

Why has Financial Sector Become the Whipping Boy of the Market?

Following are excerpts from the paper presented by Prof. Poonam Kumar, Chairperson, Mega Ace Consultancy at the 19th World Congress on Total Quality 2009. The Theme of the Congress was "Leadership in the Economy of Surprise, Wrenching Changes and Contradictions". The Congress was jointly organized by the Institute of Directors (IOD) and the World Council for Corporate Governance from January 16-18 2009 in Mumbai.

It is indeed a great privilege to be here amongst all of you to share my thoughts on a subject of current significance. Why is the Financial Sector becoming the whipping boy of the market?

Is it to do with reforms.....more reforms, more regulations; more governance; more alignment of individual countries with global economy? Or is it the result of laissez-faire and does the market have a self-healing power? If the market cannot heal the wounds it sustains resulting from its own risky behavior, then it must be discouraged from taking such risks in the first place.

At a time when the global economy is facing a major downturn with financial problems causing economic activities to stall, dimming the outlook for global growth it is important to understand where the problems lie. Is it all about finance or can we also blame the monetary policy; low interest rates which boosted the price of assets, especially 'housing'.

Act of Managing Finance

Managing finance is an act of balancing several components in an economy. Matching labour to capital, allowing savers and borrowers to defer consumption or bring it forward, enabling people to share trade and absorb & manage risks.



Prof. Poonam Kumar, Chairperson, Mega Ace Consultancy, seen along with (L-R) Mr. Arun Hariharan, President, Reliance Capital Ltd., Mr. S.N. Shaherwalla, Managing Director, Bombay Mercantile Co-operative Bank Ltd., Dr. Madhav Mehra, President, World Council for Corporate Governance, UK and Mr. K. H. Mankad, Whole Time Director, Reliance Infrastructure. at the WCTQ 2009, 19th World Congress held from 16-18 January 2009 in Mumbai

Robust Policy Frameworks

The smarter a country's financial system is, the better it will perform its act. A poorly functioning system will end-up making gruesome mistakes. It will back wasteful schemes and shun worthy ones, trap people in the present, heap risk on them and slow economic growth. This characteristic of the system puts finance in a dilemma. The irony is that a sophisticated and innovative financial system is susceptible to destructive booms; whereas a simple, tightly regulated one will condemn an economy to grow slowly.

Right thinking policy makers and regulators around the world have been trying to anticipate economic performance and create policy frameworks. The tempting solution is to find a way to try to wriggle free from this inherent dilemma of finance. A compromise is a middle path solution that permits innovation but exerts just enough control to squeeze out financial failure. It is a nice ideal; but it is a fantasy. The experience of the past year is an objective lesson about the limited power of regulators.

Before the crisis, hedge funds were regarded with suspicion as vulnerable and irresponsible. But with a few notable exceptions, they have weathered the storm less as culprits than as victims. Instead, the system's own safety features turned out to be its weakest points.

Financial Crisis of 2008

The financial crisis of 2008 has snowballed into a global economic crisis in 2009, with consumer spending crippled, Asian exports collapsing and unemployment rising at an alarming rate. Hopes that fiscal stimulus measures will support global growth have not really had the desired impact due to the hard economic reality. Government spending plans and interest rate cuts can take a long time to fully heal the current economic crisis. It is widely believed that company earnings are likely to deteriorate further in early 2009.

Globally, banks alone have reported just under \$600 billion of credit-related losses and have raised some \$430 billion in new capital. The demise of the investment banks, with their far higher gearing, as well as deleveraging

MUMBAI, INDIA
January 17, 2009



among hedge funds and others in the shadow-banking system will add to a global credit contraction of many trillions of dollars. According to the Economist, the IMF's "base case" is that American and European banks will shed some \$10 trillion of assets, equivalent to 14.5% of their stock of bank credit in 2009. In America overall credit growth will slow to below 1%, down from a post-war annual average of 9%. That alone could drag Western economies' growth rates down by 1.5 percentage points. Without government action along the lines of America's \$700 billion bailout plan, the IMF reckons credit could shrink by 7.3% in America, 6.3% in Britain and 4.5% in the rest of Europe.

Effects on Global Economy

What will be the long-term effect of this mess on the global economy? Predicting the consequences of an unfinished crisis is perilous. But it is already clear that, even in the absence of a calamity, the direction of globalization will change. For the past two decades the growing integration of the world economy has coincided with the intellectual ascent of the Anglo-Saxon brand of free-market capitalism, with America as its cheerleader. The freeing of trade and capital flows and the deregulation of domestic industry and finance have both spurred globalization and come to symbolise it. Global integration, in large part, has been about the triumph of markets over governments.

The stock markets world over reflect the confidence of investors. The recent fluctuations of the stock markets and the substantial loss of capitalization shows the investors state of mind and their level of confidence and trust.

India's stock market is no exception and has lost 60% of its value in the year 2008. The Economist points out that foreign portfolio investors, who last year put in \$17.4 billion, are having a rethink and have started drawing out investments. The global financial freeze accelerated the currency's fall, putting pressure on the rupee. The rupee lost some 20% of its value against the dollar since January, when the market peaked.

Part of the problem was that Indian companies were unable to raise capital abroad and had to turn to Indian banks for money. To support the currency, the Reserve Bank of India (RBI), the central bank, has been selling up to \$2 billion a day from its foreign-exchange reserves, which have dropped by nearly \$63 billion from a high of \$316 billion at the end of May 2008.

Indian & Asian Scenario

India, like other countries of developing Asia which initially looked well positioned to weather the global crisis- has come under increased pressure. A recent Asian Development Bank study indicates that, as global investors scale back their emerging market assets amid

continued financial system de-leveraging, Asian equities and external funding conditions have been hurt. Despite the large build-up of foreign exchange reserves since the 1997/98 Asian financial crisis, foreign currency illiquidity is also testing the resilience of Asian banks with increasing spillover into domestic bank funding markets.

The study indicates that, should credit conditions tighten further, affecting key economic activities, the growth outlook for the region could be further damaged. The impacts of a major global downturn are also to be felt through trade channels. Weakening demand for manufactured goods in major industrial countries means declining export orders from Asia, with knock-on effects for industrial production. The ADB study points out that the effects of the worsening global outlook on India and other countries in developing Asia will reflect in:

- a) the drop-off in the growth of major industrialized countries;
- b) higher cost of capital;
- c) faltering consumer and business confidence; and
- d) for net exporters of commodities, the likely decline in the terms of trade.

Global Economy Uncertainty

The end of the global recession remains uncertain. The severity of this global slowdown makes it difficult to predict the future.

At a time when the crisis is far from over, there continues to be gaps in the system; lots of questions with few answers to sort the current problems. Though some relate to regulatory mechanisms others have more to do with individual businesses and individuals in business. Issues are more of attitude of people the world over. Financial greed and growing material aspirations of people are some of the reasons that result in such a scenario.

Changes in the attitude, ethical and transparent way of conducting business along with innovation and creative thinking would be able to help us find solutions to some of these problems. It leads us back to the point from where we started - the fine art of managing finance and its various components; enabling people to share trade and absorb & manage risks. It is important that that we return to supporting bankable, sustainable projects and nurture corporations and business with strong foundation that are well versed to be managing their risks.

It is not all about regulations but some basic ethics of conducting business focusing on the value that businesses generate for stakeholders.

Mumbai Office :
68-B, Mittal Tower,
Nariman Point
Mumbai 400 021, India
Tel: +91-22-22812298, 22815126
Fax: +91-22-22812305

London Office :
10, Middle Field,
St. Johns Wood,
London NW8 6NE, U.K.
Tel: +44 207 722 7176

www.mega-ace.com