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Crisis in the United States Markets and Consequences for the Indian Markets

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The decision of the United States Treasury not to guarantee the debts or the bail out of Lehman Brothers, one of the four major investment banks in the United States, has resulted in the institution going into bankruptcy yesterday. Merrill Lynch, whose share value has halved in the last few weeks, has merged with Bank of America, to ward off a similar fate. And next in line could well be AIG, another major international finance company. The total write down in the United States alone, since the credit crisis began, exceeds US$500 billion, with possibly as much more to come.

It is interesting to examine the policy responses to the crisis in the United States and elsewhere, and to draw some conclusions on the likely future of financial markets policies in India. The origins of the crisis and the initial consequences are well known and do not need repetition. It is the policy response of the governments that bears some scrutiny. The first bank to be affected was Northern Rock in the United Kingdom. Over two days, the Bank of England did not come up with funds to bail out the liquidity crisis in Northern Rock and the bank collapsed. After a week, Northern Bank was taken over by the Bank of England, which changed the management, appointed an oversight committee and provided access to sovereign funds (actually public funds). When the Bank of England was criticised for the initial delay, it clarified that, after parliamentary amendments in 1999, the Bank of England was responsible primarily for inflation targeting and that it was not its domain to enter into the management of individual banks. Clearly, the subsequent turnaround was dictated by public outcry and the concerns in the British government about the fallouts of similar bank implosions. In effect, there appears to be an unstated commitment in the United Kingdom that retail banks would not be allowed to fail, a commitment for the depositors and the creditors, though not necessarily for the shareholders.

In the European Union, the crisis in the UBS and Deutsche Bank was handled by the banks themselves, through fresh infusion of equity, without any government guarantees or support.[1]

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[1] Interestingly, Northern Rock, UBS and Deutsche Bank are still to come out of the woods even after a year, with negative returns for the investors so far.

It is in the United States that there has been a gradual evolution of the government's response to the crisis. As long as the damage was limited to the retail housing markets, regulators were willing to allow the markets to function in that the initial losses were borne by the creditors and the mortgage banks. The secondary affects in the financial system arose out of the instruments that these mortgages had generated, and that were being traded by the large investment banks. As the underlying assets collapsed, so did the value of these instruments, and the first major institution to be affected was Bear Stearns. Over a weekend, the United States Fed and the Treasury negotiated a bailout through J. P. Morgan. A financial special purpose vehicle was created, into which the Fed transferred funds.[2] J. P. Morgan used these funds to buy out Bear Stearns; the shareholders were punished, and got only around US$4 a share.[3]

The second major intervention happened last week. Freddie Mac and Frannie Mae, the two largest mortgage finance companies, with over US$1 trillion in debt, were formally taken over by the United States government, who provided a US$100 billion dollar credit line, changed the management, and assumed control. The argument was that these were government-backed entities in the first instance and that their collapse would lead to large scale effects in the financial system. The next to go was Lehman Brothers, whose shares fell from over US$80 last year to around US$4 last week. In the case of Lehman Brothers, the Treasury and the Fed have categorically refused to provide any government guarantees and the bank had file for bankruptcy.

One sees a lack of coherence in the Treasury policy here, among the different approaches to the crisis adopted in the last one year. It is easy to understand that, initially, given free market considerations, the United States government was reluctant to intervene. It is possible to argue that the Bear Stearns rescue was characterised by its timing. Northern Rock had just collapsed, and non-intervention was being criticised; there were implosions in Europe, and the domino effects in the United States were not fully known. In some sense, it was a quick pragmatic reaction to provide a safety net for the creditors and the depositors. In the case of Freddie Mac and Frannie Mae, it could be argued that the government had an inherent responsibility, having encouraged these institutions in the first instance. In the latest case, it is possible that the Treasury decided that it cannot go down the road of supporting or bailing out all the affected banks and that the market must indeed find its own solutions. In the forthcoming weeks, these will have some profound influences on the Asian scene.

First, free market and state intervention concepts need certainly to be revised. It is clear that, even in the most open of economies, the need to intervene, on behalf of the larger citizenry, becomes both an economic as well as a political necessity. The state exists for the well being of its citizens; any aberration that significantly affects that welfare and well being needs to be corrected and cannot be left to the market forces alone. This single lesson would be drawn by many countries, some, like India, to justify continued interventions and regulation, and others, to arm themselves to intervention.

The distinction is likely to be in the transparency of the decision-making process. In all the examples cited earlier, the scene has been played out in full public view, with the stock markets factoring in each development. On the other hand, in Asia, there is still opacity about the extent of damage to the financial institutions and the banks as a result of this meltdown.

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[2] The exact amount is not public knowledge, but estimates place it around US$20 billion.
[3] Bear Stearns is not doing well either.

Little is known about the losses suffered by Indian and Singapore banks[4] or about the damage to banks in China and Japan. This lack of transparency would, at one extreme, distort asset values, with share prices not reflecting the true nature of the stressed assets, while, at the other end providing leverage to governments to intervene ad hoc without explanation. One is arguing here that in many senses, the governments in South Asia could well see these events as a license to intervene in institutions at will and also to regulate them at will. As an example, the moves of the Reserve Bank of India (RBI) to control non-banking financial companies and the bill to regulate micro-credit enterprises come to mind. In India, certainly, one is likely to see greater regulatory oversight, in insurance, financial markets, commodity exchanges and in the RBI. As a consequence, it is possible that policy reforms are continuously hedged in by regulations and processes.

The next question relates to the category of participants to be protected. In the instances so far, there has been an attempt to protect the depositors and the creditors, but the shareholders have had to take the brunt of the asset losses. The picture would be somewhat different in the South Asian countries in a similar scenario. It is likely that the shareholders, being small investors and public sector banks, get some protection as well. The actual creators of the crisis, the investment managers and chief executive officers, who put together most of the instruments, have gotten away quite free so far: it is likely that regulations may change to bring them to account as well.

Indian markets cannot be isolated from these considerations.

Currently, there are two reports on financial sector reforms that are under consideration in India – the High Power Expert Committee (Percy Mistry) report on making Mumbai an international financial centre, and the Committee on Financial Sector Reforms under the chairmanship of Raghuram Rajan. Both the reports advocate faster reforms in the financial sector, capital account convertibility, and a restriction of the RBI's role to inflation targeting. Equally, there are critics of this approach,[5] who argue that inflation targeting in India is unlikely to be effective or to guard against a balance of payment crisis. These critics argue on behalf of a more gradual approach and feel that there is little advantage to rushing in.

Financial sector reforms meet with relatively little political resistance and are, thus, easy to push through and, in India, the financial sector represents crucial command over resources. In particular, indigenous industry seeking creation of equity capital would be keen on an open architecture that enables it to access debt and equity globally – a demand that suits the advocates of the open architecture.

In the circumstances, the progress in the financial sector in India is likely to be mixed. The new Governor of the RBI is a mature economist, a reformer who would read the reports carefully, but would be guided by objectivity. One could expect some of the recommendations of the committee reports to be followed through, but not the more major ones on inflation targeting and capital account convertibility. At the same time, it is likely that the RBI's and the government's oversight over the financial institutions may actually increase, and a greater caution on the part of regulators on new instruments. It is likely that even some of the bolder reform pronouncements from the government get hedged in by regulatory processes during implementation. There would be a significant effort to ensure

[4] This is estimated to be around US$4 billion and US$1 billion respectively so far.
[5] See D. M. Nachane in Economic Political Weekly, 9 August 2008, Committee on Financial Sector Reforms: A Critique.

that the United States-like situations do not replicate in the Indian institutions. The new initiatives at the Securities and Exchange Board (SEBI) of India are likely to lead to greater transparency and accountability, and to keep the small investor in mind.

The markets, of course, are likely to be guided by global concerns and are likely to be quite soft. Foreign institutional investors, having already exited to the tune of nearly US$10 billion, are unlikely to stay invested in India except for short spells. The activity, therefore, could be in the new instruments introduced by the SEBI, rather than in secondary markets directly.

The growth story, supported by domestic demand and infrastructure investment, is still robust, but the impact of the global slowdown will continue to be felt, most importantly, in the financial markets.

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