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Global Financial Meltdown and Indian Banking Sector

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ABSTRACT: *The recent euphoria among the financial heads of major crisis affected countries primarily the USA seems to have sent the message that the global economic slowdown triggered by the sub-prime crisis leading to the collapse of banking giants in USA in 2008 has ceased to exist and many economies have come back to their normal growth path. India, despite having danced to the tune of the international financial advisers in opening up its doors to the external trade, appears to have eluded the waves of the financial crisis thanks to the strong regulatory institututional mechanism, which functions under the unparallel stewardship and acumen of the Reserve Bank of India. How has India managed to withstand the bad effects of meltdown is a matter to be fathomed. The banking sector, indispensable part of the financial system of any country, in India, is reported to have remained unshackled in the testing times of crisis. This paper aims at providing an analysis of the performance of Indian banks in the recession period. Apart from this core purpose for which the paper is designed, it also looks into the channels through which the crisis transmitted into Indian economy and the monetary responses that the Reserve Bank of India embarked on to douse the flames of financial meltdown from swallowing the Indian financial institutions and the economy. The paper is structured as follows: First section elaborates on the transmission channels of global crisis into the Indian economy, second section reviews the swift monetary tools that were pressed into action by the Reserve Bank of India and the third section makes an analysis of the performance of the three groups of banks in India viz. Public Sector Banks (PSBs), Private Sector Banks (Pvt.Bs) and the Foreign Banks (FBs) during the period of slowdown..*

I. TRANSMISSION CHANNELS OF CRISIS

It is well known that western capitalist economies like US and UK, and conglomerate capitalist group, the European Union, and the oil rich Middle East have been the epicenters of the global financial crisis. The greed of quick money and the intensifying compartmentalization of the real economy from the money economy surfaced in the form of an unprecedented crisis since the Great Depression of 1930s. One factor, which distinguishes the current crisis from the crisis of 1930s, is that the current crisis became rampant in the sense that countries contributing nothing to the germination of the crisis have had to shoulder the ill effects of the crisis. India is not an exception to that as it has been subject to the spill over effects of crisis because of its openness to the external world especially to the USA. We break the channels into three (Fig: 1): The Finance Channel, The Real Economy Channel, and The Confidence Channel.

1. The Finance Channel: The global credit squeeze unleashed an array of direct and indirect repercussions on the financial sector of our economy. The drying up of global credit markets put pressure on the Indian Companies to seek more credit from the domestic market, bringing domestic financial markets under pressure. The equity market, forex market, money markets and credit market had been badly afflicted by this credit squeeze at the global level. The frantic tendency of Indian corporate to withdraw funds from the Mutual Funds to compensate the fall in overseas funds put Mutual Funds under heavy pressure. In the forex market the value of Indian rupee plummeted to a post-reform historic low level (Figure No: 1). Three factors largely contributed to this fall in the value of rupee: (1) tremendous net capital outflow especially the portfolio investment due to frantic selling of shares by the Foreign Institutional Investors (see the figure no.2). (2) Due to the corporate behavior of converting

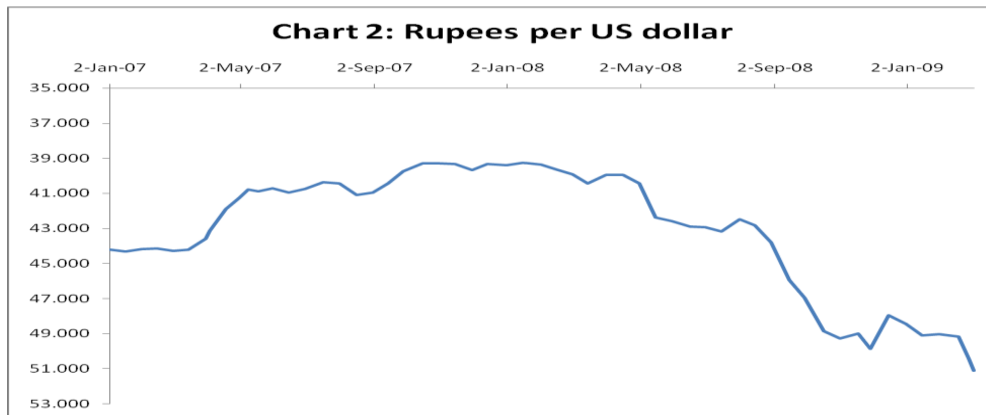


Figure No: 1

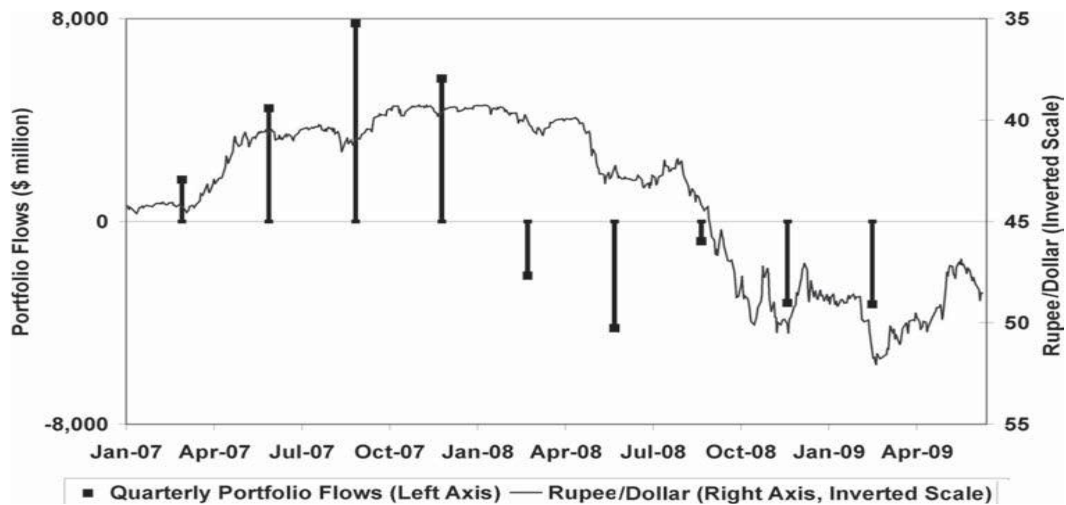


Figure No: 2

Locally raised funds into foreign currency to meet their foreign financial obligations. The fall that the stock markets of India underwent consequent upon global meltdown is an eye-opener to the extend of the external exposure of Indian stock markets. (Figure No: 3). The stock markets fell around 60 percent from their peak levels in January 2008. The sharp fall in stock market indices was also on account of the withdrawal of Foreign Institutional Investment, which held around 35% ($ 71 billion) of Indian stocks that time. A significant distinction must be noted here in respect of the crashing of stock markets in India v/s foreign markets. In the US, for instance, the stock market crashed because the real economy of the US was shocked. Nevertheless, in India, the crash in stock market had nothing to do with the real economy, as ours was the second fastest growing economy when the world was groping under the severe recessionary trend.

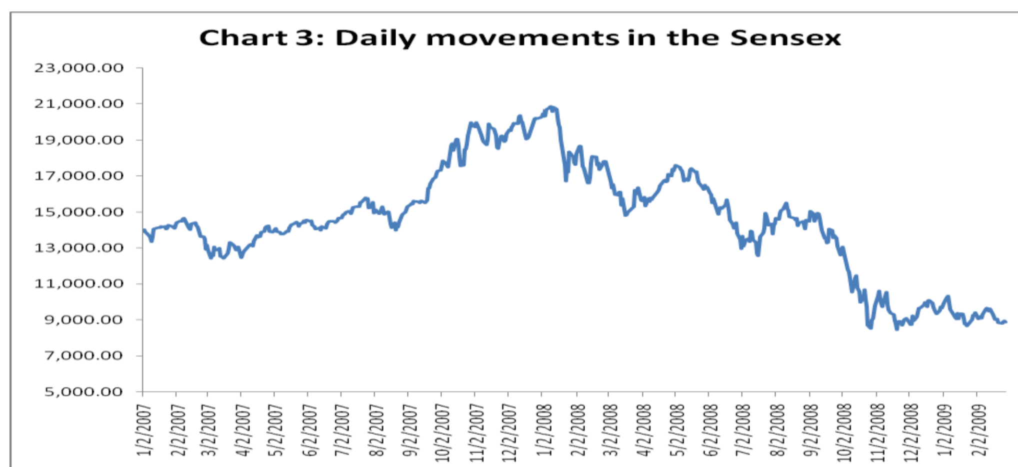
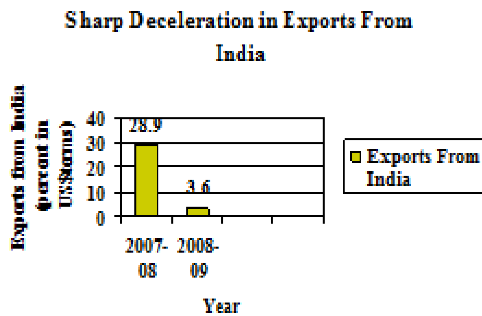


Figure No: 3

2. The Real Economy Channel: Slackening exports from India and the widening of Current Account Deficit (CAD) was the direct straight forwards real economy channel through which the global crisis had entered into the Indian economy. it should be understood that three quarters of India's trade are with the US, and EU and the Middle East which were severely hit by the crisis. That gravity of the sluggish growth in exports during the recession could be gauged from that fact that during 2008-09 exports from India grew at a rate of just 3.6 percent in US $ terms as against 28.9 percent in the year 2007-08. (Figure No: 4). India's CAD in US $ terms was constituted just 1.5 percent of her GDP in 2007-08, which went up to 2.6 percent in 2008-09. (Figure No.5). The steep upward trend in CAD was driven by weak exports growth and imports growth outpacing the growth of exports during this period.



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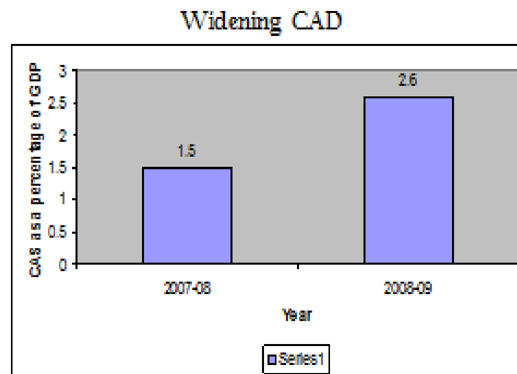


Figure No: 5

3. The Confidence Channel: The Lehman Failure in September 2008 created a panic situation and rumors were spread some Indian banks had financial dealings with this bank. This increased the risk aversion tendency of the Indian financial institutions and naturally, they became more cautious about lending on a large scale, creating liquidity problem. This naturally led to the exclusion of people from the banking network. Here it should be mentioned that banks' response to financial crisis is step towards sever financial exclusion. The loss of confidence on the part of the banks can be gauged from the sharp deceleration in credit growth from 22.3 percent IN 2007-08 to 17.3 percent in 2008-09. (Figure No: 6)

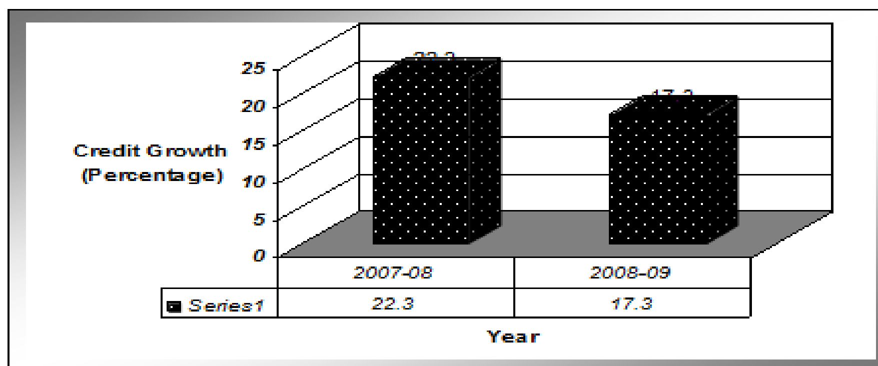


Figure No: 6 Deceleration in Credit Growth Rate

II. MONETARY POLICY RESPONSES TO THE CRISIS

Faced with the crisis of drying liquidity, any government resorts to monetary policy solutions as these are proved easy to be pressed into action compared to the fiscal policy instruments on account of the short lag effect that the former enjoys. The conventional monetary instruments like the CRR and the SLR were slashed largely to release sufficient liquidity to the credit market. The slash in CRR flooded the credit market with approximately Rs.1, 60,000 crore in mid September. Further, reduction in SLR to the tune around 1.5 percent of total demand and time liabilities resulted in a additional liquidity support of Rs.60, 000 crore. A decision was taken to hike the interest on foreign currency deposits to address the problem of the depletion of foreign exchange reserve. Rules regarding the external commercial borrowing by Indian companies were liberalized to pave the way for large foreign exchange inflows. Apart from this, the government and the Central Bank together took a decision to buy back the securities issued as a part of the market stabilization programme to inject liquidity into the credit market.

III. HAS INDIAN BANKING SECTOR WITHSTOOD THE FINANCIAL MELTDOWN?

Largely, there has been consensus among the banking experts and economists that the Indian banking sector as a whole has been completely insulated from shackles of the financial meltdown. This paper as outlined at the outset enquires into this question. For this purpose, the study has chosen three segments of banks in India viz. the Public Sector Banks, Private Sector Banks and the Foreign Banks. The yardsticks for the evaluation are Gross Profit/Loss as percentage of Total Assets, Interest Income as Percentage of Total Assets, Gross Non Performing Assets as a percentage of Total Assets and the Return on Asset Ratio. We do accept that these yardsticks are neither sufficient nor perfect in arriving at a conclusion regarding the performance of banks. Nevertheless, they are relevant as they give first hand information on the healthiness of the banking system.

IV. GROSS PROFIT/LOSS AS A PERCENTAGE OF TOTAL ASSETS

A look at the figure No. 7 and table No.1 reveals that for both public and private sector banks Gross Profit/Loss as Percentage of Total Assets increased from 1.7 and 2 in 2007-08 to 1.8 and 2.4 in 2008-09 respectively. As far as the foreign banks are concerned, the ratio went up from 3.9 in 2007-08 to 4.5 in 2008-09. Although this appears to be marginal improvement, in the light of the backlash of the crisis, this improvement ought to be regarded as a testimony to the fact that Indian banking sector remained unshackled during the time of the crisis.

Year	Public Sector Banks	Private Sector Banks	Foreign Banks
2002-03	2.3	2.4	3.2
2003-04	2.7	2.3	3.7
2004-05	2.2	1.8	3
2005-06	1.9	1.7	3.3
2006-07	1.7	1.8	3.5
2007-08	1.7	2	3.9
2008-09	1.8	2.4	4.5

Table No.1 Gross Profit/Loss as % of Total Assets

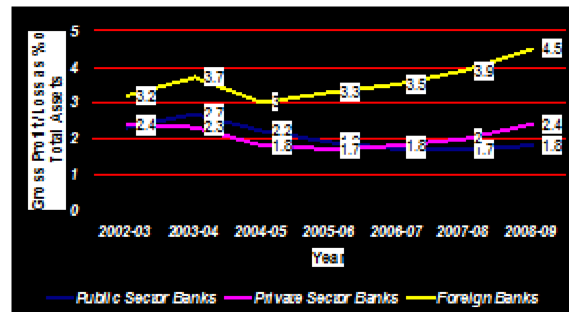


Figure No .7 Gross Profit/Loss as % of Total Assets

V. INTEREST INCOME AS PERCENT OF TOTAL ASSETs

Earnings on interest form an important source of income to the banks. Table and figure presented below clearly shows the trend in interest income as percentage of total assets of three groups of banks under our study. The private sector banks have fared better in respect of these criteria. Their interest income as percent of total assets stood at 7.6 in 2007-08, which shot up to 8.3 at the zenith of the recession, which is in 2008-09. Other two groups of banks viz. PSBs and FBs have registered marginal improvement in this respect.

Year	Public Sector Banks	Private Sector Banks	Foreign Banks
2002-03	8.3	8.3	7.7
2003-04	7.5	7	6.7
2004-05	6.8	6.1	6
2005-06	6.8	6.2	6.2
2006-07	6.7	6.6	6.5
2007-08	7.1	7.6	6.7
2008-09	7.3	8.3	6.8

Table No:2 Interest income as Percent of Total Assets

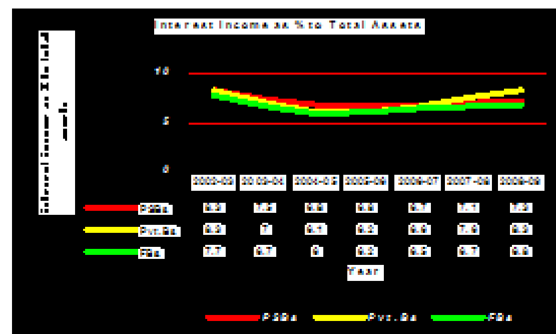


Figure No: 8 Interest income as % of Total Assets

VI. GROSS NON-PERFORMING ASSETS AS PERCENT OF TOTAL ASSETs

It is an indispensable tool by which the healthiness of a bank can easily be gauged. Non-performing assets normally relies on two things: banks inability to monitor the non-performing assets; two, general downward trend in the economy, resulting in the loss of job, making the people unable to repay the loan. Unsurprisingly, under recessionary conditions, an increase in non-performing assets is a common thing. Nevertheless, in the case of PSBs in India the gross non-performing asset as percent of Total assets has declined

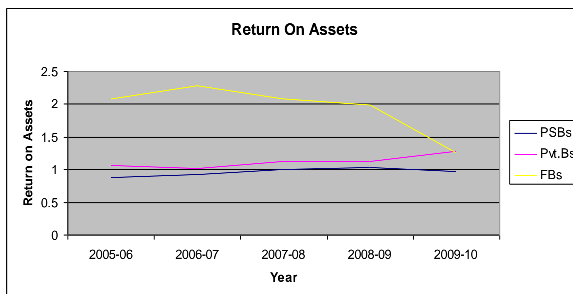
although marginally from 1.3 percent in 2007-08 to 1.2 percent in 2008-09. (Table No.3 and Figure No. 9) whereas in the case of both Pvt.Bs and FBs, the non-performing assets have increased marginally.

Year	Public Sector Banks	Private Sector Banks	Foreign Banks
2002-03	4.2	4	2.4
2003-04	3.5	2.8	2.1
2004-05	2.7	2.1	1.4
2005-06	2.1	1.4	1
2006-07	1.6	1.2	0.8
2007-08	1.3	1.4	0.8
2008-09	1.2	1.7	1.5

Table: 3 Gross Non-Performing Assets as Percent of Total Assets

VII. RETURN ON ASSETS

Perhaps, one would find this yardstick as best in the sense that it gives a birds' eye view of all that happen to be relevant to judge the performance of a banking institution. Going by the available information on this, we find an interesting that private sector banks in India have made a noticeable upward trend in this regard. Their return on assets remained 1.13 percent during the turbulence years of crisis that is 2007-08 to 2008-09. Thereafter, in 2009-10, they have shown in increase to 1.28 percent. But it quite interesting that foreign banks, which may have been deeply exposed to the external financial institutions and its functioning, have experienced a downward trend in their return on assets ratio to 1.26 in 2009-10 form 1.99 in 2008-09. In 2007-08, the return on assets of FBs was 2.09. to put in a nutshell, FBs have been witnessing a continues fall in return on assets ration since 2006-07. Public Sector Banks on the other hand have experienced a fall in return on assets ratio in 2009-10 to .97 from 1.03 in 2008-09.



Return on Assets

Banks	2005-06	2006-07	2007-08	2008-09
PSBs	0.88	0.92	1	1.03
Pvt.Bs	1.07	1.02	1.13	1.13
FBs	2.08	2.28	2.09	1.99

VIII. CONCLUDING OBSERVATIONS

To conclude, while the crisis has had its ill effects on a handful of sectors like the IT and ITESs, germs etc, which are dependent more on exports and foreign exchange conditions, the Indian financial sector, particularly the banking sector remained unaffected barring some stray reports of exposure of a few banks to external financial turbulence. The main reason, it is presumed and theoretically supported, that the crisis in India has been an imported one and hence it has had little to do with the fundamentals of the real economy. So long as the real sector remains compact and undeterred small blemishes that appear on the face of the financial sector can hardly do anything. Whereas in the case of the crisis affected West, the crisis itself came through the maladies of the real sector. The lesson that we have learned from the crisis is likely to cement the argument that cent percent deregulation is not the apt way to be adopted in the name of reforming the financial sector. Reform should not be reckoned with deregulation alone; it has to be in line with allowing the horse to run with the rope in the hands of the rider.

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