

Speech Given By Mr. Maneesh Kumar To Rotary Club, Mumbai On January 17, 2009



None of us know where the bottom in the market is. But what we do know is that the present crisis was mainly due to the subprime crisis.

The declaration of the Summit of G-20 leaders on “financial Markets & the World Economy” in November tried to summarize the root cause of the current crisis as follows:

“During a period of strong global growth, growing capital flows, and prolonged stability earlier this decade, market participants sought higher yields without an adequate appreciation of the risks & failed to exercise proper due diligence. At the same time, weak underwriting standards, unsound risk management practices, increasingly complex & opaque financial products, & consequent excessive leverage combined to create vulnerabilities in the system. Policy-makers, regulators and supervisors, in some advanced countries, did not adequately appreciate & address the risks building up in the financial markets, keep pace with financial innovation, or take into account the systemic ramifications of domestic regulatory actions.”

We can go further back in time but let’s start with the sub-prime crisis. As Nassim Taleb would put it, a Black Swan Event.

What it was was, leverage on leverage on leverage.

Once prices of homes stopped going up, homeowners couldn't refinance any more. Their incomes weren't rising, their spending wasn't going down so, homeowners started defaulting. Let's flip this scenario around – lenders to these homeowners weren't keeping these loans on their books, they were bundling these in baskets getting rating agencies to rate them & re-selling them. As defaults grew, mark to market losses in these bundles grew as well. This started a spiral that ended up wiping out huge amounts from balance sheets of investment banks all over the world. Some got wiped out, some got taken over by other banks & some got taken over by the government. Yet others were mandated to convert to bank holding companies. In the end, it was mayhem, it was chaos, it was murder!

The only entity that could have started the healing process was the government. Even for that Henry Paulson had to get down to his knees. The earlier monies had to go toward re-capitalization of these ailing companies. The latest news out of U.S. is that the \$ 775 B will go toward paying mortgages of people so earlier, the monies went toward the mortgage giver, now, it is to the mortgage taker.

The fact that balance sheets of companies got wiped out along with the correction in the financial markets, created an unprecedented credit squeeze in the U.S., banks couldn't lend anymore, corporate couldn't expand any more & a lot of them could not even continue at the same pace as before – the result mass layoffs thus raising the unemployment rates.

Because the U.S. & European economies slowed down to such an extent, imports slowed down tremendously & hence all **economies exporting to the U.S. got hurt**. Secondly, since there was a crying & a dying need to re-capitalize companies at home for the U.S., **FII monies also flew out of economies** all over the world which further hurt these economies. This also explains the interim strengthening of the dollar vis-à-vis other currencies.

What is happening now?

Appr. \$ 3Tr of dollars is spoken for in the U.S. economies which is appr. 20% of the U.S. GDP. With this amount of money floating around in the system, what is bound to happen? The **dollar is bound to weaken** but by how much? Not as much as most experts think – Why? Because, other countries too are both monetarily & fiscally loose. China announced over a \$ 600B fiscal stimulus, Japan announced their biggest budget ever, Taiwan, India, Europe – all have loosened their purse strings. What this will do is buttress the fall of dollar. What else may happen? It will cause first **some degree of deflation followed by massive inflation**. Which asset class benefits the most when there is this amount of cheap money floating around in the system? – Hard assets, i.e. **Gold**. Inflation will also be caused because a bulk of world oil trade is done in which currency – U.S. dollars. Therefore, oil prices will rise for other countries - This too will cause deflation/inflation

What happens to India?

Since oil is priced in dollars, oil prices is likely to go up. At the same time, official estimates are still suggesting growth in the range of 5-7% in the next 2-3 yrs, therefore once we get over the next few months when due to the high base effect, we may even feel that we are experiencing deflation, we'll be racing toward inflation – hence gold will be a great asset class to be in. However, if Rupee appreciates vis-à-vis the dollar, buying gold in rupees may not be wise. Secondly, since India too has made its intentions clear that it'll embark on massive fiscal stimulus along with monetary easing, economy WILL recover. Expectations are that this could happen by 3rd quarter of 09-10. Stock market precedes economies by a few months so, by second quarter of this yr, equity markets could start to recover. But, gazing into a crystal ball is difficult – hence, we're recommending investing in stock markets through SIP & STPs.

For U.S., a possible solution for it is to export its way out of trouble. However, observing its Balance of Payments, its competitive edge is in mining, agri & hi-tech including arms & ammunition. It'll therefore have to look at avenues to increase exports in these

industries. Also, China, being primarily an export oriented economy can thrive if it continues to export at a robust level. But in normal times, it is a different matter. Now, U.S. could embark on a protectionist approach possibly based on non-compliance of environmental & quality standards.