Marcellus: Lehman, liquidity & India's exposed financial system

A decade on from Lehman, financial markets have become more, not less, important and India's financial system has clearly become more vulnerable to disruptions in global liquidity flows. It is remarkable therefore that the weight of Financials in the Nifty is at an all-time high.

"Globalisation is not in retreat. A revamped version of it, with digital underpinnings and shifting geopolitics, is already taking shape…while debates raged…about the effects of globalization, globalization itself proceeded apace….Rather than relitigating old debates, it is time to accept the reality of the new era of globalization and work to maximise its benefits…" – **Susan Lund (McKinsey & Company) and Laura Tyson (Haas School of Business at UC, Berkely) in Foreign Affairs (May/June 2018)**

On a crisp winter's morning in January 2007 I sat down with, John Kay, the Chairman of the firm I had co-founded in London in 2003, for our monthly chat. Over the next hour or so, John's penetrating intellect helped me understand why the overleveraged British financial system would blow up. Then, through the

entirety of 2007, we first helped our clients sell their holdings in British lenders and then began efforts to sell our own firm. A buyer was finally found in May 2008 and within 24 hours of the sale, my wife and I migrated to India. I still remember my wife's ashen face as, toddler in hand, we navigated our trolley through Heathrow and left behind our friends, our families and a country, in which we had spent 17 happy years.

Upon landing in Mumbai we found then – as now - sanguine local investors in India who subscribed to the notion of India decoupling from the global financial system. In the months that followed, most of these investors' portfolios were hammered by the meltdown in the global financial system. And then, just as everyone had given up on stocks, in March 2009 began the greatest rally seen in equities seen this century. Since then the Nifty Total Return Index has compounded by 17% (in Rupee terms) and even more astonishingly, the S&P500 has compounded by 15% (in US dollar terms).

Many books have been written both about the Great Financial Crash and about the remarkable decade following the GFC. What have we learnt from this mountain of literature? And, more importantly, can a financial crisis on such a scale recur?

Firstly, we now understand the power that central banks and monetary policy can wield even in the most trying of economic circumstances. The inter-connected nature of global financial flows has made the Federal Reserve the main guardian of the global financial system. Never before have central banks played so central a role in a stock market bull run and stock price forecasting has now become as much about understanding liquidity as it is about understanding about earnings growth. Whenever the Fed tightens monetary policy (as it did in June 2013 or as it is doing now), Emerging Markets come under pressure and liquidity tightens even in a large economy like India.

Secondly, it is evident now that policy interventions intended on stabilizing asset prices exacerbate wealth inequalities both in the West (the Western elites are

heavily invested in financial assets and in prime real estate) and in India (India's elites' wealth & income are linked to the global financial system partly through the Financial Services and Tech sectors and partly through the ability to invest in the West). This widening of inequality has in turn spawned a new brand of populist politics centering on targeting elites and minorities. The new wave of populist leaders in turn are erecting trade barriers on the contentious premise that it is global trade – not global financial flows – which have triggered the rise in inequality.

Thirdly, the economic hammering that the Western economies took in 2008-2011 alongside the rise of protectionist/nationalistic Western leaders has punctured the West's desire to foist the "Washington Consensus" – free trade, financial liberalization, capital account convertibility, labour market reform – upon the rest of us. In particular, the World Bank and the IMF – who used to be the flag bearers of this brand of economics – seem to be shadows of their former selves and we are no longer subjected to economic sermons from Western leaders.

Amidst these changes, the irony is that financial markets have become more, not less, important. The market cap of the world's top 10 stockmarkets has risen from $23 trillion fifteen years ago to around $55 trillion now. Not only have financial markets become bigger, the role of human agency has diminished in such markets – nearly 2 in 3 trades executed in the US market are triggered by algorithms. These developments I reckon contain the grains of the next financial crisis especially in the context of the Indian financial system.

With India's public sector banks largely neutered, the economy is now funded by the wholesale financial markets in India. These financial markets in turn are umbilically linked to the global financial system (through foreign portfolio investors' flows and through the Rupee Non Deliverable Forward market). With the US economy growing at nearly 4.5% and running at full employment even as a trade

war generates its own inflationary impulse, the odds are rising in favour of an inflation-scare in America. If the Fed tightens monetary policy in the wake of such a scare, the liquidity tightening will ripple straight into the Indian economy via our wholesale markets. In 2006, in 2008 and in 2013, liquidity tightening in the US triggered a 30-35% correction in India's banking index. Now, with Financial Services accounting for nearly 40% of the Nifty's market cap – the highest weight ever commanded by a single sector in the Nifty – the risk to the India's wholesale funded lenders is higher than it has ever been. Such lenders are, by design, heavily leveraged, run asset-liability mismatches and lend money to each other. Those are the three features that prompted me to help my clients in London sell their holdings in British lenders in 2007.
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