Global Economic Meltdown

Understanding the US-led global economic crises

There is a whopping increase of 116% in the number of enterprises closing shop at **25,000** this year; up from **11,044 in 2006**. Another 7000 have gone for bankruptcy, up from the 3500 two years ago. These figures give ample idea of the financial trauma in the United States. These are unprecedented in the 'land of opportunities.'

Perhaps, never before in recent history, has any economic development been so talked about as the ongoing 'economic meltdown'. Therefore let us understand this phenomenon gradually and fully. This will also give us a clear picture of the existing global and national economic administration and functioning. We will stop by important terms and incidents provided in boxes or in other places as indicated.

As is clear no one person or institution ever understands the world economic network and functioning completely. Naturally, the fault could not be detected until the symptoms proved beyond repair.

The sudden collapse of global finance giants like Lehman Brothers, AIG, and battering of numerous other behemoths like Citi Corp triggered the collapse of the stock capital, affecting all US financial institutions, the effect spreading to European and Asian markets, leading to a *worldwide credit crunch* or lack of capital for daily operations, loans and expansions across all sectors and all markets. This present situation-- of substantial loss of stock money, shares being traded very low across all stock exchanges, high rates for borrowing money, and low productivity due to low demand-- is termed 'economic meltdown'.

How it started: The sub – prime crises

Actively supported by the government, large banks, led by Citi Corp started encouraging the lower middle/lower class to seek loans to 'own a house' in America. While the banks wanted to cash in on the booming real estate market, the less affluent were lured by the idea of having their own houses. Since the boom in real estate appeared real and actually gave high returns, the banks forayed into lending to those incapable of repayment –the poor and the students. Loans to this category were known as NINJA loans or No Income No Jobs or Assets Loan. It was assumed, *and here lies the 'core' of the storm* the house shall always be worth more than the defaulted amount and therefore the banks would always yield profits—even in the 'default' case. As stated above, the US government actively encouraged this arrangement as suited its welfare agenda of 'house for all'. Institutions like Fannie Mae and Freddie Mac, which gave unlimited mortgage based loans to individuals were supported by it. Since this model appeared to yield high returns in less time, hedge funds started operations. The advent of huge and easy money for house loans made loan seeking very popular among the NINJA awardees. Till 2006 and early 2007, all gained. The poor had houses; the hedge funds went for a kill. The banks made sedate profits and the US was more socialist now, comfortable in the idea that in US, all will have a house of their own.

House owners who had no income had to default one day. This happened in 2007. Then this became a trend and suddenly hedge funds, which cannot tolerate losses for long, started withdrawing. The banks, which had given loans many times more than they should, couldn't do much to stop the flight out of funds. Since, the realty sector was earlier booming, investors had put in major capital in realty stocks. Now they started withdrawing. As the realty stocks plummeted, the realty sector no longer commanded premium. The worst point came when the houses themselves lost premium and were now worth less than the loans forwarded. This meant all loans ever forwarded were loss making. The banks themselves had taken loans to forward loans to retailers. As a result, in a free fall, all realty stocks crashed.

How and why the crisis spread all over the seas.

PLEASE UNDERSTAND THAT THE CRISIS PRECIPITATED *NOT* BECAUSE OF CONSTRUCTION ACTIVITIES BUT DERIVATIVE OR FUTURES TRADE AND SPECULATION OR GAMBLING BASED ON CONSTRUCTION ACTIVITIES.

Role of investment banks (i-banks), Hedge funds and HNI money.

Generally, a bank has substantial ‘liquid cash base’ on the basis of individual and corporate deposits. This is safe and has continuous supply of cash, which forms the base capital of all banking operations. Investment banks like Lehman Brothers, Goldman Sachs and JP Morgan are not the usual individual ‘account holder type’ of banks we have explained above. They have no security of assured individual clients like the State Bank of India! They earn as returns on the investments. They assess and predict the profitability of a project, invest a huge amount and earn profits as returns. Thus Lehman and others gambled on house mortgage big time. Hedge funds made capital or money available for investing in high-risk high-return projects. While the i-banks and hedge funds made the mortgage market huge, the losses too were vast. And since the same companies also invest in other global projects, the crisis spread like wild fire. As the markets crashed, all investors who would have funded other equity projects, infrastructure works, construction activities, export oriented manufacturing across the globe went bust; all their projects collapsed.

Since investor money was completely wiped out, no other stock found purchasers, leading to all round loss across US exchanges. Since all major world companies had invested in US exchanges, all these companies lost hugely. There was heavy selling and no buying across all exchanges leading to collapse of the system. Short selling further added to the panic. Additionally, no money was now available to any new activity. In London, inter-bank loan rate was trading at unrealistically high levels. This was because no bank knew the level of losses of other banks and was reluctant to give loans to other banks. The distrust was complete. It was clear, just as in stampede, where all near the point of origin generally die/ get injured, all major money forwarding institutions, were paralyzed.

Immediate Impact: It is said that this crisis has wiped out 30% of bank assets in the US. Lehman Brothers were trading 30 times more than they should have. Citi Corp losses are in billions of dollars. Washington Mutual, Wachovia, Merrill Lynch, Goldman Sachs, etc. were big names that orchestrated the world economy. Some of these companies’ total assets are higher than the GDP of many countries. Citi Bank’s total assets equal a whopping $ 2tn. Lehman Brothers' assets are pegged at $ 300 bn plus. They predicted, financed and rated future beneficial projects and were at the core of all global plans. As they plunged same-day-same time, the world followed suit.

Long-term impact:

Capital for future projects are based on predicted future profitability of the project. Let’s take an example for elucidation. If ONGC announces an IPO for an oil project, the investors will assume profit based on increasing demand of oil due to rise in population and purchasing power, pushing the oil demand. This is how money will be made available to ONGC today.

In the present situation, investors will take the following considerations into account:

1. There is no guarantee of increase in purchasing power as no new jobs are foreseen.
2. Projects might suffer due to credit crunch, as banks have no excess money. Therefore, the project might suffer delays and increasing cost overheads.
3. There are little prospects for the share of the company rise in near future.
4. No one knows when the global recession is likely to end.

Therefore, if a company is to launch new major projects now, it may not find easy funding. Many global majors cannot survive without new projects and almost all companies have to innovate. But again no funds are possible for R & D, innovation or expansion.

India and the US Crisis:

At the beginning of this rather depressive chapter, we noted the gloom statistically. Now relate it to the fact that the US market formed 14% of our exports in the year ending March 2008.

The prime minister while admitting slow down of our economy has clearly stated that there would be no recession in our economy. WTO chief Pascal Lamy, said India and China has saved off the world economy from total collapse. He said India along with Brazil, Russia and South Africa are still growing economies. These statements suggest soundness and resilience of the Indian economy in the face of global fluctuations. Still, the impact, in the immediate term, is showing heavily…

The 'meltdown impact' on India has been moderate to heavy based on the sector/area we are referring to. There is no uniform assessment across all sectors of our economy. The top Ten Indian Companies have lost over 3 lac crore rupees through stock capital losses, as of Oct 2008.

Broadly, we must analyze the following activities:

1. Banks operations: Most affected. While we from interest on our saving or current deposits, banks themselves earn through speculation, futures trading and further investment. In the absence of these options, as of now, not much capital is available with the banks to grow. Though individual money is safe under government's strict regulation, banks are unlikely to offer easy money to individuals, companies and other banks leading to slack in manufacturing and trade. It is largely speculated that the ICICI bank has been particularly affected by the crisis owing to its heavy exposure to world derivative market. As a result of this rumor, no bank was willing to supply credit to this bank, furthering its woes. In the quarter ending September this year, ICICI lost Rs 11,000 Cr in deposits contraction, while the 'safe' public sector banks (SBI and PNB) gained Rs 70,000 Cr in the same three months, as fresh deposits. By 'safe' we mean from the 'public perception' angle.
2. Sectors affected: Banks and all other financial institutions; real estate; construction; BPO; Aviation; Hospitality.
3. Job market: projected 20% job cuts. Fresh hiring is negligible. Bonuses affected. Most affected: IT, Finance; Banking, BPO; Real estate and Construction.

Most of the leading IT companies have recorded low Q3[1] profits due to meltdown.

[1] Q means a Quarter. Q3 = third quarter of a financial year i.e. July-August

Some leading corporations like Tata Motors have temporarily closed down some of its plants to prevent the piling up of the inventory or previously produced unsold goods and material.

4. Not yet impacted: FMCG; Pharma; Media;
5. Stock Exchange: Plunged from a high of 21K in Jan '08 to 6 K by Oct 08. This is mainly because of global cues indicating slack future economic activity and withdrawal of foreign money (FIIs) by parent companies themselves affected by the losses.
6. Slack in demand of Indian goods leading to decrease in export volumes. This means no demands and therefore no work for EOU or Export Oriented Units.
7. Lack of tourist footfalls.
8. Read along with point 3, decreasing business trips to India is already leading to slower growth in high-end luxury hospitality sector.
9. Slack demand for Indian professionals in US or other European countries.
10. NRIs across the globe and particularly in the US may send lesser remittances back to India.
11. Possible job cuts, as there could be a gap/delay in new international projects/ because of less economic activity in sensitive sectors like aviation.
12. All major BPOs are run on US led projects. They may be impacted.
13. This would mean fewer dollars added to our FOREX. This may impact our national debt servicing. It would also impact the Sovereign wealth fund.
14. Owing to fluctuations in the dollar trade, the government leverage in regulating currency demand supply may be restricted. In other words, there could be more demand on the dollar as less and less dollars would be available for international trade.
15. Government has admitted to slow down in economic activity. India will not achieve 8% growth rate in 2008 and our five-year plans shall also suffer with a targeted achievement of 9% annual growth.

The governments' reaction:

The US government has meanwhile made available $ 700 bn (Troubled Asset Relief Program) to the ailing financial behemoths and for the general resurrection of the **recessionary** US economy. The US has provided money to the banks to ease pressures on liquidity demands and other such purposes, subtly encouraging moving away from speculation based trading. Likewise, the two major surviving investment banks (Goldman Sachs and JP Morgan Chase) have restructured themselves to regular banks. The government is keeping a close watch on all major economic activities and has banned **short selling** in the stocks for now. It bailed out mortgage banks Fannie Mae and Freddie Mac; bought majority stakes in AIG to make it government aided and helped in all bailouts and mergers.

A brief digression is required here: Was the government right in offering such a bonanza to these institutions? Yes and No. The government at the end of the day is the final guarantor. If all else fails, the government has to intervene. Second, this crisis was cancerous and was eating away at all financial institutions and the entire economic fabric of the US - therefore the bail out. Opposition says there was no need to fund the greedy professionals who lived off gambling with poor people's hard earned money. Actually all derivative trade is a form of gambling and governments do not and should not bail out failed gamblers ever.

India's reserve bank and the bankers' bank, the RBI has made available more than a lakh crore rupees since the crisis to banks by allowing them to keep less cash with the RBI (CRR). It is also encouraging banks to lend easy money to other banks by restricting call money market (rate at which one banks lends money to other banks for short periods). The RBI is also easing off restrictions on stock trading through **Participatory Notes**, to infuse more foreign exchange and cash in the bourses.

In the long-term the government may look into banking reforms, liberalize foreign direct investment norms, further de-control industry and generally boost trade and investment

Select Institutions Affected and Bail out Actions Taken

- **Fannie Mae and Freddie Mac : US Govt. has taken over**
- **AIG : 80% Government stake**
- **WaMu : JP Morgan**
- **Wachovia : bought by Wells Fargo (Warren Buffet backed) for $ 15 bn**
- **ML : bought by BoA for $ 44 bn**
- **Lehman Brothers : various – Barclays, Noumora**

Economic Financial Meltdown

Role of RBI in the control of Money supply

We shall talk about RBI (The PMO[2] for all banking operations in India) in the specific context of its role as troubleshooter in the recent meltdown.

Basically, the banker's bank is the supreme monetary institution in India. It is also the watchdog of all economic transactions in India. In the ultimate interest of our economy, RBI is authorized to initiate measures to control money supply in the country.

In troubled times, as in the present, RBI virtually becomes the doctor, whose skill shall shape the destiny of the patients' health.

We shall see how exactly, the RBI intervenes in the times of crisis, as in late 2008:

1. Repo rate is the rate at which our banks borrow rupees from RBI. When the repo rate increases, borrowing from RBI becomes more expensive. Naturally, a reduction in the repo rate will help banks to get money at a cheaper rate. Every half percent cut infuses one lakh twenty thousand crores into the market (@current price) for lending, growth purposes. A cut in the repo rate will add pressure on commercial banks like HDFC or ICICI to lower the 'bank rate' or the interest charged on loans they would give individual retail consumers. Now, the loan activity will increase leading to a greater economic activity or growth due to expansion.

2. Cuts the CRR. Well, CRR is a potent fiscal instrument with the RBI to control (rupee) money supply in the market. **CRR or the Cash Reserve Ratio,** is the compulsory requirement on the part of each bank governed by the RBI or 'scheduled' banks to keep a certain amount of money in the liquid form with the RBI. Every one percent cut would mean Rs. 40,000 cr that banks can retain to give as loans to people.
   These ensure the following:
   a. No bank will go bankrupt, as some of its money is always available with the RBI, which may be utilized for this bank.
   b. More importantly, the RBI can check reckless lending by the bank to the retailers, flooding the market with excess rupee.

[2] The 'Prime Ministers' Office

3. Give more window or leverage to banks to borrow from the banks against their deposits to be used to firm up the Mutual Funds floated by the bank.
4. Special refinance measures by RBI to commercial banks against their deposits. This measure is done to enable more funds with the banks for short-term investment purposes.

By the end of October 2008, the RBI had already pumped in more than 2 lac crore into the system through RBI interventions.

Are the measures undertaken by the Indian government, enough?

Well, first of all, the question itself is inappropriate. We must first understand that to survive and progress in the present age of competitive market, we need to streamline our economic patterns and steadily integrate with the global village.
More isolated (or closed) the market, more insulated it is to international fluctuations {as we were before the 1990s}.

The nation has been swiftly moving towards globalization for the preceding 17 years.
It is only natural that when a 13-trillion dollar economy suddenly gets devastated, affecting the world economy-- to which we were trying our best to align with-- we are bound to be affected. So, do not take a knee jerk stance. Understand the core of the issue.
Still, are these troubleshooting measures by the RBI enough? No, the RBI can only give you an umbrella during rains; it cannot either prevent rains or attend to pneumonia.
In the long term we must strongly discourage heavy speculative trade; or at least move away from our over dependence on select financial institutions, which thrive on risky investments.
We must make our banks and institutions more accountable and transparent
Exports need to be encouraged and diversified, both with respect to product and market.
Our contribution to world trade stands at a measly 2%. We need to enhance this portion.
We need to diversify our trade partners and move away from US based export partnership to perhaps new markets like the ASEAN.

We have seen how an increased purchasing power can lift up sectors like telecom, retail etc. We need to develop our human capital to perhaps lead world trade through a stronger trading center.
The point is, rather than being panic, we must use the interval to warm up ourselves and emerge stronger in trade, commerce, science and education. These are the basic requirements to become a world leader.