

The Global Financial Crisis and Its Impact on Indian Capital Market

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INTRODUCTION

The Global financial crisis has occurred several times. The US administration and Congress are creating a \$700 billion rescue-package to resolve the worst financial crisis since the Great Depression of 1930s.

In 1942, Winston Churchill's commented, "This is not the end. It is not even the beginning of the end. But it is, perhaps, the end of the beginning."

The financial crunch that began in mid-2007 has worsened so dramatically that all politicians have agreed to a government rescue. In that sense, we have reached the end of the beginning of the current drama.

But two major chapters are yet to unfold. The first relates to problems that will hamstring, and maybe doom the rescue. The second relates to the global recession that has probably started, and will hit countries like India far harder than mere the Wall Street turmoil.

Professor Nouri-el Roubini was the first to predict this massive carnage. He now estimates bad loans at \$2 trillion, large enough to overwhelm the rescue package. Roubini correctly predicted the fall of the shadow financial sector-lightly-regulated financial entities that avoided the tight supervision imposed on banks, such as off-balance sheet SIVs (special investment vehicles), leveraged investment banks, and leveraged hedge funds. He now predicts that the carnage will spread to hedge funds, for which the rescue package makes no provision.

Meanwhile risk is set to multiply in derivatives. Most at risk are credit default swaps (CDS), which insure against bond and loan default. The size of the CDS market is \$62 trillion, four times the GDP of the US! After netting out offsetting transactions, the balance CDS risk is around a trillion dollars.

The future of the CDS market depends on the real economy. A major recession is now unavoidable, and this will mean more corporate and banking defaults. Some experts think at least 4,000 US banks will go bust. Recessions typically lead to a 10% default on corporate bonds. The default rate last year was only 1.8%. So a surge in defaults is coming, and CDS markets are trembling.

Despite a credit crunch starting with the bursting of the US housing bubble 13 months ago, the US and world economy has remained remarkably resilient so far. GDP growth in the US was 3.3% in the last quarter of 2007 on an annualized basis. The Indian and Chinese economies have slowed, but only modestly.

US monetary and fiscal policies have flooded the country -and the world-with dollars to try and stave off recession. The Fed has given financial markets unprecedented access to liquidity and the cut in interest rates was just 2%. The US Congress has legislated \$140 billion in cheques mailed to consumers, just to increase purchasing power. The trade deficit remains high, and is paid for by issuing dollars to the world. This Niagara of dollars has kept purchasing power (and GDP) rising despite the credit crunch.

But a major recession is now unavoidable. For global financial crisis, Japan and some European countries suffered negative growth in the 2nd quarter of 2008, and the US may already be in recession this quarter. Emerging markets are all slowing down.

The credit crunch means that fresh financing of both consumers and industry is going to slow down, in the US and globally. Risk aversion in financial markets means that emerging economy companies will face problems in rolling over \$111 billion of debt falling due over the next year. Several Companies that had banked on cheap loans and high IPO prices now find doors closed. The problem may persist through 2009-10. So, the greatest financial crisis since the Great Depression has a long way to go yet. And the journey may be long and painful.

CRISIS OF FINANCIAL INSTITUTIONS

The 158-year old Lehman Bros, the fourth largest investment bank in the world, had filed for Chapter 11 bankruptcy (akin to a company taking refuge in BIFR, the Board for Industrial and Financial Reconstruction in India). And the equally blue-chip Merrill Lynch, brokerage giant whose name is more familiar in India than Lehman, thanks to its long partnership with DSP as DSP-Merrill Lynch, had been bought over by Bank of America.

Two major financial deals announced on the same day - but while one saw a venerable name (Lehman) disappear altogether (though it may reemerge in another avatar some years hence) the other saw another equally proud name

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(Merrill) survive; perhaps as a pale shadow of its earlier self, but survive nonetheless.

So what distinguished them and hence determined their dramatically different fates? Just one word: Leadership. Add to that another that many have talked of after the collapse of Lehman: hubris.

Contrast this with what happened at Merrill Lynch. As one of the most powerful brokerage houses in the US, CEO John Thain had reason to be just as cocky as Lehman.

But he was also more pragmatic. Though a relative newcomer to Merrill, or perhaps because of it, Thain, who joined only in November last, was able to adapt to the fast-changing environment. He was quick to catch on that if Lehman could go down, so could Merrill. So he quickly sealed the deal with Bank of America, which had been toying with an idea of taking over Lehman and might even have preferred to do so had the price been right.

Fuld's obduracy gave Thain the chance he was looking for. He managed to seduce Bank of America with a deal that even if it values Merrill at half of what it was a year ago is a good sight better than zero! At 70% above Merrill's closing price on Friday and 29% higher than its average price last week, many believe that Bank of America might even have over-paid. It certainly couldn't have had time to do a proper due diligence.

Net result is Merrill survived, Lehman bit the dust. To quote JP Morgan's Jamie Dimon, "there is a difference between buying a house and buying a house that's on fire!". Thain recognized that difference; Fuld did not and that made all the difference!

India's top software exporters are closely monitoring the financial crisis spreading across markets. The IT giants which had all these investment banks as their clients are TCS, Wipro Satyam and Infosys Technologies. HCL seems to have escaped the loss as neither Lehman nor Merrill Lynch (ML) were its clients.

The Indian government is worried that the ongoing crisis would have an adverse impact on Indian banks. Lehman Brothers and Merrill Lynch had invested substantially in the stocks of Indian banks. The banks, in turn, have invested in derivatives, which might have exposure to these investment bankers. PSU banks like Bank of India, Bank of Baroda have exposure towards derivatives. ICICI bank is the worst hit as of now. With Lehman Brothers filing for bankruptcy in the US, the country's largest private bank, ICICI Bank is expected to lose approximately \$80 million (Rs 375 cr), invested in Lehman's bonds through the bank's UK subsidiary. The meltdown is also expected to hit Axis bank but the impact is not clear yet.

IMPACT ON INDIA

Globalization has ensured that the Indian economy and financial markets cannot stay insulated from the present financial crisis in the developed economies. The debate, therefore, can only be on the extent of impact and how resilient India is to withstand the storm with minimal damage! In the light of the fact that the Indian economy is linked to global markets through a full float in current account (trade and services) and partial float in capital account (debt and equity), we need to analyze the impact based on three critical factors: Availability of global liquidity; demand for India investment and cost thereof and decreased consumer demand affecting Indian exports. The concerted intervention by central banks of developed countries in injecting liquidity is expected to reduce the unwinding of India investments held by foreign entities, but fresh investment flows into India are in doubt. The impact on India of this will be three-fold: The element of GDP growth driven by off-shore flows (along with skills and technology) will be diluted; correction in the asset prices which were hitherto pushed by foreign investors and demand for domestic liquidity putting pressure on interest rates.

While the global financial system takes time to "nurse its wounds" leading to low demand for investments in emerging markets, the impact will be on the cost and related risk premium. The impact will be felt both in the trade and capital account. Indian companies, which had access to cheap foreign currency funds for financing their import and export, will be the worst hit. Also, foreign funds (through debt and equity) will be available at huge premium and would be limited to blue-chip companies. The impact of whim, again, will be three-fold: Reduced capacity expansion leading to supply side pressure; increased interest expenses to affect corporate profitability and increased demand for domestic liquidity putting pressure on the interest rates.

Consumer demand in developed economies is certain to be hurt by the present crisis, leading to lower demand for Indian goods and services, thus affecting the Indian exports. The impact of whim, once again, will be three-fold: Export-oriented units will be the worst hit impacting employment; reduced exports will further widen the trade gap to put pressure on rupee exchange rate and intervention leading to sucking out Liquidity and pressure on interest rates. The impact on the financial markets will be the following: Equity market will continue to remain in bearish mood with reduced off-shore flows, limited domestic appetite due to liquidity pressure and pressure on corporate earnings; while the inflation would stay under control, increased demand for domestic liquidity will push interest rates higher and we are likely to witness gradual rupee depredation and depleted currency reserves.

Overall, while RBI would inject liquidity through CRR/SLR cuts, maintaining growth beyond 7% will be a struggle.

The banking sector will have the least impact as high interest rates, increased demand for rupee loans and reduced statutory reserves will lead to improved NIM while, on the other hand, other income from cross-border business flows and distribution of investment products will take a hit. Banks with capabilities to generate low cost CASA and zero cost float funds will gain the most as revenues from financial intermediation will drive the banks' profitability.

Given the dependence on foreign funds and off-shore consumer demand for the Indian growth story, India cannot wish away from the negative impact of the present global financial crisis but should quickly focus on alternative remedial measures to limit damage and look 'inwards' to sustain growth!

FUNDS MAY DRY UP

Emerging companies will have to re-look at the aggressiveness of their plans. Sectors, which are capital intensive, would be facing tough times. Emerging companies in sectors such as power and infrastructure, aviation, software and real estate would be the worst hit.

In the past few months, small companies starved of cheap funds had seen a ray of hope with the influx of private equity and FDI. But with the collapse of many large financial institutions in the US, that route of funding could soon dry up. Over the long term, say 6 to 18 months, private equity fund flows into the country is likely to slow down. The researcher is of the view that the money which has been pledged and announced was certain to come, but raising future funds and their easy disbursements will be severely affected. To add salt to injury, even if funds become available, deal valuations were likely to take a beating as PE players will start to be more aggressive.

According to Rajesh Jain, chairman and managing director of EMCO Ltd, a Rs 700-crore power sector company, the biggest casualty of the crisis will be the availability of finance at competitive rates and companies will be forced to rethink their strategies, "As the capability to raise funds, or rather cheap funds becomes difficult in such a downturn, companies will be forced to rethink their strategies," As the capability to raise funds, or rather cheap funds becomes difficult in such a downturn, companies will have to re-look at the viability of new projects as the cost of funds will go up." It also means that ramping up capacities isn't going to happen anytime soon.

Private Equity investors are assessing the small and medium enterprise sector, especially those with higher exports dependency on the US. The more the dependence, the tougher it would become to raise funds for expansion. Though we haven't put brakes on our investment strategies towards SMEs yet, it is imperative we become selective.

Indian companies having larger dependency on the US may find the going tough. Also, there will be an impact on valuations for such companies. But there are still a few small players who are ready to strike deals at this level because they see an opportunity ahead. Industry experts are predicting a slowdown in inflows of foreign direct investment (FDI) too. Many small companies in the manufacturing sector were raising funds for their expansion through FDI. That was also another way of accessing technology. But if FDI slows down, companies, which have built up over the years, will find it difficult to upgrade their products for lack of technology. One way to tackle this is to acquire companies abroad. But companies looking to raise funds overseas may not be able to fetch attractive deals.

At the same time, Indian SMEs who prefer to raise finances through debt may face difficulty in raising funds as many banks, which lend money to the SME sector are already under stress following repercussions of the recent developments. Already reeling under inflationary pressures, overall increase in input costs and an already higher lending rate by banks has already made lending to SMEs difficult. Small companies are usually the last -end borrowers as they are the most risk prone as far as banks are concerned. SMEs have already witnessed a slowdown of 10-15 % over the last 5 -6 months owing to these pressures. Some sectors, of course, are hit more than the others --like auto components and suppliers to the housing sector.

PERVADE ON INDIAN CAPITAL MARKET

Wall Street's wolf pack has lost its fangs, and the Indian markets are finding it tough to stand apart despite strong economic fundamentals and a largely insulated macroeconomic situation. The answers are quite clear; this is the underbelly of globalization. The Indian economy is feeling the heat of the contagion effect, like never before.

We will certainly be influenced by this global slowdown; the pain will be felt with the stock markets reacting in a downturn.

There has been a double whammy for India. Direct hit are the ones, which had some kind of business linkages with no longer existing global investment banking giants, such as IT services, real estate and infrastructure. The major

players, which are hurt in the IT segment, include TCS, Wipro and Satyam. In the real estate sector, Unitech and DLF, among others, have been affected. Analysts agree that all those companies, which had these investment banks' holdings as a significant proportion of their portfolio and business 'are feeling the squeeze. Among banks, ICICI Bank is the worst hit private bank, while PSU players, Bank of India and Bank of Baroda are affected because of their derivative exposure. FIIs pressed the panic button on India as global agency Fitch downgraded the credit profile to "negative". However, investors in India have been hit only indirectly, through exposure in the markets. The linkages of Indian investors with these events have been weak as none of these banks are allowed to set up branches in India. There is a consensus among asset managers that Indian investors will not be affected very badly. The Indian markets are certainly over-reacting. The global meltdown has created volatility in the markets but it will not last for long. However, not all are optimistic. But every large player had invested in some way or the other in India. Lehman had holdings in Satyam, AIG had partnership with Tata's insurance wing and Merrill Lynch had business with Infosys. But nobody is aware of the depth and magnitude of the crisis. The situation is not transparent as of now.

The impact of global financial crisis on Indian Capital Market will certainly be felt but not at the portfolio level. The short - term volatility may erupt but the medium and long-term perspectives are healthy and safe.

MITIGATING RISKS

In such a scenario, one of the ways to mitigate risks would be to spread it among many clients. If you are an exporter, you don't have complete dependency on the US alone. A dollar billing could be disastrous. So, why not sign up businesses in Europe or insist on Euro billing.

Also, doing business with more than one company will be a good idea. Reliance on one big client means your prospects are severely affected if that company faces financial trouble. Big companies have to grow in order to ensure that the smaller companies also prosper. But there is something called the trickle-down effect.

Insurance companies at the same time expect SMEs will resort to insurance to insure themselves from such risks. The recent developments may not directly affect Indian enterprises yet but those who have dealings with companies based in overseas markets especially in the US will surely face the pinch when it comes to payments.

Exporters will be the worst affected right in the beginning. Those supplying goods or services to the US or UK might not receive payments from customers in time. With credit being tight, buyers would find making payments extremely difficult. Such a situation calls for options such as credit insurance. Most insurers and banks offer this option. Credit insurance is cheap and can cover 100% of the losses arising from payment defaults. The premium for credit insurance cover tends to be about 0.2 % of the sum assured. We expect widespread demand for these products in the next couple of weeks, as the effects of recent developments sink in.

Also important will be liability insurance. Lehman and Merrill Lynch didn't just supply capital to companies but also to banks, including Indian banks. The ability to provide fresh credit to SMEs may thus be compromised, which is expected to have a cascading effect on supply of goods and services. If that is the case, insurers expect the spotlight to fall on liability products, such as product liability insurance and errors and omission insurance.

At this stage, insurers are sitting on the sidelines and are adopting a wait and watch approach. There are some subtle fears in the tile SME segment, but whether that will translate into increased sales of covers remains to be seen. However, insurers would be reaching out to this segment to make them aware of the risks they could be facing, especially with relation to credit default. The challenge will be to get them to shed their dependence on Chartered Accountants and introduce them to a proper risk analysis and protection mechanism.

The hazy definition of SMEs in India and their diffused nature make it challenging for insurers to identify the pain points they face as a sector. But as traditional sectors slowly get more organized and rely on banking relationships, bancassurance products too will be in demand going forward.

NEED FOR RAPID AND DECISIVE ACTION

Now, the main problem in India is the liquidity crunch. There is absolutely no liquidity in the system. Spooked investors everywhere are unwinding their positions and swiftly moving to cash. In India, the foreign institutional investors (FIIs) have acted like lemmings and withdrawn several billions of dollars in the last few weeks by selling their equity exposures. But they aren't the only scared rabbits facing the headlights. Banks all over, and the Indian ones are no exception, are making big investments in pillow-cases to stuff whatever cash they can sequester. No wonder, then, that the over night LIBOR rate has shot above 6%; and, at home, the inter-bank call money rate rules between 23 % and 19 %.

How can we, in India, deal with this dried out liquidity scenario? In a sentence, by taking quick, decisive and

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Websites

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big-ticket actions. Reserve Bank of India (RBI) with appropriate blessings of the ministry of finance can take the following actions:

Action 1: Cut the cash reserve ratio (CRR), and cut it deep. Yes, the RBI has finally cut CRR by 150 basis points-up from a very timid initial move of 50 bps. And it deserves kudos for this action. However, it isn't enough to infuse the liquidity needed to re-inject some degree of comfort in the system. Consider this. Even up to April 13, 2007, the CRR was 6%. There is absolutely no reason why the CRR cannot be brought down in another 150 bps cut to 6%. It will show the RBI's commitment to making decisive moves-and to tell the players that it can intervene big when the situation so demands.

Action 2: Cut the Repo and Reverse Repo rate by 200 basis points to 7%. Do so in one fell swoop, instead of bits and bobs of 50 bps per time. Again, this will demonstrate proactive flexibility and the ability to make serious interventions - something that the RBI needs to do.

Action 3: Rapidly set up a sovereign fund with a corpus of at least \$25 billion to support the equity of well-run Indian listed companies and mutual funds. The Life Insurance Corporation or the State Bank of India can administer the fund, with trustees and the investment committee being represented by major public sector financial institutions. As the FIIs sell, this fund can buy.

Given the current price-earning ratios, and the otherwise good prospects of the better run Group A and Group B1 corporates, most of these investments will earn solid profits in a year or two. This was done just a few years ago to save the Unit Trust of India under Jaswant Singh in the North Block. The investments had fetched returns in spades. The upside of this action is obvious at the current P/E ratios. The downside is equally obvious. If nothing is done, soon enough, we will see the FIIs and corporates rapidly accelerate the process of unwinding their exposure in liquid and money market funds. Many already have. If this becomes a wave, there will be massive redemption problems leading to a further liquidity crisis - something we can ill afford today.

Action 4: This is related to Action 3. The RBI should allow money market mutual funds to access the Repo window. The researcher foresees significant redemption pressures over the next few weeks as investors, FIIs and domestics alike move to cash and fixed deposits. The RBI needs to relieve this pressure by allowing money market mutual funds to access money at repo rates.

CONCLUSION

From this study, it may be concluded that India will still end up with 7.5% real GDP growth in 2008-09, the best performance in today's world after China. We need to keep this growth going, which needs liquidity. Nothing saps animal spirits more than banks not willing to lend at any price. So, we need to understand that these measures are like injecting adrenaline in a time when extreme steps are needed to get an otherwise healthy patient from keeling over.

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