SAJTH, January 2015, Vol. 8, No. 1

Global Financial Crisis and Impact Assessment on Service Sector

KIRAN RAJ KUMAWAT* and RITIKA MOOLCHANDANI**

*Kiran Raj Kumawat, Research Scholar Commerce, Bhagwant University, Ajmer
**Ritika Moolchandani, Research Scholar Commerce, M.D.S. University, Ajmer

ABSTRACT

The subprime crisis has spread rapidly in unanticipated ways and is wreaking havoc at the core of the global financial system. As a result, the global expansion is losing momentum and fears are mounting about global recession. The last few months have seen a dramatic shift in the global macroeconomic environment. The intensification of global crisis and its contagion effect have constricted the supply of credit and have led to a significant cut in the growth forecast particularly in developed economies. The last few months have therefore seen an extraordinary heavy dose of fiscal stimulus packages and pumping of large sums of money into the system at reduced interest rates. Attempts are also being made to coordinate the monetary policy action of different countries. Today, the global financial system is under increasing strain and risks to financial stability remains imminent. The recent global financial turmoil has been caused essentially by three factors. The first is the US subprime crisis, the second is the rising oil prices and the third is inflation. The three challenges have obviously certain interlink ages as well. The monetary and fiscal policies of various economies have to address these challenges through long-term strategies. This has clearly reflected a combination of three outcomes: weakening balance sheet of financial institutions, continuous falls in the asset price and the weakening global growth. The International Monetary fund and OECD warned about the crisis and threatening stagflation in the financial system and the required measures to be taken to shore up investors confidence.

Keywords : *Financial Crisis; Indian Economy; Impact Assessment: Service Sector*

Introduction:

For the past two years, global economies have been in turbulence. The main reason is the most infamous case of the subprime crisis in the US. This has resulted in huge losses for major investment bankers, and in the process, caused liquidity and credit crunch globally.

The crisis begin eight months ago in US high risk , subprime home loan market and has spread into a global credit squeeze, dragging down world growth . While the US became the focal point, financial institutions in other countries have also been affected, reflecting the unreliable global financial conditions and weaknesses in risk management system and prudential previsions.

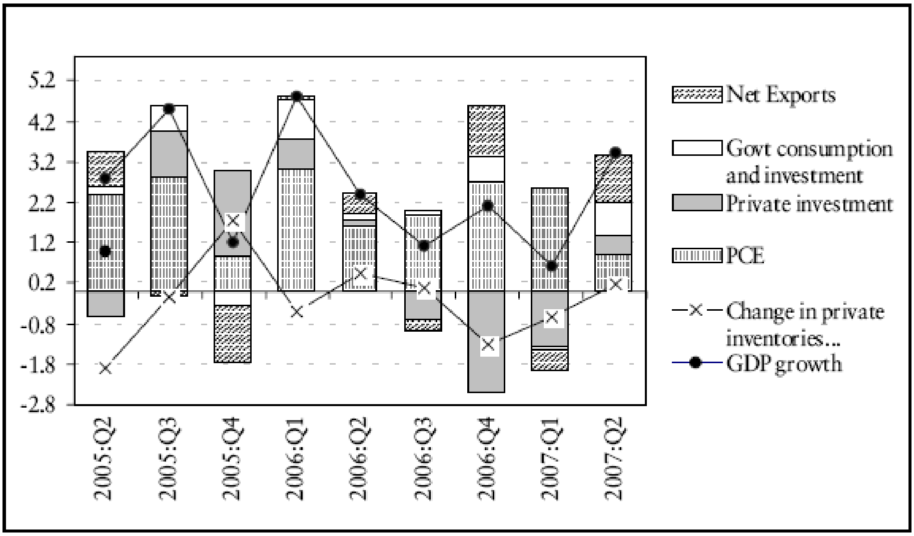
However, rising fuel and food prices have also added fuel to the fire. These conditions would probably have limited direct effect on India, but the implication for global demand could result in a moderation in exports. Moreover, heightened risk aversion could also impact pricing of assets. The global increase in commodity prices has been widely attributed to the inequality between physical demand and supply. Tremendous growth in emerging markets like India and China has lead to demand for oil. The economic boom has led to higher consumption globally. This imbalance between demand and supply and the financial market changes also have played a part in fuelling the commodity price boom.

The subprime crisis, fuel and food prices have been literally causing havoc with inflation, interest rates and liquidity. The collapse of the embattled and illiquid bear sterns, the fifth largest US investment bank, mark the moment and the global financial crisis went critical. It looks like that there is no end in sight to the havoc as the US Federal Reserve and the treasury department are no closer to solve the mess. Deepening financial distress in the United States has affected even the most basic financial intermediation, with US authorities currently making great efforts to restore fully functioning markets. Global GDP Growth is estimated at 4.9% in 2007 slightly below 5% in 2006; even as developing countries grew by a strong 7.9% , developed economies slowed to a record at 2.7% growth from 3% in 2006 as the US growth slowed to 2.2% from 2.9%. Since the latter half of year 2007, global growth has been challenged by turbulent financial market condition with the US subprime crisis continuing to unfold; global credit market conditions deteriorated sharply since late July as a reprising of credit risk sparked increased volatility and a broad loss of market liquidity. Growing uncertainty about the amount and distribution of associated valuation losses and concerns about the off – balance sheet exposure of financial institutions have added to the concern. In developed markets there has been a consequent drying up of high-yield corporate bond issues, a sharp contraction in the asset- backed commercial paper market, disruptions of liquidity in the interbank market, stress on institutions funded through short-term money market and falling yields on government papers. Emerging markets have also witnessed widening sovereign spreads, highly volatile stock markets and capital flows. Emerging market countries have also faced strong foreign exchange inflows through both current and capital accounts, reflected in exchange rate appreciations and rapid accumulation of international reserves that has driven strong domestic credit growth and posed challenges for their central banks. Thankfully in high-income countries, an inflationary pressure was sufficiently under control during 2007 to allow central banks to end a period of monetary tightening. Escalating food and oil prices have, however, contributed to heightened pressures, particularly in a number of emerging markets and developing countries with strong growth of domestic demand and higher weights of food in the consumer price index.

Deficit spending by the US households has supported the US economy for over 10 years, may be no longer, as the pace of deficit spending is retarding with home price deflation setting in. Also, with the credit crunch in place, there could be severe curtailment of the household credit growth, a sure recipe for economic recession. In recent years, the United States has been more a source of global instability than a source of global problem- solving. Example includes the war in Iraq, launched by US on false premises; obstructionism on efforts to curb climate change, violation of international treaties such as Geneva Conventions, etc. In United States of America, the government is not relenting in its efforts to rescue the troubled financial sector.

A fortnight ago, the Federal Reserve Bank, injected $85 billion into American International Group, AIG. Under the deal, the government will get a 79.9 % stake in AIG, one of the world's largest risk firms. The problems of AIG stemmed from its insurance of mortgage- backed securities and other risky debts against defaults. But financial analyst fears that if AIG could pay back the already soured debts, the consequences would pose a greater threat to the United States financial system.

CHART G. 1.1
US GDP Growth (qoq, saar) and Contributions to Growth (per cent)



Source: BEA, US Department of Commerce.

Impact on Developing Nations:

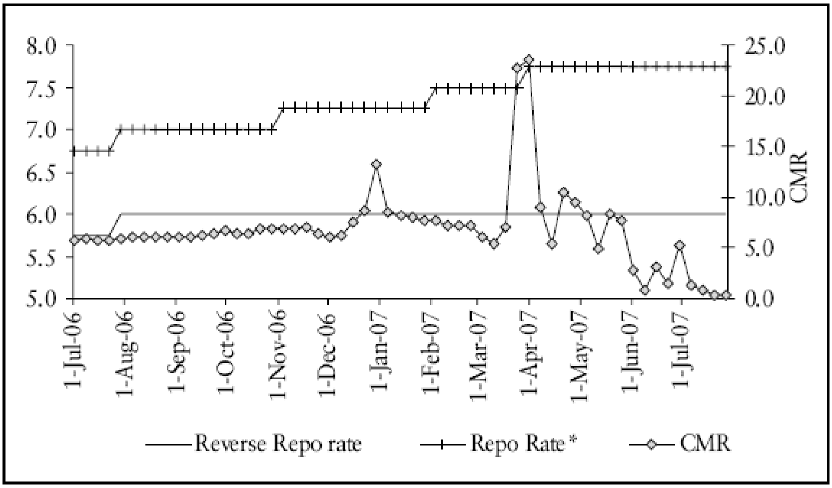
India and China are two large economies in the world where growth rate are expected to continue at above 7–7.5% in the near to medium term. This is because the fundamental demand drives are expected to continue because of a growing young population and infrastructure requirements .It is not expected that these countries will slip into depression anytime in the near future. At the same time, one needs to be careful about asset bubbles and their cascading effects. Valuation of assets is another area where one needs to be aligned to realities rather than go purely by mathematical models or other premises.

In today's globalized world, it is unlikely that any country will be untouched by what is going on elsewhere in some manner of the other. But as long as fundamental demand drives are strong, growth will continue. Currently, despite increasing interest rates, credit growth is still going strong at 26% in India, higher than in the corresponding period for the last year. Also, the exposure of Indian companies to the entities which are in difficulty elsewhere is not significant; hence the direct impact of the global crunch will be limited.

Financial markets in India:

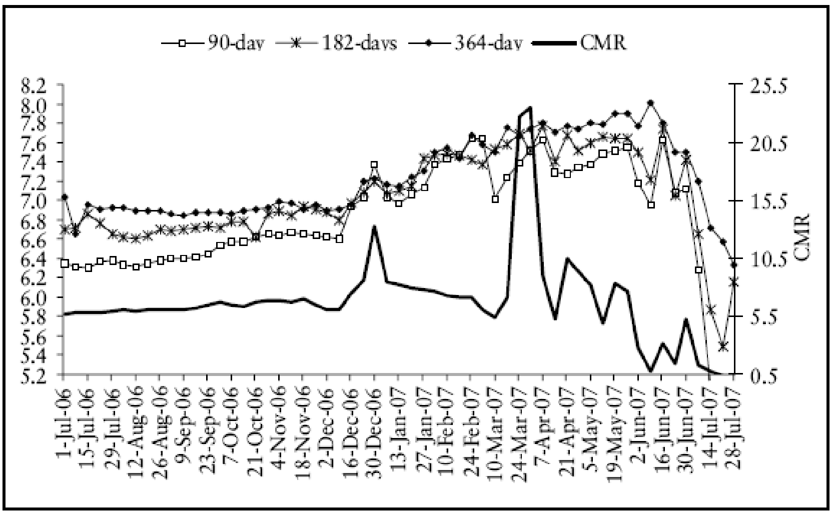
The Indian economy is projected to grow at 8.7% in 2007-08, making a deceleration from the high growth of 9.4% and 9.6% achieved in the previous two years. The slowdown in 2007-08 is generally spread across most of the sectors except electricity, community services and the composite category trade, hotels, transport & communication. Manufacturing and construction, which grew at 12 % in 200-07, is estimated to have decelerated to 9.4 and 9.6% in 2007-08. Cement and steel , the key inputs into construction, grew by 7.4 % and 6.5% respectively, during April-November 2007-08, down from 10.8% and 11.2 5 in the previous year, dampening growth in the construction sector; the infrastructure sector recorded a growth of 6% compared with 8.9% a year ago, while the services sector continued to record double-digit growth (10.5). The temporal decline in the share of the agriculture sector in GDP continued, with a decline from 24% in 2001-02 to 17.5% by 2007-08. On the demand side, private consumption is estimated to have grown by 6 % in 2007-08 as compared with 7.1% in 2006-07, taking its share in GDP 1% point lower in this fiscal year. Growth of GFCF has increased to 15.7% in 2007-08 from 15.1% earlier, taking its share in GDP to 32.6%. IIP grew by 8.7% during April – January 2007-08 as compared with 11.2% during April – January 2006-07 as the manufacturing sector registered a slower growth of 9.2% compared with 12.1 % recorded during the corresponding period of the previous year. The declaration in consumer durables was the most important factor in the slowdown of manufacturing. Consumer goods production slowed growth from 9.7% in April-January 2006-07 to 5.9% in the same period this fiscal as consumer durables showed a 1.7% declaration. Merchandise exports posted a growth rate of around 22 % during April January 2007-08, moderating from a growth rate of 32.2% over the same period of 2006-07. Growth in imports at 29.6% was also lower than that 37.5 % recorded in 2006-07. Overall, the merchandise trade deficit widened to $67.4bln in April-January 2007-08 from $45.7 bln in the previous year. The country's foreign exchange reserves have gone up to $309.16 bln in end march 2008, higher by $109.98 bln as compared with end march 2007. WPI inflation declined gradually from April 2007 onwards to reach 3.6% in December 2007. However, the trend reversed northwards and the annual rate of inflation stood at a high of 7.14% at end march, compared with 5.94% a year ago. The commodity composition of the main drivers of inflation in recent months indicates that domestic inflation has been affected by global commodity price changes (metals, mineral oils, edible oils and food items), domestic supply shortfalls (edible oils and food) and a buoyant demand (machinery, chemicals and cement).

CHART F.1
CMR and RBI's Fixed Reverse Repo and Repo Rates



Source: Cygnus search Dec 2008

CHART F.2
CMR and T-bill Yields



The chart is based on six-day weeks.

Source: Cygnus search Dec 2008

Weathering the Storm

IT Companies which are dependent on financial services firms in the US and elsewhere are feeling the aftershocks of the Wall Street. Call it collateral damage or a bolt from the blue. The fact is that the US financial meltdown will have a long, lasting and potentially damaging impact on the $ 50 billion Indian Industry. Companies that bet heavily on banking and financial services tasks will find no place to hide while others would be pressed hard to look at non banking verticals to keep the business asloat. That we are in for tough times can be gauged from Nasscom's downward revision of growth forecast for the sector and also from the fact that about 30-35% of the work Indian majors do is related to the beleaguered banking and financial services domain.

In fact, fiscal 2009-10 will be critical year for Indian IT companies. While there might be some companies which can absorb the shock, many small IT companies which pin on one or two clients might not be able to sail through. Analyst predict that the after effects of the subprime crisis of 2007 and the wall street meltdown will continue through 2009 till 2010 , when financial measures will become stable. Till then, we might see salary cuts, single digit hikes, unoptimised employee layoffs and flattish sequential growth all through 2008 till mid FY 2010 "Derisking their investment portfolios from the dollar should be the immediate concern of Indian IT majors right now. They should also come out into open and give their revised guidance rather than putting up a brave face in front of the shareholders all the time.

Source: Cygnus search Dec 2008

The Dollar Factor

When the rupee played hardball with operating profit margins of many IT companies last year, they took a different call. The Indian IT majors had started concentrating on markets like UK and Europe after burning their fingers in the severe dollar depreciation last year. But now the Europe foray strategy seems to be falling. With a global financial downturn the pound and the Euro have also fallen against the dollar. The reason behind this is panic selling by FIIs (Foreign Institutional Investors) as they lose confidence in the global markets. The panic selling on large European exchanges like the London and Frankfurt has resulted in demand for the dollar against the pound and the Euro. This has resulted in a sharp fall in the value of those currencies leading to a decline in operating profit margins of IT companies exposed to pound or euro revenue. Similar to a fall in pound and euro against the dollar, the rupee has also seen a sharp fall because of the fall in Sensex from above 20,000 levels last October to around 13000 now. For example tech Mahindra has a major dependence on one client – British telecom. Almost 72%

of Tech Mahindra's revenue comes from Europe. HCL technologies have about 30% exposure to UK and Europe revenue. Infosys and Wipro, however, have 27% and 245 exposures to Europe revenue, respectively. As new organizational structures of the i-Banks emerge, the IT sector might start seeing renegotiation of contracts and vendor consolidation. The regeneration will be at lower price but volumes might grow suddenly for one vendor and might vanish for another.

There are several strategies that companies can adopt in such times. For instance, companies which have forayed into the domestic IT market will be at an advantage. Moreover, Investment surplus economies like Russia and West Africa will be attractive destination to make revenue portfolios risk free. Asia Pacific economies like China, Singapore, Indonesia, Malaysian and the Philippines are other good sources of revenue steady clients. But it could take anywhere between 18 and 24 months for businesses to stabilize. Companies which are capable of rejigging their portfolios and making the right bets on new businesses will see their strategies paying off. For others, there may be little option but to shut shop.

Riding on the back of brisk growth in the global economy since 2002, India's exports have witnessed a phenomenal three fold rise during the period 2002-03 and 2007-08. This powerful dynamo for employment generation is now threatened by the liquidity crunch and declining global demand. India needs to properly manage the fallout from the current global slowdown on its export sector in order to limit adverse consequences for the employment situation.

A quick analysis by Unctad-India shows that a 10% decline in overall export of goods from the 2006-07 level would result in a direct and indirect loss in employment of 2.2 million man years. In order to sustain the export momentum and job losses, the central government has finalized an economic stimulus package comprising measures aimed at easing the liquidity crunch and providing enhanced incentives to exporters. In order to sustain the export momentum and contain job losses, the central government has finalized an economic stimulus package comprising measures aimed at easing the liquidity crunch and providing enhanced incentives to exporters. While these measures may provide some relief to exporters, the present crisis should be used as an opportunity to address more deep seated problems by adopting suitable mitigation strategies for sustaining the export growth in the long term. Despite targeted efforts by the Government for seeking new markets for India's exports, the EU and US continue to be the main destination of India. Although markets will likely spend much of the coming year wallowing in a broad trading range, few macro themes will still dictate underlying trend.

As the New Year approaches, investors across the world are feeling like locusts in a dessert. After getting used to picking off a feast, there are currently no asset classes that offer may obvious appeal.

In many parts of the marketplace valuation and sentiments do seem quite depressed. But that largely pertains to risky assets and with global economy entering its worst growth spell since the great depression, its hard to make a universal case for being long risk. On the flip side, government bonds and companies with a relatively steady earnings stream – mainly in the consumer staples and healthcare sector – offer greater safety but valuations in this space have been stretched to the extent that there's talk of "risk averse" assets falling victim to the next bubble.

Not surprisingly, then, markets are stuck in a tight trading range. And this tug of war between deteriorating economic fundamentals on the one side and oversold markets with low valuations and hyperactive policy action on the other will likely continue for much of 2009. Patience is the key in such an environment as there could be many false dawns and misleading breakdowns.

A major take away from the 1930's experience is that there is nothing wrong in husbanding cash in a deflationary world. In a piece of telling research, Birinyi Associates estimates that a dollar invested in the US stock market in 1966 would be worth only $1.11 today if you missed the best five trading days during entire period. But if you avoided the worst five days, the dollar would be worth $2696 – emphasizing the point that the first rule of investing is not to lose money. Still, even in a broadly sideways market, it's important to have a fix on the few themes that will prove to be enduring and serve as the fundamental backdrop for making investment decisions in the year ahead.

The sluggishness in the west will increase the relative appeal of investing in emerging markets. This is in contrast to the 1980s and 90s when the US was growing at the robust 3% - nearly as fast as developing world- and looked at much risky. Furthermore, emerging markets are currently trading at 25% discount to the developed world on the most valuation matrices. While it will be hard for emerging markets to completely free themselves of the US market's ball-and-chain, this asset class should overtime deliver higher returns as has been the case over past 5 to 10 years despite the higher daily and weekly correlations .

A secular bear market in commodities: it's amazing to see how many financial analyst are still consumed by the myth that commodity prices are in a secular uptrend due to the continued industrialization of emerging market economies such as China and India. They are forgetting lessons from history. Commodity prices decline over the long term as the cost of production falls with better technology, increase automation and greater economies of scale. Although they oscillate wildly around their long term trend line, the broad direction is unmistakably down.

After overshooting in the late 1970s, commodity prices steadily fell through the 1980s and 90s even though global growth remain robust through those two decades. As the 2003-07 credit bubble artificially inflated growth across the world to well above trend level, commodity prices surged but are not quickly reverting to their long term mean. They have no justification for trading above their marginal cost of production and in times of distress, the prices fall well below the cash cost of production. All of this suggests that price of commodities from oil to copper are going back to levels that prevailed prior to the 2003-07 boom. One clear implication is that the prices of oil over the next couple of years is most likely to average closer to $30 a Barrell rather than consensus price of $60/bbl factored into estimated future earnings for oil related companies.

A mix of value and quality at a reasonable price should outperform: the dispersion in valuation – defined as the gap between the highest and lowest price stock – is currently at near record levels. Ordinarily that would suggest it is time to blindly buy the lowly valued equities and sell relatively richly price stock, typically in the defensive stocks. But the problem is that the cheap stuff is mostly in troubled sector such as financials. It's hard to see such stocks outperforming unless the bear market regime comes to an end.

However, there will be a limit to the dollar’s decline . The deflation of the credit bubble is a global phenomenon and almost all countries around the world are in an aggressive easing mode it's just that the US is ahead of the curve. But expect other central banks to soon enough engage in the similar accommodative policy framework as the US, which inturn should limit any downside for the dollar. The dollar is unlikely to make fresh record lows against major currency.

Conclusion

India witnessed an unprecedented growth ever since liberalization, almost close to two decades. It took a long way marching towards capitalistic spell of growth; currently it is witnessing a downturn. The inadequate regulations, lack of transparency, accounting violations, highly levered debts, huge off balance sheet exposures and huge employee perks were some of the major issues that are listed to be reasons for the existing mess. Thanks to our policy maker, for the paced and cautious reforms indeed gave us some breathing time to modernize financial sector reforms, but for which the effect could have been lethal. Though, these paper losses, the RBI believes that banks are well capitalized and can easily take the punch. Overall Indian banking system is sound, well regulated and can continue to provide credit to all sectors of the economy.

On one hand, the crude becoming cheaper, there is great sigh of relief now. As a cost cutting strategy, American Inc. may still focus to outsource its operations to India, could be an added advantage to us. The fall in the cost of oil, steel, machinery, and commodities can boost further infrastructure, all these opportunities can be well capitalized with our inflationary pressure. The government of India and the RBI has been very vigilant and has monitored and tackled the scenarios with appropriate measures very quickly. During the times of excess of liquidity, when markets were flooded with foreign currency, the RBI monitored the situation thoroughly and tightened the liquidity by increasing the CRR or hiking repo rates or increasing risk weighs to real sectors to avoid real asset bubble. The ability to predict and being pro active have been the traits of our regulators. It is expected that I will continue to infuse confidence in the investors and take appropriate measures. In the current scenario, India Inc. will definitely show its great resilience in turbulent conditions and use this as opportunity to strengthen its infrastructure; bolster by sturdy indigenous demand will move out of this mess and let's hope it will use this opportunity to exhibit all its intellectual talent to the world.

References

1. Reshma Nasereen and Y. P. Singh, Corporate governance Policy Perspectives First edition 2007 The ICFAI university press, Corporate governance: Focus on Functional Areas pg. 1, 2.
2. Reshma Nasereen and Y P Singh, Corporate governance Policy Perspectives First edition 2007 The ICFAI university press, Corporate governance: Focus on Functional Areas pg. 30, 31.
3. Reshma Nasereen and Y P Singh, Corporate governance Policy Perspectives First edition 2007 The ICFAI university press, Corporate governance: Focus on Functional Areas pg. 27.
4. Pain and Karmakar, Nirbachita and Asis Kumar, Corporate Governance and Sarbanes Oxley Act, Act An Introduction pg. 13, 14.
5. www.encycogov.com, Mathiesen [2002]
6. B. K. Kulkarni, "Corporate Governance and Social Onus." Financial express. August 1998, Business ethics and corporate governance, December 2003,. The ICFAI University press, Corporate governance: An Overview. pg 192
7. Iti Bose, Corporate governance Policy Perspectives First edition 2007 The ICFAI university press, Corporate governance: Focus on Functional Areas pg. 231, 232.
8. B.K. Kulkarni, "Corporate Governance and Social Onus." Financial express. August 1998, Business ethics and corporate governance, December 2003. The ICFAI University press, Corporate governance: An Overview. pg 187
9. www.indiajuris.com/presentations/CG.ppt
10. Reshma Nasereen and Y P Singh, Corporate governance Policy Perspectives First edition 2007 The ICFAI university press, Corporate governance: Focus on Functional Areas pg. 30, 31.

11. Iti Bose, Corporate governance Policy Perspectives First edition 2007 The ICFAI university press, corporate governance: Focus on Functional Areas pg. 233.
12. B. K. Kulkarni, "Corporate Governance and Social Onus." Financial express. August 1998, Business ethics and corporate governance, December 2003, The ICFAI University press, Corporate governance: An Overview. pg 217.
13. John, Kose and Senbet, W. Lemma (1998): Corporate Governance and Board Effectiveness; Journal of banking and Finance, (371-403).
14. Summary of Sarbanese Oxley Act of 2002, AICPA, http//www.aicpa.org/info/sarbanesoxleysummary.html.
15. Aggarwal, Rajesh & Andrew Samwick, 1999. Executive Compensation, Strategic Competition, and Relative Performance evaluation: Theory and evidence. Journal of Finance. 54: 1999-2043.
16. The Enron crisis: The AICPA, The Profession & Public Interest, http://www.Aicpa.org/info/regulation02.html
17. Pain and Karmakar, Nirbachita and Asis kumar, Corporate Governance and Sarbanes Oxley Act, Act an Introduction pg. 13, 14.
18. J. Wolfensohn, President of the World Bank, as quoted by an article in financial times, June 21, 1999.
19. The journal of finance, Shielfer and Vishny.(1997, page 737)
20. "Auditor Size and Audit Quality "Journal of Accounting and Economics, Vol. 3 (December), pp. 183- 199.
21. The CPA Journal; January 2005 http://nysscpa.org/printversions/cpag/2005/105/p. 26.html
22. The CPA Journal; January 2005 http://nysscpa.org/printversions/cpag/2005/105/p. 26. html
23. B. K. Kulkarni, "Corporate Governance and Social Onus." Financial express. August 1998, Business ethics and corporate governance, December 2003, The ICFAI University press, corporate governance: An Overview. pg 190.
24. Surendra Kumar, Corporate Governance: The Question of Ethics. Galgotia Publishing Company. First Edition, 2000 Pg. No. 91-103
25. "Corporate governance issues hamper emerging markets." Financial Express. November 1999.