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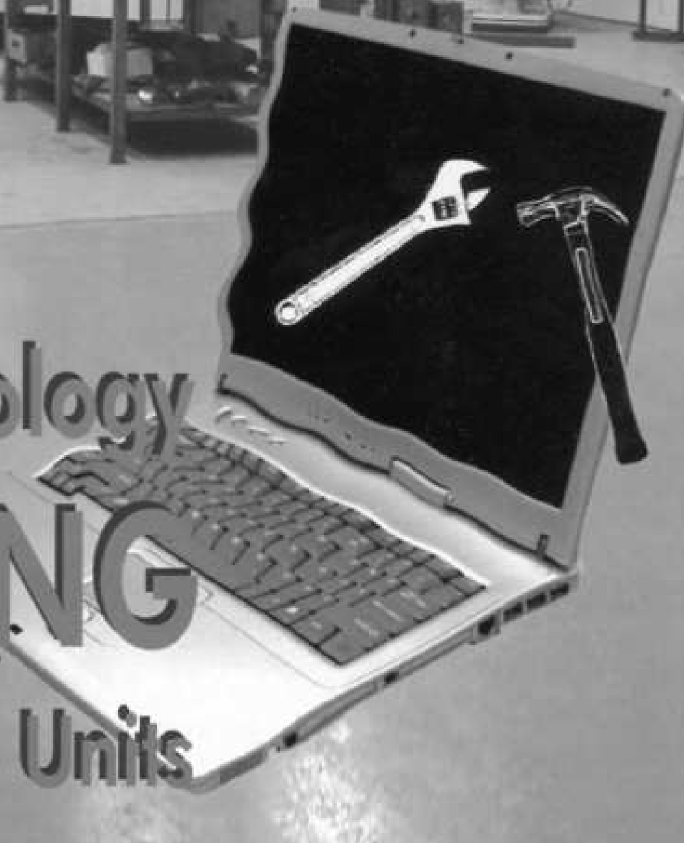

Global Crisis Can Be An Opportunity For India

R.P. Gupta

Recently, when leading investment banker Lehmann Brothers declared its bankruptcy, a lot of other US banks' financial positions were also exposed. Since the size is enormous, there has been a worldwide impact. The capital and commodity markets started crashing. Perhaps for the first time, public confidence was shaken on the entire financial system.

The US government sanctioned a bailout package of $700 billion and other countries also announced similar packages. Though the major problem was concentrated in the US and Europe, its effect was felt in other countries also. Funds invested by the US and Europe in other countries (including India), started flowing back for meeting their redemption requirement. No doubt, this is the worst financial crisis so far.

But how much has India been affected in real terms, and to what extent? To the best of my knowledge, the Indian economy is not yet integrated with the world to completely, since the process of integration started only a few years ago. Our economy is also not export dependent as is the case with China. Our financial system is conservative and more regulated and well capitalised. Our growth rate has been the highest next to China in the past five years.

Hence, the quantum of associated problems with India concerning the ongoing global crisis is too small and manageable, provided that swift and multiple steps are being taken by the government and regulators. Few steps has been already initiated but much more still needs to be done soon.

In my opinion, this is the right opportunity to prove our strength and emerge as a strong nation with a sound financial system and growing economy. If India can establish these facts, it will be the most favoured destination for investment.

Our country is currently led by eminent economist Dr Manmohan Singh. If adequate support comes from every section, we can definitely turn this crisis to an opportunity for future growth. It only requires swift action. The CRR cut by RBI is a good start to overcome the liquidity problem. However, if we are to establish ourselves as a strong nation, much similar action needs to be taken by various regulators.

Background of the crisis

About decade ago, when the US economy was slowing down, the government took the initiative for liberal consumer financing to stimulate demand. Hence, US banks opened the floodgate for consumer financing.

As of now, total exposure on consumer finance in the US is exceeding $14 trillion. It exceeded normal borrowing by productive sectors. Even loans were sanctioned to Ninja category (no income, no job and assets).

US banks converted these loan portfolios into packages of tradable security, popularly known as mortgage securities. The securities were rated by agencies. Weaker securities were insured to improve ratings. These mortgage securities were sold to investment banks.

Funding for these securities by investment banks was arranged either through public deposit/investment or by raising loans from commercial banks. Effectively, bad money was financed by good money.

Defaults in interest and repayment were covered by interest capitalisation and time extension to keep the rating of the security intact. Even some derivatives were designed for onward trading. Because of trading of such mortgage security, hands were always changing and "troubled assets" as a part of the package were hidden. Banks of other countries also participated in buying such mortgage security. Hence, the problem spread throughout the world.

When the price of real estate started moving down, the percentage of troubled assets increased and finally the bubble burst. The indication was available before a few months in the shape of the subprime crisis. However, corrective actions were missing.

The basic question that arises is whether it is rational to stimulate growth by 'Expenditure funding?' In my opinion, borrowed funds should be utilised as an input for productive purpose. Borrowed funds should not be deployed for comfort or luxury, such as buying a car, or household appliances or for a pleasure trip.

However, for a social reason, house loans can be considered with adequate margin and proper security. Educational loans should be considered when the nation is creating human capital out of it. Similarly, new house construction is also an addition to national wealth/infrastructure.

Our country should not promote "expenditure funding" rampantly, other than house and educational loans. A balance approach will increase the margin. The concept should be "resource gap funding" only backed with adequate security and margins.

Attention should be paid to increase the public income vis-à-vis GDP so the spending power of consumers increases without too much depending upon loans. The clean money of depositors/investors has to be deployed for productive purposes to generate further income or wealth for the nation. This concept shall pay dividends in the long term, with stability.

Effect on real economy

The financial system in any country constitutes banks, capital markets vis-à-vis depositors and investors. The good money of the investor/depositor may be provided to the productive sector through banks/capital markets for investment and increase of GDP/public income concerning the economy.

If the confidence of the depositor/investor is shaken in banks/capital markets, they will obviously withdraw their money from the financial system and the ultimate sufferer will be productive sector and public by large.

Though such an effect on the productive sector comes later, it is essential to safeguard the interest of the investor by building confidence in the financial system. The immediate and burning problem can be overcome by the government or central bank injecting sufficient liquidity through various instruments.

However, it is equally important to rebuild the confidence of the investor. Once we regain the confidence, not only domestic investor but the foreign investor too will enter our country again. This will increase the availability of finance for the productive sector and the economy will grow at a faster rate.

Effect of currency depreciation

The value of a currency in the international market should reflect the financial strength, fundamentals or the economic strength of any country. If the epicentre of the present crisis is the US, why should the dollar gain over the rupee?

This is sending the wrong signals to NRIs and foreign investors, including FIIs and FDI. Despite the sound financial system in India , clubbed with healthy economy, there will be resistance to keep their money in rupee denomination.

The government's present policy needs to be revisit in this area. In my opinion, the rupee should emerge a strong currency, at least in comparison to the dollar, euro and pound. With a stronger rupee, the present flight of forex shall also slow down. All such temporary and permanent measures should be taken faster to make the rupee stronger.

Whenever the topic of the rupee-dollar conversion rate arises, there is the fear that exports shall be affected. Hence, let the rupee depreciate. However, I think rupee depreciation is never good for our country.

Our imports are more than exports. At present, we are subsidising imports, mainly oil imports. The export subsidy is any day a better option than an import subsidy in the larger interest of the economy. A stronger currency itself is enough incentive for inflow of investment, may it be NRI, other institutional investment or FDI. For the past year, performance on this account is a burning example as the rupee was getting stronger. Our forex kitty went up more than $100 billion.

A few suggested actions (not exhaustive) for making the rupee stronger are:

- Frequent and aggressive intervention by the central bank in the forex market
- RBI to provide dollars to oil importing companies and large import houses directly so demand for the dollar in the open market remains low and, hence, favourable sentiments prevail
- Removal of curbs on ECB and NRI remittances; encouragement instead
- Removal of restrictions on export of several items and removal of export duty
- To pass on the burden of oil subsidy to consumers (in part) through a price rise so consumption of petroleum is reduced. This reduces the import/subsidy bill. However, subsidy may reduce automatically with a stronger rupee.
- To discourage investment in gold, which amounts to outflow of foreign exchange
- To review and relax investment norms related to FIIs
- To restrict imports wherever feasible and possibly through a hike in import duty

Role of capital markets

The capital market is an important part of the financial system as a whole. Heavy fluctuation and volatility shakes the confidence of investor. None of the stocks should be allowed to reduce or increase more than 5 to 10 percent in a single day. Sudden falls or rises are due to sentiments based upon information/misinformation and not upon the real facts in a majority of the cases. There should be circuit limits for all stocks, futures and options. It may be continuously reviewed by the regulator.

In the present system, a review of the circuit limit is done in case of abnormal increase in the stock price. It may be implemented in case of abnormal decrease also. Reduction of volatility vis-à-vis heavy fluctuation in a single day cuts down on panic and builds up an investor's confidence. The circuit limit should also be applicable for futures, options and derivatives to contain volatility or heavy fluctuation.

The government may also take the initiative to provide more liquidity to capital markets during the present crisis through mutual funds. Insurance companies and pension funds may be allowed for rational exposure in the capital market to provide liquidity in the capital market in such a crisis.

A healthy, regulated and stable capital market shall attract more investors. Capital markets provide seed money, that is, equity capital for any productive sector and infrastructure spending. Unless the seed capital is made available, investment vis-à-vis GDP and the real economy cannot grow.

Liquidity infusion

Out of all the points, a liquidity crisis is one of the major reasons which can create havoc overnight in any financial system. The government has rightly identified the liquidity crunch as the basic problem requiring immediate remedial measures.

However, the quantum infused by the government through a CRR cut is not enough so far. Perhaps, it must utilise more tools to infuse sufficient liquidity in the system. The government may not bother on the inflation front for the time being because commodity prices are coming down and the result will be reflected in the subsequent months. Now, its priority is to rebuild the confidence in the financial system and thereby attract investment for maintaining growth of the real economy.

Inflation no worry

With double digit inflation, the government is very cautious about liquidity infusion or liberal inflow of forex funds. However, in my opinion, with the present global scenario of commodities, inflation is bound to come down in the subsequent months.

I feel monetary expansion and liquidity infusion are two different aspects. Monetary expansion arising from the fiscal deficit and subsidies is the basic reason for inflation. Whenever GDP grows, the disposable income vis-à-vis purchasing power of the public obviously increases, creating more demand.

However, such demand gets offset with higher production/ GDP. If the fiscal deficit or subsidies are monetised through overdrafts, it leads to monetary expansion without any matching increase of production and, hence, results in inflation. In view of this, I feel the government should not worry about infusing liquidity or relaxing the inflow of funds with the fear of inflation.

However, other factors to control inflation – such as removal of supply side constraints, cost push factors – are to be looked into.

Conclusion

If swift action is taken by the government on all fronts, such as liquidity, rupee-dollar conversion and the capital market, India's position will be different from other parts of the world. It will send positive signals that India is strong enough in its financial system and can grow at a faster rate despite crisis. It is likely to become the most favoured investment destination. Let us take this opportunity to grow, instead of taking up a defensive posture.

There is no substitute for GDP growth, if we are determined to eradicate poverty and command respect in the world fraternity. ■

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