BRIEFING PAPER

25 years 1983 2008 CUTS International

14/2008

Fighting the Financial Meltdown

*Siddhartha Mitra**

Introduction

The world economy is currently passing through a recession. This financial recession which originated as a mortgaging crisis in the United States has acquired global dimensions in today's inter-linked world and threatens to engulf India – one of the fastest growing emerging economies where the annual average rate of GDP (gross domestic product) growth has been around nine percent per annum over the last three years.

This Briefing paper examines whether a major economic recession in India is inevitable and concludes that the largeness and diversity of the economy coupled with positive behaviour on the part of all economic agents – government, consumers and individual investors – might be enough to save the Indian economy from collapse. A four fold mantra elaborates on what constitutes positive behaviour in this crisis.

An economy exhibits bipolar tendencies, ranging from the very buoyant to the very depressed. Psychiatrists treat their human patients who exhibit such tendencies with great care, mixing therapy sessions with strong medicine to even out moods. The government, associated think tanks and wise men clubs can do the same thing for an economy.

Markets run on sentiment, not on logic. Booming stock markets attract investors to participate more vigorously; the vigour translates to a further extension of the boom. Unlike what the common man might think and what is often painted by media hype a boom does not imply that everything in the economy is going well. Excessive spending fuelled by bullish sentiments might stoke inflation. People with fixed incomes suffer; their purchasing power declines and there often is deepening of inequality and poverty.

Think tanks, NGOs and the media can, should and often do step in: they point to the raging inflationary fires and the spread of deprivation and try to wipe off the smugness that comes from rapid increases in wealth in certain sections of the economy. The government is forced to step in with measures to douse inflationary fires: more often than not interest rates are raised and credit constrained to suck out liquidity from the economy.

As people have less to spend the boom often dies out and the stock market plateaus. What this illustrates is that the government and its associates treat the economy in the same way as a bipolar patient is treated by his psychiatrist. The psychiatrist wants his patient to be happy but not too happy; extreme happiness is a warning signal that the patient is veering to self destruction. Similarly, a government wants an economy to boom but too prolonged or exaggerated a boom might lead to greater incidence of deprivation and intensification of inequalities. Such strong booms often compel the government to step in with strong medicine and therapy which soothes overly buoyant moods.

The Genesis of the Current Recession

Most recessions are often started by isolated events which expose the structural weaknesses of the global/national economy. For example, the current recession has been triggered by a mortgage crisis: an earlier buoyant phase in the real estate market at the beginning of the 21st century prompted US banks to lend very liberally (and greedily at high rates of interest to cover the high risk of default associated with liberal lending) for purchase of housing: the thinking was that the highly priced collateral (the house itself) would neutralise the risk of default (see Box 1 for the immediate events that preceded the financial crisis).

Not much attention was paid to the ability of borrowers to earn and repay; when many of them defaulted on the payments of their loans there was a sudden increase in supply in the real estate market. As the increasing number of houses recovered from borrowers augmented the supply of housing, real estate prices came crashing down. Suddenly, the houses which had been pledged as collateral were not enough to recover the value of corresponding loans.

Though this was bad enough it was not the entire story; mortgaging had been used to build castles of sand. Lenders to purchasers of real estate had leveraged their mortgages to gain access to other funds; their lenders had in turn

* *Director (Research), CUTS International*

leveraged for more financial access and so on. With people defaulting on the payment of housing loans – the base for a whole chain of financial flows – these impressive but unstable castles collapsed. The rubble, dust and smoke generated have enveloped the global economy and plunged its consumers and investors into deep gloom. Another round of therapy and strong medicine might be in order.

Over recent years the financial linkages among various countries of the world, in particular the developed and emerging economies, have been strengthened. Foreign investors like to invest in emerging economies as they generally grow faster than their developed counterparts and yield rates of return that are higher. In a way this is good as funds get diverted to the areas of highest return and emerging economies can play catch-up with developed economies. But even though developments like greater "interdependence", "association" and "cooperation" among various countries is often linked to greater global efficiency and growth, the downside in terms of greater instability and vulnerability is often ignored.

The recent financial meltdown confirms that too much of a good thing (the mentioned inter-linkage) might be bad. The real estate loan crisis in the US has travelled through the channels linking developed and emerging economies and resulted for the first time in a truly global recession, much more global than the Great Depression of the 1930s. As borrowers of housing loans have defaulted, their lenders owing money elsewhere (and their lenders and so on) have either defaulted on their financial commitments or have been threatened by a failure to honour these. Banks and financial institutions therefore have come under a lot of financial stress. Somehow the promised liquidity has had to be mopped up from elsewhere; faced with such a problem these institutions have had two choices: to sell their investments in emerging stock markets or perish. Naturally many of them have done the former.

It would be instructive to illustrate what has happened next through a moving picture of the Indian economy. As foreign institutional investors (FIIs) pulled out their shares from the stock market and sold them a huge excess supply of shares was generated; as a result share prices and the Bombay Stock Exchange (BSE) came crashing down.

What the crash did was to generate a wave of bearish sentiment; the adverse psychological impact meant that potential domestic investors just sat on the fence as they expected the stock markets to fall further. With almost no new demand being generated despite the continuous pull out by FIIs, the decline soon turned into a bloodbath. As of now the BSE stands at 9788 points, a mere 47 percent of its level exactly a year ago.

Box 1: The Origins of the Current Recession

Although the forced sellout of Bear Stearns, a leading investment bank, to JP Morgan, a world leader in the provision of a broad spectrum of financial services, was the first sign of an economic crisis, Lehman Brothers' (another investment bank) September 15th bankruptcy was the first to attract media attention. Since they posted losses at 613 billion dollars and may be the largest bankruptcy in history, the media attention isn't surprising. However, the increased attention is also related to the events surrounding Lehman Brothers' demise. The fall of this 158-year-old banking giant coincided with the forced buyout of Merrill Lynch (a world leader in financial management and advisory services) and was preceded by the government seizure of two of the largest mortgage companies, Fannie Mae and Freddie Mac. Both firms (Lehman Brothers and Merrill Lynch) which were financially linked to the mentioned mortgage companies, were forced to act after losing billions in investments on the U.S. mortgage market (Daily Mail Reporter; Oct. 2008). Not to be left out, American International Group (AIG), the world's largest insurer, asked the US Federal Reserve for 40 billion dollars in assistance for short-term financing due to steeply declining stock values. As of September 17th, this request was approved.

Together these events resulted in a 500 point drop in the Dow Jones; its steepest drop since the day the stock market reopened after the Sept. 11, 2001, attacks. The reprecussions of this crash will be felt worldwide. Alan Greenspan, the former chairman of the U.S. Federal Reserve, believes 'we will see other major firms fail'. True to the fears of many, stock markets throughout the world have plummeted and exchange rates have become more volatile. Instability and confusion have caused a sharp drop in consumer confidence rates, despite governmental attempts to soothe public fears.

The obvious question seems to be: how can large companies that survived through the Great Depression possibly go bankrupt with very little warning. This idea is mind-boggling to the average person. To the well-trained expert, however, there have been plenty of warning signs. The year 2008 as of September 17 has seen 81 public corporations file for bankruptcy in the United States, already higher than the 78 in 2007. This series of financial collapses is the consequence of the real estate lending crisis and credit crunch. Unfortunately, these problems were not addressed appropriately when they occurred which led to the current economic situation.

This explosive environment has shown no signs of abating soon; since September 17 even more financial collapses have occured. In hopes to prevent more bank failures, the US congress has approved a bailout plan which will assist financial firms with bad mortgage securities to declog the credit market.

Table 1: FII Net Purchases from India during the Current Crisis (18th September -31st October 2008)			
Date	Purchases (Rs.cr)	Sales (Rs.cr)	Net purchases (million USD)
Sep 18,2008	3762.0	5095.5	-330.6
Sep 19,2008	7146.7	7745.4	-148.4
Sep 22,2008	6826.2	5658.3	289.5
Sep 23,2008	3245.3	3134.0	27.6
Sep 24,2008	1895.8	2763.5	-215.1
Sep 25,2008	3505.6	3680.0	-43.2
Sep 26,2008	4214.5	4918.3	-174.5
Sep 29,2008	2712.2	3316.3	-149.8
Sep 30,2008	3394.6	3007.7	95.9
Oct 01,2008	4203.1	4118.6	21.0
Oct 03,2008	1969.8	2254.0	-70.5
Oct 06,2008	2785.3	3831.3	-259.3
Oct 07,2008	1995.2	3116.6	-278.0
Oct 08,2008	2797.6	3345.7	-135.9
Oct 10,2008	3016.7	3864.4	-210.1
Oct 13,2008	3959.0	6282.2	-575.9
Oct 14,2008	3150.8	3993.0	-208.8
Oct 15,2008	3789.3	3978.4	-46.9
Oct 16,2008	2041.8	2882.5	-208.4
Oct 17,2008	2233.6	4144.9	-473.8
Oct 20,2008	2234.3	3101.8	-215.1
Oct 21,2008	1870.2	2710.3	-208.2
Oct 22,2008	2725.6	2611.8	28.2
Oct 23,2008	1724.6	1997.5	-67.7
Oct 24,2008	2162.0	2509.4	-86.1
Oct 27,2008	2284.1	3462.1	-292.0
Oct 29,2008	1802.4	2813.3	-250.6
Oct 31,2008	2685.9	3760.8	-266.5
Sum			-4453.2
Mean			-159.04
Median			-266.5
Mode			-215.1
Maximum			289.5
Minimum			-575.9
Source: Derived from data provided by http://www.capitalmarket.com/bulletin/fii.asp			

The above Table illustrates the pull out by FIIs. Between September 18 and October 31 FIIs pulled out a total of 4.45 billion dollars from the Indian stock market and judging by even conservative estimates, more is expected. Almost each and every day of transactions in the stock market was marked by a major pull out – the median or representative pullout being close to a quarter billion dollars – and the relentless pressure on the stock market led to one of the steepest slides in recent history. In this brief one and a half month period the BSE index, the Sensex, declined from 13263 to 9788, a decline of 3475 points (26.2 percent). With 28 trading days during this period, this meant that on an average the Sensex declined by 0.83 percent everyday.

In Conclusion: Fighting the Crisis

Whether the fall in the Sensex will soon peter out is anybody's guess. Of course, one can be sure that it will peter out ultimately. Moreover, consumers, the government and think tanks can do more about hastening such stabilisation and engineering a recovery than what they themselves might be aware of.

All citizens, many of whom belong to the ranks of actual or potential investors, need to step up their financial awareness. When the media talks about investor wealth getting halved domestic investors should regard this as a notional decline in wealth; after all if they do not sell their stocks and securities and the stock market recovers to new highs in a few years, the losses pointed out by media reports would never be incurred.

Suggestion No.1 is do not worry, be happy and definitely do not sell shares of companies which have come up with good performances in the past in terms of profits generated and dividends distributed. Try and gain satisfaction from dividend incomes; do not react adversely to declines in notional wealth.

Strangely this is also the time for good buys, similar to picking up cheap woollens through an off-season discount. A look at indices shows that potential investors never had it so good. Blue chip companies like *Tata Steel* and *Tata Motors* now exhibit price-earnings (P/E) ratios lying between 2 and 3; *Hindalco* currently has a P-E ratio of around 1.8. (Others like those of Reliance Industries have descended from double digit levels to a much more reasonable 6 or 7.) This clearly indicates undervaluation of shares. A low P/E ratio implies that earnings are a significant proportion of the total value of shares bought. In this case you cannot go wrong by picking up these shares: these earnings will result in a high percentage dividend if distributed among share holders; if not these will be reinvested and add to the value of the stock.

It would be justifiable to say that a low P/E ratio of a company, usually an indicator that investment in its shares is a good proposition, does not offer the same comfort in a world characterised by recession as growth of demand for its products might be in doubt . This logic might be sound for small countries such as Singapore that cannot swim against the global tide. But India with its large population and labour force (around 17 percent of that of the world) and a considerably enhanced GDP, now about one trillion USD, can manufacture its own success by keeping up the pace of increase in consumption, investment in capital goods and infrastructure and diversification in both consumption and production. In other words, we have got to the stage where the country can grow over long periods of time on the basis of its own steam provided it tries to do so intelligently and vigorously.

Suggestion No. 2 is "retain your spirit of adventure; the recent financial meltdown does not imply that you rush with your lifetime savings to the nearest nationalised bank for safe keeping or insure yourself against risk through fixed deposits or precious metals. If you have some extra cash on hand try to park it in some cheap blue chips. If you do not do that soon others will beat you to it and these blue chips might not remain cheap for very long". Also when you are investing money in these it is akin to performing a national service that is at the same time profitable to you. Your investments and those by others might fuel the eagerly awaited turnaround in the stock market and in many senses the national economy.

It is imperative to be calm while maintaining good communication with other people. You should definitely have your antennae out but should not necessarily take everything they catch at face value. The air is rife with rumours of banks failing; it is not unusual in these stressed times for even banks to regard each other with suspicion. It is important to realise that a bank is often as good as its depositors. A bank which is not covered by government support can fail if one fine morning all its depositors come hammering on its doors for return of their deposits. This is because economic viability of a bank dictates that its cash reserves are just a fraction of its deposits.

Suggestion No. 3 is for customers of each bank to form networks (probably online and preferably registered with the government to rule out accusations of malicious intent) to exchange information; these should be coupled with withdrawals that continue to be of a normal magnitude. If banks continue to honour these withdrawals then these networks can be used by customers to reassure each other. On the other hand, the networks can be used to send out warning signals. Again, each customer should take a warning signal seriously only if many customers send identical ones out; isolated warning signals are often sent out by rumour mongers.

The last thing that the common economic agent needs to realise is that a financial crisis and the economic recession born out of it often result from a crisis of confidence. In the long run economic growth is born out of hard economic activity (manufacturing products and producing services). If India was good enough to have an average of around 9 percent annual growth in GDP over the last three years there is nothing that should prevent it from doing the same again in the near future. The roadblocks again are all in the mind and a collection of pessimistic or overcautious mindsets can spell doom for the economy.

Suggestion No. 4 is "try and be normal in your spending and earning behaviour and quietly try and influence others to do the same. Do not scrimp too much on the good things in life if you can afford them. Your expenditure is income for other people just as other people's expenditure constitutes your income. When everybody spends healthily incomes are generated and the economy prospers. When expectations of bad times cause people to act in a close fisted manner, not much income is generated and the prophets of doom are proved right".

In all this the role of the government and the associated think tanks as therapists for the economy cannot be overemphasised. In fact any government which emphasises what this article has said might be doing the citizens of the country a great favour and at the same time contributing to the long run growth and sustainability of the economy.

Steps like releasing more liquidity into the economy through interest rate cuts help. But note that an economic recession has more to do with market psychology than productivity changes; it is very important for the government to continue talking to its people on the lines of the suggestions in this article. The ability of the Indian economy is not in doubt but the confidence needs boosting. For this purpose it is necessary to supplement macro-measures with general homespun wisdom that appeals to individual consumers and producers.

To top it all it is necessary for the government sometimes to flex its muscles: this might provide succour to some citizens and at the same reassure others. Infrastructure projects might be a good idea; they provide employment and at the same time present new opportunities for business.

If one were to summarise the entire advice dispensed through this article in a nutshell, it is the same for private individuals, firm owners and the government: think and act positive.

The author acknowledges the research assistance of Lora Joy Grabau and comments received from Pradeep S. Mehta and Bipul Chatterjee of CUTS and an SME entrepreneur: C. M. Shukul of Vadodara. For comments and clarifications, please contact: sm2@cuts.org.
