AMERICAN MELTDOWN

Of Misconception and Panic

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There is hardly any valid reason to get worried due to collapse of the share markets. The immediate reason is huge losses incurred by American bank 'Bear Sterns'. This bank had aggressively given huge loans to persons with weak credit ratings known as 'sub-prime' borrowers. These loans went into default and the bank incurred huge losses. The bank stopped getting new business while old clients rushed to withdraw their monies. This forced the bank to sell its assets like shares at low prevailing prices and it incurred huge losses. The shares of this bank traded at $172 sometime ago. Presently they are quoted at $6. The troubles did not end here. Rival bank J P Morgan Chase has offered to buy its shares at a price of $2. An employee of the bank told this writer that they are unlikely to get a better offer. Another American bank Lehman Brothers is also seen to be in trouble. These troubles have forced a sell off in the share markets across the world including India and lie at the root of present troubles in Indian share markets.

It should be obvious that bad business practices adopted by one shopkeeper should not unsettle the business of others. So also with the American banking crisis. The troubles of a few American banks arising from bad loans should not affect India. Indeed, the world economy appears to be strong and buoyant. Oil prices are at historical high of $116 per barrel even though there is no cut in production. This means that demand for oil is increasing. Factories can afford to produce goods with expensive energy made from oil because market is willing to pay high prices. Similarly, high prices of steel and food grains indicate that real economy is strong. People have the money to build and buy new houses. Price of gold is also rising. This is, in part, due to investment demand. Investors are selling shares and buying gold in order to save themselves from a bigger market collapse. But, in part, this is also due to demand for the yellow metal even at these high prices. Property prices have almost doubled in the last six months in Rohini and Dwarka areas of Delhi. These many parameters indicate that movements in the share markets do not reflect movements in the real economy. Just as fishes swim merrily deep in the sea while huge waves bash the coasts on the surface relentlessly; similarly the real economy is chugging along merrily while there is mayhem in the share markets.

The situation earlier was entirely different. Few years ago the collapse of the American share markets saw a decline in oil prices from $27 to $10 a barrel. That meant that people did not have money to buy petrol to fill up tanks of their cars. Prices of other commodities were also low. The decline in share prices at that time was an indicator of weakness of the real economy. Consumers did not have income to buy petrol or steel. Investors felt that companies will not be able to sell their goods at high prices and profits will decline. The low prices of shares and low prices of commodities went together. The present situation is entirely different. Decline in the sensex from 21,000 to 15,000 has been accompanied with a rise in price of oil from $80 to $111 per barrel. Thus the decline in the share markets is not due to weakness in the real economy.

The present decline is in the nature of readjustment in the role of America in the world economy. Truly, this decline had started in 2002 after bursting of the dotcom bubble. But the US Federal Reserve Bank lowered interest rates on housing loans at that time and encouraged people to buy houses. This created an artificial demand for cement and steel in the market and the share market remained buoyant. But this did not hold. Ultimately investors began to sense that American people do not have the incomes to repay their loans. Global investors withdrew their monies from the dollar. That decline raised cost of imports and pushed more housing loans into bankruptcy. The American share markets are falling because American banks have incurred huge losses. This shakeup is affecting the Indian share markets. Banks like Bear Sterns have had to liquidate their holdings to meet their immediate payment obligations. This impact is likely to be small and temporary because commodity prices remain buoyant.

One can see two negatives in the Indian economy. GDP growth rate is down to 8 percent from 9 percent. Inflation has increased to 7 percent from 4 percent. Again these impacts may be nominal. Just as death in the neighbourhood spontaneously creates a melancholy atmosphere in every home; similarly decline in the American economy is leading to sympathetic shedding of tears in share markets of Mumbai. It is noteworthy that foreign investors have not indulged in big sell-off in the Indian markets. Their behaviour reflects long term confidence. Sales have been made more to meet their immediate needs of liquidity than aversion to Indian economy.

One section of analysts holds that Sensex at 21,000 was an aberration and now the share markets have stabilized at true valuations. The reality maybe otherwise. The continuous rise in commodity prices does not indicate a downturn. It is more likely that the present bear run is the handiwork of a bear cartel. These players see that Indian economy is strong and likely to remain unaffected by the US meltdown. They sense an opportunity in this. They want to create panic among retail investors in order to get them to sell. The market is likely to bounce back once the cartel has made the purchases.

Decline of the American economy is fundamentally beneficial for India. An example will help. The breakup of Zamindari led to many problems for the poor people of the village. The Zamindar gone, there was no purchaser in the village for the milk or vegetables. They lost their jobs as tractor operators for the Zamindar. But soon roads were made and milk was sold at better prices in the nearby cities. Distribution of land led to coming of ten tractors in the village instead of one earlier. The short term collapse of the village economy was followed by long term prosperity. Similarly, the collapse of the American economy will certainly create problems in the short run as seen in the weakness of share markets. Income of IT companies will face pressure and exporters will face lower incomes from rising rupee. But the fall of American economy will soon see the flowering of many smaller economies. The world will become multi-polar with Europe, Japan, India, China and Brazil acting as anchors. Thus one should not get overly perturbed by the present decline in share markets. □□□