Managing Crisis To Recovery: The Road Ahead For India

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INTRODUCTION

According to Prof. James Van Horne of Stanford University, credit crisis in US, often caused or accompanied by real estate collapses, occurred on an average once every 14 years from 1800 to 1970s and once every 8 years since 1970. During the panic of 1819, real estate speculation involved farmland on the Ohio frontier. In the panic of 1837, there was a real estate bubble along the Mississipi. The panic of 1873 and 1893 involved investments in land near rail lines. The crash of 1929 was preceded by the bursting of real estate bubbles in Florida & Southern California. After 9/11, American people were encouraged to spend in the spirit of patriotism to help restart the failing economy. To fuel that spending, in the extraordinary political and psychological climate of that time, U.S. policy makers actively encouraged levels of borrowing and lending that would never have been allowed otherwise. Federal reserve cut interest rate to 1%, the financial services industry sensed that a lot of money could be made and went over-vigorously in real estate, seemingly unaware that low interest rate could be disguising larger risks. Commercial banks and investment banks lent for house purchases and consumer loans to borrowers who were not really equipped to repay. The easy lending pushed up housing prices, which then went up still higher, when speculators bought houses on the expedition of further price increases. The price rose significantly because of easier access to funds/loans as also historically low interest rate, looser lending, low appraisal standards and documentation. When the easy lending initially slowed and eventually stopped during 2006-07, housing prices peaked. However, once interest rates began to rise and housing prices started to drop moderately, refinancing became more difficult.Defaults and foreclosure activity increased dramatically as easy initial terms expired, home prices failed to go up as anticipated, and interest rates reset higher and this triggered a global financial crisis through 2007 and 2008. In the world economic forum annual meeting in Dalian, a Chinese participant remarked, "*The teachers have made big mistakes.*" (Martin Wolf, Financial Times, Sep 14' 09).

CAUSES

The reasons proposed for this crisis are varied and complex. The crisis can be attributed to a number of factors pervasive in both housing and credit markets, factors which emerged over a number of years. Causes proposed include the inability of homeowners to make their mortgage payments, poor judgment by borrowers and/or lenders, speculation and overbuilding during the boom period, risky mortgage products, high personal and corporate debt levels, financial products that distributed and perhaps concealed the risk of mortgage default, monetary policy, and government regulation (or the lack thereof). Ultimately, though, moral hazard lay at the core of many of the causes. In its "Declaration of the Summit on Financial Markets and the World Economy," dated 15 November 2008, leaders of the Group of 20 cited the following causes:

"*During a period of strong global growth, growing capital flows, and prolonged stability earlier this decade, market participants sought higher yields without an adequate appreciation of the risks and failed to exercise proper due diligence. At the same time, weak underwriting standards, unsound risk management practices, increasingly complex and opaque financial products, and consequent excessive leverage combined to create vulnerabilities in the system. Policy-makers, regulators and supervisors, in some advanced countries did not adequately appreciate and address the risks building up in financial markets, keep pace with financial innovation, or take into account the systemic ramifications of domestic regulatory actions.*"

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IMPACT OF SUB-PRIME CRISIS ON THE GLOBAL ECONOMY

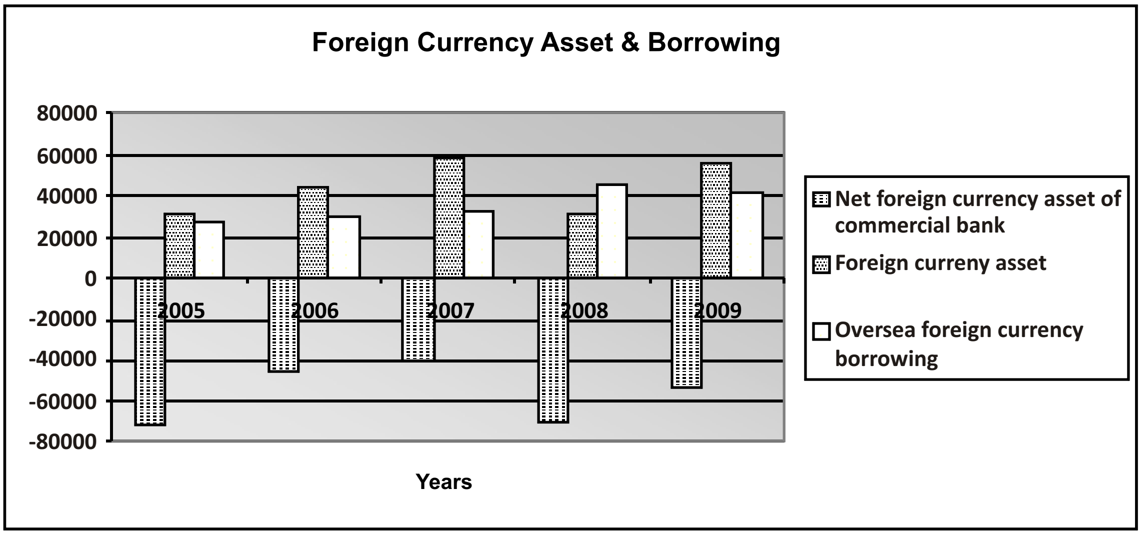
During 2007, nearly 1.3 million U.S. housing properties were subject to foreclosure activity, up 79% from 2006. Financial products called mortgage-backed securities (MBS), which derive their value from mortgage payments and housing prices, had enabled financial institutions and investors around the world to invest in the U.S. housing market. Major Banks and financial institutions had borrowed and invested heavily in MBS and reported losses of approximately US$435 billion as of 17 July 2008. Effects on global stock markets due to the crisis have been dramatic. Between 1 January and 11 October 2008, owners of stocks in U.S. corporations had suffered about $8 trillion in losses, as their holdings declined in value from $20 trillion to $12 trillion. Losses in other countries have averaged about 40%. Losses in the stock markets and housing value declines place further downward pressure on consumer spending, a key economic engine. Leaders of the larger developed and emerging nations met in November 2008 to formulate strategies for addressing the crisis.The crisis began to affect the financial sector in February 2007, when HSBC, the world's largest (2008) bank, wrote down its holdings of subprime- related MBS by $10.5 billion, the first major subprime related loss to be reported. During 2007, at least 100 mortgage companies either shut down, suspended operations or were sold. Top management has not escaped unscathed, as the CEOs of Merrill Lynch and Citigroup resigned within a week of each other. As the crisis deepened, more and more financial firms either merged, or announced that they were negotiating seeking merger partners. Merrill Lynch was joined with Bank of America in a forced merger worth $50 billion. Finally, concerns over insurer American International Group's ability to stay capitalized caused that stock to drop over 60% in a day. Stock indices worldwide trended downward for several months since the first panic in July-August 2007. Mortgage lenders and home builders fared terribly, but losses cut across sectors, with some of the worst-hit industries, such as metals & mining companies, having only the vaguest connection with lending or mortgages. Beginning in mid-2008, all three major stock indices in the United States (the Dow Jones Industrial Average, NASDAQ, and the S&P 500) entered a bear market. The most noteworthy trigger was the declared bankruptcy of investment bank Lehman Brothers. All of these events culminated into a stock sell off that was experienced worldwide. Overall, the Dow Jones Industrial plunged 504 points (4.4%) while the S&P 500 fell 59 points (4.7%). Asian and European markets rendered similarly sharp drops. The subprime crisis has had a number of actual and likely economic effects. Declining house prices have reduced household wealth and the collateral for home equity loans, which is placing downward pressure on consumption. Members of USA minority groups received a disproportionate number of subprime mortgages, and so have experienced a disproportionate level of the resulting foreclosures. Minorities have also born the brunt of the dramatic reduction in subprime lending. House-related crimes such as arson have increased. There have been significant job losses in the financial sector, with over 65,400 jobs lost in the USA as of September 2008. The unemployment rate rose to its highest level since 1994 in October 2008, reaching 6.5%.The tightening of credit caused a major decline in the sale of motor vehicles**.** The much anticipated passage of the $700 billion bailout plan was struck down by the US Government.

IMPACT OF THE SUBPRIME CRISIS ON THE INDIAN ECONOMY

The global economic down turn has had its repercussions for India. The key question confronting the economy now is the backwash effect of the American (or global) financial crisis. Central banks in several countries, including India, have moved quickly to improve liquidity. Since stock valuations have suffered in the wake of the FII pull-out, the alternative of funding through fresh equity became more expensive. Projects that are halfway to completion, or companies that are stuck with cash flow issues on businesses that are yet to reach break even, will run out of cash (steel projects, Mesco, Usha and others).One danger, meanwhile, is of a dip in the employment market. There was already anecdotal evidence of this in the IT and financial sectors, and reports of quiet downsizing and a significant drop in new hiring -- in many other fields as companies cut costs has changed the complexion of the job market. India's Information Technology sector is a world leader and a driving force for the economy. But the industry, which greatly depends on business from the US, is suffering severely in the economic slowdown. The IT business in India has performed well in recent years, growing by 30% last year. But times are getting tougher, and the estimated growth in the current year is down to a little more than 20% and employees are feeling the pinch. Times are also getting harder in the service sector. The companies are now benching employees, meaning they are kept sitting around in anticipation of work. But a time when everyone seems adversely affected by the economic slowdown, the Indian business outsourcing sector may actually benefit in the medium term. More economic regulation means more administration, and India's lower costs make it an attractive market for US and European companies to outsource their work to.

The currency composition of India's external debt is mostly dependent on the US dollar accounting for a share of 56.5%. Rupee, Yen and SDR are other three major units that cumulatively accounted for another 37.8%. Indian Rupee has 15.1% share, Japanese Yen rank third with 13.5%, followed by Special Drawing Rights 9.2%, Euro 3.6%, Pound Sterling 1.9% and others 0.2%. The economic slow down had definitely squeezed the flow of foreign investment in the Indian market. India's external debt to GDP was the highest in 1991-92 (38.7%) amounting to Rs. 2,52,910 Cr. which reduced to 18.1% in 2006-07amounting to 7,46,918 Cr. due to tighter borrowing norms but a creeping increase could be noticed due to the growing confidence in the market after recession. It increased to 19% in 2007-08 and stood at 22% amounting Rs. 11,69,575 Cr. in March 31, 2009. If we talk about the cost of borrowings, we can find that till the second half of 2007, Indian companies had borrowed heavily from overseas markets at favourable rates. However, the collapse of Lehman Brothers and the US government's rescue of AIG have prompted banks to raise interest rates, to cover the risk that their debtors wouldn't be able to repay loans. In October 2008, the three-month dollar Libor touched 4.82%. During 2008-09, higher costs resulted in a 29.44% fall in external commercial borrowings by Indian companies to $17.62 billion, compared with $24.97 billion in the previous financial year.

Figure 1 : Foreign Currency Asset and Borrowing



The foreign currency asset has been increasing over the years from Rs. 31294 Cr. in 2005 to Rs. 43494 Cr. in 2006 and Rs. 58754 Cr. in 2007, but it decreased in the year 2008, remaining only Rs. 31189 Cr. A slow increase was seen in 2009 to reach to Rs. 55312 Cr. but hasn't increased as much as in 2007. The overseas foreign currency borrowings has decreased in the year 2007 to Rs. 31905 Cr. by Rs. 2071 Cr. from the previous year, but a steady increase could be

Table 1

Month	Export		Import	
	Amount in million $	Percentage Change	Amount in million $	Percentage Change
July08	19036	52.85	31189	70.12
Aug	16005	26.88	29946	51.20
Sept	13748	10.38	24380	43.34
Oct	12822	-12.11	23360	10.57
Nov	11505	-9.89	21571	6.11
Dec	12690	-1.05	20256	8.84
Jan09	12381	-15.87	18455	-18.22
Feb	11913	-21.73	16823	-23.30
Mar	11516	-33.26	15561	-33.99
Apr	10743	-33.17	15747	-36.56
May	11010	-29.20	16212	-39.24
Jun	12815	-27.73	18977	-29.34
Jul	13623	-28.44	19621	-37.09

Source: Ministry of Commerce & Industry.

viewed in 2008 amounting to Rs. 44451 Cr. Again, in 2009, it decreased to Rs. 41404 Cr. The net foreign currency asset of commercial bank show negative figures over the years by -45616 Cr. in 2006, -40612 Cr. in 2007 and highest in 2008 amounting to -70196 Cr. This may be due to increase in foreign reserve cash outflow during the crisis period. It decreased in 2009 by -53359 Cr., but is still larger than the amount before the crisis.

India's exports as well as imports have taken a hit due to the global economic turmoil. Trade data reveal that exports in the month have fallen by 28.44%, while imports declined by 37.09%. Slow down in global demand has resulted moderately in exports. A continuous decrease could be viewed in the export from July 2008 $19036 Million till June 2009 $12815 Million, due to which the exporters had suffered a lot. On the other hand, imports remained positive till Dec. 2008 but the amount has been continuously declining and from January 2009 onwards, it has shown a negative trend. Indian banks have found it difficult to raise funds from abroad, and had to rely on the domestic borrowing to pump that money for their overseas operations. The borrowing by banks from the RBI too has been rising from Rs. 1488 Cr. in 2006 to Rs. 11728 Cr. in 2009. Consequently, the domestic liquidity tightened and manifested in call money rates soaring to as high as 23 per cent. Percentage of Revenue deficit over GDP was 1.94% and 1.11% in 2006-2007 and 2007-08 respectively. It rose to 4.40% in 2008-09. On the other hand, the percentage of fiscal deficit over GDP was 3.40%and 2.70% in 2006-2007 and 2007-08 respectively and it rose to 6% in the year 2008-09. The severity of the problem is visible from the fact that the country's finance minister and the RBI governor had to repeatedly step in to cool the nerves, with soothing words, and immediate measures to ease the problems and forward-looking initiatives. The banking sector credit grew at unprecedented rates during the 5 years to 2007-08, backed by rising GDP from 8.3% in Oct.04 to 9.2% in Oct 05 and 9.7% in Oct.06, but declined to 9% in January 08. On an annual basis, overall credit grew at 27%, retail advances at 32% and corporate and other non retail advances at 26% over this period. However, subsequently, credit growth declined to around 18% in 2008-09, with fall in GDP from 9% to 6.5% in the same period. CRISIL expects growth at around 6% and credit growth to be in the range of 12-14% in 2009-10 due to steep slow down in retail advances and the reduced borrowing appetites of companies. CRISIL's analysis reflects that growth in retail credit slowed sharply to around 4% in 2008-09 from the peak of 425 in 2004-05. The decline in retail credit growth is on account of reduced demand for all retail segments.

Table 2 : The Top 10 Banks In Terms Of Credit (Rs. Crore)

Bank	2007-08	Percentage Change	2008-09	Percentage Change
ICICI Bank	89,783	5.33%	82,986	-7.57
State bank	64,459	46.54	71,079	10.27
PNB	26,147	64.28	33,197	26.96
IDBI Bank	18,706	14.08	24,740	32.25
HDFC Bank	14,641	64.79	22,794	55.69
Bank of India	18,543	26.66	22,668	22.24
Axis Bank	17,053	40.33	21,522	26.21
Central Bank	12,193	46.66	18,988	55.73
Union Bank	14,900	21.50	18,638	25.09
Canara Bank	16,327	9.39	17,700	8.41
Private banks(11)	1,34,261	15.98	1,41,603	5.47
Public Sector(27)	3,11,546	31.01	3,67,420	17.93
Total(38)	4,45,806	26.08	5,09,023	14.18

Source:RBI

Bank credit to sensitive sector comprising real estate and capital markets rose at a slower pace of 14.18 % in 2008-09 compared to 26.08 % in 2007-08 as the largest private sector bank, ICICI Bank, took a cautious approach on retail lending after the bankruptcy of Lehman brothers in Sep 2008. It declined by 7.6% in 2008-09 due to the liquidity crisis. State bank showed four times decline from 46.54% to 10.27%. Other banks also depict a decline twice as compared to the previous year.

The good part is that the measures like CRR cut, from 9% in Sep 2008 to 5% in Sep 2009 have solved the problems, at least for the near-term, as over Rs. 100,000 cr. (Rs.1 trillion) worth of funds have been infused into the system. Additionally, the first tranche of farm loan waiver disbursements, repayment of fertilizer loans to banks along with central government employee's arrears is likely to give a boost to the sagging liquidity conditions going forward. Repo rates decreases by 9% to 4.75% from Sep 2008 to Sep 2009. Reserve Repo Rates has decreased to 3.25% in 2009 from

6% a year before. RBI has successfully managed to infuse liquidity in the market by adopting these measures.

CONCLUSION

The global financial crisis contagion sprouted out into serious risk aversion the world over, leading to a severe liquidity crunch transcending all the surmountable boundaries. While the involvement of India's banking system in the sub-prime crisis has been negligible and hence it remained relatively unscathed, it is now facing its own set of problems locally. Among the most recent ones was the extremely tight liquidity conditions. While the government and the RBI have announced measures that have alleviated the pressures for the time being, the Indian banking system continues to be surrounded by a host of issues which include high cost of funds, slowing business growth and concerns pertaining to asset quality. At the heart of the problem lie questions of liquidity and confidence. What the RBI needs to do, as events unfold, is to neutralize the outflow of FII money by unwinding the market stabilization securities that it had used to sterilize the inflows when they happened. This will mean drawing down the dollar reserves, but that is the logical thing to do at such a time. If done sensibly, it would prevent a sudden tightening of liquidity, and also not allow the credit market to overshoot by taking interest rates up too high. The regulatory bodies in India had been strong enough to lay down new rules to cope up with the global slow down, still, the Indian economy has to become more practical, futuristic and intelligent enough to smell any type of disturbance at local or global level.

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