



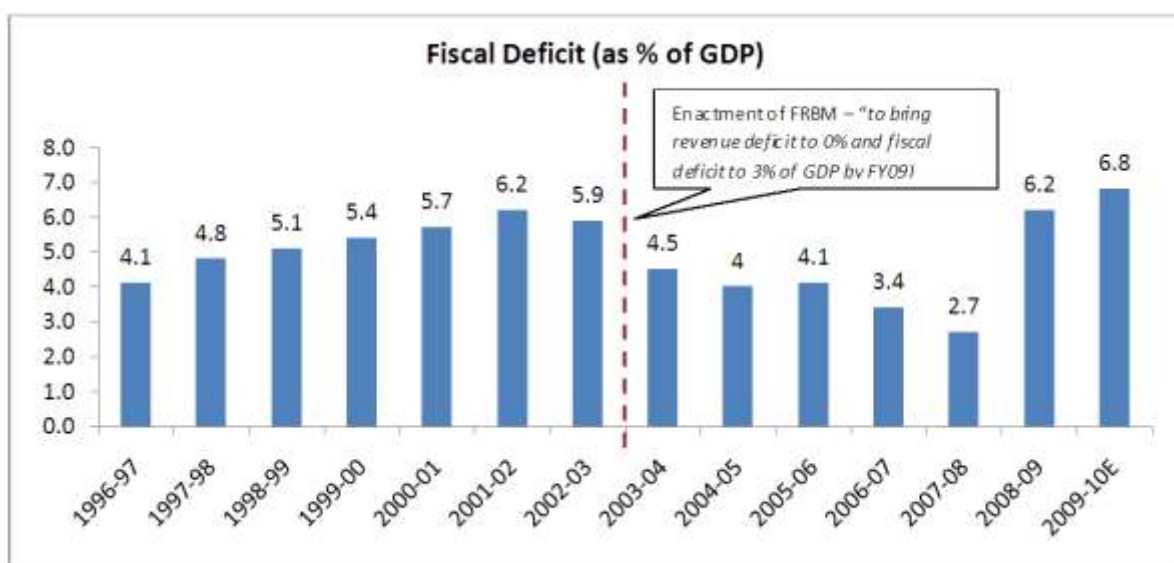
CENTRE STAGE

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A year after Lehman Brothers

The downfall of Lehman Brothers is now a part of Wall Street folklore: LB going bust was widely regarded as the epicentre of the global financial crisis and the economic meltdown that followed. The indications of the crisis were visible as early as Q2, 2007 with decrease in output growth, commodity price inflation and tightening of interest rates. Little did central banks all over the world knew that they would soon have to replace their monetary tightening policies with money infusion policies. A year after Lehman Brothers went down under, the atmosphere is still not investor friendly and retail investors are playing cautiously. Much of the revival that we have seen and hope to witness in the near future will be a result of the government stimulus in the economy which has led to dangerous levels of fiscal deficit as depicted in the graph below.



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The fiscal deficit trends points towards a V shaped economic revival and with the ongoing debates on whether the slowdown has bottomed out (so that the fiscal incentives can be gradually withdrawn), the worrying factor is that the V shaped revival might become a W shaped revival. We might have to witness a double dip recession in case the stimulus is withdrawn early. This calls for the same sense of timing by worldwide markets and governments as Wall Street was expecting a year ago in order to exit the toxic assets market just in time.

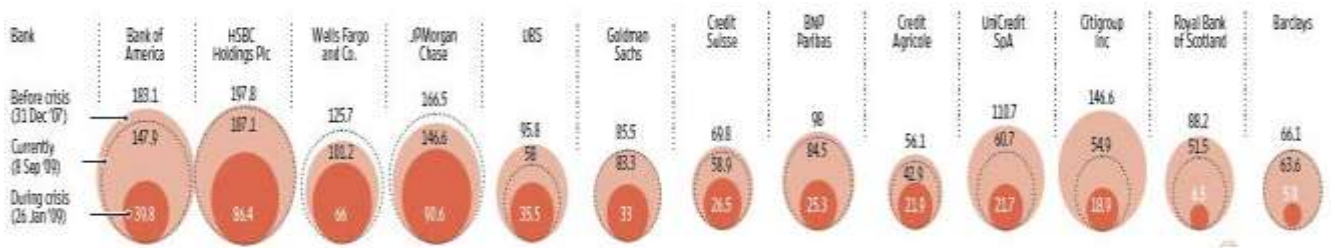
With no indications of US unemployment rates coming down (they currently stand at 9.4% in Aug'09) any time soon and with India and China leading world economies (thanks partly to their relatively conservative financial systems), there are murmurs of China replacing the US as the next super power and Yuan replacing the dollar as the global currency. India, though not too far behind China in terms of GDP growth, has till now effectively weathered the storm. The Gross Domestic Product is projected to grow to 6.5% this fiscal and many sectors are experiencing the revival phase. In Q1'09, electricity generation and mining were the best performers, growing by 6.2% and 7.9%, respectively, against 2.7% and 4.6% a year ago. Financing, insurance, real estate and business services also expanded to 8.1% against 6.9% a year ago. Construction was slightly down to 7.1% from 8.4% and community services to 6.8% from 8.2%. All these statistics point towards an upbeat mood in the economy in the times to come. The worst-hit sectors were trade, hotels, transport & communication. Together, these sectors posted 8.1% growth in the first quarter this fiscal compared to 13% a year ago. Manufacturing was down to 3.4% against 5.5% and agriculture to 2.4% versus 3%. The services sector, which accounts for more than 57% of the economy's output, grew an annual 7.8% in the first quarter, against 10.2% a year ago. ^[1]

Having said that, numbers are not always true indicators of growth. Just like the recent recovery in the secondary equity markets does not signal return of retail investor's confidence, a 6.5% growth might not be sustainable as this is largely due to the fiscal stimulus. Going by this trend, the growth next year could be back to 9% but that would be because of a lower base in '09-'10. Nevertheless, there are a lot of positives coming out of this crisis as far as banking regulations are concerned. Savings rate in the US have increased lately. Citibank has restructured its operations in the US and plans to loan only on credit cards and jumbo home loans. The credit for the real estate sector which led to the bubble might be tightened in India soon with the risk weight being increased to 125 % and banks required to keep Rs. 11.25 for every Rs.100 they lend in this sector. This could put a check on the possibility of the bubble developing again.

As can be seen below, the market capitalization of leading banks has returned to figures comparable to those before the crisis. ^[2]

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This definitely bodes well for the global economy as the credit markets will smoothen out and interest rates will ease out promoting investments. However, the crowding out effect cannot be ruled out as government spending continues. This will offset any possible decrease in interest rates. To ensure that this does not happen in India at least, it is important that the government does not finance the fiscal deficit from either the RBI or other nationalized banks. Disinvestment, changes in MAT and 3G auctioning should be the measures taken to fund the deficit instead.

Given all this, the crisis is far from over in the western economies and central banks need to learn their lessons in terms of levying stringent regulations on the Wall Street which till now was working sans regulations and took unnecessary risks. Q4'09 will reveal a much better picture of where the global economy actually stands and whether the crisis is really over. Prima facie, the efforts of the governments all over the world should be applauded for containing the effects of the crisis. A year post Lehman Brothers, a dream company for many to work for, will unfortunately remain a dream forever, but there is still some work to be done for the financial and economic system regulations before the next Lehman Brothers is born.

References:

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