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Theme 204
GLOBAL FINANCIAL CRISIS
PART-II

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Theme No. 204 : GLOBAL FINANCIAL CRISIS - PART II

6. What is the impact of Global financial crisis on equity, and commodity market?

Stock markets crashed world over as a result of the financial crisis. The share prices quoted in most of the stock exchanges are now less than half of what were a few months back. The stock markets has fallen around 60% from its peak level in January, 2008. Since the foreign institutional investors, who hold 35% ($ 71 billion) of Indian stocks, are still in a flight mood, there is scope for the market to fall some more. There are some key differences between the Indian and other markets which have declined. In the US and Europe, there is a problem in the real sector. There the economies are slowing, the financial sector is in a mess because of bad loans and the financial sector crisis has passed on to the stock markets. In India, it is the other way round. Still Indian economy is the second fastest growing and the bank balance sheets are sound, but the stock markets have collapsed because of the flight of foreign funds.

Crude oil price fell substantially during the last few weeks due to fears of a decline in global fuel demand. The Organization of Petrolium Exporting Countries (OPEC) has cut its 2009 demand forecast because of worsening conditions in financial markets. Gold price rose due to its appeal as a haven asset. Almost all other metals like silver, copper etc. declined on worries over economy. The price of wheat, pepper, rubber etc. also fell due to demand worries. Commodity stocks declined substantially and still remain under pressure.

The global recession will reduce the volume of trade between different countries of the world. It may also affect the profitability of companies and some professionals and employees will loose their jobs. Already there are indications that the IT companies and Airways are planning to trim the number of employees. Consumer and Investment demand will also decline, as the world economy slide into recession.

7. What is the role of global financial crisis in the liquidity crunch facing the Indian markets?

While the problems of global banks are mainly due to exposure to sub-prime mortgage lending and investments in complex collateralized debt obligations, the liquidity crunch facing the Indian markets is qualitatively different. The prevalent domestic factors are more responsible for the pressures on the Indian banking system. The liquidity crunch facing the Indian markets is due to the large selling of stocks by foreign institutional investors, interventions by the RBI in the forex market, continued growth in advances and the earlier increases in CRR to counter inflation, the drying up of external commercial borrowings and the decline in international suppliers credit availed by domestic corporates. The credit-deposit ratio (CDR) of scheduled commercial banks has hit an all time high of 75.16 per cent on 10^{th} Oct.2008.

The report by rating agency, Crisil, states that the Indian Banking system is relatively insulated from the factors that caused the global financial turmoil. Higher funding costs, mark to market requirements on investment portfolios, and asset quality pressures due to a slowing economy will put pressures on the profitability of banks, the findings say. The banks would also have to contend with declining interest rate spreads, lower fee income due to slow down in retail lending and lower profit on sale of investments.

The prevailing economic environment, characterized by slower GDP growth, depressed capital market conditions and high interest rate regimes will be some of the challenges, which the Indian banks would face.

8. What are the steps initiated by RBI and government of India to face the liquidity crunch?

Reserve Bank of India has reduced the Cash Reserve Ratio from 9% to 7.5% and again by another two percentages to 5.50%. The total CRR reduction by 3.50% will release Rs.140,000 crores into the liquidity-starved economy. Statutory Liquidity Ratio (SLR) has been reduced from 25% to 24%. RBI has also allowed a temporary relaxation in SLR to the extent of 1.50 percent. This facility was granted to enable banks to borrow the Rs.60,000 crores of additional facility, to on lending to mutual funds. RBI also decided to cut repo rate by one percentage to 8% and again by 0.50% to 7.50%.

The measures announced by RBI include removal of restrictions on P-notes. RBI has increased the interest rate ceiling on NRE and FCNR(B) deposits of banks. RBI has also allowed banks to borrow funds from their overseas branches and correspondent banks, upto a limit of 50 percent of their unimpaired Tier I capital as at the close of the previous quarter or $ 10 million, whichever is higher, as against the existing limit of 25 percent.

The Finance Minister Mr.P.Chidambaram, announced that RBI would provide temporary liquidity support of Rs.25,000 crore to commercial banks and NABARD against the farm debt waivers first instalment reimbursement, due to them on Ist November. The Government has decided that the limit of foreign institutional investment (FII) in corporate bonds would be raised from $3 billion to $6 billion. Also, the government has decided to provide certain banks access to finance, to raise capital adequacy to 12 percent by a suitable date in future.

9. What helped Indian banks to tide over global financial crisis?

Indian Banks have escaped the financial crisis mainly because of the excellent regulations by RBI and the decision not to allow investment banking on the US model. RBI has also enforced the prudential and capital adequacy norms without fear or favour. RBI regulations are equally applicable to all the Indian Banks, both in the public and private sector. They are professionally managed and proper risk management systems are put in place. But, in U.S. certain relaxations were permitted in the case of large banks which were considered “too big to fail”. Now, it is proved that it is not the size that matters, but prudence and proper risk management systems. Though the Banks are sound, the Indian economy cannot remain fully insulated. The impact of the economic slow down on asset quality of the banking sector will be felt only in a couple of months from now.

The role played by our present Prime Minister helped tide over the 1991 financial crisis in India. The various recommendations made by the Narasimham Committee were implemented and that helped strengthen our banks. In particular, the capital adequacy norms, the provisioning requirements and the need to reduce NPA and to recapitalize the banks were recognized. The SEBI must also be congratulated for having played a calibrated role in managing the flow of money from abroad. The promoters are now allowed to increase their holding in their companies up to 75% through creeping acquisition route. Earlier restrictions prohibited them from acquiring more than 55% of the company's equity. Abundant caution exercised by RBI and going slow on opening up new complex financial products also helped insulate our banks from a major financial crisis.

10. Will global financial crisis derail Indias economy?

India may escape serious impact of the global financial meltdown, but the northward march of the economy may be affected. There is a danger of lower consumption and deceleration in investment. This will hit Indian exports, production, interest payments, job expansion and stock markets. Even though our financial system is relatively insulated, our trade and economic systems are now integrated with the rest of the world.

Being largely a domestic economy with exports at 17% of GDP, India is relatively insulated in comparison with most other economies. There is some trouble brewing for Indian IT and BPO companies. Indian IT Companies have 30% exposure to financial services including banks in US and Europe. The liquidity crunch of Indian banks could result in some uncertainty for the real estate sector. The impact on growth, exports and capital flows are not clear now. It is expected that Indian growth rates will continue to attract robust long-term investments, though there may be a fall in the short term.

Fall in global commodity prices will help reduce imported inflation and frame policies to revive growth. Indian GDP growth may moderate around 7 to 8 per cent next year from the 9.30% in 2007-08. But, this is a good number when compared with expected economic growth of most other countries. The policy responses in the coming months will be a reverse of what happened over the last 3 years when RBI was faced with surging capital flows, and had to hike the cash Reserve Ratio and check rupees appreciation. Now the worsening balance of payments will adversely affect the local money market liquidity and also put pressure on rupee to weaken. Also, policy makers will ease the restrictions on capital inflows to ease dollar supply. Expectations of lower inflation will prompt significant reversal in interest rates.

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