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Global Financial Crisis: Lessons in Theory and Policy

The crisis that engulfed the financial sector of the US in September 2008 has since spread across the globe. The recently released IMF World Economic Outlook (October 2008) describes the crisis as "the most dangerous financial shock in mature financial markets since the 1930s." This global financial crisis will have far-reaching implications, both for the international economic order underlying globalisation, especially the global financial architecture, as well as the policy regimes in developing countries.

CAUSES AND CONSEQUENCES OF THE CRISIS

Since the 1990s, growth in the US economy has mainly been on account of credit-driven consumption. The level of indebtedness of American households reached unprecedented levels during this period, mainly due to housing loans (mortgages) and consumer loans (credit cards). The growth in consumption occurred despite increasing income and wealth inequalities in the US.[1] This happened because of the stock and property market booms, which increased the financial wealth of upper class households, made them feel richer and drove them into greater borrowing and spending. The debt-income ratio in the US, i.e. total household debt as a proportion of total personal disposable income, increased steadily from around 67% in the 1960s and 1970s to 95.6% in the 1990s.[2] The first jolt to this debt-induced consumption spending in the US came with the stock market crash and the collapse of the ICT boom in the US in 2000. This led to a recession in the US in 2001, which also caused a global slowdown. The finance, which had flown out of the stock market following the bursting of the dotcom bubble, found its way in the housing market. This created a real estate boom, which led to economic recovery both in the US as well as in the global economy from 2002. This boom was partly engineered by the huge tax cuts announced by George Bush in June 2001 and partly by the Central Bank of the US, the Federal Reserve, through repeated cuts in interest rates. The real interest rate remained negative in the US from mid-2002 to early 2006, fuelling credit growth.[3] The debt-income ratio reached an unprecedented 130% for the period 2000-08. Liberalized rules for banks coupled with easy liquidity conditions enabled mortgage-lending banks to reduce mortgage rates and adopt reckless lending strategies. This fuelled housing demand, which increased property prices and the real estate bubble started building up. A Special Report released in 2005 by *The Economist* noted:

> [T]he total value of residential property in developed economies rose by more than $30 trillion over the past five years, to over $70 trillion, an increase equivalent to 100% of those countries' combined

> GDPs. Not only does this dwarf any previous house-price boom, it is larger than the global stock market bubble in the late 1990s (an increase over five years of 80% of GDP) or America's stock market bubble in the late 1920s (55% of GDP). In other words, it looks like *the biggest bubble in history*.[4] (Emphasis added.)

The extent of the speculative bubble in real estate could be seen from the increasing ratio of housing prices to the rental applicable to the houses in the US. While the ratio remained stable for more than two decades since 1975, there was a sharp increase in housing prices relative to rentals since 2000. According to the *Economist* Report, 23% of the homes bought in 2004 were purely for investment purposes, while 13% were bought as second homes. "Investors [were] prepared to buy houses they [would] rent out at a loss, just because they [thought] prices will keep rising—the very definition of a financial bubble."

With the US economy being driven by the growth in real estate financed by debt, there was an increasing tendency by the mortgage-lenders to indulge in reckless lending practices. In order to keep the real estate boom alive and push up their businesses, the mortgage lenders increasingly indulged in sub-prime lending—giving housing loans even to those borrowers whose ability to repay the loans were doubtful. Such borrowers were enticed into housing loans, which were sweetened by special treatment and unusual financing arrangements—little documentation or mere self-certification of income, no or little down payment, extended repayment periods and structured payment schedules involving low interest rates in the initial phases which moved sharply upwards at later periods.[5] All these misleading offers of credit by the mortgage lenders encouraged borrowers to take loans which they could not afford to repay. The proportion of such loans with high risk of default, i.e. sub-prime loans, in total loans kept increasing over time. US Federal Reserve Chairman Ben Bernanke said in May 2007: "About 7.5 million first-lien subprime mortgages are now outstanding, accounting for about 14% of all first-lien mortgages. So-called near-prime loans—loans to borrowers who typically have higher credit scores than subprime borrowers but whose applications may have other higher-risk aspects—account for an additional 8 to 10% of mortgages."

These loans accumulated by the mortgage lending banks were packaged into securities and were sold off to other financial institutions like the Wall Street-based investment banks and hedge funds, in complex transactions that were made possible by financial dereg-ulation. The Wall Street-based investment banks such as Lehman Brothers, Bear Stearns, Merrill Lynch, Morgan Stanley, Goldman Sachs, etc., bought into these housing mortgages, pooled and packaged them into securities (Collateralised Debt Obligations or CDOs), got them rated by credit rating agencies, and sold them to other buyers in the financial markets like pension funds, mutual funds, etc., for huge fees and commissions. Estimates suggest that the value of such housing mortgage backed securities reached over $2 trillion by 2003.[6] Rather than correctly assessing the high risks associated with the assets underlying the securities they were trading, the investment banks were happy to transfer those risks by creating layers of complex derivatives and selling it to other market players for quick and high profits.

The assumption underlying such "financial innovations" was that it would enable the mortgage lenders as well as the investment banks to insulate themselves against loan defaults by spreading the risks associated with these loans. This, however, was a flawed assumption since spreading of risks through complex derivatives cannot make the risk disappear completely. Thus when defaults on such housing mortgage loans started rising, all the financial institutions linked to sub-prime mortgages were affected. Eventually a full-blown crisis surfaced in the US in 2006 when the housing bubble went bust. With increasing defaults and repossession of houses by the mortgage lenders, suddenly there were only sellers and no buyers left in the housing market. Sharp falls in property prices and increasing interest rates also led to the collapse of hundreds of mortgage lenders engaged in sub-prime lending, with even the largest mortgage lender in the US, Countrywide Financial, heading towards bankruptcy. The investment banks, which had made huge investments in sub-prime mortgage based securities in order to reap speculative gains on the basis of the property bubble, started suffering huge losses.

The bankruptcy of Lehman Brothers, the fourth largest investment bank in the US, in September 2008 marked a considerable deepening of the financial crisis in the US, precipitated by the collapse of the real estate bubble. Another investment bank, Merrill Lynch, was taken over by the Bank of America through government facilitation, similar to the manner in which Bear Stearns got taken over by JP Morgan Chase some time ago. Goldman Sachs and Morgan Stanley have decided to transform themselves into ordinary deposit-receiving banks. Thus, investment banking in the US, representing the most powerful force on Wall Street which led the financial globalisation offensive from the front, has been virtually decimated by the financial crisis. Two other mortgage-lending institutions, Fannie Mae and Freddie Mac have been nationalised to prevent their collapse. AIG, the world's largest insurance company, has managed to survive for the present through the injection of funds worth $85 billion from the US Government.

Similar crises have simultaneously afflicted the banks and financial institutions in other advanced capitalist countries, which were heavily exposed to mortgage-backed securities. With the real estate bubbles going bust globally, crisis has spread across global financial markets causing huge losses for banks and financial companies. Faced with this financial meltdown, the Bush administration stepped in and announced a $700 billion bailout package, aimed at buying up the bad debt of the US banks and financial institutions. After some initial discomfort and debate over using public funds to compensate for private sector losses, the US Congress finally approved the bailout package with minor modifications in early October 2008. The British Government has followed suit and announced a 500 billion rescue plan for its banks and financial institutions, including 50 billion of direct capital injection against preference shares for the government in private sector banks like Lloyds TSB, Royal Bank of Scotland and mortgage lender HBOS. The US Treasury has recently announced that $250 billion out of the $700 billion bailout package will be used to inject capital into private banks against shares transferred to the government.

Such measures towards partial nationalisation of private banks in the US and UK set the stage for similar steps by other advanced capitalist countries. Iceland, a small European country, went bankrupt after it fully nationalised its three largest banks, which had their presence across Europe and had suffered heavy losses due to the crisis. In an unprecedented move, Central Banks across the world like the US Federal Reserve, the European Central Bank and others in England, China, Canada, Sweden, Switzerland and elsewhere have also cut interest rates in a coordinated manner in order to prevent a drying up of credit flow into the financial markets. However, with fears of a recession in the US spilling over into a global recession, gripping the financial markets across the world, no amount of interest rate cuts and pumping "liquidity" into the financial system will work. According to the Bureau of Labour Statistics of the US Department of Labour, the unemployment rate in the US, which reached 6.1% in August 2008, remained at the same level in September.[7] The Federal Reserve has also reported that industrial production in the US dropped by 2.8% in September 2008, while according to the US Census Bureau, retail trade sales for September declined by 1.2% from August. While its policy establishment continues to be in a state of denial, the US economy already seems to be in a recession.

Two issues emerge clearly from these significant events occurring in the US and other advanced capitalist economies. Firstly, the deregulated and liberalized financial system of the US, which was held up as a model for the rest of the world to emulate, has clearly failed. It has failed because far from bringing efficiency in the financial markets, deregulation has only promoted reckless speculation and greed. "Financial innovations" have meant the proliferation of complex derivative instruments, which do not reduce but only conceal the real risk involved in underlying assets, and therefore lead to a systemic underestimation of risk.[8] Secondly, as the ongoing debate over government bailout of the loss-stricken financial firms has highlighted, financial liberalization involves a huge moral hazard problem. While the investment banks and other financial entities, especially their executives, have made enormous profits out of their speculative operations over the past few years, once they suffer losses the government feels obliged to bail out these companies using taxpayers' money. The need to save the entire financial system from a collapse is cited as the rationale for the bailout. It is true that if these banks and institutions, which are financial behemoths with their operations spread across countries, are allowed to collapse it would also lead to the collapse of thousands of other banks and companies worldwide who have lent to them. But question that arises is why they were allowed to grow to such size in the first place. Such huge concentration of finance capital in the hands of a few financial firms, besides being detrimental from the anti-trust point of view, has also turned out to be hugely inefficient. Since the money managers of these financial giants knew that they were "too large to fail," i.e., the government will be ever willing to underwrite their losses to prevent a systemic collapse, they have not shown any diligence or prudence in handling other people's money and indulged in reckless speculation.

There is hardly any attempt so far, in the US or elsewhere, to fix responsibility for the speculative excesses, let alone penalize those who have profited from them. In fact, the CEOs and top executives of the financial firms who have caused the crisis have ensured "golden parachutes" for themselves, i.e., contracts specifying that large amounts of benefits and bonuses will accrue to them in case their employment is terminated. Thus these financial bosses have not only profited from the speculative bubble but are also profiting from its collapse, while taxpayers have to bear the burden of the bailouts. While nothing more can be expected from the US establishment, given that the Treasury Secretary Henry Paulson is himself a former CEO of the erstwhile investment bank Goldman Sachs, this is sure to erode the credibility of the system in the eyes of the common people.

THEORETICAL REFLECTIONS

In *Capital*, Marx had noted the growth of "money-capitalists" along with the growth of "material wealth" under capitalism, linking it up with the growth of rentiers and the development of the credit system, and underscoring the speculative tendencies that arose out of it:

> With the growth of material wealth the class of money-capitalists grows; on the one hand, the number and the wealth of retiring capitalists, rentiers, increases; and on the other hand, the development of the credit system is promoted, thereby increasing the number of bankers, money-lenders, financiers, etc. With the development of the available money-capital, the quantity of interest-bearing paper, government securities, stocks, etc., also grows. . . . However, at the same time the demand for available money-capital also grows, the jobbers, who speculate with this paper, playing a prominent role on the money-market . . . . With the development of the credit system; great concentrated money markets are created, such as London, which are at the same time the main seats of trade in this paper. *The bankers place huge quantities of the public's money-capital at the disposal of this unsavoury crowd of dealers, and thus this brood of gamblers multiplies*.[9] (Emphasis added.)

While underlining that the basis of a credit crisis lie in the unplanned nature of capitalism which leads to periodic over-production, Marx had also emphasised the role of speculation in precipitating such crisis:

> In a system of production, where the entire continuity of the reproduction process rests upon credit, a crisis must obviously occur—a tremendous rush for means of payment—when credit suddenly ceases and only cash payments have validity. At first glance, therefore, the whole crisis seems to be merely a credit and money crisis. And in fact it is only a question of the convertibility of bills of exchange into

> money. But the majority of these bills represent actual sales and purchases, whose extension far beyond the needs of society is, after all, the basis of the whole crisis. At the same time, an enormous quantity of these bills of exchange represents plain swindle, which now reaches the light of day and collapses; furthermore, unsuccessful speculation with the capital of other people; finally, commodity-capital which has depreciated or is completely unsaleable, or returns that can never more be realised again. The entire artificial system of forced expansion of the reproduction process cannot, of course, be remedied by having some bank, like the Bank of England, give to all the swindlers the deficient capital by means of its paper and having it buy up all the depreciated commodities at their old nominal values. Incidentally, everything here appears distorted, since in this paper world, the real price and its real basis appear nowhere, but only bullion, metal coin, notes, bills of exchange, securities. Particularly in centres where the entire money business of the country is concentrated, like London, does this distortion become apparent; the entire process becomes incomprehensible; it is less so in centres of production.[10]

The description of the credit system as "an artificial system of forced expansion," where "an enormous quantity of these bills of exchange represents plain swindle, which . . . collapses" and "speculation with the capital of other people" is rendered "unsuccessful," offers deep insight into the functioning of capitalism, which is very relevant to the understanding of the current financial crisis. However, Marx was analyzing capitalism at a time when money-capital or finance was closely tied to industrial capital. Over time, as the size and predominance of the class of "money-capitalists" grew, finance became increasingly independent of industry and speculation took more complex and disruptive forms. In his *General Theory*, Keynes had located the basic problem of contemporary capitalism in the increasing predominance of "speculation" over "enterprise" alongwith the development of the financial markets.

> If I may be allowed to appropriate the term speculation for the activity of forecasting the psychology of the market, and the term enterprise for the activity of forecasting the prospective yield of assets over their whole life, it is by no means always the case that speculation predominates over enterprise. As the organisation of investment markets improves, the risk of the predominance of speculation does, however, increase. In one of the greatest investment markets in the world, namely, New York, the influence of speculation (in the above sense) is enormous. Even outside the field of finance, Americans are apt to be unduly interested in discovering what average opinion believes average opinion to be; and this national weakness finds its nemesis in the stock market . . . when he purchases an investment, the American is attaching his hopes, not so much to its prospective yield, as to a favourable change in the conventional basis of valuation, i.e. that he is, in the above sense, a speculator. Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on a whirlpool of speculation. When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done. The measure of success attained by Wall Street, regarded as an institution of which the proper social purpose is to direct new investment into the most profitable channels in terms of future yield, cannot be claimed as one of the outstanding triumphs of laissez-faire capitalism—which is not surprising, if I am right in thinking that the best brains of Wall Street have been in fact directed towards a different object.[11]

The financial crisis afflicting the US and other advanced capitalist countries today is an outcome of these structural contradictions underlying capitalism, which were underlined by Marx and Keynes. Following the Great Depression of the 1930s, which was precipitated by a collapse of asset prices leading to a deep recession and burgeoning unemployment, the ideas of Marx and Keynes had gained currency. It was also noted widely that the socialist countries where the state played the predominant role in economic activity and finance was strictly under state control, had remained immune from the Depression. While the Depression had initially led to inter-imperialist conflicts and the rise of fascism culminating in the Second World War, the post-War period saw the adoption of the Keynesian policy prescriptions in the capitalist world: “comprehensive socialisation of investment,” implying state intervention in demand management to ensure full employment and “euthanasia of the rentier” meaning low interest rates, strict regulation of finance and control over capital flows.

The decade of the 1970s, however, was characterized by crucial developments, both in the realm of economic thought as well as economic policymaking in the advanced capitalist world. The oil price shocks had led to high inflation in the developed countries, which unleashed a theoretical as well as policy-level backlash against Keynesian demand management and full-employment policies. The theoretical backlash came in the form of Milton Friedman’s monetarist counter-revolution, which basically argued that a market economy has a “natural rate of unemployment” to which it would always settle and any intervention by the state to reduce unemployment below this “natural rate” would only result in accelerating inflation. This reincarnation of the flawed classical theory, which was so decisively challenged by Keynes, nonetheless set the stage for the adoption of neoliberal policies, entailing withdrawal of state from economic activity and abandonment of demand management. Full employment as a policy objective was replaced by an obsession to control inflation, mainly by creating unemployment through deflationary policies and attacking the trade unions and workers’ rights, in order to weaken their bargaining power and suppress wages.

These were also accompanied by significant developments in the sphere of money and finance. The collapse of the Bretton Woods and the gold standard in the early 1970s unravelled the international financial architecture of the post-War period, which was based on fixed exchange rates and restrictions on cross border capital flows. The new regime of floating exchange rates and liberalized capital flows, which was put in place, set the stage for dollar hegemony whereby capitalist countries across the world pegged their currencies to the dollar. The stability of the value of the dollar vis-à-vis primary commodities and labour in turn was ensured by the US state through imperialism.[12] The political economy of this phase was marked by the ascendancy of finance capital as a supranational entity. Financial deregulation within the capitalist countries and liberalization of cross-border capital flows enabled the emergence of an international finance capital, which not only divorced itself to a large extent from the specific countries of its origin but also from the sphere of commodity production, i.e. the real economy. Rather than seeking profits through the process of capital accumulation; i.e. capital investment in commodity production and earning profits through the appropriation of surplus value of workers in the production process; finance capital increasingly sought to make profits through short-term capital gains by indulging in speculation over various kinds of assets. Besides conventional banking undergoing a change with the emergence of new kinds of banks (investment banks), a host of new “institutional investors” like mutual funds, pension funds, hedge funds, etc., gradually came into being, which specialized in mobilizing savings and speculating over assets, making enormous profits through capital gains in the process.

World capitalism since the 1970s, i.e., the process of globalisation, has mainly been driven by financial liberalization. This has meant the opening up of the financial sectors of capitalist economies to unregulated flows of international finance capital and allowing myriad kinds of speculative activities in the markets for equity, debt, currency and commodities. This financialization of global capitalism has had important implications for the capital accumulation process. On the one hand, financialization imparted a short-termist character to capital, whereby it became increasingly unwilling to be locked into long-term investment projects. On the other hand, due to the neoliberal policies of withdrawal of the state and squeezing of the working class, the source of demand shifted from state expenditure and workers’ consumption to consumption by the capitalists and upper classes. The finance-driven growth process, however, was crucially dependent on the state in two significant ways. Firstly, through the maintenance of low interest rates and influencing the allocation of credit, the monetary authorities in the capitalist countries aided and abetted the creation of asset price bubbles in the equity, commodity or property markets. These asset price bubbles not only made the rich richer, but also enabled them to consume and spend heavily, incurring debt based on their increasing wealth. Secondly, unemployment and "flexible" labour markets were maintained to ensure depressed wages and prevent any surge in inflation owing to distributional conflicts. Such a finance-driven, elite-consumption based growth regime, however, cannot be sustainable since the asset price bubbles on which such growth is dependent invariably bursts at some point of time.[13]

IMPLICATIONS FOR DEVELOPING COUNTRIES LIKE INDIA

Through the past two decades several developing countries—Mexico, Thailand, Malaysia, Indonesia, South Korea, Russia, Turkey, Brazil and Argentina—have all witnessed financial crisis and currency crashes on different occasions. All of these crises were caused by the activities of speculative finance and the bursting of asset price bubbles in several cases. The impact of these crises on the world economy, however, remained limited to minor and short-lived shocks, which did not undermine the overall growth regime. Now with crisis engulfing the financial sector of the US and other advanced capitalist countries, the global growth process has received a deadly blow.

Over the past one decade, global economic growth has mainly been driven by the US economy. This found reflection in the widening external deficit of the US. The current account deficit of the US, which was around $140 billion in 1997 or 1.7% of the GDP, witnessed a continuous and dramatic increase to over $800 billion, or 6% of the GDP in 2006. This unprecedented level of current account deficit enabled several countries across the world to grow through exports of goods and services to the US market. While globalisation meant shrinking public expenditure and a shift away from domestic market oriented growth in most countries, the US provided the major market for export-oriented growth regimes. Growing current account deficits also meant that the US economy became increasingly indebted, but the growing indebtedness of the US economy was sustained by huge capital inflows into the US from the rest of the world. This ability of the US to attract capital inflows despite growing external indebtedness is based upon dollar hegemony. Since the dollar is conceived as the most stable currency, the bulk of the wealth and assets in the world are held in dollars and most international transactions are undertaken in dollars. This has ensured a high and stable international demand for the dollar and enabled the US to borrow cheaply from the rest of the world. Developing countries together hold over $3 trillion of foreign exchange reserves, typically held in assets in developed countries, including US Treasury Bills. Following the financial crisis and the consequent downturn in the US economy, serious questions have arisen regarding the very sustainability of the current international economic order.

In its latest *World Economic Outlook* the IMF has warned that: "On an average annual basis, global growth is expected to moderate from 5.0% in 2007 to 3.9% in 2008 and 3.0% in 2009, its slowest pace since 2002. The advanced economies would be in or close to recession in the second half of 2008 and early 2009, and the anticipated recovery later in 2009 will be exceptionally gradual by past standards . . . There are substantial downside risks to this baseline forecast." Given the intensity of the credit crisis, the US recession is likely to be a prolonged one precipitating a global slowdown, with recession afflicting the other advanced capitalist countries. This provides an appropriate setting for rethinking India's economic development strategy. It is clear that the stimulus for domestic economic growth is not going to come from global markets in the near future. Export growth is likely to come down and export-oriented sectors adversely affected. There is an obvious need therefore to shift the focus away from trade liberalization and external markets. However, from the Indian economy's point of view, it is not the rate of economic growth but the nature of the growth process, which causes grave concern in the light of recent developments. The spurt in GDP growth witnessed in India since 2003–04 has been driven by processes similar to those which fuelled the expansion of the US economy through the present decade—booms in real estate and the stock market alongwith credit-driven consumption spending by the urban rich and upper middle classes.

This pattern of growth, far from generating adequate employment opportunities or improving the living conditions of the working people, has increased income and wealth inequalities in an unprecedented manner.[14] While big business and the urban elites have enjoyed the benefits of faster income growth and rising purchasing power, the working class in the urban areas and almost all the agrarian classes in the rural areas have experienced stagnant or dwindling opportunities of income and employment. Recent experience from across the world has shown the unsustainability of this credit-driven elite consumption-based growth process. Moreover, while the working people hardly benefit from such growth, they bear the brunt of shrinking output and employment opportunities following a financial crisis. The spate of financial crises witnessed in the developing countries since the late 1990s starting from South East Asia have borne this out. Therefore, not only should the Indian financial system be insulated from the turbulence being witnessed in the financial markets of the US and elsewhere, but the current pattern of credit allocation within the economy, which is fuelling asset price bubbles and elite-consumption based growth, needs a thorough overhaul.

POLICY LESSONS FOR INDIA

While big bang financial sector reforms could not be pushed through mainly because of the opposition from the Left Parties, incremental liberalization and integration with the global financial markets has continued in India, whose impact is already being felt in the meltdown witnessed in the Indian stock market, in tandem with global markets. The rupee has slided considerably vis-à-vis the dollar, touching historically low levels (nearly Rs 50 per dollar), due to capital outflows caused by the portfolio adjustments by the FIIs. The FIIs have been net sellers in the Indian stock markets over the past few months, taking out $7.3 billion from India between April to October 2008 (October 10th). The current account deficit reaching a record $10.7 billion during the first quarter of 2008, despite a weakening rupee, does not reflect a healthy trend. In this context, the ongoing moves by the government towards greater capital account liberalization and deregulation should be stalled immediately. Moreover, regulations need to be tightened in several areas where recklessness is already visible.

Reverse Capital Account Convertibility

Despite the experience of the South East Asian crisis, where liberalized capital accounts were primarily responsible for the currency meltdowns, the Indian government has continued with moves to make the rupee fully convertible. Following the recommendations of the Tarapore Committee, some steps have already been taken by the Reserve Bank of India. These include, among others, raising the remittance limit for resident Indians to $200,000 per financial year, easing of norms for external commercial borrowings by banks and other entities, raising the limit on FII investments in government securities to $5 billion and corporate debt to $3 billion and enhancing the extant ceiling of overseas investment by mutual funds upto $5 billion. (Details of capital account liberalization measures in India are listed in the Appendix.) These measures, which have considerably liberalized our capital account, need to be reversed.

Prohibit Participatory Notes

The RBI has repeatedly advocated the phasing out of these non-transparent derivative instruments used by the FIIs to invest money in the Indian capital market on behalf of undisclosed entities and individuals. However, the government has shown reluctance to ban PNs despite the National Security Advisor having alleged that even terrorist funds are being invested in India through these instruments. The wide fluctuations experienced in the Indian stock markets over the past few years have mainly been on account of the FIIs. In October 2007 SEBI, while refusing to prohibit PNs, had applied a 40% cap on total assets held by FIIs under PNs. However, with the stock market witnessing successive crashes in the wake of the global financial crisis, SEBI has summarily removed all its earlier restrictions in one stroke in order to woo the FIIs back in order to shore up the Indian stock market. SEBI's efforts to appease the FIIs come in the backdrop of reports that the FIIs are undertaking short selling through PNs. These are precisely the kind of activities that have played havoc in global financial markets. The phasing out of PNs cannot wait any longer. The desirability of such FII inflows, which merely comprise of "hot money" and are totally incapable of meeting the long-term development financing needs of India, is itself highly questionable. Allowing speculative hedge funds and other dubious entities to invest in Indian markets without any adherence to disclosure norms is the antithesis of prudential regulation.

Halt Pension Reforms

A New Pension Scheme has been initiated whereby the earlier pension scheme of government employees has been replaced by a contributory scheme. The government seeks to allow the pension funds to invest in the stock market under the regulatory supervision of the Pension Fund Regulatory Development Authority (PFRDA). While opposition from the Left Parties did not allow the passage of the PFRDA Bill in Parliament, an interim step was announced in January 2007, allowing upto 5% of pension funds under the New Pension Scheme to be invested in the stock market. The new scheme does not guarantee a minimum pension for the government employees and makes the pension amount contingent upon conditions in the stock market. The government has also pushed the Employees Provident Fund Organisation to invest a portion of their fund in the stock market through private fund managers. Several countries have suffered due to such pension reforms, whereby speculative forces have played havoc with the retirement savings of employees. Nearly $2 trillion worth of retirement savings have been wiped out in the US since June 2007, due to the financial crisis. Privatization of pension funds is now being reconsidered and revised in some of the developing countries, which were pioneers in its implementation, like Chile and Argentina. In this backdrop, such pension reforms should be abandoned by the Indian government and the PFRDA Bill scrapped. The pension scheme for government employees should be reworked to ensure minimum guaranteed pension.

Roll Back Banking and Insurance Sector Deregulation

Due to steadfast opposition from the Left Parties, the government has been unable to push through legislation meant for further deregulation of the banking and insurance sectors. Among the proposed legislation is the Banking Regulation (Amendment) Bill, which seeks to remove the cap of 10% applicable on exercise of voting rights by shareholders in banks. This is meant to facilitate the takeover of Indian banks by foreign banks. The State Bank of India (Amendment) Bill allows for a reduction of the government's shareholding in SBI from 55% to 51%. There is also an ongoing move to increase the FDI cap in the insurance sector from the present 26% to 49% by amending existing legislation and also allowing foreign reinsurance companies without any capital base in India to open branch offices. Hectic lobbying by foreign insurance companies has continued over the past few years to bring this policy change. In the backdrop of the moves by the governments in US, UK and elsewhere to partially nationalise their private banks as well as the involvement of insurance companies like the American International Group (partner of Tata-AIG Life Insurance in India) in the sub-prime lending crisis, the steps pursued by the Indian government to further deregulate the banking and insurance sectors appear to be anachronistic.

Check Unbalanced Expansion of Retail Credit

The scorching pace of expansion of retail credit over the past few years is a matter of serious concern. Non-food gross bank credit had been growing at 38%, 40% and 28% respectively during the three financial years ending March 2007. This points to a substantially increased exposure of the scheduled commercial banks to the retail credit market comprising of housing loans, credit cards, auto loans and loans against consumer durables. Overall personal loans amount to more than one-quarter of non-food gross bank credit outstanding. This increase in retail exposure of commercial banks is a direct outcome of increased competition among banks, which has forced them to diversify in favour of more profitable lending options. The resulting search for volumes and returns has encouraged diversification in favour of higher risk retail credit. Besides the risks involved in such fast-paced expansion of retail credit, which arise out of the same factors which precipitated the sub-prime crisis in the US, the lopsidedness of the credit system in catering to the urban upper classes at the cost of priority sectors like agriculture and small industries distorts the development process in the country. The current lending pattern of the scheduled commercial banks, both in terms of its underlying risks as well as its impact on overall economic development, needs to be overhauled with a much larger share of the credit flow going to the priority sectors.

Strictly Regulate Securitised Debt

The Indian financial sector has begun securitising personal loans of all kinds so as to transfer the risk associated with them to those who could be persuaded to buy into them. Although a proliferation of credit derivates has not happened yet, the transfer of risk through securitisation is well underway. As the US experience has shown, this tends to slacken diligence when offering credit, since risk does not stay with those originating retail loans. The Securities Contracts Regulation (Amendment) Bill, passed by Parliament despite dissent by the Left, has sought to provide a legal framework for trading in securitised debt, including mortgage-backed debt. This is an attempt to imitate the “financial innovations” in the US and other advanced economies, which have been encouraged by financial liberalisation. In the light of recent experience, the existing regulatory framework for trading in securitised debt should be tightened so as to prevent a sub-prime crisis like predicament. The regulation of securitised debt should also cover private placements and Over The Counter (OTC) transactions besides the exchange traded ones.

Curb Lending to Sensitive Sectors

At the end of financial year 2007, the exposure of the scheduled commercial banks to the so-called “sensitive” sectors, like real estate and the capital and commodity markets, was around a fifth (20.4%) of aggregate bank loans and advances, out of which 18.7% comprised of real estate loans and 1.5% comprised of loans to the capital market. In the case of the new private sector banks and foreign banks, however, real estate loans comprised of a much higher proportion of their total loans; 32.3% and 26.3% respectively. In the light of the US experience, such high exposure of private and foreign banks and financial institutions to lending for commercial real estate is a matter of concern. Despite RBI’s attempts to check the flow of credit to this sector, the outstanding loans to this sector continue to remain high, with debt-based mutual funds also being substantially exposed to securitised real estate loans. The movement in property prices in the past few years point towards a bubble in the realty sector, with the possibility of widespread defaults once the bubble bursts. Immediate steps should be taken to curb excessive fund flow to the realty sector and frame stringent regulation to ensure its orderly development.

CONCLUSION

The reason why India has so far not witnessed a financial meltdown of the kind being witnessed in the US and elsewhere is mainly because the Indian financial system remains far more regulated and public sector dominated than most capitalist countries. However, over the last decade, policy makers in India were all too eager to emulate the US financial system and integrate with the international financial markets in order to benefit from the globalisation of finance. Since the formation of the UPA Government, staunch neoliberals like the Prime Minister and the Finance Minister, far from reversing the course adopted by the erstwhile BJP-led Government, sought to accelerate the pace of financial liberalization. The Left Parties, which resisted such a course, were constantly attacked and vilified by the policy establishment for stalling "reforms" and thus impeding "economic growth." The financial meltdown in the US and other advanced economies has come as a fitting rebuff to such neoliberal hubris.

In an Afterword to the second German edition, *Capital, Volume I*, Marx had noted: "The contradictions inherent in the movement of capitalist society impress themselves upon the practical bourgeois most strikingly in the changes of the periodic cycle, through which modern industry runs, and whose crowning point is the universal crisis. That crisis is once again approaching, although as yet but in its preliminary stage; and by the universality of its theatre and the intensity of its action it will drum dialectics even into the heads of the mushroom-upstarts of the new, holy Prusso-German Empire." Similarly, the global financial crisis and the onset of the recession will drum dialectics into the heads of the neoliberal ideologues, both in India and abroad. The chickens of globalisation are now coming home to roost.

APPENDIX
CAPITAL ACCOUNT LIBERALIZATION IN INDIA

There has been a continuous process of liberalization of transactions on the capital account, as the 2006 report of the Committee on Fuller Capital Account Convertibility (Tarapore Committee) had noted. The strategy has been to allow convertibility in various forms, subject to ceilings, which have been continuously raised. As of now, liberalization permits capital account movements of the following kinds:

i) Investment in overseas Joint Ventures (JV)/Wholly Owned Subsidiaries (WOS) by Indian companies up to 400% of the net worth of the Indian company under the Automatic Route.

ii) Portfolio investments abroad by listed companies up to 50% of their net worth. An earlier requirement of 10% reciprocal share holding in listed Indian companies by overseas companies for the purpose of portfolio investment outside India by these Indian companies has been dispensed with.

iii) Prepayment of External Commercial borrowings (ECBs) without the Reserve Bank of India's approval of sums up to $500 million, subject to compliance with the minimum average maturity period as applicable to the loan.

iv) Aggregate overseas investments by mutual funds registered with the Securities and Exchange Board of India (SEBI) of up to $5 billion. In addition, investments of up to $1 billion in overseas Exchange Traded Funds are permitted by SEBI for a limited number of qualified Indian mutual funds.

v) Resident individuals, who were first permitted in February 2004 to remit up to $25,000 per year to foreign currency accounts abroad for any purpose, are now allowed to transfer up to $200,000 per head per year under the Liberalised Remittance Scheme (LRS).
vi) Non-resident Indians are permitted to repatriate up to $1 million per calendar year out of balances held in "non-repatriable" non-resident ordinary (NRO) Accounts or out of sales proceeds of assets acquired by way of inheritance.
vii) Limits on borrowing abroad by Indian corporates have been relaxed substantially. Under the automatic route each borrower is allowed to borrow up to $500 million per year with a sub-limit of $20 million with maturity of 3 years or less; and above $20 million up to $500 million for maturity up to five years. Cases falling outside the automatic route need approval, but obtain it virtually without limit.
viii) The limit on FIIs investment in corporate debt was raised to $3 billion from $1.5 billion and in government securities to $5 billion from $3 billion.

NOTES

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[1] According to T. Piketty and E. Saez, the income share of the top 10% of the population in the US, which remained between 30-35% from 1950s to the mid-1980s, increased to nearly 45% by mid-2000s. See "Income Inequality in the United States, 1913-2002," http://elsa.berkeley.edu/~saez/piketty-saezOUP04US.pdf.

[2] Robert Pollin, *Contours of Descent: US Economic Fractures and the Landscape of Global Austerity*, Verso, 2005.

[3] The real interest rate is negative when the rate of inflation is more than the nominal interest rate prevailing in an economy.

[4] The Economist, *In Come the Waves: The Global Housing Boom*, 2005.

[5] C.P. Chandrasekhar and Jayati Ghosh, "Lessons from the US Sub-prime Lending Crisis," 2007, http://www.macroscan.org.

[6] Data from the Securities Industry and Financial Markets Association (SIFMA), http://www.sifma.org/.

[7] The number of long-term unemployed (those jobless for 27 weeks or more) in the US rose by 167,000 to 2 million, an increase of 728,000 over the past 12 months.

[8] Prabhat Patnaik writes: "This piece of 'financial innovation'… leads to an underestimation of risk during any boom in asset prices, which makes such booms more prolonged and more pronounced, and the subsequent collapse in the asset prices more precipitous, and hence more calamitous for the world of finance." "The End of the Illusion," *People's Democracy*, September 28, 2008.

[9] Karl Marx, *Capital Vol. III*, Part V, Chapter 32, Money-Capital and Real Capital. III, http://www.marxists.org/.

[10] Karl Marx, *Capital Vol. III*, Part V, Chapter 30, Money-Capital and Real Capital. I, http://www.marxists.org/.

[11] John Maynard Keynes, *The General Theory of Employment, Interest and Money*, Chapter 12, The State of Long-Term Expectation. http://www.marxists.org/.

[12] The role of imperialism in sustaining dollar hegemony and the international financial architecture underlying globalisation is discussed in detail in Prabhat Patnaik, *The Value of Money*, Tulika, 2008

[13] Prabhat Patnaik discusses these issues in "A Perspective on the Crisis," Presentation to the United Nations, October 2008. Also see C.P.Chandrashekhar, "Growth and Crises in Contemporary Capitalism," *The Marxist*, Vol. XXIII, No. 3, July–September 2007. The accumulation process in advanced capitalist countries under finance-driven globalisation is discussed in detail in Prasenjit Bose, "Capital Accumulation and Crisis: A Theoretical Study," 2003 (unpublished doctoral thesis) and Rohit, "Concentration of Capital and Its Macroeconomic Impact: A Study of the United States in the 1980s and 1990s" (ongoing work on doctoral thesis).

[14] According to the National Commission for Enterprises in the Unorganised Sector, by the end of 2004–05, about 836 million or 77% of the population were spending less than Rs. 20 per day or Rs. 600 per month. The per capita income in India in 2004–05 was Rs. 23,241 a year or Rs 1937 a month. This per capita income is more than three times what is earned by more than 77% of the population. On the other hand, there were 48 Indian individuals with wealth over $1 billion (Rs 4000 crore) in 2007, rising from 25 in 2006. According to the Forbes magazine, the collective wealth of forty richest Indians went up from $ 170 billion (Rs 6,80,000 crore) in August 2006 to $ 351 billion (Rs 14,04,000 crore) in 2007.