Fault Lines: Todays Spark, Tomorrows Inferno

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Introduction

“A Spark Neglected Burns the House”, a well-known story authored by a legendary writer, Leo Tolstoy, wherein a trifle between the two families, who once happened to be close and friendly neighbors became strong enemies is the trigger for writing this article. As this article tries to bring to the forefront the spark that is deliberately ignited by some galaxy of experts, which later takes the shape of conflagration, thereby engulfing not only one economy but almost the whole globe. But let us first have a brief understanding of the story. The tale is all about a trifle which later took the shape of a battle started by a so-called silly mistake committed by a hen, that belonged to Ivan’s daughter-in-law, who lay eggs in Gabriel’s compound and later when Ivan’s daughter-in-law inquires about the same, Gabriel’s mother declined to accept this fact and so the quarrel which began as a spark burned the long-standing relationship between the two families. The argument of minuscule scale which could have been controlled in an amicable manner became an inferno due to the conscious ignoring of the issue. Here our ignorant friend, the hen was responsible for this problem, but who should be blamed for various financial disasters that took place at the micro or macro level? In the majority of the cases, we can see that the trigger for such fiascos is the great minds, who are actively engaged in the formulation of plans, policies, strategies, financial and economic models, etc. Now a question that emerges is that if so-called experts are so excellent in devising efficient business or economic models, then why we had to witness Asian Financial Crisis, Dot Com Crisis, Global Economic Crisis, Eurozone Crisis and other crisis?

This article is an attempt to delve into such ongoing events which currently may be at a minor or first stage, but possesses all the potential to reach the third stage (like in the case of cancer) or they may prove to be beneficial also. But embracing the conservative approach, first, we would like to understand the negative aspects, as various financial crises that have shattered our confidence forces us to concentrate on the darker sides. However, once again, it is being reiterated that focusing upon negatives does not mean we are ignoring the positives but it is only to ensure that we are well prepared to face and conquer any unfavorable results.

Sailing into the Deep Ocean

So let us leave the shores and move into the ocean. But from where to start? As we are surrounded by so many disasters that which one to pick up, is really a tough job. But there has to be a beginning, so let us begin our voyage by initiating discussion about the ugliest economic phenomenon, i.e., ‘Global Economic Crisis’. Broadly, we are aware of how it happened and the magnitude of its onslaught. But can we close the chapter by merely assigning the complete blame upon the sub-prime borrowers, some of whom may have been enmeshed just out of their genuine ignorance! Perhaps this may be a heinous crime on our part as a responsible citizen of
a country, as a responsible citizen of this earth and more importantly as a rational human being. If we observe closely then the event was a complete collapse of corporate governance. Every participant and some of them very clever, played their role impeccably to ensure that the destruction is inevitable. The turmoil was a collective creation of the world’s central banks, lenders, credit rating agencies, underwriters, investors and obviously the poor homeowners, as if you are a party to any wrongdoing, maybe unknowingly, but still to some extent you will be held liable. So here also homeowners can be held liable, as it is their dream of getting a quick house landed them in the ‘Bermuda Triangle’ and consequently, could not come out of this web of home loans. But what about the blunders on the part of officials of banks and credit rating agencies, who went about committing one mistake after another till it became a mammoth issue, almost beyond anyone’s control. Big investment banks such as Lehman Brothers, Bear Stearns, Merrill Lynch and Morgan Stanley played a pivotal role in stoking the crisis by packaging questionable mortgages into securities and selling them. The second guilty party was credit rating agencies who possessed all the farsightedness to detect the shortcomings of the mortgage-backed securities and collateralized debt obligations simply kept silent and went on providing a high rating to such toxic assets. Is it so that while assigning the ratings on such securities, the learned personnel forgot the difference between the two extremes of rating parameters, i.e. highest credit quality and junk? Will it not be correct to say that rating agencies were enticed to offer better rates in order to continue receiving better service fees, or they run the risk of the underwriter knocking the doors of another rating agency. Thus, it is the hunger for hefty money that not only put at stake the future of one but also of the whole nation and consequently almost half of the globe. Now, we are more or less conversant with the aftermath of the global economic crisis, but it compels us to ponder over certain vital points: a) Does the global economic turmoil have subsided or to put differently, whether it has gone into hibernation and will again wake up with severe consequences? By severe consequences we mean that is it some more lethal exotic financial products are in the pipeline, which will create a nuclear fission and the complete world will be engulfed into an irreparable loss in terms of a substantial fall in aggregate demand, aggregate supply, unemployment, widening the gap between haves and have not etc.? Do countries across the globe or in other words, the global financial markets are thinking deeply over the sanctity of the securitization process? Do academicians, industrialists, financial experts and government authorities are keeping a vigil on the functioning of credit rating agencies so that they don’t involve in giving fake ratings to securities having a poor intrinsic value.

After the global economic crisis impacted the globe, analysts, financial experts, and various government authorities came into action, which was an example of remedial maintenance, but had the participants of this crisis have exercised their prudence and integrity, that is, preventive maintenance, the calamity could have been avoided. There is every reason to blame the creators of this crisis, as it resulted in an unwanted global emergency. In several countries, the crisis had imposed painful cutbacks in educational, health, and social services; put on hold justified social claims and struggles for social justice; many employees were served with pink slips with no clue for alternative employment opportunities. Consequently, some governments responded to the crisis with austerity policies. These policies damaged different systems of integration like the labor market, the educational system and social services, civil society entities, and other social and economic mechanisms that in the past assisted to counter the marginalization of families, groups and communities from full participation in social life.

The crisis has been discussed at length by various scholars, and yet there remains substantial disagreement among experts relating to its roots and possible solutions (Barth, 2009; Krugman, 2008; Stigliz, 2009; Taylor, 2009). One of the theories suggests that crisis is part of the cyclical
inflections of the capitalist system, in which periods of expansion are followed by times of contraction (Harman, 2009; Valencia, 2012). It was precisely the unsteady nature of capitalism that constituted one of the reasons for the establishment of the welfare state, which was justified as a way to protect society against chronic turmoil (Cantillon, 2010; Katz, 2008). However, despite the fact that the welfare state was a response to the cyclical nature of capitalism, the dominant discourse that emerged from the crisis points a finger at the costs of maintaining the welfare state as one of the main causes of economic collapse (Garret, 2009). Whatever theories or opinions we accept the crux of the matter is that the crisis has eroded the wealth of the world. The repealing of Glass-Steagall Act and the passing of the Gramm-Leach-Billey Act of 1999 was one of the blunders committed by Republican Senator Phil Gramm who played a key role in writing and passing the mentioned latter act. Now here is a catch, i.e. when the previous act clearly separated the powers of commercial and investment banking, thereby, ensuring that banks do not take too much risk with depositors' money, the new act contributed substantially in stoking greed as it went for bank deregulation. Between 1999 and 2008, Wall street became less like the fabled financial district and more like the Las Vegas Strip. Even the regulation that still existed didn’t seem to be working. An erudite Fed Reserve Chairman, Alan Greenspan also championed deregulation of the banks. Was it not an irrational approach on the part of the head of such a mammoth central bank? The event also raises the questions on the acts of the Securities and Exchange Commission (SEC), which possess the power for better disclosure of the securitization process of the credit default swaps. The Federal Reserve and the Federal Deposit Insurance Corporation (FDIC) both regulate commercial and retail banks. Where were they when these banks were making questionable mortgages to sub-prime borrowers? The list of questions is in-exhaustive, but if they would have been raised at an early state, things would not have been worse.

The above discussion was about an event which had already happened. Now let us discuss something which has just started and we don’t know how things turn out in the years to come. The list of such events is also unending, so let us take up a banking angle as banks are the fulcrum of any economic system. Here we will take up the discussion on BRICS Bank. The establishment of the bank was agreed to by BRICS leaders at the 5th BRICS summit held in Durban, South Africa on 27th March 2013. The highlighting objectives of this bank are to offer financial assistance for infrastructure projects and create a “Contingent Reserve Arrangement” worth $100 billion which will help member countries in facing future financial shocks. So the purpose of BRICS bank is pious, but will they be able to attain their objectives. What guarantee is there that these member countries will remain united for a long time? Post the Eurozone crisis, there was news regarding the uncertainty of some member countries, especially, Portugal, Ireland, Greece and Spain (PIGS), as they were the biggest sufferers due to the crisis. Now, if we imagine for a moment that some economic crisis surface in the future exerting a negative impact on the financial positions of BRICS member countries and suppose any of these or more than one member countries economic conditions becomes so bad that they are unable to repay the loans they have taken for financing infrastructure projects. Moreover, infrastructure projects involve a high gestation period, so repayment of principal and interest amount will definitely become uncertain. Now if any of the member countries have supposed borrowed funds for construction of roads, ports, airports, setting up of power or telecom projects, etc. commits a default, then it will definitely result in erosion of proposed BRICS bank capital. As the bank’s capital will be contributed by various members so in the situation of rising non-performing assets, it will definitely impact the economic growth and development of member countries. Fall in aggregate production, investments (both FDI and FII), per capita income, gross domestic product and very importantly credit ratings of member countries. Already our and other economies have suffered from the global economic crisis and the
Eurozone crisis and previously due to some other crisis. So through this BRICS bank are we calling from another crisis and of bigger magnitude? Do we have a ‘Disaster Recovery Plan’ in place so that in the event of any crisis we can save our economy from financial shocks? To add fuel to the fire, suppose BRICS bank design some bonds/debentures and float them in both BRICS member countries and other countries' financial markets and later could not honor the payment obligations with respect to coupon and principal, then what catastrophes it can bring for BRICS members and other nations?

Is any draft agreement regarding the formation of the bank is in place? Has it been circulated for discussion among banking sector experts, financial experts, academicians, regulatory bodies, etc. so that a concrete plan of action emerges. Moreover, the views of the mentioned groups should not be restricted to only a single member country; rather all member countries need to be involved in the process. While authoring the bank proposal due emphasis needs to be given to the political laws, economical laws, banking laws, financial market laws, mercantile laws and other necessary legislations. Another issue is of currency to be in use, i.e. whether we should converge to a uniform currency like Euro for Eurozone members or BRICS members should continue with their respective currencies? If BRICS members are allowed to operate with their own currencies then how to account for volatility in exchange rates, as some country's currency may be highly volatile while others may be relatively stable. If any member country severs its tie with BRICS then how to assure survival of the bank?

Thus, today what we are seeing as a way towards a great financial integration does not prove to be a financial suicide. So before the bank becomes a reality, a detailed homework is a must!

**What to do?**

One approach can be that we can keep silent and allow the things to happen and when any undesired will happen we will react. But a more rational approach would be to scan the business environment on a continuous basis, keenly observes various events, whether it is in stock markets, capital markets, the banking system, insurance, political developments etc. and immediately react before it becomes too late. Whether it is any crisis or any financial event, if we explore its reasons, we may find that the unwanted outcomes could have been avoided at a very initial stage, but we human beings are so selfish that till the things go in our favor we remain quiet but when those things start going against us then we start criticizing. For example, various banks offer lucrative credit card offers and customers tends to become extravagant without understanding the perils of credit cards. Finally, when a huge bill comes it is a flabbergast for them and they start criticizing the banks which offer such credit card services. No doubt, the primary responsibility lies with the bank officials to educate the customers regarding the benefits and risks associated with the usage of credit cards, but is it not the customers are also responsible. Similarly, we are attracted towards various quick earning money schemes like chit funds, collective investment schemes, etc., offered by various financial services companies, wherein people invest huge amounts without going into their details. Whenever, such companies germinate it should be the duty of the stakeholders of the society, i.e. academicians, financial experts, officials of regulatory bodies, etc. to take action immediately so that it is not too late.
Conclusion

As already mentioned, there is an unending list of events which are right now a spark, but what needs to be done is to put in place the necessary measures to prevent it from becoming an inferno. Thus, it is high time that nations across the globe at a macro level and various organizations and individuals of a nation at micro level needs to come together and formulate policies so that it can address the issues at a primary stage.

Negatives can take any form, not only financially, but this article has focused on finance, as whatever crisis we see around, somewhere down the line finance is associated with it. But we need to identify the sparks that are widespread right from capital markets, banking, insurance, monetary and fiscal policies, political system, education system, etc. So we need to act swiftly whenever we observe any significant deviations from the standards, to ensure that we don’t face the same agony that was faced by the characters of the story, “A Spark Neglected Burns the House”.

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