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# Impact of US Subprime Crisis on Indian Economy

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**ABSTRACT** *The word 'subprime' in relation to mortgages in the USA generally refers to those mortgages targeted at borrowers with impaired or low credit ratings and low income level who may find it difficult to obtain finance through traditional sources, such as, prime mortgages. Subprime borrowers have the highest perceived default risk, as compared with Prime borrowers. The current paper tries to discuss the emergence of US subprime crisis in United States of America which later affects the entire world. The turmoil in Global market was not in short duration of time. This paper also focuses on the Stages of Subprime crisis and the main causes of the same. In the later part of the paper negative effects of subprime crisis on Indian economy is explained and at last the paper also put in plain words some of the constructive steps taken by RBI and SEBI to minimize the Subprime effect on Indian Banking sector and Indian Capital Market respectively.*

**Introduction**

The U.S. subprime mortgage crisis was a set of events and conditions that led to the late-2000s financial crisis, characterized by a rise in subprime mortgage delinquencies and foreclosures, and the resulting decline of securities backed by said mortgages. The Wall Street investment banks and brokerages hemorrhaged $175 billion of capital in the period July 2007 to March 2008[1], and Bear Stearns, the fifth largest, was 'rescued' in March, at a fire-sale price, by JP Morgan Chase with the help of $30 billion of guarantees from the Federal Reserve. The percentage of new lower-quality subprime mortgages rose from the historical 8% or lower range to approximately 20% from 2004 to 2006[2], with much higher ratios in some parts of the U.S. A high percentage of these subprime mortgages, over 90% in 2006 for example, were adjustable-rate mortgages.[3] These two changes were part of a broader trend of lowered lending standards and higher-risk mortgage products. Further, U.S. households had become increasingly indebted, with the ratio of debt to disposable personal income rising from 77% in 1990 to 127% at the end of 2007, much of this increase mortgage-related.[4]

**Stages of US Subprime Crises**

The crisis has gone through stages. First, during late 2007, over 100 mortgage lending companies went bankrupt as subprime mortgage-backed securities could no longer be sold to investors to acquire funds. Second, starting in Q4 2007 and in each quarter since then, financial institutions have recognized massive losses as they adjust the value of their mortgage backed securities to a fraction of their purchased prices. These losses as the housing market continued to deteriorate meant that the banks have a weaker capital base from which to lend. Third, during Q1 2008, investment bank Bear Stearns was hastily merged with bank JP Morgan with $30 billion in government guarantees, after it was unable to continue borrowing to finance its operations. Fourth, during September 2008, Fannie Mae and Freddie Mac, representing $5 trillion in mortgage obligations, were nationalized by the U.S. government as mortgage losses increased. Next, investment bank Lehman Brothers filed for bankruptcy. In addition, two large U.S. banks (Washington Mutual and Wachovia) became insolvent and were sold to stronger banks.[5]

**Causes for the US Subprime Crisis**

**1. Boom and bust in the housing market**

Low interest rates and large inflows of foreign funds created easy credit conditions for a number of years prior to the crisis, fueling a housing market boom and encouraging debt-financed consumption. The USA home ownership rate increased from 64% in 1994 (about where it had been since 1980) to an all-time high of 69.2% in 2004.[6] Subprime lending was a major contributor to this increase in home ownership rates and in the overall demand for housing, which drove prices higher. Between 1997 and 2006, the price of the typical American house increased by 124%. This housing bubble resulted in quite a few homeowners refinancing their homes at lower interest rates, or financing consumer spending by taking out second mortgages secured by the price appreciation.

**2. Homeowner Speculation**

Speculative borrowing in residential real estate has been cited as a contributing factor to the subprime mortgage crisis. During 2006, 22% of homes purchased (1.65 million units) were for investment purposes, with an additional 14% (1.07 million units) purchased as vacation homes. During 2005, these figures were 28% and 12%, respectively. In other words, a record level of nearly 40% of homes purchased was not intended as primary residences.[7] David Lereah, NAR's chief economist at the time, stated that the 2006 decline in investment buying was expected "Speculators left the market in 2006, which caused investment sales to fall much faster than the primary market."[8] Subprime mortgages amounted to $35 billion (5% of total originations) in 1994, 9% in 1996,[85] $160 billion (13%) in 1999, and $600 billion (20%) in 2006. [9]

**3. High-risk mortgage loans and lending/borrowing practices**

In the years before the crisis, the behavior of lenders changed dramatically. Lenders offered more and more loans to higher-risk borrowers, including undocumented immigrants. Lending standards particularly deteriorated in 2004 to 2007. Subprime mortgages amounted to $35 billion (5% of total originations) in 1994, 9% in 1996, $160 billion (13%) in 1999, and $600 billion (20%) in 2006. [10] In addition to considering higher-risk borrowers, lenders had offered increasingly risky loan options and borrowing incentives. In 2005, the median down payment for first-time home buyers was 2%, with 43% of those buyers making no down payment whatsoever. [11]

**Shocks of Subprime Crisis on Indian Economy**

Though in the beginning Indian official denied the impact of US meltdown affecting the Indian economy but later the government had to acknowledge the fact that US financial crisis will have some impact on the Indian economy.

**1. Crash on stock market**

The immediate impact of the US financial crisis has been felt when India's stock market started falling. On July 23, 2007, the SENSEX touched a new high of 15,733 points. On July 27, 2007 the SENSEX witnessed a huge correction because of selling by Foreign Institutional Investors and global cues to come back to 15,160 points by noon. Following global

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cues and heavy selling in the international markets, the BSE SENSEX fell by 615[12] points in a single day on August 1, 2007.

**2. Collision on India's Foreign Exchange Reserve**

The trade deficit is reaching at alarming proportions. Because of worker's remittances, NRI deposits, FII investment and so on, the current deficit is at around $10 billion. But if the remittances dry up and FII takes flight, then we may head for another 1991 crisis like situation, if our foreign exchange reserves depletes and trade deficit keeps increasing at the present rate. Further, the foreign exchange reserves of the country has depleted by around $57 billion to $253 billion for the week ended October 31, 2008.[13]

**3. Impact on India's export**

With the US and several European countries slipping under the full blown recession, Indian exports have run into difficult times, since October. Manufacturing sectors like leather, textile, gems and jewellery have been hit hard because of the slump in the demand in the US and Europe. Further India enjoys trade surplus with USA and about 15 per cent of its total export in 2006-07 was directed toward USA. Indian exports fell by 9.9 per cent in November 2008[14], when the impact of declining consumer demand in the US and other major global market, with negative growth for the second month, running and widening monthly trade deficit over $10 billion.

**4. Impact on India's handloom sector, jewelry export and tourism**

Again reduction in demand in the OECD countries affected the Indian gems and jewellery industry, handloom and tourism sectors. Around 50,000 artisans employed in jewellery industry have lost their jobs as a result of the global economic meltdown. Further, the crisis had affected the Rs. 3000 crores handloom industry and volume of handloom exports dropped by 4.6 per cent in 2007-08,[15] creating widespread unemployment in this sector.

**5. Exchange rate depreciation**

With the outflow of FIIs, India's rupee depreciated approximately by 20% against US dollar and stood at Rs. 49 per dollar at some point[16], creating panic among the importers.

**6. IT-BPO sector**

The overall Indian IT-BPO revenue aggregate is expected to grow by over 33 per cent and reach $64 billion by the end of current fiscal year (FY200). Over the same period, direct employment to reach nearly 2 million, an increase of about 375000 professionals over the previous year. IT sectors derives about 75 per cent of their revenues from US and IT-ITES (Information Technology Enabled Services) contributes about 5.5 per cent towards India's total export[17]. So the meltdown in the US will definitely impact IT sector. Further, if Fortune 500 hundred companies slash their IT budgets, Indian firms could adversely be affected.

**7. FII and FDI**

The contagious financial meltdown eroded a large chunk of money from the Indian stock market, which will definitely impact the Indian corporate sector. However, the money eroded will hardly influence the performance real sector in India. Due to global recession, FIIs made withdrawal of $5.5 billion, whereas the inflow of foreign direct investment (FDI) doubled from $7.5biilion in 2007-08 to $19.3 billion in 2008[18].

**Safety Reasons of Indian Economy Against Global Turmoil**

- Despite its immediate impact on the financial markets and the trade flows, the crisis did not have very significant impact on the Indian financial system. The reasons for the muted impact is attributable primarily to (i) the macro prudential approach to regulation (ii) multiple indicator based monetary policy, (iii) calibrated capital account management, (iv) management of systemic interconnectedness, (v) robust market infrastructure for OTC transactions and (vi) a conservative approach towards financial innovation.
- The Reserve Bank of India made sharp reduction in the policy interest rates – the effective policy rate was cut from 9 per cent in September 2008 to 3.25 per cent (reverse repo rate) in April 2009.[19]
- The cash reserve ratio was reduced from 9.0 per cent in September 2008 to 5 per cent in January 2009[20] with a view to injecting liquidity into the banking system.
- Liquidity injection in bulk was made through purchase of government securities under open market operation (OMO) and unwinding of the balances under Market Stabilization Scheme (MSS) through buy-back, redemptions and de-sequestering.
- The Reserve Bank of India allowed institution of a rupee-dollar swap facility for Indian banks to give them comfort in managing short-term foreign funding requirements of their overseas branches; special liquidity support to banks for on-lending to mutual funds and non-banking financial companies.
- The Security Exchange Board of India (SEBI) has started taking measures to save Indian Capital Market. It has introduced P-notes, Venture Capital, etc to enhance the safety for the Investors and Indian Capital Market.
- The fiscal and monetary measures were successful in achieving their objectives. Financial markets and the banking sector began to function normally. Real GDP growth which took a hit in 2008-09 as it reached 6.8 per cent recovered quickly to reach 8.0 per cent in 2009-10 and 8.5 per cent in 2010-11[21] under the impact of stimulus measures as also the inherent strength of domestic demand. Strong recovery in demand, along with persistent supply pressures, however, led to inflationary pressures during 2010-2011.
- CRISIL believes that the Indian banking system is relatively insulated from the factors leading to the turmoil in the global banking industry. Further, the recent tight liquidity in the Indian market is also qualitatively different from the global liquidity crunch, which was caused by a crisis of confidence in banks lending to each other.
- Indian banks' global exposure is relatively small, with international assets at about 6 per cent of the total assets. Even banks with international operations have less than 11 per cent of their total assets outside India. The reported investment exposure of Indian banks to distressed international financial institutions of about USD1 billion is also very small.
- The strong capitalization of Indian banks, with an average Tier I capital adequacy ratio of above 8 per cent, is a positive feature in their credit risk profile.

**Conclusion**

Many lessons can be learned from the recent subprime crisis. Those lessons have not been systematically addressed, perhaps because everyone has been busy with 'fighting the fire'. This is not a normal crisis period, and hence, no normal post-crisis recovery was expected. The financial wizards seem to remain overly optimistic that the crisis will be followed by a normal economic recovery so that life can get back to normalcy. The US meltdown which shook the world had little impact on India, because of India's strong fundamental and less exposure of Indian financial sector with the global financial market. Perhaps this has saved Indian economy from being swayed over instantly. Unlike in US where capitalism rules, in India, market is closely regulated by the SEBI, RBI and government.

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