ISAS Brief

No. 83 – Date: 17 September 2008

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Crisis in the United States Markets and Consequences for the Indian Markets – An Update

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The aftermath of the Lehman Brothers bankruptcy and the Merrill Lynch sale were somewhat muted in the New York Stock Exchange on 15 September 2008. The Dow Jones numbers did fall, but by a smaller amount than were initially expected. One possible explanation is the difference in expectations in the financial sector and the goods and services sector – the so called 'financial street' versus 'main street' firms. Oil prices have fallen to less than US$100 a barrel, and commodity prices, including copper, zinc and aluminum have stabilised. Steel demand is no longer rising, and there is a softening of iron ore demand and steel demand. The inflationary pressures caused by commodity price increases as well as oil prices are easing. Even food prices have stabilised globally. There are definite indications that there would be a slowdown of inflation in many countries. This is good news and several central banks are already contemplating easing up interest rates. China did so on 15 September 2008. The United States Fed was expected to reduce interest rates but it has kept the interest rates steady. Instead, the United States Fed has injected liquidity into banks.[1] Therefore, along with the bad news in the financial markets, there is good news in the real economy scripts. It is not surprising that, the expectation that the damage will be contained to the financial markets, to those sectors in the real economy that are highly leveraged, and to the secondary markets in equities, would keep recessionary trends at bay. This could be an explanation to the fact that, while prices of commercial bank, investment bank and insurance company shares fell sharply, the prices of refinery shares and other export oriented companies remained steady.

This is likely to be the key to understanding what is likely to happen in other economies, especially in South Asia and Southeast Asia. Two strands are visible. First, where there is exposure to all the stressed assets in the United States, either directly or indirectly, the values of the investors are likely to suffer. It is not surprising that, all the wealth funds who rushed to grab the stressed assets in the earlier part of the sub-prime crisis, have seen their investment values sharply eroded. China Investment Corporation had invested US$3 billion in Blackstone Group and lost 46 percent of its value on 12 September 2008. The shares of

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[1] There are reports today that the United States Fed would provide a loan of US$85 billion to bail out AIG, which would otherwise have to file for bankruptcy before the end of 17 September 2008.

Barclay's Bank have dropped by more than 62 percent since China Development Bank agreed in July 2007 to pay US$3.13 billion for 3.1 percent of the British bank. Temasek Holdings has a 14 percent stake in Merrill Lynch – it may actually gain in valuation after the merger, but the price is likely to fall as Bank of America share prices fall. The Government of Singapore Investment Corporation has invested heavily in Citigroup and UBS, and has seen the value of investments erode over the last year, and would have to sit back and wait some more time for returns. Further, wherever there is direct exposure to equities or assets by the institutions that have imploded, the asset values would naturally suffer. Lehman Brothers has over US$100 million invested in Indian equities, and as much in real estate, and one is likely to see these stressed. The impact of the distress of the investment banks and the financial institutions in these sectors and firms, through the world, is likely to be direct and quick. Finally, where there is external debt – Lehman Brothers owes a lot of money to Japanese banks – recovery would be more difficult, lowering the performance of the lenders portfolios. Carrying on, every time another financial institution in the United States is stressed, the impact would extend to all its investments and investors overseas, and this is a story that we are likely to witness several times in the next year, before it is fully played out.

The second and more interesting corollary is that most of the sovereign funds, including those of Abu Dhabi, Qatar and Kuwait, have scaled back their activity in the United States and European markets, and have already signaled that they are looking for opportunities in India, Southeast Asia and closer to home. For countries that have a strong domestic demand, need for funds for infrastructure, and a growing economy, it is possible that these developments may see greater inflow of investments. In the case of India, while foreign institutional investors may move out, it is possible that there may be greater opportunities for foreign direct investment, especially in sectors where value creation would be in the medium term-say three to five years. Good sectors, apart from real estate, would be power and energy, pharmaceuticals and light engineering, logistics and transportation. It is also likely that the financial markets would be more cautious and less volatile.

The distinct advantage of an economy where the commercial banks are largely government owned is that there is always a sovereign guarantee against run on banks. This is an advantage that both India and China enjoy. In India, in particular, the balance sheets of the banks are unusually healthy, with the write-off of all agricultural loans and recapitalisation by the government that has reduced non-performing assets to very low levels. In short, India looks to be an economy where the collateral damage caused by the financial crisis in the United States is likely to be limited in the financial markets, and extend only to some sectors in the economy that are directly linked with exposures in, or from the global markets. Given the underlying strengths in the economy, the crisis would be weathered fairly smoothly. Given that inflationary pressures are lower, one could expect the Reserve Bank of India now to push for growth by reducing interest rates, while still retaining a wary eye on inflation.

The short message is that there is no need to panic, and that there are adequate correctives in the system to ensure return to equilibrium. At the same time, the pain is not over, and there will be other banks that go down.

Stepping back, it is important to look at the future and relevance of investment banks vis-a-vis commercial banks. In the United States, the concerns over leveraging led to the separation of the two entities. Essentially, the investment banks were greater risk takers and, in retrospect, inadequately regulated. While credit creation was a legitimate portfolio of both, the latter had to abide by Central Bank standards of deposit ratios and credit reserve ratio.

The open leveraging of the investment banks has been a major source of the present crisis. The merger of Merrill Lynch and Bank of America is, therefore, but a partial solution, for the risks of the investment bank is now subsumed into a commercial bank, and it is expected that the share prices of Bank of America will fall significantly. The solution does not lie in categorising one arm as good or the other as bad, but in ensuring that both sectors are properly regulated. Transparency and accountability are the final touchstones of an open and competitive market. It appears important that, all Central Banks together, come up with norms for regulating investment banking, whether through institutions or hedge funds, and that these regulations are global, transparent and ensure accountability. In particular, individuals that led institutions to crisis must also be held accountable, and this means those fund managers and investment bankers, whose individual avarice has led these institutions to distress.

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