduced stimulus package while the Reserve Bank shifted its policy stance from monetary tightening in response to the elevated inflationary pressures in the first half of 2008-09 to monetary easing in response to easing inflationary pressures and moderation of growth engendered by the crisis. The fiscal and monetary response to the crisis has been discussed in the following points-

I. Fiscal Response

The Government launched three fiscal stimulus packages between December 2008 and February 2009. These stimulus packages came on top of an already announced expanded safety-net programme for the rural poor, the farm loan waiver package and payout following the Sixth Pay Commission report, all of which added to stimulating demand.

The challenge for fiscal policy is to balance immediate support for the economy with the need to get back on track on the medium term fiscal consolidation process. The fiscal stimulus packages and other measures have led to sharp increase in the revenue and fiscal deficits which, in the face of slowing private investment, have cushioned the pace of economic activity. The borrowing programme of the government has already expanded rapidly in an orderly manner by the Reserve Bank of India which would spur investment demand in the domestic market. So while the government will continue to support liquidity in the economy, it will have to ensure that as economic growth gathers momentum, the excess liquidity is rolled back in an orderly manner. In India monetary transmission has had a differential impact across different segments of the financial market. While the transmission has been faster in the money and bond markets, it has been relatively muted in the credit market on account of several structural rigidities. In order to address these issues, the government has to effectively and carefully take up the following steps -

- Enhance coordination and harmonization of the regulatory apparatus internationally, given the global scope of the recent crises with increased crossborder financial integration;
- Introduction of countercyclical prudential regulatory policy;
- Design regulation and supervision of financial companies for non-deposit taking financial entities having the potential to cause systematic instability, as evident in the current crisis;
- Supervision and management of liquidity risk and greater transparency in the financial sector to improve better risk assessment by the customers and investors;
- Improvement in transparency in the structured credit instruments.

The rise in macroeconomic uncertainty and the financial dislocation of the year 2008 have raised a problem of adjustment in market interest rates in response to changes in policy rates