

International Financial Crises and its Ramification

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The international financial crisis has assumed panic proportions. It originated in the sub-prime mortgage crisis which surfaced over a year ago in the US. Once interest rates started rising and home prices started falling, there were defaults and foreclosures. However, it would have remained as a purely mortgage market crisis, had it not been for the fact that these sub-prime mortgages were securitized and packaged into products that were rated as investment grade. Once doubts about these assets arose, they not only rapidly mortgage crisis started affecting a host of institutions which had invested in these products. Since these assets had become globally financial system was enveloped into an acute crisis. The crisis in the financial system has now moved to affect the real sector. At this point it is not very clear how deep the recession in the US and Europe will be and how long it will last and to what extent the direct and indirect effects will erode growth prospects in India and other emerging economies. However, there is no doubt, that this will be the deepest recession in the US since the first half of the 1970s.

Two Characteristics

The severity of the crisis in the developed world has taken everyone by surprise including the regulators. The regulators failed to see the impact of the derivative products which clouded the weaknesses of the underlying transactions. Quite clearly, there was a mismatch between financial innovation and the ability of the regulators to monitor. Regulatory failure comes out glaringly. Two things stand out of the crisis. First, there was imperfect understanding of the implications of the various derivative products. In one sense, derivative products are a natural corollary of financial development. However, if the derivate products become too complex to discern, where risk lies, they become sources of concern. Rating agencies in the present case played havoc by certifying the derivative products as investment grade, trapping many financial institutions into investing in these products. Even as the authorities deal with the immediate problems arising from the crisis, the regulators need to pay attention as to how to deal with derivatives.

The second issue relates to leveraging. The Institute that have fallen into trouble are those which are highly leveraged. In fact, the entire US economy is highly leveraged. Almost every segment of the society including households is a net borrower. The net savings rate of the hose hold sector has turned negative. It is true that in a globalised system a country's investment rate is not determined by its own savings rate. Nevertheless, the extent of leverage is an issue to which regulators and policy makers have to pay attention, if financial stability is to be achieved.

Fixing the Financial System

In a situation as the one faced by the developed countries today, The most immediate concern is to provide liquidity to institutions which are locked into assets that cannot be easily realized. That is what the USA and European countries have done. The recovery package of \$700 billion approved by the US Congress is a massive effort in this direction. These funds are being utilized to inject capital into banks. They may also be used to buy the distressed assets. Injection of capital into banks will provide additional liquidity and also improve the solvency. Buying of assets will lead to revival of markets such as housing. Only if housing prices start to rise, there can be a solution to the basic mortgage crisis. Since the tail of the financial system is wagging the dog of the economy, primary focus has to be on fixing the financial system.

Impact on India

The crisis is no longer confined to the developed world. The heat is being felt by the developing world including India. The impact on India can be both direct and indirect. The direct impact comes from the exposure to the 'toxic' or 'distressed' assets by the Indian banks and other financial institutions. This is expected to be minimal. Indian banks, in general, have very little exposure to the asset markets of the developed world. Indian banks have very few branches abroad. The indirect impact will be through trade and capital flows. With the fall of international commodity prices such as crude oil, the import bill will come down sharply from the earlier estimates. On the other hand, export growth will be adversely affected by the recession in the developed world. It will have an impact both on merchandise exports and service exports. Taking the exports and imports together, the current account deficit will moderate and may be in the range of 2 per cent of GDP in the current year. The deceleration in the export growth may sharply affect some segments of the economy which are export oriented. Given the nature of the crisis, it is only to be expected that capital inflows into the country will dry up. The FIIs have already disinvested and taken out close to \$ 10 billion. This has had the most serious impact on stock market. Stock prices have fallen by 60 per cent from the peak they had reached ten months ago. Apart from the loss to stock holders, this will have the most serious impact on the primary market. Inability to raise fresh funds will affect investment and capital formation in the corporate sector. Conversion of positive to negative flows on portfolio capital can also lead to a fall in the value of the rupee. Disinvestment by FIIs will put additional pressure on the demand for dollars. The availability of dollars is affected by the difficulties faced by Indian firms in raising funds abroad. This, in turn, will put pressure on the domestic financial system for additional credit. Though the initial impact of the financial crisis has been limited to the stock market and the foreign exchange market, it is spreading to the rest of the financial system and all of these are bound to affect the real sector. Some slow down in the real growth is inevitable.

The first priority should be to ensure that the financial system is liquid and is able to meet the legitimate credit needs of the different segments of the economy. As external sources of funds dry up, the pressure on domestic banking system will increase. RBI's decisions to reduce CRR and Repo rates are in the right direction and taken in time. As the reserves come down, this will also suck out liquidity. It is, therefore, important for the RBI to keep a watch on liquidity and take such actions as reduction in CRR and Repo rates to enlarge the availability of liquidity. RBI's ability presently to help other institutions such as Mutual Funds and NBFCs directly is limited. It can only help them indirectly by reducing the pressure of the corporates on them for redemption through the enlargement of liquidity of the banking system. The pressure of the corporates will come down only if banks use the additional liquidity made available to them to provide the needed credit to the corporates. It has been argued that along with the measures to support the financial system, we must increase public spending. There can be no dispute with the contention that public spending should remain at a high level in a situation like the present one. With the Supplementary Grants approved recently by the Parliament, it is almost apparent that the fiscal deficit of the Centre in the current year may touch 4 per cent of GDP, at least 1 per cent above the FRBM target. While it can be argued that the fiscal deficit target should be an average over the cycle, we need to remember that even in boom years we have not been able to hold the deficit at the target level. The level of public spending currently envisaged is appropriate and should be adequate to meet the current situation.

What is needed at present is to focus on the financial system and enable it to fulfill adequately its functions in terms of the provision of credit to productive sectors. The domestic credit system must also fill the gap created by the drying up of the external sources. We also ought to be thinking of a scheme to provide additional funds for long term capital requirements, since the ability to raise funds from the capital market is bleak. There will be some tendency for the rupee to depreciate which cannot be avoided. In relation to exchange rate, the monetary authority should use the reserves to prevent extreme volatility in the market.