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Words not enough

The Prime Minister was doubtless being both sincere and rational when he spoke over the week-end about the need to curb the ballooning subsidy bill, especially since much of the bill does not benefit the poor, in whose name many subsidy decisions are sought to be justified. All sensible people have called for such corrective action over the years, but there has been little by way of any response from the government. It is possible that, by speaking out at the jubilee celebrations of the Institute of Economic Growth, Manmohan Singh was trying to rally troops to the cause, just as budget-making has got under way in North Block. But such statements from the leader of the government do beg a question or two when the same government has been moving in the opposite direction from that being exhorted.

Oil prices, to take the obvious example of the moment, have climbed steadily over the months, but the government has not found it possible to raise retail prices even though petroleum products like petrol and cooking gas are consumed by people whom the government should not be subsidising. It might be argued that the Left will not allow a price increase and therefore the government can do little. But opposition comes not just from the Left, it has also come from the DMK (which at one stage did not want a price increase before elections in Tamil Nadu), and indeed from the Congress itself, perhaps because of elections in some other state. Dr Singh may be relatively new to the world of politics, but he has known for a long time that governments are hyper-sensitive about raising the prices of sensitive items. That is why his initial mistake of allowing Mani Shankar Aiyar, as petroleum minister, to bring oil prices back within the formal ambit of government decision-making, is so hard to understand.

The most egregious example of unwarranted subsidies being doled out is of course the under-pricing of spectrum, thus handing out thousands of crores of unearned benefits to telecom companies who are perfectly capable of bidding competitively for spectrum in an open auction. Indeed, at least one company has said it is willing to have such an auction. Surely, there is nothing here that prevents the government from doing the right thing.

These examples come with evidence of the government rolling back reforms. For instance, in its efforts to tackle the price problems faced by exporters on account of the rising rupee, the finance ministry has re-introduced pre-ordained interest rates that banks must observe when lending to specific sectors. And the frequent recourse to contingent liabilities, like the oil bonds and for re-capitalising the State Bank of India, is undermining the credibility of the fiscal deficit numbers. It would seem that in its eagerness to show that the deficit targets in the Fiscal Responsibility and Budget Management (FRBM) Act are being met, the government is willing to hide the full truth in the defective system of accounts that is called the Budget. Indeed, the buoyancy in tax revenues gives the government the required cushion to meet its liabilities in a straightforward manner, and have them included in the deficit numbers. So it is not enough for the Prime Minister to be conscious of what needs to be done. He also needs to be more assertive within his own government so that the right things do get done.

What, me worry?

Leading information technology stocks, which have been the darling of the Indian investing community, have fallen off their pedestals. They currently trade at a 30 per cent plus discount to their peaks. The prob-

they suddenly shoot up; that growth does not last, but the boys go on to become robust youngsters.

The IT leaders can look forward to a bright future because of the steps they have taken and will continue to do in

Illustration by BINAY SINHA

Another Great Depression?

THE CREDIT MARKET CRISIS - I / DEEPAK LAL

There are ominous parallels between the US of the 1920s and today. A Gilded Age, with a boom in house prices and the stock market, followed by a threat of bank collapses associated with a softening in the housing market, pressure on the dollar and a rise in protectionist and isolationist sentiments. Are we on the verge of another Great Depression?

The origins of the current crisis in credit markets lie in the "Greenspan put" after the stock market dotcom crash in 2000 and the terrorist attacks of September 2001. The low interest rates led to booming property prices and the accompanying financial innovations — the proximate cause of the current crisis. Structural changes in the financial system have also contributed. These entailed the conversion or absorption of non-bank financial institutions specialising in financing mortgages [savings and loan (S&L) associations in the US and building societies in the UK] by commercial clearing banks, which in turn had absorbed or taken on the roles of specialised investment banks. The effect was to blur the distinction between what were previously non-bank financial institutions and banks. This distinction is important because it is only clearing banks which can add to (or reduce) the stock of money.

A clearing bank holds deposits in cash (legal tender base money) from non-banks, repaying deposits in notes, and making payments for depositors by settlements in cash through an account in the central bank. When a clearing bank extends a loan it adds to its assets and simultaneously creates deposit liabilities against itself, increasing the broad money supply at "the stroke of a pen". This ability to create money "out of thin air" is limited by the bank's capital and cash. As cash can be borrowed from the central bank, the ultimate constraint on its ability to create money is its capital. But it is only because banks take in cash deposits —Keynes' "widow's cruse" — that they can create money.

By contrast, a non-bank financial intermediary, say, a mortgage lender, when it takes deposits or makes a mortgage loan has to "clear" these through deposits held at the clearing banks. Thus when someone deposits "cash" at an S&L this comes out of the depositor's bank account with a clearing bank. Similarly when the S&L makes a loan to a mortgagee this comes from the S&L's bank account with a clearing bank.

Thus the essential difference between non-bank financial institutions and clearing banks is that they cannot create the bank deposit component of broad money (M2 or M4).

With the blurring of the historical and institutional distinction between mortgage lenders, investment banking and clearing banks, and the loosening of monetary policy following the "Greenspan put" which led to large increase in house prices, bank absorbed mortgage lenders went on a lending spree. In California they were in caravan parks extending loans to the *ninja* (those with no income, no job, no assets) at low 2-year teaser rates which even members of the "underclass" could pay with the high hope of getting enough equity in their new homes with rising house prices to sell before the teaser rate ended. These sub-prime loans were then repackaged by the financial wizards in the investment banking parts of the clearing banks into opaque financial products which were then sold off to financial institutions and other banks around the world. This Ponzi scheme depended upon a continued rise in house prices.

With the softening of the US housing market with monetary tightening in 2006-07 , the Ponzi scheme collapsed. The *ninja* could no longer pay and walked away from their sub-prime mortgages. This in itself would not have mattered. The *ninja* never expected to own a home and some probably got out with some equity from sales before the housing market collapsed. If the sub-prime assets had been held by the specialist S&L of yore, their shareholders would have taken the necessary hit. But the financial "masters of the universe" had packaged them with various other financial assets, and these were now spread through the world financial system. It was like a piece of infected meat having been processed with healthy meat into infected meat pies which could not be distinguished from the wholesome. Many of these infected meat pies were held in off balance sheet structured investment vehicles (SIVs) by the banks.

When credit market conditions tightened in May and the sub-prime mortgage market collapsed, the opacity of many of the financial assets in these SIVs meant that they could not be sold on, and had to be taken on to the bank's balance sheets. To balance their books the banks had to find liabilities to balance these new found assets. The liabilities of banks' comprise their shareholder capital and deposits. With their share prices falling and economies slowing, capital is hard to get, except for those like Citigroup and UBS able to "touch" rich emerging market investors.

The final element in the crisis is Basle II, under which banks are required to maintain a capital ratio of 8 per cent (of assets). With limited hope of raising capital this cannot be done without cutting back on their lending, and thence a contraction in the broad money supply — the major cause of the Great Depression. Central Banks have tried to avert this by the coordinated addition of massive liquidity into credit markets. This has failed to increase inter-bank lending or to substantially reduce the spread of LIBOR over their lowered discount rates. The banks are still hoarding cash and refusing to lend to each other. Their problem is to continue achieve the Basle II capital ratios, which they cannot do without a massive contraction in lending and thence broad money. As many commentators are now urging, and as the Bank of England has hinted, these Basle requirements are likely to go soon, alleviating the credit crisis of Western banks. This should avoid another Great Depression. The long-term implications flowing from this "cure" will be discussed in my next column.