U.S Sub-prime Crisis And Its Impact On India

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Perspective

"An infectious greed seemed to grip much of our business community. . . . . It is not that humans have become any more greedy than in generations past. It is that the avenues to express greed have grown so enormously.

- Alan Greenspan, testimony before the Senate Banking Committee, July 16, 2002

The present global financial crisis, which is characterized by weak economic environment, low liquidity and volatile debt, commodities and forex markets, was triggered by the sub-prime mortgage crisis in the US. Financial crisis implies sudden erosion in large part of the value of some financial institutions or assets. The violent disruption in the global financial markets, which had been in the making for over a year, erupted in September 2008, when major US and European financial institutions were about to go under and had to be bailed out by their governments and central banks. The crisis highlighted the vulnerabilities of many financial systems and corporate sectors that had experienced credit booms and had borrowed short and in foreign currencies.
The present global financial crisis has been differently defined because of the semantic difficulty in conveying various meanings and different connotations implicit in the term. Consequently, attempts need to be made to examine various dimensions of the global crisis without being dogmatic. In common parlance, the present global financial crisis has been used interchangeably with the "subprime crisis". But, as a recent BIS paper showed, the present global financial crisis transcends the subprime sector. The term subprime applies to the borrower, signifying a low-income borrower, or one with an impaired credit record; loans with risky features such as limited documentation mortgages originated by subprime lenders, defined in turn as 'lenders meeting criteria unrelated to their customers'.

According to the IMF's latest *Global Financial Stability Report* (GFSR), the widening and deepening fallout from the U.S. subprime mortgage crisis would have profound financial system and macroeconomic implications. Financial markets remain considerably stressed because of a combination of

weakening balance sheets of financial institutions, continued process of deleveraging, free fall in asset prices and difficult macroeconomic environment in the wake of debilitating global growth. Jaime Caruana, Head of the IMF's Monetary and Capital Markets Department maintains "the recent Fed actions in solving the Bear Stearns case and also in providing liquidity to a broader range of counterparties have reduced the probability of a tail event, although there are still funding pressures that continue".

The International Monetary Fund's twice-yearly *Global Financial Stability Report* warned that many of the lax lending practices of the past few years will have to change and economic growth will be crimped by the current correction. This observation seems to acquire a sharp poignancy in the wake of the collapse of the world capitalist system—widely acknowledged to be portending a catastrophe of dimensions not seen since the Great Depression of the 1930s and leading to another Great Depression. The stunning series of events include the collapse of the big five financial giants on Wall Street — Fannie Mae, Freddie Mac, AIG, Lehman Brothers and Merrill Lynch — with revenues totalling nearly $322 billion in 2007, followed by two of the largest banks — Washington Mutual (WaMu) and Wachovia. In sharp contrast to the case of Bear Stearns and AIG, Lehman Brothers was allowed to go bankrupt. Lehman was not treated on par with Bear Stearns and AIG for the simple reason that AIG's failure posed a much bigger risk to the entire financial system than the Lehman Brothers. Had AIG failed, $307 billion of its derivatives written to banks out of $441 billion worth of Credit Default Swaps (CDS) in its portfolio would have brought to the fore the problem of recapitalisation of the banks primarily in Europe but also to some extent in the US.

The ease with which the world's most powerful institutions were brought to the precipice is symptomatic of a larger malaise: the devastating crisis of confidence. Increasing complexity, loss of control and lack of regulation are clearly reflected in the meltdown of the rich world's financial system, plummeting stock markets, stoppage by banks of lending to one another, closure of money markets and credit markets with skyrocketing interest-rates, fear of a generalised run on the banking system and the shadow banking system - broker-dealers, non-bank mortgage lenders, structured investment vehicles and conduits, hedge funds, money market funds, and private equity firms – being particularly vulnerable on their short-term liabilities. The collapse is devastating ever wider layers of the population with the debris left behind devastating the working class through a rapid growth of

unemployment, poverty, homelessness and social misery. All the advanced economies are characterized not just by recession and a severe financial and banking crisis but also a severe political crisis, a crisis of leadership for capitalism. While markets across the development spectrum have been adversely impacted by the escalation of delinquencies and defaults, the US mortgage market was particularly susceptible to growing macroeconomic debilities and the depth of the abyss that opened up for world capitalism

The markedly different institutional settings in the US and elsewhere influenced different responses to global financial developments and the interaction between these institutional details made a large difference to the end result. The uniqueness of the US mortgage market to the gathering storm stemmed from the triad of the US housing construction boom itself, which created supply far in excess of the underlying needs; much greater easing in US's lending standards (e.g., documentation, loan-to-valuation (LTV) ratios (including second mortgages) and loans where principal was not paid down in the early stages of their lives) than elsewhere, across a number of dimensions such as documentation standards, LTV ratios (including second mortgages) and loans where principal was not repaid in the early stages and the quick rise in mortgage arrears rates. The "marketisation" of loans, i.e., the conversion of loans into tradeable securities together with ineffective regulation, dubious credit ratings, large exposures on the part of highly leveraged institutions dependent on wholesale funding all hastened the journey to a perilous crossroads. In hindsight, it is plain that the rise in house prices in America in an environment of declining real incomes was absurd.

Macro economic weakness in the US, which was caused by deregulation, low interest rates, surplus funds and lax regulations, transcends the liquidity crunch and set in motion a vicious cycle. Plummeting housing prices led to reduction in household worth and therefore, reduced consumer spending; downsizing in terms of fewer employees led to lower wages and salary incomes; higher prices of food and energy caused a further fall in real incomes; and reduced economic activity in the rest of the world lowered demand for US exports. In view thereof, the United States remains at the financial quake's "epicenter". The backwash effect of the American (or global) financial crisis, however, also devastated financial institutions in other countries "reflecting the same overly benign global financial conditions, an inattention to appropriate risk management systems, and lapses in prudential supervision". The highly inflammable mix of low interest rates and easy

access to funds encouraged reckless lending, the infamous interest only, no-down payment, no-documentation ("liar") sub-prime mortgages.

Inflated house prices or more stretched corporate or household balance sheets enhanced the vulnerability of emerging Europe, which experienced rapid credit growth, some of which also have large current account deficits financed by private debt or portfolio flows. Emerging markets are hurt because the earlier benign financial conditions and low interest rate environment induced higher risk taking. Even the BRIC countries (Brazil, Russia, India, and China) have been susceptible to the rapidly worsening situation, which has been driven significantly by exogenous events and force a look at the future with some trepidation. With choked-off credit lines, massively leveraged firms, mounting bad assets, sinking mortgages, panicked consumers and paralysed companies, it cannot possibly get any worse, can it? Bank-Ki-Moon, United Nations General Secretary has correctly pointed out "the global financial crisis endangers all our work. We need a new understanding and business ethics and governance, with more compassion and uncritical faith in the 'magic' of markets".

Box 1: Biggest bankruptcies

Lehman Brothers, the fourth largest US investment bank, which filed for bankruptcy, is the biggest corporate bankruptcy in history in terms of assets held.

Firm	Assets ($bn)	Date filed
Lehman Brothers	$639.0	Sep.15, 2008
WorldCom	103.9	July 21, 2002
Enron	63.4	Dec.2, 2001
Conesco	61.4	Dec.18, 2002
Texaco	35.9	Apr.12, 1987
FCA	33.9	Sep.9, 1988
Refco	33.3	Oct. 17, 2005
IndyMac	32.7	Jul.31 2008
Global Crossing	30.2	Jan.28, 2002
Calpine	27.2	Dec.20, 2005

Source: Bankruptcydata.com

Historical Perspective-Countdown to Armageddon?

Considered in a proper historical and comparative perspective, the seamless progression to the dangerous manipulation of American financial markets did not erupt overnight but has clearly been in the making for some time. The problem was exacerbated by soaring oil prices, lower spending by the corporate sector and rising unemployment. Some of the signposts in the historic failure of American and world capitalism could be identified as the downgrading of General Motors' bonds by rating agencies from investment grade to non-investment grade or "junk", HSBC sacking head of its US mortgage lending business with losses reaching $10.5 billion (February 22, 2007), suspension of shares in New Century Financial on fears of bankruptcy (March 12, 2007), heavily discounted sale by cash-strapped firm Accredited Home Lenders Holding of $2.7 billion of its sub-prime loan book (March 16, 2007) and filing of bankruptcy by New Century Financial (April 2, 2007). Other chronological indicators of the implosion of major corporations, the devastating consequences of a greed-driven culture and dubious or illegal corporate accounts and standards of behaviour included heavy losses of GM finance unit on sub-prime mortgages and closure of UBS's US sub-prime lending arm, Dillon Read Capital Management (May 3, 2007), bailout package of $3.2 billion by Investment bank Bear Stearns of two of its funds exposed to the sub-prime market (June 22, 2007), announcement by Bear Stearns to its investors to write-off the money invested in two of its hedge funds (July 18, 2007), Bear Stearns ban on cash withdrawal from a third fund because of heavy redemption requests and filing of bankruptcy protection for the two funds bailed out earlier (July 31, 2007). Filing of bankruptcy by American Home Mortgage (August 6, 2007), BNP Paribas' announcement regarding its inability to fairly value the underlying assets in Parvest Dynamic ABS, BNP Paribas ABS Euribor and BNP Paribas ABS Eonia because of exposure to US subprime mortgage lending markets (August 9, 2007) were climatic moments in a protracted process and clearly reflected the terrifying rise of financial skullduggery and systemic damage wreaked.

Convulsive Crisis of Capitalism- A Sense Of Déjà Vu!

The thesis of the inherent nature of the crisis in the capitalist system can be substantiated both by the incisive analysis of Karl Marx and the fact that the capitalist system has lurched from one crisis to the other with disruptive effects. In fact, over the past three decades, market economies have faced

more than 100 crises. Of the large number of banking crises, stock market collapses and credit crunches, mention may here be made of the collapse of Overend and Gurney in May 1866, the Barings Crisis in 1890, the Wall Street crash of 1929 contributing to the Great Depression of the 1930s, US Savings and Loan Scandal, 1985, the US stock markets crash of 1987, the collapse of hedge fund Long-Term Capital Market (LTCM), which originated in Asia in 1997 and spread to Russia and Brazil in 1998, the Dot.Com Crash, 2000. With global capital markets, investment banks and derivatives becoming more complex than ever, it is important to fit all the pieces of the puzzles together for a holistic assessment. On the basis of an incisive analysis of disruptions to periods of financial stress that rocked the world, the IMF has identified and isolated the following important lessons:

- ✓ Globalisation has increased the frequency and spread of financial crises, but not necessarily their severity;
- ✓ Early intervention by central banks is more effective in limiting their spread than later moves;
- ✓ Difficult to tell at the time whether a financial crisis will have broader economic consequences and regulators often cannot keep up with the pace of financial innovation that may trigger a crisis.

This stark reality check, which needs to be looked at against the broader macro-economic canvas, prompted the US treasury secretary Henry Paulson and the Federal Reserve to announce a slew of measures to move troubled assets from the balance sheets of American financial companies into a new institution in an attempt to avoid a downward spiral in the markets and to make the wheels of finance turn again. In a move reminiscent of Greenspan's scathing comments of "privatizing profits, socializing losses", the Fed will lend to banks to meet redemption demands from money market mutual funds and plans to buy debt from bond houses to aid financial market liquidity. Some "financial socialism" this!

The *Financial Times* recently reported that compensation for major executives of the seven largest US banks totaled $95 billion over the past three years, even as the banks recorded $500 billion in losses. This is why it is important to ensure that persons, who controlled the banks and finance houses, must not be allowed to go scot-free and held accountable for the bankruptcy, sale, restructuring and merger of some of the world's largest

financial institutions that devastated the international stocks and money markets.

Real and Worrisome Fault-lines

Nouriel Roubini has persuasively argued "The crisis was caused by the largest leveraged asset bubble and credit bubble in the history of humanity where excessive leveraging and bubbles were not limited to housing in the U.S. but also to housing in many other countries and excessive borrowing by financial institutions and some segments of the corporate sector and of the public sector in many and different economies: an housing bubble, a mortgage bubble, an equity bubble, a bond bubble, a credit bubble, a commodity bubble, a private equity bubble, a hedge funds bubble are all now bursting at once in the biggest real sector and financial sector deleveraging since the Great Depression".

The real and worrisome fault-lines in the functions and working of exalted institutions like the Federal Reserve, the Securities and Exchange Commission (SEC), the absurd level of CEO salaries (last year, CEO's got an average of 344 times the wages of the typical worker as against Peter Drucker's reasonable suggestion of capping them at 20 or 25 times), the inefficiency and collusion of both the internal and external audit, the avarice and the vaulting ambition of top management of these companies and the fallacies of the "too big to fail (TBTF)" hypothesis- all contributed to the global doom and gloom. At best, the revered institutions like the Fed, SEC overlooked the potential calamity inherent in the excessive leveraging of equity to the extent of 30 to 40 times by investment banks, i.e., Bear Stearns, Lehman Brothers and others; at worst, these institutions colluded in the meticulously worked out elaborate farce. It does not need either rocket science or advanced knowledge of particle physics to know the imminent catastrophic impact of even 5 per cent erosion in value of $800 billion worth of assets on an equity base of just $20 billion, i.e., a factor of well over 40. Lehman's position was not a flash in the pan because both Fannie Mae and Freddie Mac just had a capital adequacy ratio of around 0.5 percent, which made it impossible for them to bear the mounting losses trigerred by huge mortgage defaults and the US house-price collapse. Clearly, it was too good to last, the bubble had to burst, the cookie had to crumble and how! As Sherlock Holmes would have said "elementary, my dear!"

The dubious ratings process, which had awarded 'AAA' (Alarm, Assault & Agony) ratings on most of those companies were subsequently downgraded to BB ratings (Better beware?), has justifiably evoked concern and consternation on the deplorable rating acquisition practice of huge fees. The abolition of the Glass-Steagall Act, which had kept a firewall between the commercial and investment banking parts of the financial system since the 1930s and the adoption by the U.S. Congress in 1999 of the Financial Services Modernisation Act, which scrapped all regulatory restraints on financial services, spawned the spread of a new banking model. This model played a catalytic role in rapidly deteriorating ground realities characterized by deflation, rising unemployment and Keynes' liquidity trap rearing its ugly head once again. The predatory corporate practices of derivative instruments like options and futures by investment banks and hedge funds worsened the festering problem, wherein millions of Americans lost their homes and their jobs and contributed significantly to the crisis of the American economic and political system.

Credit deterioration initially discernible in the U.S. subprime market gradually spread to higher-quality residential mortgages, U.S. commercial real estate, and the corporate debt markets. The plummeting valuations of structured credit products and the liquidity crunch worsened the situation. Uncertainty about the size and distribution of bank losses, reduced capital buffers, and the normal reduction in credit in the economic downturn also adversely effected household borrowing, business investment, and asset prices in turn affecting employment, output growth, and balance sheets. The gravity of the US being mired in a "once-in-a century" financial meltdown now more than likely to spark a recession is forcefully brought in the words of James Howard Kunstler. Kunstler said "Fastening your seat belts may not be enough for this ride. Better superglue yourselves to the floorboards and pray for God's mercy".

When the going was good investment banks made super-normal profits because of their reckless, over-leveraged businesses with very little regulation of the kind faced by traditional banks and no system of checks and balances. In hindsight, it is manifestly clear that not only the whole investment-banking model was saddled with inherent contradictions but also there were serious deficiencies in risk measurement and management of the entire system of complex financial instruments starting with creation of artificial demand for housing leading to ridiculously high prices, 1.3 million foreclosures in the

US during 2007, sale of dubious sub-prime liabilities to hedge funds, insurance companies and foreign banks, who further repackaged them into mortgage-based securities. All this complex web of deception and deceit aimed at making more and more money with casino like operations culminated in this financial catastrophe of humungous proportions. The IMF's warning "Thus, it is now clear that the current turmoil is more than simply a liquidity event, reflecting deep-seated balance sheet fragilities, which means its effects are likely to be broader, deeper, and more protracted" has a prophetic ring.

Interestingly higher degree of leverage, i.e., borrowing to finance investment in the stock market ("margin buying") also contributed to the Great Depression of 1929. The problem was exacerbated by soaring oil prices, lower spending by the corporate sector and rising unemployment. As an op-ed in The *Wall Street Journal* puts it, "With the benefit of hindsight, everyone can see that the US economy built up an enormous credit bubble that has now popped. . . this bubble was created principally by a Federal Reserve that kept real interest rates too low for too long. In doing so the Fed created a subsidy for debt and a commodity price spike". Clearly, the system, which was fraught with danger, should have necessitated a closer look at the mortgage backed security and risk transfer methods employed by financial institutions.

The rot in the banking system was worsened by the trading practice of 'going short'. While this undesirable practice has some times been eulogized as an integral part of an efficient market, short selling has been discouraged in India because of its implications for value destruction. Others veered round to new ground realities with SEC prohibiting short selling in about 800 stocks of US banks, insurance companies and securities firms till October 2, 2008 and the Financial Services Authority in the UK banning short sales of financial shares for the rest of the year. Standard & Poor's pithy observation in its latest report on 'Broader Lessons From Lehman Brothers' Bankruptcy' would certainly enjoy a fair measure of consensus. Globally also "looking beyond just the Lehman failure, during the past few decades, the financial system has become more concentrated, and, in our opinion, risk at financial institutions has grown with a mix of riskier assets that are common across a larger number of institutions. While mitigation efforts, such as securitizations and credit insurance, attempted to lower financial institutions' risk exposure, the ultimate result in many cases has been quite the opposite. It now has become clearer that the specific structure of these instruments and their

‘interconnectedness’ many times negate any expected benefits. From this perspective, systemic risk has risen” (Standard & Poor).

The worsening sub-prime crisis of illiquid loans and accounting for on an accrual basis in the “banking book” rather than on a mark-to-market basis in the “trading book”, the frenzied speculation that caused cataclysmic disruptions in the international stocks and money markets could conceivably cause a liquidity crunch aggravating the slowdown and precipitating a recession. A key theme and driver was the "suboptimal, duplicative and out-of-date" regulatory forbearance (a case of the watchdog becoming the lap dog!) that characterised the ostensibly “transparent” but actually opaque markets, which are typical of modern finance.

As Nouriel Roubini says that the US and the advanced industrial countries are now “headed towards a near-term systemic financial meltdown... All the advanced economies representing 55% of global GDP… entered a recession even before the massive financial shocks.” This “recession” is now combined with “a severe financial crisis and a severe banking crisis in advanced economies”. Moreover, there is a “re-coupling of the emerging market economies” encompassing stock markets, credit markets, money markets and currency markets. The concern is not just psychological but also financial and economic because of greater inter-linkages and interdependencies. While countries with large current account deficits and/or large fiscal deficits and with large short-term foreign currency liabilities and borrowings have been taken the most hit, the better performing ones, including the BRICs (Brazil, Russia, India and China) face clouded prospects.

Enormously corrosive mistrust is all pervasive now in an environment variously described as ‘catastrophe’, ‘end of the world’, ‘apocalypse’, ‘epidemic’ and ‘contagion’. No wonder, then, things have come to such a sorry pass that counterparties no longer trust each other. The situation is reminiscent of Walter Bagehot’s pithy observation: “Every banker knows that if he has to prove that he is worthy of credit, however good may be his arguments, in fact his credit is gone.” As these problems get worse, the stakes rise higher necessitating correctional recipes for banking with Europe favouring more regulation and the US resisting erosion of free enterprise. Taking of enormous risks through innovative and exotic (treacherous!) instruments by financial institutions brought to the fore the difference between regulation and supervision. Contrary to popular perception,

government regulation and oversight are prerequisites to a functioning market economy. While excessive regulation and concomitant red-tapism stifles innovation, the near universal calls for greater regulation and state intervention certainly have some merit. American banks were reasonably regulated and investment banks were not regulation-free. In fact, it has been argued-and perhaps not unjustifiably- that excessive risk-taking, credit default swapping and leveraging were, to some extent, attempts to bypass rules. The inability of the supervisors to fully understand the magnitude and the implications of the toxic instruments together with the highly inflammable mix of loose money and light regulations made the supervisors oblivious to the imminent dangers of the impending catastrophe. Lawfulness in governance and regulatory mechanism needs to be strictly adhered to. There has to be enough oversight now and restrictions to make sure that the bad practices of the past do not recur and that new lending does occur.

While financial owes rattled the world markets, there are still no definitive answers on tackling this crisis. But there is mo doubt that the severity of the global financial crisis and the long, hard task of fixing the financial system requires streamlining of financial regulations and supervision. It needs no clairvoyance to perceive that what is needed is a balanced set of proposals that include both a short-term programme of survival and long-term structural changes. Some of the basic elements of the new strategy for financial regulation and bank supervision and reforming the architecture of the international system, as isolated and identified by Dr. Michael Sakbani, include uniformity of international standards, applicability of the new regulatory system to all financial institutions doing the same function, be it banks or non banks, strengthened prudential oversight of banks and other financial institutions and adoption of best practice models, establishment of common international models for asset risk valuation and common financial accounting standards for examining, auditing and supervising all financial institutions, revised role and uses of credit ratings and in the standards applied by these agencies in their work, implement agreed modalities to strengthen the responsiveness of authorities to systemic risk; and set robust arrangements for dealing with stress in the international financial system and establish internationally standardized system for data definitions, gathering and electronic dissemination to all participants and to the public at large. Some of these measures may seem to be far too radical, unconventional and aggressive measures to restore confidence and stabilise the markets. But a clear, dispassionate analysis would distinctly bring out that these measures are

imperative in the context of the vicious circle of deleveraging, asset collapses, margin calls, and cascading falls in asset prices well below fundamentals and panic.

Bailout Package

The $700 billion 'bailout', which marks the biggest federal intervention in financial markets since the Great Depression of the 1930s, is meant to unclog global credit markets. The $700 billion rescue package would let the government implement a "troubled asset relief programme" called Toxic Asset Dump (TAD) by William Buiter. The Bank of England announced the 500-billion-pound bank rescue plan followed by an interest rate cut. Germany and France unveiled plans to inject fresh capital into their banking sectors worth 470 billion euros and 340 billion euros respectively. Italy's bailout announcement was preceded by Spain providing guarantees up to 100 billion euros for new debt issued by commercial banks in 2008 and an unspecified amount next year. Norway offered its banks up to 50 billion euros in government bonds for mortgage debt and Portugal is to make available 20 billion euros in guarantees for its banks. According to the Bank of England's latest Financial Stability Report, "perhaps as much as £5 trillion ($8 trillion on the date of the report) has implicitly or explicitly been made available by the central banks and governments since April 2008 to support wholesale funding." The success of these measures would allow frozen credit to begin flowing again and prevent a serious recession. What is needed is a concerted and coordinated approach to the crisis that is crippling an inextricably linked system.

Impact of the US Crisis on Developing Economies- The Big Picture

According to the World Economic Report, prepared by UNCTAD, the current financial crisis in the developed markets including US and European countries will not affect the developing countries, which are growing at fast rate. The problem related to sub-prime mortgage lending and their fallout in the US have disrupted the financial markets, with broad impact on the US economy as a whole. The resultant liquidity problems have extended to some European countries as well. The liquidity problem leading to increase in the cost of funds will affect the foreign direct investments (FDI) flows. At the firm level, the survey conducted by UNCTAD in June 2008, revealed that one third of multinational companies envisaged negative impact on FDI flows in

short term but about half of the firms surveyed suggested no impact. But, in case of developing economies, resilience of growth of economies suggest there is not much effect of financial crisis in US. India's plan to fund $495 billion infrastructure development spread over five years till 2012 could face financing gaps. According to the World Bank estimate, $500 billion are required over a period of 2001-2010. The annual financing gap during 2001-2010 is estimated at close to $14 billion. For the entire period, it worked out to be about $140 billion.

Indian Macroeconomic Growth-For Whom The Bell Tolls

Despite the turmoil in global financial markets, the Indian growth story is still intact and the macro-economic fundamentals of the economy continue to be robust. Prime Minister Dr. Manmohan Singh assured parliamentarians and the nation that "there is no place for fear. This is the time for unity of purpose and resolute action." While the Indian economy became more resilient, domestic demand continued to be its key growth driver and the Indian financial market has been more circumspect than the western regulators, the spillage of the sub-prime domino has significant negative impact on the Indian economy in the current context of a rapidly falling Sensex, a depreciating rupee, faltering growth momentum, domestic credit stringency and a slowdown of exports of both goods and services. The recessionary shock has begun to hit Indian exports and slowing down of the Indian economy has affected various sectors. Sectors, such as, textile, real estate, infrastructure, civil aviation, automobile, housing and few export dependent sectors like information technology are likely to be impacted. Similarly some sectors like cement may see slowdown due to over expansion in some parts of the country. Consequently, there is a rising crescendo of demands from industry for more reductions in policy interest rates and the pressure on banks to provide cost effective prompt services to its existing and potential customers has increased. Alleviating the pain of the slowdown requires bankers to be more fleet-footed, to take decisions faster and more judiciously.

Heightened risk aversion in the international financial markets to emerging market economies has reduced the Indian corporate sector's ability to raise global funds, thereby, impeding investment growth. India is not exposed to the new and innovative financial instruments that brought about this financial tsunami, there are large foreign exchange reserves making it possible to tide over any short-term disruption in capital inflows.

The Indian banking system is sound, well capitalized and well regulated. Indian banks do not have any direct exposure to sub-prime mortgages. Most of Indian banks' exposures are to those Lehman Brothers' subsidiaries, which have not filed for bankruptcy. Overall, these banks' exposures especially to Lehman Brothers, which has filed for bankruptcy, is insignificant and are adequately provided for. According to a RBI study undertaken in September 2007, there was no evidence of any direct impact on account of direct exposure to the sub-prime markets. However, some banks suffered some losses on account of the mark-to-market losses caused by widening of the credit spreads emanating from the sub-prime crisis on term liquidity in the market.

Six public sector banks (PSBs) and ICICI Bank have a total exposure in entities like Lehman Brothers, Fannie Mae and Freddie Mac, etc. of approximately Rs 640 crore with ICICI’s exposure alone being nearly Rs 400 crore. But ICICI’s exposure is quite modest in relation to its huge investment assets. Hence, the exposure is clearly limited; Indian PSBs are well regulated and have strong balance sheets. Thus, while the banking system is immune from the present global imbroglio and there is no systemic concern, the negative global sentiments will adversely affect the liquidity and outlook of the banking and other sectors, such as, real estate, aviation, information technology. The renewed emphasis of Indian banks on the repayment capacity of the borrowers to cover the risk of defaults and delinquencies would lead to a northward movement of the rate of interest on loans. But real estate prices in India could drop by 10-15 per cent in the next few months because of the cash crunch of US companies, which had invested in Indian real estate companies; no fresh inflow of funds to Indian real estate given the non-accessibility of easy and cheap dollars easily and at a cheaper rate; difficulties in finishing ongoing projects because of reduced inflow of such money making project completion difficult; and absence of buyers.

Some of the ramifications of the severe liquidity and credit crunch could be seen in lower capital inflows, reduced ability of Indian corporate to raise resources via the equity route, significantly increased risk perception leading to keeping all future investments by institutional investors such as pension or endowment funds in abeyance and cascading effect on private equity (PE) firms. Given the complete drying up of sources of funds — foreign borrowing and capital markets, it is necessary for the government to ease overseas borrowing norms for Indian companies.

The global credit crisis, which has caused all round havoc, poses a danger not only to the US economy but also the world economy. The magnitude and severity of this widespread crisis, which could lead to a total loss in excess of US$3 trillion globally, would hurt India's IT industry because 15-18 percent business of the Indian outsourcing companies from banking, insurance, and the financial sectors has now become uncertain. S accounts for more than 25% of the world's IT output of over $50 trillion. Given that IT is a multi-geography and multi-industry enabler, events and developments in any major economy or industry have a cascading effect. The National Association of Software and Service Companies (Nasscom) also indicated that while export will reach the $60 billion target in 2010, it may revise its software export growth target downwards by few percentage points for 2008-09. What is worse is that Lehman Brothers had outsourced deals amounting to Rs 550 crore to Rs 700 crore (annually) to 14 services providers, including Tata Consultancy Services, Satyam Computer Services and Wipro. Lehman Brothers's investments in some IT firms could be liquidated to raise funds and most of its 2,500 employees in India have been given the pink slip. Going forward, incremental pricing may weaken, and be renegotiated downwards; there could be a weakening of YoY growth rates; contracts could take longer to be awarded; start dates could get deferred; no significant deal expected in the BFSI space for at least a year; consolidation and mergers of banks could lead to reduced IT spends; benefits from fall in rupee may get limited by over-hedging; off-shoring to India may face backlash as firms issue pink slips to US employees and small-cap Indian IT firms' weaker offshore models could suffer most

While measures by the RBI and the government like the CRR cut from 9 percent to 5.5 percent, the effective reduction in the SLR from 25 percent to 21.5 percent with 1.5 percent points of the reduction earmarked for liquidity support by banks to mutual funds and NBFCs , the reduction in the Repo rate from 9 percent to 7.5 percent and a slew of other measures to enhance liquidity, liberalise terms for NRI deposits and external commercial borrowing (ECB), augment export credit refinance and reduce banks' provisioning norms for loans for housing, real estate, personal loans, credit card receivables and capital market exposure are certainly good, they are not good enough. In an extremely insightful paper, Jahangir Aziz, Ajaya Shah and Ila Patnaik have made wide-ranging suggestions, such as, cutting CRR to 5 per cent and SLR to 20 per cent, making oil and fertiliser bonds SLR-eligible, increasing the range of repo-eligible assets and even providing

insurance against counterparty risk in interbank transactions, setting up a weekly dollar-swap facility against rupee-denominated assets and investing part of the foreign exchange reserves in one-year deposits in foreign branches of Indian banks. While these suggestions may not find universal acceptance, there is no doubt that given the enormity of the crisis, innovative and ‘out-of-box’ solutions need to be seriously considered to shore up the financial system

Policy Prescriptions to Tackle The Crisis On All Streets!

- Juan Somavia, Director-General of the International Labour Organisation has correctly stressed **“**the current search for better financial regulation and a global surveillance mechanism of checks and balances is a welcome step. But we must reach beyond the financial system. *This is not simply a crisis on Wall Street; it is a crisis on all streets***”.** Today's global economy needs creation of an effective multilateral agency, including a new global regulatory agency. Given the inherent limitations of unilateralism in a world of economic interdependence, support from a truly global polity with a focus on international cooperation is needed as the basis for a new global economic order. As the G-7 Summit stressed, what is needed is "a coherent framework that will direct our individual and collective policy steps to provide liquidity to markets, strengthen financial institutions, protect savers, and enforce investor protection".
- A sharper focus of financial firms on liquidity risk management and risk transmissions and check on credit derivatives.
- Greater international cooperation because of the inherent inconsistency of the ‘decoupling theory’ starkly reflected in the rapid spread of a bubble in Florida condos and California McMansions to monetary catastrophe in Iceland.
- A re-look at the instruments of Central Banks for emergency liquidity support and convergence by Central Banks to a set of best practices for system-wide liquidity management. Central banks must continue to work together during this period of market stress and take further steps in conformity with emerging need and requirements.
- Restricting the spread of dislocations to other markets and to repair banks' balance sheets through greater capital infusions into banks and recapitalization of institutions to boost confidence and avoid further undermining of credit channels.

- More rapid and informative disclosure of financial institutions to dispel doubts by timely and accurate aggregate information.
- Changes in the design of regulation of mortgage to prevent the recurrence of a supply overhang leading to a painful correction of housing prices.
- The traditional virtues of savings and thrift need to be encouraged and persons should be encouraged to cut their coat according to the cloth. There is a clear need to ensure greater care in decision making and not to undertake imprudent risk in the future. Banks and financial institutions should extend loans to households on the basis of the traditional canons of disposable income, security norms and repayment capacity and mortgage underwriting needs to be strictly regulated.
- Even in this era of sweeping globalization, the free play of unfettered market mechanism is fraught with great danger. The market on its own is not enough. Accordingly, the governments must play an important role in shaping the economic policies and the broader frame of reference. The Keynesian thesis of "pump-priming" continues to be relevant today and fiscal stimulus has an important part in the route back from the precipice. True the government in October enacted the largest ever supplementary demand for grants of Rs 237,286 crores, reflecting a record 33 per cent increase over budget estimates. The bulk of this money was accounted for by government pay increases, fertiliser subsidy, National Employment Guarantee Programme spending increases, oil bonds, fertiliser bonds and the farm loan waiver. Adding this 4.5 per cent of GDP supplementary to the budgeted fiscal deficit yields a true central fiscal deficit (including off budget items) of 7 per cent of GDP for 2008/9. A consolidated (Centre plus States) fiscal deficit of around 10 per cent of GDP still seems quite likely. Hence given the overarching fiscal stress, what is needed is not just larger but also smarter investment prioritized on national goals and on performance outcomes. Investments in infrastructure and technology in general and speedy implementation of various components of the National Highways Development Projects power projects and airport privatisation in non-metro cities will stimulate the economy in the short run and enhance growth in the long run.
- Banks must put in place a constellation of measures both on interest rates and liquidity to ward off the impending crisis. Towards this end, banks must ensure both the timeliness and reasonable pricing of credit, particularly to the SMEs and the housing sectors in India.

- The global financial system has proved to be woefully inadequate, particularly in view of the manifest structural deficiencies in meeting the regulatory requirements of the present-day international financial system of the Bretton Woods architecture, which led to the establishment of the International Monetary Fund in 1945. The extraordinarily synchronized nature of the sub-prime crisis makes it necessary to launch the creation of a "global monitoring authority to promote global supervision" of cross-border investment, trade and banking with the fast-growing economies, such as, China, India and Brazil playing a far more important role in the new global financial architecture and ensuring that the results trickle down to the grassroots level. This is particularly important because as cogently argued by Juan Somavia, world unemployment could increase by 20 million by the end of next year, in the process surpassing the 200-million-mark for the first time. What lends urgency to the need to devise effective remedies is his finding that the poor, the deprived and the vulnerable will be affected much more severely than the better-off.
- While devising a new global financial system, we need a multi-pronged strategy to surmount this crisis. It is also important to draw lessons from the regulatory failure in the US and implement a transparent and effective framework in conformity with the growth and diversification of our economy and financial sector. Domestic reforms must be accompanied by prudential norms, efficient regulatory systems and healthy capital adequacy norms with a focus on prudent investments and quality lending. Since institutional resilience can effectively reduce the severity and duration of economic shocks and dislocations, there has to be an accent on institutional strengthening.

Despite the problem of 'moral hazard' (owners and employees should bear the costs of their mistakes; taxpayers getting a raw deal), setting the house of world finance must have overriding priority in view of the sheer magnitude of the crisis. A comprehensive programme along these lines is urgently needed to discernibly alter the ground realities. Half-hearted approaches, whether in life or in time of economic crisis are a recipe for disaster. In sum, the strategy of banking and financial institutions needs to be redefined to prevent recurrence of either such situations or the unhappy experience of UTI fiasco or Global Trust Bank by check on derivatives and other high-risk exposures, thrust on creditworthiness of borrower, robust risk management systems, prudence and regulations staying ahead of innovations. The writing on the

wall is clear, the message of history unmistakable: the world needs new ways of thinking about finance and the risks it entails. For, as Albert Einstein cogently argued, “we need a substantially new manner of thinking if mankind is to survive”. Indian banks and financial institutions can no longer afford to exist in cocoon or adopt an ostrich like attitude in the wake of the inexorable process of globalization. And the dangers of progressive across the board liberalization make it necessary not to be oblivious of safeguards while moving ahead with financial reforms and bringing in best practices in mapping the future of Indian banking.

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