

DYNAMIC FINANCIAL INSTITUTIONS: AN ANALYSIS

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**Abstract**

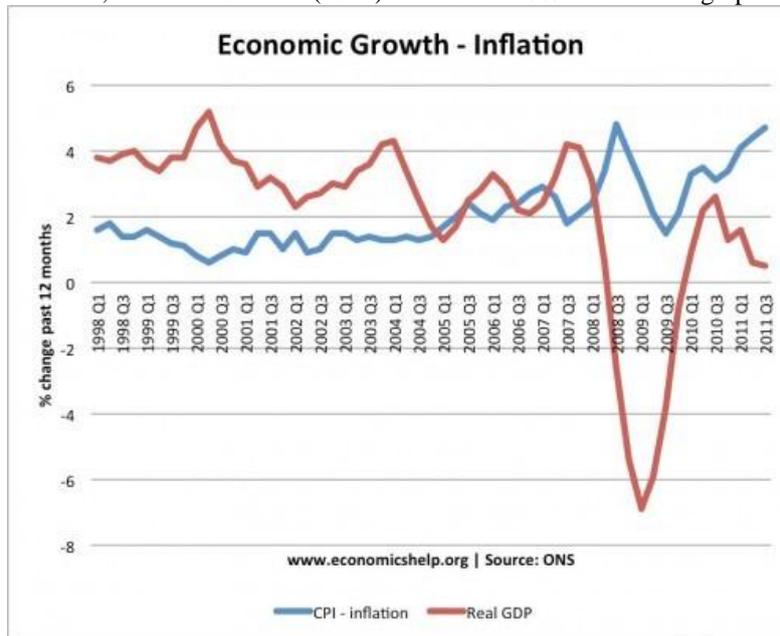
*Recession is one of the challenges to financial institutions. Economic growth is the causality and many firms disappear. Capital is lost and management skills are questioned. Efforts are always visible to the wisdom of management but how these efforts turn to be futile it is mystery. Man is competent each time from failure but the economy struggles always. Many governments disappear and there is political instability. There are several management and political decisions which are contributing to institutional failures. Reasons are many including natural calamities. It directly affects financial institutions. Financial institutions should survive or perish. Mechanism has to be reinvented suitably.*

**Key words:** Finance; Financial Institutions; Banks; Mortgages; Financial Crisis

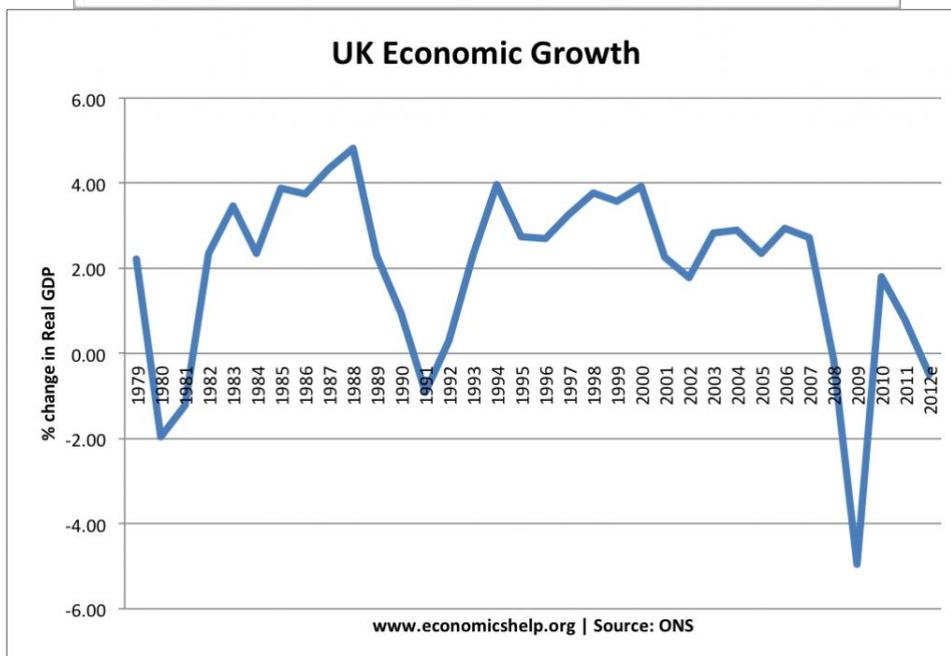
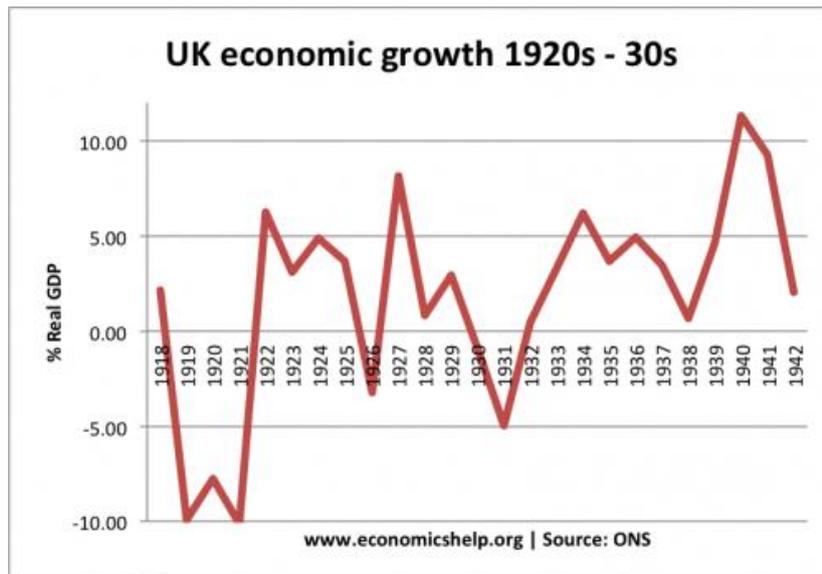
**JEL Classifications:** G28

**I. RECESSION AND RECOVERY**

In the last decade recession the financial institutions had to declare bankruptcy or to look for bail out by government (Thomas H. Jackson, David A. Skeel Jr (2012). Recession 2009 is shown in graph:



The most important cause for recession is the negative economic growth rate and it is common to 1930-32 and 1981 recessions as shown below:



The paradox shift played havoc in consumption and low employment continued during 1930-32 recession. Several economists of classical theory lost their wisdom of solution. The stock market crash of 1929 initiated this paradox shift. Austrian economists like Hayek and Ludwig Von Mises blamed unscrupulous credit boom. JM Keynes criticized wrong fiscal policy of tax cut poor monetary policy poor public spending. Marxists concluded the collapse of global capitalism. Friedman blamed the mismanagement of money supply and the failure of averting bankruptcy. Nearly 744 US banks became bankrupt in 1930. The recession in 1981 was due to faulty fiscal and monetary policies of foreign exchange rate and interest rate. The causes for the recession of 2008-2009 were mainly the wrong policies of fiscal and monetary policies and the loss of confidence of finance sector.

The financial institutions are responsible for the recessions and they are the worst affected institutions. Political and economic considerations are predominantly leading the institutional finance activities. Each recession has revealed the loss of employment, purchasing power, and growth rate.

There are several remedial measures to overcome recession. The first is the political decision. The second is the economic decision. The parameters of success are reflected in price stability, financial stability, balanced economic growth and employment. The implementing agencies are financial institutions. Thus the financial institutions shall be dynamic. Recovery from recession is associated with political and economic decisions. A comprehensive study on recessions and recoveries was carried for 21 countries such as Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, United Kingdom, and United States and there were three findings which include less frequent recessions in

advanced economies but with longer duration; financial crises are more severe with slow recoveries than other shocks like stock market collapse etc; and recoveries are weaker in case recession of region (Prakash Kannan et. al (2009)).

## **II. IMPACT OF DYNAMIC FINANCIAL INSTITUTIONS**

There are three impacts in the European Union and they pertain to liquidity and equilibrium, risks and stability, and short term influence (Jyh-Lin Wu et.al (2010)). The effect of recession of 2008-2009 was noticed early in 2007 on the instability of financial system in USA. In order to provide home loans USA introduced Fannie Mac and Freddie Mac to buy back securities from banks. The political decision of federal government imposing new controls on Fannie Mac and Freddie Mac resulted in loss of revenue to banks in 2004. It resulted in shifting mortgage pool to private sector from federal and the banks started mortgage securitization. The Securities and Exchange Commission allowed the investment banks for more liquidity in terms of debt limit of \$ 15 to \$ 40 to each every dollar (Brian Keeley and Patrick Love (2010)). When the financial crisis became louder, a global survey of CEO's held from September to December 2008 that the short term prospects declined from 42% to 11%. Trade also collapsed from 7.3% in 2007 to 3% in 3%. Unemployment increased from 7.5% in 2007 to 10% in 2009 in euro zone. China was worst hit by 53% less export but financial institutions acted swiftly in late 2008 to increase liquidity through high public spending. The financial institutions of Brazil and India performed so well during the recession. China, Brazil, and India helped in recovery from global recession (Brian Keeley and Patrick Love (2010)). Romania was less affected in the 2008-2009 recession and most of African nations remained less affected in the impact of recession as African Development Bank. Political decision of economic reforms and economic decisions of financial institutions in rationalizing corporate and bank balance sheets helped India to achieve higher growth. It improved the bank credit (Asian Development Bank (2016)). African Development Bank to bail out Nigeria from recession of 20 years by sanctioning loan \$1bn and to improve financial institution it has provided \$ 500 million to Development Bank of Nigeria (African Development Bank (2016)). African Development Bank has granted \$ 600 million to improve fiscal policy and structural reforms. The development of financial institutions in Nigeria is essential for economic growth. Unfortunately during recession the government is multiplied due to poor tax collection payment on social security schemes. It is another tool of mismanaging financial institutions. It does not equip financial institutions for future contingencies. Unfortunately the economists call it as 'automatic stabilizers'. Due to the mismanagement of financial institutions in the recovery of recession the financial instability leads to price instability.

## **III. RULES AND REMEDIES**

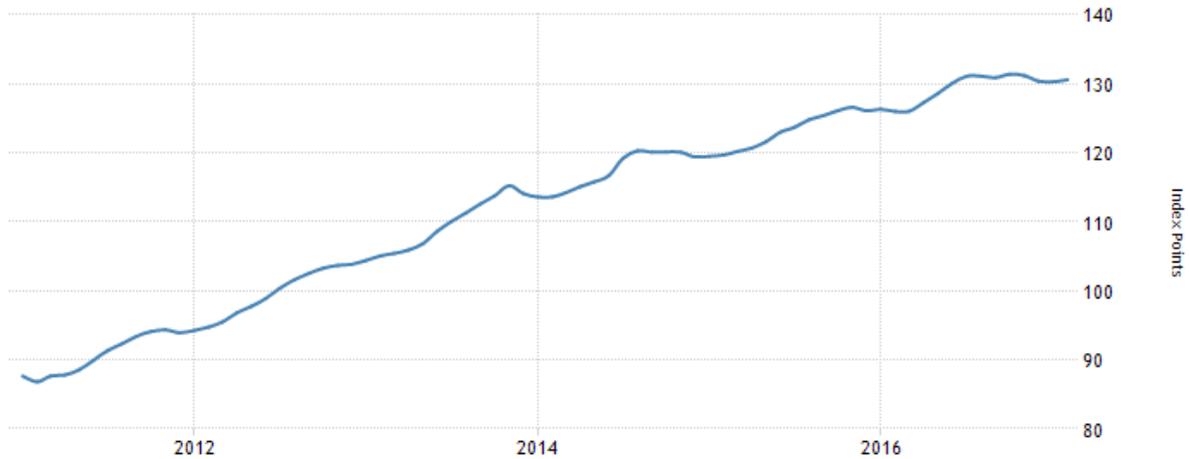
Over a period of time we have enhanced the competence of financial institutions through legal provisions, capital and investment guidelines, and the effective banking system (Thomas J. Brennan, Andrew W. Lo (2014)).

There are many tools to strengthen financial institutions. One of them is "ring-fencing" that has been followed in USA, UK, and Scotland. It identifies bad assets for which the governments gives guarantee and allows banks for normal banking. Another tool is the creation of bad bank like National Asset Management Agency (NAMA). It buys the troubled loans to avert collapse of property prices. This creates a vicious circle of bad assets under the nose of government. It is one of the worst instruments ever created in several nations. This is focused on public sectors which are managed by government directly or indirectly. The bad assets are piled up regularly. It is a gift to mismanagement. This has never made financial institutions dynamic. Another tool is nationalization of banks and it is successfully working in India and other countries. This tool facilitates financial institutions to function under defined rules and regulations. Now the private banks are also brought under Central vigilance Commission to curb practices. It is the extension of regulating banking system in complete. To empower the financial institutions there are three policies that include regulating financial markets, dealing with tax evasion and global ethical behaviour (Brian Keeley and Patrick Love (2010)). US Fed has already increased the interest rate and now within a span of four months the second increase is in 15 March, 2017. In fact it is third increase after financial crisis in 2008-2009. The rate hike will reach between 0.75 to 1.00 percentage points equaling the rate before 2007-2009 (Janet Yellen (2017)). The financial crisis affected GDP. It is reported that the President Trump administration will pursue

The Macroprudential policy aims to offer certain principles for dynamic financial institutions. One of them is to safeguard entire financial system rather than individual financial institutions (Luis I. Jacome and Erlend W. Nier (2012)). The proposals of Macroprudential policy are allowing the traditional rules and regulations to exist and serve the financial system and generate new regulations to counter systemic risks for safeguarding stability (Crockett, 2000). In fact this approach is still evolving and this approach is itself dynamic. It suggests three important policy issues such as institutional underpinnings, policy action against systemic risks, and international cooperation. These policy issues are nothing new and these are the same put in new bottle. However there are findings that the monetary policy is useful in containing recession and strengthening recoveries. Fiscal policy performs stimulus role for recoveries (Prakash Kannan et. al (2009)). These findings are not genuine as USA took almost 10 years to recover after 2007 and European Union is still recovering. Recently in India the price of vegetables and pulses increased abnormally during the period of Dr. Man Mohan Singh, who is respected economist and the then Prime Minister of India. Dr. Montek Singh Alluwallia was the

Deputy Chairman of Planning Commission, a renowned economist during this period. The raising prices could not be stopped. Weekly promises to control the price rise were regular but without a relief.

INDIA CONSUMER PRICE INDEX (CPI)



SOURCE: WWW.TRADINGECONOMICS.COM | MINISTRY OF STATISTICS AND PROGRAMME IMPLEMENTATION (MOSPI), INDIA

Reserve Bank of India maneuvered the interest rate and rapo rate to contain inflation from 2012 onwards either increasing the rapo rate or reducing the interest rate. Unfortunately inflation continued to increase. Thus the monetary policy has failed to contain inflation.

India Prices	Last	Previous	Highest	Lowest	Unit	
<u>Inflation Rate</u>	3.65	3.17	12.17	3.17	percent	[+]
<u>Consumer Price Index CPI</u>	130.60	130.30	131.40	86.81	Index Points	[+]
<u>GDP Deflator</u>	125.40	119.50	146.50	100.00	Index Points	[+]
<u>Producer Prices</u>	185.50	184.60	185.90	97.50	Index Points	[+]
<u>Producer Prices Change</u>	6.55	5.25	34.68	-11.31	percent	[+]
<u>Export Prices</u>	300.00	312.00	312.00	100.00	Index Points	[+]
<u>Import Prices</u>	518.00	518.00	518.00	100.00	Index Points	[+]
<u>Food Inflation</u>	2.01	0.53	14.72	0.53	percent	[+]
<u>Cpi Transportation</u>	117.40	117.10	117.40	103.20	Index Points	[+]
<u>Inflation Rate Mom</u>	0.23	-0.08	1.77	-1.00	percent	[+]



As soon as food inflation declined among other political decisions the inflata rate declined. When the bumper harvest took place the food prices declined. Even though there was bumper harvest of onion the price increased because of wrong political decision of export. The hoarding also contributed for price rise because of political tolerance. The economic decisions slowly yielded result.





EU inflation slowly increased in the last 11 months from July 2016 onwards. The recovery of recession took almost a decade. It shows the monetary policy cannot contain liquidity. Here both financial and non financial institutions to work together to regulate liquidity and equilibrium.

Therefore the dynamic financial institutions have to devise the strategies which are more appropriate to meet the challenges. It does not we do not have answers. We have sufficient answers but that need to operate along with new strategies and new functioning models.

1. The Policy mix of JM Keynes is excellent strategy for recovery from recession
2. The Philips curve of JB Taylor is equally good.
3. New strategies:

3.1 Slower growth model

After financial crisis, the banks reduced their high risk assets and returned normal growth. In the process these banks reorganized their assets in the ratio of 50:50 between income and business structure. Mortgage loans declined fast which resulted in reduction of retail loans. In USA it fell down from 65.1% to 53.5% and European banks followed the same with 50% decline from 2009 to 2014. But China improved it from 20% in 2009 to 30% in 2014. The shift policy has accelerated quick recovery from recession and the growth rate remained the same unlike in Euro areas and USA (Bank of China (2016)).

3.2 Overseas expansion

The overseas profit of major banks declined by 4% in 2014 from 2010 of US and Europe but in contra it increased by 2% and 7% of Chinese and Japanese banks respectively. The financial institutions are dynamic in China and Japan and therefore recovery from recession was very quick and fast.

3.3 Cost control, and

Most of the banks reduced their employees and shut down unremunerative outlets.

The firing the employees during lean season and hiring more in boom are the bad practice of financial institutions. This is for survival. This is neither economic decision nor political decision but it is decision of failure. Such practice would never become dynamic. The philosophy of HRD and man power competence were thrown to wind and again procured them at boom in the open market. The employment generation and degeneration are the aspects of normal monetary policy which failed miserably during the recession selectively and universally. In other words the defect is not in monetary policy but the financial institutions are not dynamic.

3.4 Corporate governance

During the recession the banks have implanted several corporate governance principles and the banks have realized success. This is one of the key areas of dynamic functioning of financial institutions.

4. Liquidity Profile of financial institutions

The monetary and fiscal policies are responsible for liquidity management but during the recession and recovery these policies appear to be ineffective. Mere policies do not cause recession and recovery but there are other unrelated events and political climate do contribute immensely in the recession and recovery. Unexpected and unsolicited conditions do occur normally and it cannot be said that it is abnormal. The challenges are the opportunities to prove the dynamic functioning of financial institutions. In 1991 the Reserve Bank of India decided to bail out Indian economy by pledging gold in Bank of England when IMF failed to help India in the

balance of payment crisis. This is the best decision of the dynamic function of financial institutions. The single decision of the Reserve Bank of India has proved successful for the new Finance Minister Dr. man Mohan Singh to bring economic reforms. Today India is the fifth largest economy overtaking Britain in terms of GDP in 25 years of this decision. India will overtake USA in 2050 to become the second largest economy and China has overtaken USA already to become first largest economy (Darren Boyle (2017)).

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