Global Meltdown and the Need for Shaping Financial Architecture

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"The world is flat", said Thomas Friedman, in 2005. Now, David M. Smick says, the world is 'curved'. In 1989, there was a paradigm shift towards capitalism. The new entrepreneurs chase opportunities unfolded by innovations in information and communications technologies. Ownership of diversified assets has become an integral part of their life styles. Work force in the world virtually doubled in recent years. The Asian countries also started participating in these ventures since the mid-1980s. The global structures depend on management of internals. Transaction, information and technological costs have fast declined. With personal computers, web sites, internet, television, and telephones, it has become a borderless world. In this globalised world, political freedom, wealth-creation and poverty alleviation have come to occupy the central place.

Eventful Decade (1995-2006)

The world was awash with an "ocean of liquidity". It was a wave of prosperity by chasing productivity revolution. This provided support for boosting consumption and led to a housing boom in the U.S. The banks, hedge funds and other financial intermediaries used to operate on a fractional reserve systems. The lenders lowered the eligibility criteria, and lent to borrowers who had hardly any credit history. Such loans inflated the financial risk. The financial tools included private equity funds, private debt placements, hedge funds, high-yielding bonds, venture capital funds, turnaround funds, and private mezzanine investing. The loans were converted into smaller parts and sold to financial institutions in secondary markets in Europe, Asia and elsewhere. They were adjustable rate mortgages and the rates started rising from their low introductory incentive rates. The total quantum of derivatives estimated at $ 600 trillion were 10 times the global GDP of $ 60 trillion!

Credit crisis

The innovative instruments have not been well understood. The borrowers failed to honour their liabilities. The lending institutions have gone into bankruptcy. There was lack of transparency. The lenders had to sell their assets at throw-away prices in a buyer's market. The insurance giant, the American International Group (AIG), was in a mess. The large-scale defaults in sub-prime mortgages, especially in housing and credit card portfolios made the lending institutions write offs loans and write down capital. The new accounting standards of marking to market added fuel to the fire since they meant making further loss provisions. As loans have been parcelled and packaged, the origin of "toxic waste" has not been known. The off-balance sheet vehicles for operating the new financial instruments escaped critical look as to their actual liabilities. The stock markets melt down. The banking crisis spread to the entire economic and financial world, necessitating the process of deleveraging.

Action on Banking front

In the U.S., over 1.5 million foreclosures of housing loans began in 2007. The Federal Reserve (Fed) in August 2007 provided $ 100 bn. to the money market to ease bank borrowing. In March 2008, filings of foreclosure proceedings substantially rose. The housing market was depressed. There were mergers and acquisitions. J.P. Morgan Chase acquired Bear Sterns, the fifth largest U.S. investment bank. Bank of America

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acquired Merrill Lynch. U.S. Government virtually bought Fannie Mae and Freddie Mac. Lehman Bros. was allowed to go out of the scene. U.S. Government rescued the American International Group (AIG) to prevent the shaking of foundation of the insurance system. J. P. Morgan Chase also bought Washington Mutual. Wells Forge bought over Wanchovia Bank.

Fed started reducing interest rate since September 2007 and the rate by October 2008 stood at 1 per cent. Fed ensured liquidity through its Term Auction Facility, introduced in December 2007, by offering loans to institutions. The U.S. Treasury announced the U.S. $ 700 bn bailout plan to mitigate illiquidity in the markets.

In Europe, Fortis was saved. In the U.K., in September 2007, Bank of England provided emergency funds to Northern Rock. Lloyds TSB acquired Halifax Bank of Scotland. U. K. Government nationalized Bradford & Bingley.

Global players multiply

Unlike the past, the U.S. economy is not the main player in the global market. The European Union of 15 countries with common Euro as its currency, Japan with its huge export capability, China with immense manufacturing facilities and export potential brought about a sea change in the globalised world. Asian economies like Korea, Taiwan, Indonesia, Hong Kong, Thailand and the rest are also significant players. India is one of the key players. The oil-producing countries form another group to be reckoned with. Globalisation and its scope for vast trade relations created such an evolving scenario that no one country could on its own influence the world economy. It is the overall actions of the world players that decide the growth prospects or otherwise. An additional dimension is the demographic profiles of Europe and Japan, China and India and the rest of Asia.

Impact on Emerging Economies

Emerging economies have come to occupy a key position in the world economy. Without relatively high incremental growth in emerging economies, world growth rate would plummet. In fact, three-fourths of global growth in the past 18 months is accounted for by emerging economies. In early 2007, there were supporters of the "decoupling" theory and they felt that the emerging economies might not suffer much but the linkages in banking, capital markets, global trade, commodity market and sourcing of services brought the turmoil to the doors of emerging economies. The banking crisis travelled to the share, currency and credit markets in the emerging economies as well. In Brazil, the declining commodity prices hit its economy hard. South Korea and Russia have been strengthening their banking systems. South Korea guaranteed $ 100 bn. of its banks' debt. Russia devoted $ 200bn. to strengthen its financial services industry. Hungary secured $ 6.6 bn. from the European Central Bank and is negotiating with the IMF for loan. So is Ukraine negotiating with IMF for loan. Growth is slowing down in India and China.

India in dilemmatic situation

Like the Asian crisis in 1997-98, since January 2008, the funds invested in India, especially in the share markets, are on reverse flow since the funds are badly required to meet the western meltdown. The favourable trends in India include good forex reserves, lower oil prices, liquidity of over 2 lakh crores, declining cement and steel prices and interest rates. On the other hand, unfavourable trends include a fall of 60% in Sensex, mutual suspicion among banking institutions, monsoon being not very good, and strong rupee. Large infrastructure and industrial projects are languishing for want of funds.

In this context, the RBI cut the repo rate to 7.5% to reduce cost of borrowing and cut the cash reserve ratio to 5.5% to ensure liquidity. RBI also reduced SLR to 24%. Further, banks could borrow from RBI to lend to mutual funds up to 1.5% of their deposit base and significantly, non-banking finance companies are also included in the scheme. In addition, banks could borrow up to 1% of deposit base for 90-day period from RBI. RBI also agreed to the buyback of dated MSS securities. To boost public confidence in the Indian banking system, the Government, RBI and bank official reiterated that judged by any standards, Indian banks have been on their fine fettle.

Key Unknowns – Cause for Concern

The recent events have brought to the fore certain threats to the global economy. So far less realized but now they assume added significance. On the political fronts, there are uncertainties like coalition governments with their on-going compromises on even major issues. The economic and social organizations are often found beyond the control of governments. NGOs make sharp swings on issues of significance. Further, several geopolitical issues like role of oil-rich middle-east, Palestine and Israel, Iraq, and other sensitive spots call for considered actions. Further, on the trade front, the failure of the Doha Round of Trade Talks was on account of differences between developed and developing countries and this could lead to adoption of beggar-thy-neighbour policies. In Patents/International Property Rights, subsidies, professional services sector and duties and tariffs, there could be inward-looking policies.

Further, heavy investment in U.S. Treasury bills has an embedded threat perception. Concentration of huge funds in one country and in one currency, however safe it might be, could be a built-in weakness in the system. For world growth, best possible utilization of savings is essential. Again, if immigration policies of governments become more restrictive, especially for intellectuals, scientists and students, the research output might decline for want of cross-fertilization of ideas and congenial research environment. This may affect world prosperity. Similarly, if taxes are levied on imported goods on considerations of energy efficiency and environment, it will be a setback.

After the Enron debacle, new accounting standards have been set. There are country-based accounting systems like the US GAAP. But now the International Accounting Standards based on "fair value" concept is unfolding new dimensions in accounting. If International Financial Reporting Standards (IFRS) are introduced on a world-wide basis, the reporting systems require in-depth review by accountants, economists, entrepreneurs and others concerned. As regards international financial system is concerned, the Bretton Woods twins viz. the IMF and the World Bank as of now are dominated by the post-World War II powers without relevance to the growth of other countries since 1944 like Japan, India, China, oil-producing countries and the rest of Asia and countries in Africa. In fairness, there should be a new global financial architecture. The centres of financial activity are fast changing. Finally, sovereign wealth funds (SWFs) comprising oil money and funds from countries endowed with natural resources could play major role in future world growth.

Concluding Observations

Irrational exuberance and greed in the U.N. financial sector led to innovative financial tools which culminated in the snowballing of the global crisis. Rather than keeping quiet when adverse situations unfold, the regulators should have the knowledge, confidence and assertive wisdom to exercise timely control over institutions. Their main business is to ensure sundness in the system. Be it the developed or emerging economies, growth should be inclusive. Left to market forces alone, unless public agencies play an effective guiding role, as Joseph E. Stiglitz warns, even an increase in GDP could actually leave out most citizens worse off inasmuch as trick-down theory of economics does not always work.

The existing system of floating exchange rate was introduced in 1971 when the Bretton Woods system collapsed after the oil crisis in the early 1970s. There has been clamour for changing the structure of international institutions like the IMF and the World Bank. Apart from the credit crisis, there are certain key unknowns affecting the global economy. In this scenario, the group of 20 countries (G-20) (7 major industrialized nations, the European Union, and Argentina, Australia, Brazil, China, India, Indonesia, Mexico, Russia, Saudi Arabia, South Africa, South Korea and Turkey) met on November 15, 2008 in Washington, D.C., U.S. At the meeting of G-20 leaders, it was agreed to undertake the preparatory work for building an appropriate global financial structure. Also agreed at the November 2008 conference was that the credit rating agencies, the names of which got tarnished, would be monitored by regulators. Also, there would be review of bankers' compensation. The leaders would have to adopt balanced ethical standards without sacrificing incentives for work, so that, as Klaus Schwab points out, "the current crisis hopefully has a transformational character" for future good.