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TERMINATOR

SAFE UPDATES – KEEP INFORMED

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Editorial Preamble: Terminator

1.1 POLICY ERRORS

Poisonous fallout of quarterly dislocation

The magnitude of the dislocation caused in the last quarter of 2008 to businesses across the globe, and certainly in Asia, is crystallising into hard and unpleasant numbers. One caused by the financial crisis generally and the mid-September 2008 failure of Lehman Brothers, in particular. The international *financial crisis* has given way to the international *economic crisis*.

Japan gives the best evidence. Japanese banks did not, as a rule; load up on toxic US mortgage debt. Yet the crisis affected the country deeply. For many years leverage was easily available to Japan due to the carry-trade. That was the prolonged period when the yen functioned solely as a safe haven. Then, with the credit market turned, bringing the carry trade down with it. It's squeezed out of the system in Q4 of 2008. For Japanese trade, the financial crisis had two critical effects – it made its exports too expensive, thanks to the yen appreciation and it slashed away global demand for those exports. The sight of half-laden container ships playing the seas is a real clue that this is no ordinary global showdown.

There was one development and one event that played a fundamental role in shaping the depth and severity of the crisis. The development was the astronomic rise in crude oil and food prices through the last quarter of 2007 and first half of 2008 – well after the financial crisis in the US mortgage market was out in the open. And the Lehman Brothers failure was that one event that sent an already enfeebled and disoriented global economy to the floor.

After five years of above-trend geographically well-distributed growth, the world's economies were squeezing resources tight and a cyclical downturn was on the cards.

It seems to be a long time ago. But not even a year has passed since riots broke out in small developing countries that import their food. It has only been six short months since skyrocketing oil prices were devastating household, corporate and government budgets. And these price explosions came at a time when much of the developed world was already in recession! It did not pass away into the night as a memory of another disturbing nightmare, but caused material and considerable damage to every aspect of the world's economies, leaving it much more vulnerable to external shocks.

Sound policy in previous time periods places us in a batter position in future ones. Likewise, policy errors make for a steeper hill to climb. A self-delusion that it was market demand and supply which had pushed oil to $147 per barrel. Also the one that suggested slashing policy rates in January '08 to avert recession or the prize-winning decision to let Lehman go in September '08, have made the hill ahead of all of us, and especially for the US, that much harder to climb. Oh, and by the way, did you know that global oil demand in 2008 was actually less than it was in 2007?

There is another aspect of the deep dive that most Asian economies took in the last quarter of 2008 that is interesting. Over the years there has evolved an arrangement:

Japan exports machinery and high-tech stuff to China; S-E Asia ships intermediates to China. All of this is then used to make goods for sale in the US. At each stage there is some value added and the final product on sale in a US department store is the sum of all of the value added. When demand sank in the US, the impact on the supply chain was much larger. The sum total of the damage was much larger than the slippage in the final aggregate demand emanating from the US consumer. Not just by virtue of the multi-part transactions, but also because many transactions could not be completed because one part failed to materialise – leading to inventory piling up and stock losses.

Is this the market bottom?

After writing off 2008 as a bad dream, the Indian investor is now left wondering whether it is time to call a market bottom anytime soon or if 2009 will be a repeat of miserable 2008. Expert opinions are divided between a potential market rebound and an imminent crash. It is, therefore, worth trying to make some sense out of the mayhem that may help guide investors to make informed decisions.

Viewed through the prism of the critical factors that influence equity markets – earnings growth, valuation, interest rates and liquidity – and given the earnings de-growth projections of corporate India and the consequent issues on market valuation, the potential firming of the interest rates in the next few months and the dim prospects of capital inflows it is not surprising that the market is in a state of stupor. The policy vacuum for the next three months in views of the elections, especially in the context of continuing global meltdown is certainly adding to the all pervading negative sentiments.

Investors would do well to work towards enjoying the symphony of long-term value creation. Subjecting available information to a rigorous analysis and identifying companies that can survive the economic slowdown and grow their business and cash flows can indeed be rewarding, more so because of the current rock bottom valuations of several investment worthy companies.

It is important to realise that the stock market reflects price and not value. The market price represents the meeting point between the most motivated seller and the keen buyer willing to part with his money. Given that the shares that are exchanged represent a small portion of the company's share capital, the price of the transaction does not affect the true worth of the company.

To sum up, though the near-term outlook for the market is not rosy, this phase too shall pass. Beyond the current bear market, the economic growth potential of the Indian economy is certainly not in doubt. An intelligent investor should identify companies that can survive the current downturn and generate good returns when the tide turns over the next few quarters.

1st week of March '09 – Sensex down by 6.36% in the week

Daily review	27/02/09	02/03/09	03/03/09	04/03/09	05/03/09	06/03/09
Sensex	8,891.61	(284.53)	(179.79)	19.20	(248.57)	127.90
Nifty	2,763.65	(89.05)	(52.20)	22.80	(68.50)	43.45

Rate cut, receding inflation and buoyant world market failed to inspire confidence in the bulls. Sensex crashed to a fresh 40-month low on Thursday. Brokers attributed the slide to heavy selling by leading FIIs, who are learnt to be swamped with redemption requests in their home markets. US-based Janus Capital Group, Fidelity Global, UK-based Crown Capital, and the Children's Investment Trust were said to be among the prominent sellers. Domestic institution continued to remain net buyers.

Weekly review	27/02/09	06/03/09	Points	%
Sensex	8,891.61	8,325.82	(565.79)	(6.36%)
Nifty	2,763.65	2,620.15	(143.50)	(5.19%)

In the week gone by, Indian capital market continued to display extreme volatility, and sentiments were spooked with both Sensex and the Nifty touching three-year low. Global markets also saw a big meltdown during the week and the Dow Jones plunged below 6,600 mark. RBI announced rate cuts by 50 bps in both repo and reverse repo. However these rate cuts failed to boost the market sentiments.

The next week, a short one with just three trading sessions will continue to remain choppy. FIIs pulled out about Rs 2,000 crores from markets in just last one week pushing rupee to a new low of Rs 52.18. This has resulted in indices cracking significant levels and closing nervously. With election programme now announced, uncertainty in the markets is likely to stay with absence of any other positive triggers. Inflation remained the only silver lining for the economy moderating to 3.03%. On the whole, markets could remain edgy with global news flows driving the sentiments.

2nd week of March '09 – Sensex up 5.17% in the week

Daily review	06/03/09	09/03/09	10/03/09	11/03/09	12/03/09	13/03/09
Sensex	8,325.82	(165.42)			183.35	412.86
Nifty	2,620.15	(47.00)	Holi	Holi	44.30	101.80

Distinctly weak global trends weighed on the local bourses on Monday as the benchmark Sensex fell by 165.42 points and registered its 40-month closing low of 8,160.40 on all-round selling by foreign funds and operators. The market resumed on a sluggish note on the back of faltering Asian indices at the opening, which later remained in negative after a lower beginning in European markets.

Weekly review	06/03/09	13/03/09	Points	%
Sensex	8,325.82	8,756.61	430.79	5.17%
Nifty	2,620.15	2,719.25	99.10	3.78%

On Friday Sensex shoots up 413 points on strong global cues despite FII outflows. The benchmark Sensex registered its highest gain in the current calendar year. Fall in inflation for 6th consecutive week to 2.43%, the lowest in nearly 7-years, also partly boosted sentiment. The domestic capital markets were driving more by global news flows. This week saw the Dow Jones moving up by around 8% with the NASDAQ also surging by about 10%, typically being a bear market pull-back rally. The greatest reason for hope at present is that almost all hope seems to have been lost.

3rd week of March '09 – Sensex up 2.40% in the week

Daily review	13/03/09	16/03/09	17/03/09	18/03/09	19/03/09	20/03/09
Sensex	8,756.61	186.93	(79.22)	112.86	25.07	(33.07)
Nifty	2,719.25	58.00	(19.80)	37.25	12.45	(0.10)

Weekly review	13/03/09	20/03/09	Points	%
Sensex	8,756.61	8,966.68	210.07	2.40%
Nifty	2,719.25	2,807.05	87.80	3.23%

Indian capital markets continued to trade in a narrow range with a positive bias. Both the indices – Nifty and the Sensex – closed moderately higher by around 3% following strong sentiments witnessed in the global markets which resulted in continued unwinding of short positions in the local markets.

Wall Street recovers further from 12-year lows. Details of the Treasury Department's much delayed plan to sop up bank's toxic assets are expected early next week, ahead of a key G20 meeting in early April. The weakness of the economy will also likely be highlightened by reams of economic data. Still the bank plan more than any other factor probably will be in the forefront of investor's mind. Pretty much everything else is going to be background noise to the core issue: confidence in banks.

4th of March '09 – Sensex crosses 10k-mark

Daily review	20/03/09	23/03/09	24/03/09	25/03/09	26/03/09	27/03/09
Sensex	8,966.68	457.34	47.02	196.86	335.20	45.39
Nifty	2,807.05	132.85	(1.20)	45.65	97.90	26.40

Weekly review	20/03/09	27/03/09	Points	%
Sensex	8,966.68	10,048.49	1,081.81	12.06%
Nifty	2,807.05	3,108.65	301.60	10.74%

The Sensex closed above the psychological 10,000 mark after more than two-and-a-half months, reviving fond memories of the boom time, and hopes that equities may finally be on the recovery path. Brokers attributed the gains of frantic covering of short positions in the derivative segment – being settlement day – and the upbeat mood in world markets. Brokers say mutual funds have been booking profits due to redemption pressures, but insurance companies continue to be steady buyers.

The key index registered its largest weekly point-wise gain of 1,081.81 points in the year 2009 on all round buying as bulls were back in action. The 30-share index also recorded its fourth highest ever weekly point-wise gains in the history of the BSE. The Sensex completed its three-week gaining string with a sharp rise a total of 1,722.67 points, or 20.69%, indicating that the worst might be over. Most of the global indices displayed a firm trend on hopes that the downturn in US economy is easing.

It is hard for data to come worse than expected

Since hitting those significant lows, the US market has rallied strongly, lifting the benchmark S&P 500 more than 20%. Eminent portfolio managers said that consolidation will not be a bad thing. But they are continuing to look for signs that things aren't getting worse.

The market will be looking for continued 'green shoots' that things continue to improve on a marginal basis, either slower rates of decline or actual improvement.

Reports that have helped fuel hopes of some stabilisation include unexpected strong February new and existing home sales as well as a slightly less dire than expected reading on fourth-quarter gross domestic product. The release of long-awaited US government plan to rid bank balance sheet of money-losing "toxic" assets has also been a big spur.

Analysts said there was an emerging consensus that economic data could not get much worse, opening the door to possibly more gains. We are now in a position where and from the corporate level we're even seeing positive surprises. Not necessarily good number but not as bad and expected.

Last 2 days of the fiscal

Daily review	27/03/09	30/03/09	31/03/09	01/04/09	02/04/09	03/04/09
Sensex	10,048.49	(480.35)	140.36	193.49	446.84	
Nifty	3,108.65	(130.50)	42.80	39.40	150.70	Holiday

Weekly review	27/03/09	31/03/09	Points	%
Sensex	10,048.49	9,708.50	(339.99)	(3.38%)
Nifty	3,108.65	3,020.95	(87.70)	(2.82%)

Monthly review

Month	Dec '07	March '08	June '08	Sept. '08	Dec. '08	Jan. '09	Feb. '09	**March'09**
Date	28/12/07	31.03.08	30.06.08	30/09//08	31/12//08	30/01//09	27/02//09	**31/03//09**
Sensex	**20,206.95**	**15,644.44**	**13,461.60**	**12,860.43**	**9,647.31**	**9,424.24**	**8,891.61**	**9,708.50**
Points	Base	(4,562.51)	(2,182.84)	(701.17)	(3,213.12)	(223.07)	(532.63)	**816.89**
%	Base	(22.58%)	(13.95%)	(5.21%)	(24.99%)	(2.31%)	(5.65%)	**9.19%**

D-street gets Rs 80k-cr LIC cover to fight bears

Living up to its image of a contrarian investor, the Life Insurance Corporation of India (LIC) has been the biggest buyer of Indian equities during the current financial year. The insurance major has invested close to Rs 40k crore in equities and other Rs 40k crore in non-convertible debentures of companies. LIC's purchases come at a time when foreign institutional investors have been fleeing the Indian markets in droves. So far in 2008-09, FIIs have net sold shares worth nearly $10 billion.

LIC has increased stake in many frontline companies, including banks such as SBI, HDFC Bank, Syndicate Bank, Union Bank of India, Allahabad Bank and Andhra Bank, through open-market purchases. The insurance major bought an additional 2-3% in these banks over the past 6-7 months. It has also increased holdings in a few non-banking blue-chip companies such as Cummins India, ABB, Mahindra and Mahindra, Dabur India and Zee Entertainment, according to disclosures filed with BSE.

LIC executive director N Mohan Raj says, "We are long-term investors. We don't take sector-specific calls, rather prefer to invest in specific stocks of companies which have growth potential and are available at attractive valuations".

LIC's equity investment pattern shows that it focus has been largely on banking stocks, which have witnessed massive value erosion amid the ongoing global financial crisis as well as a slowdown in the domestic economy. The largest insurer in the country has also increased its investments in NCDs of many blue-chip companies, pumping in more than Rs 40,000 crore. Compared to last year, LIC's investments in NCDs have increased substantially in 2008-09. NCD is a structured debt product that cannot be converted into equity shares of the issuing company as opposed to convertible debentures. LIC has invested in NCDs which will earn them a coupon rate between 11% and 13%.

When will the bull return?

The stock market is crashing, and more than $10 trillion of stock market wealth has vanished. The questions on the minds of investors and money managers are threefold: How much longer will the bear market last? How low will the averages go? And when might investors get their money back?

History can't provide as many clues to the market's direction as usual. That's because while most bear markets more or less track the business cycle, but this one began with a broken financial system. And that makes the current bear more like the one that started from 1929-32 than others of the past 100 years. But that analogy doesn't fit perfectly either. So we have no good precedence to help us.

Price-earning ratio:
The most basic market gauge is the PE ratio, which measures a company's share price relative to the earnings it generates. Historically, the overall market has traded at price that average 15 times earnings, ranging from roughly 8 during the worst bear markets to 25 or greater during bull runs. At the start of 2009, the market's PE ratio was about 11, suggesting that stocks were already cheap and wouldn't drop much more. But, why did the PE ratio get it so wrong? It's because *t*he "e" has plunged further, and as a result the stock market is dropping.

Sure, a lot of earnings vanished amid a fog of one-time charges that may say nothing about companies' future profit power. But analysts still aren't seeing through that fog; their earnings projections are more scattered than they've been in two decades. "You don't know what the 'e' is because the economy is in free fall," says Charles Biderman, CEO of TrimTabs Investment Research.

Monetary policy:
Before the current slump, in all but one bear market since World War II: When the economy slowed, the Fed began cutting rates to turn the business cycle back up. The Fed has cut rates 10 times since August 2007, to essentially zero, and yet the markets keep slipping.

Cash on the sidelines:
Another signal is the cash on the sidelines or funds in money markets or saving bank accounts. In the normal times, strategies could look with some confidence to money in these accounts as buying power that investors were holding back from the stock market. The greater the cash compared with the value of the overall market, the more impact it could make on stocks. In January the reading reached its highest levels since 1984. Even so, he's dubious. As long as investors are worried about their own income, the money seems most likely to stay right where it is.

With the ordinary historical measures and analytical ratios failing, experts are looking further for clues. During the Great Depression, the Dow plunged 89% from the 1929 crash to July 1932. Then it went through some big swings before losing 49% in 1937-38 as the economy tanked again. World War II, which grew in part out of financial stress around the globe, followed. The Dow didn't get back to its 1929 high until 1954. Back then Washington made major policy mistakes, such as erecting trade barriers and letting too many banks fail without protecting depositors.

Much, of course, has changed in the US since the Great Crash. This time, with a couple of exceptions, the government hasn't blundered so, even though it hasn't yet solved the economy's many problems. So this bear market likely won't rival that of the Great Depression.

No room for adventurism

The last quarter GDP growth for the calendar year 2008 at 5.3% came in well below expectations, the immediate consequence being a sharp revision in 7.1% growth estimate for the entire fiscal 2008-09 and a lot lower for the 2009-10 fiscal. The sharp drop in growth is largely because of a 2.2% contraction in agriculture, forestry & fishing, which would raise worries about rural consumption, the major support to the economy in this downturn. While part of the reason for contraction in the farm sector is the high base of the last year – 6.9% growth in Q3 last fiscal – there is definitely some stress.

It should now be clear to policymakers that the near 9% average growth in the first four years of UPA rule had many of its drivers outside the country. In the high tide of liquidity-driven global boom, India, too, went a couple of percentage points up as investments added to the cheap debt-fuelled consumption demand. By that reckoning, we also need to quickly discard the illusion that we can return to the high growth path through our own efforts anytime soon.

Exports dip 13% in February

The downslide in India's exports continued for the fifth straight month of February 2009 making the revised export target for the fiscal appear distant. Exports posted a 13% fall at $13.04 billion taking up the total for the April-February 2008-09 period to $156 billion. Exports started declining in October 2008 when it registered a dip of 12.1%, followed by a 9.9% dip in November 2008, a smaller 1.1% decrease in December 2008 and the sharpest fall of the fiscal in January 2009 at 15.9%

External debt expands to $231b in Q3

Finance ministry said that the country's total external debt rose to $230.85 billion at the end of December 2008, up $6.2 billion from the total foreign debt in September, mainly because of a rise in long-term borrowings. Total external debt stood at $205.98 billion at the end of December 2007. More than 53% of the country's external debt was in dollars while almost 16% was in yen.

Current a/c deficit widens, capital a/c turns negative

The deepening of the financial crisis has taken its toll on the country's external sector balance sheet. India's balance of payments position worsened with deficit in both current and capital accounts widening during the quarter ending December 31, 2008. Invisibles, essentially comprising remittances from Indian diaspora, and software services export proceeds have failed to salvage the current account deficit. They have risen only marginally over the previous comparable quarter. However, since imports rose faster than exports during the period, the trade deficit has almost doubled. The current account records transactions against purchase of goods and services or income from a service.

Moreover, the global credit crunch resulted in huge capital outflows both by portfolio investors and banks. As a result, the capital account ended in a deficit. For the first time in a decade, the capital account balance turned negative during Q3 of 2008-09 mainly due to net outflows under portfolio investment ($5.8 billion), banking capital ($4.9 billion) and short-term trade credit ($3.1 billion). Capital account inflows are investment or debt-creating flows. The overall balance of payments – the country's external sector balance sheet – witnessed a deficit of $17.8 billion compared to the record surplus of $26.7 billion recorded in the same period a year ago. The balance of payments is the sum of the current account and capital account transactions.

Print notes to keep the economy afloat

The newly-elected president of industry body CII Venu Srinivasan said, "High fiscal deficit due to government borrowings is preventing interest rates to fall further, delaying private sector investments in the economy. Pointing out that the combined fiscal deficit of the central and state governments is more than 10%, he said: "Monetising the deficit and improving the currency flow is very important, or else investments will dry up in the country."

Mr Srinivasan said that if banks buy bonds, instead of lending, borrowing will shrink, which will impact economic growth. "In spite of the government's measures and RBI's decision to reduce policy rates, credit to the industry is still scarce and expensive."

CII chief said, "If the government is going to borrow from the market to fill the fiscal deficit, then they are going to suck up all the money available in the banks and we will be crowed out." Raising concerns over the government's decision to raise additional Rs 300,000 crore during 2009-10 to fund public expenditure, CII chief said very little money would be left for the private sector.

He asked the government to print more currency notes to bridge fiscal deficit and keep the economic growth, which is reeling under the impact of global financial meltdown. Pitching the monetisation of the budget deficit, he said, "It means printing notes - which means you have the risk of increasing inflation but at the same time you will keep the economy afloat."

He further said that government should also amend the Fiscal Responsibility and Budget Management Act, which imposes restrictions on public expenditure. He further added that the central bank should further cut repo and reverse repo rates by another 50 basis points. "However this would only be effective if bond yields start reflecting the actual health of the economy."

Talking about growth, he said that the Indian economy is expected to grow at around 6.5%, as per the forecast made by IMF in 2009-10 and stressed on boosting the share of manufacturing sector in GDP. "It is imperative to reduce competitive disadvantages faced by Indian companies in relation to power and transportation infrastructure. High interest and infrastructure costs have put Indian manufacturing at about 15% cost disadvantage, compared to their peers in other emerging economies."

He said, the implementation of goods and services tax (GST), scheduled for April 2010, would unify the Indian market but the government should announce a detailed road map and framework before implementing next year. "GST would be useful only if it is unified and industry has to deal with tax authorities at one location only."

He announced the 3 priority areas for CII: Economic revival through stimulating manufacturing sector and renewed focus on services besides focusing on infrastructure development and governance.

Mr Srinivasan, also the chairman and managing director of two wheeler maker TVS Motor, sought fundamental changes in the automobile sector. Referring to the system of repossession of vehicles from loan defaulters, he said that the entire process should be made easier to encourage banks to extend retail finance in the automotive sector. "Bank would not come forward and lend unless they are allowed to repossess vehicles on which money is outstanding." Banks had scaled down retail auto finance as recovery and repossession from defaulters become a problem which slowed retail financing and brought down sales in the industry.

The Obama housing plan

India cannot grow fast again till the US economy recovers. And US recovery depends on reviving the housing sector. Alas, the Obama Plan for housing is a crutch, not a cure. Putting all the blame on insufficient regulation and overpaid greedy lenders cannot rectify the structural flaws of the US housing. Equally to blame is the political illusion that by tweaking markets and arm-twisting lenders, you can make all Americans home owners.

The Obama plan has three main components: One, cash incentives (totalling $75 billion) for lenders and home owners to renegotiate mortgages; Two, allowing those whose mortgages exceed home valuation to refinance up to 105% of the home value; Three, fresh capital of $200 billion for government agencies (Fannie Mae and Freddie Mac) to expand mortgage lending.

The Obama plan aims to raise distressed home value by $6,000, cut foreclosures, and prevent entire localities from becoming ownerless and derelict. However, refinancing mortgages up to 105% of home value will be disastrous if home prices fall further. The crisis owes much to the slack lending standards of Fannie Mae and Freddie Mac, yet the Obama Plan provides these agencies additional capital to extend substandard lending. This risky approach will work only if home prices rise soon. Otherwise, it will cause another housing crisis within two years. The Obama Plan addresses current distress, but ignores two fundamental flaws in the whole housing system:-

One is the limited liability of home owners:

In most countries, a mortgage is secured by the value of the home plus a personal guarantee of the home owners. So, if he defaults, the lender can go after his salary or other assets. This is called a full recourse loan, and encourages home owners to do their best to repay loans. For instance, European countries have full recourse mortgages – the lenders can go after all assets.

But, the US has non-recourse mortgages, secured only by the house. The lender cannot go after other assets of the borrower. If the market price of a house sinks below the mortgage outstanding, the owner can simply walk out and mail the house keys to the lender, with no further liability. This “jingle mail” loophole encourages willful defaults.

The Obama Plan is silent on closing the jingle-mail loophole. Politicians currently paint all lenders as crooks and borrowers as victims. Such populism ignores the perverse incentives of jingle mail, which erode the foundations of the housing market.

The second, more fundamental flaw is the political determination to tweak housing markets to somehow attain the ideal of universal home ownership:

In a market system, monthly mortgage payments are necessarily higher than monthly rents. People with uncertain incomes should rent cheaply, not borrow expensively to buy house. Renting is an essential part of a housing market, not a deficiency.

Political measures to subsidise ownership and discourage renting have contributed to terrible lending and borrowing practices that caused the current crisis. Instead of reforming these, the Obama Plan provides billions to subsidise those same terrible practices. These practices survived for 60 years because of a quirk: US home process never fell after World War II.

In a market system prices fall as well as rise. So, when finally US home prices fell in 2007, the system collapsed. The US like other countries has a housing system that can cope with declines in home prices. Though well intentioned, The Obama housing plan is a wrong instrument.

If you seek universal home ownership, the best way is massive public housing followed by privatisation (sale to the renters). Government should build low-cost houses and rent these cheaply to people with low or uncertain incomes. Renters who pay rent for a specified period – say 12-15 years – will become owners. Margaret Thatcher in Britain converted millions of tenants into home owners. This is not socialism. Even in pre-communist Hong Kong, almost half of all housing was public housing. It was a non-market measure for a non-market aim.

If Obama is serious, he must grasp some nettles. He cannot have both responsible lending practices and universal home ownership. If he wants responsible lending, he must explicitly abandon the goal of universal home ownership, and aim for affordable rents. If on the other hand Obama wants to aim for universal home ownership, he should opt for massive public housing followed by privatisation.

Alas, the Obama Plan refuses to face up to these hard choices. Instead, it seeks to reform to the pre-crisis situation, which was based on the assumption that home prices would always go up and never down. This is myopia or cowardice, or both.

Obama's protectionism

President Obama is unquestionably more protectionist than Bush. In his latest move, he pledged to withdraw tax breaks for the US companies that shipped jobs abroad.

US companies getting government assistance have been stopped from issuing H1B visas to professionals from abroad. More threatening is the prospect that such companies will not be allowed to offshore any services at all. Forcing such companies to use expensive US services instead of cheap offshore services can only worsen their financial health.

More than 1,000 US companies have operations abroad, and some politicians may interpret this as shipping jobs abroad. That is plain wrong. In a competitive world, firms that do not offshore services become uncompetitive and die. Thus offshoring saves jobs, though Obama dare not say so during a recession. Economist knowing full well how the Smoot-Hawley tariffs, intended to protect US jobs in the Great Depression, which actually worsened the Depression.

Right now, Obama's protectionism is at a low level. But if the recession persists – which is quite possible – expect protectionism to go from low to medium.

New British norms

London: A distant dream for skilled Indians

The recent changes to Tier 1 of UK's points-based immigration system – which addresses highly-skilled immigrants, and attracts young Indians in a big way – is causing sleepless nights for many of those aspiring to go to the UK. The new terms – which make a master's degree and a salary of at least 20,000 pounds necessary – will close the doors for several young Indians. The UK government has also tightened the resident labour market test for Tier 2 skilled jobs so that employers must advertise more rigorously in the local market before they can bring in a worker from outside Europe.

Global economy to contract in Great Recession: IMF

IMF managing director Dominique Strauss-Khan said, “The world economy is likely to shrink to “below zero” this year, in what many are now referring to as the Great Recession. Continued de-leveraging by world financial institutions, combined with a collapse in consumer and business confidence is depressing domestic demand across the globe, while world trade is falling at an alarming rate and commodity prices have tumbled. He said the crisis threatens to unravel economic and social success over the last decade and that millions of people will be thrown back into poverty. We must ensure that the voices of the poor are heard. This is not only about protecting economic growth and household incomes – it is also about containing the threat of civil unrest, perhaps even war.

US trade deficit shrinks

The US trade deficit plunged in January to the lowest level in six years as a deepening recession cut demand for imported goods at an even faster rate than for exports. The Commerce Department said the trade imbalance dropped to $36 billion in January ’09, a decline of 9.7% from December and the lowest level since October 2002. The crude oil imports dropped to the lowest point in three years and demand for a wide variety of other foreign goods from autos to heavy machinery and household appliances declined. The import declines helped offset a continued slide in US exports which fell to their lowest level since September 2006, a drop that has contributed to the severe recession in US manufacturing. For January, exports of goods and services fell 5.7% to $124.9 billion. Demand for a wide variety of US-made products from farm goods to autos to civilian aircraft all dropped in January.

Imports fell even more sharply in January ’09, declining 6.7% to $160.9 billion, the lowest level for imported goods since March 2005. The decline in imports was led by a 25.2% drop in imported crude oil, which fell to $11.9 billion in January ’09, the lowest level since February 2005. The average price for a barrel of crude dropped to $39.81, also the lowest point since February 2005.

US economy plummets, biggest since 1982

The US economy suffered its deepest contraction since early 1982 in the final quarter of 2008, shrinking at a much worse-than-expected -6.2% annual rate as exports plunged and consumers slashed spending. A month ago, the Commerce Department had estimated the economy shrank at a 3.8 percent pace in the final quarter ending December 2008. But downward revisions to inventories, exports and spending led it to issue a much weaker figure, just shy of the 6.4% rate drop seen in the first quarter of 1982, when the economy was in a recession that lasted 16 months. Chief economist Bill Cheney, at John Hancock Financial in Boston said, “These numbers show a very depressed state of the economy at the end of 2008 and point to it continuing to be equally bad in the first part of 2009. It tempers the shock and surprise.

The Commerce Department said consumer spending, which accounts for more than two-thirds of domestic economic activity, dropped at a 4.3 percent rate in the final quarter of 2008, the biggest decline since the second quarter of 1980. The spending decline lopped more than 3 percentage points off GDP. Consumer spending contracted for a second straight quarter. Exports, until recently one of the few pillars supporting the distressed economy, tumbled at a 23.6 percent annual rate, the steepest plunge since 1971. Inventories show a $19.9 billion decline in final quarter of 2008 highlighting the severity of the recession. Business investment fell at a 21.1 percent rate, the largest drop since 1975. That took away nearly 2.5 percentage points from overall GDP.

3.1 MUTUAL FUND HOUSES

Assets in a flux

As the 2008-09 fiscal year drew to a close, the chief of one of the biggest fund houses watched with dismay as his top institutional investors led by banks and corporates pulling out over Rs 10,000 crore in just two days. For banks, with excess cash that it parked in liquid or liquid plus schemes, this is the time for year-end window dressing. The fund house boss reckons that the mutual fund industry’s assets would have fallen by close to at least Rs 100,000 crore in March alone.

For over a decade, in tune with the growth in the equities market, and the need to ensure more allocative efficiency of capital, policymakers had sought to push mutual funds as a safer vehicle of investment for retail or small investors. Fiscal incentives in the form of tax breaks have also helped the industry scale up in size. The upswing in equities fuelled by excess liquidity led to a heady run for fund houses for a good part of 2005 to 2007-2008. But in October 2008, the draining of assets prompted by liquidity-strapped investors fleeing and worrying over the quality of the asset portfolio of some of the asset management firms turned the spotlight on the industry again, especially after the Indian central bank was forced to open a special window to provide liquidity for addressing a near-term concern of fixed maturity plans.

Less than 25% of the assets of the industry are accounted for by equity investments. One of the top fund houses has less than 5% of the corpus in its schemes in equity, which would imply that its fortunes are hitched to the liquidity taps of other institutional investors. That makes it volatile money, which is hardly a source of comfort to retail unit-holders.

Attempts to ring-fence them in the form of segregation of schemes into institutional and retail have bounced in the face of an industry that appears more keen on growing assets the easy way and pocketing gains. However, it appears that given the reluctance of large asset management firms to invest in a distribution network, the reliance on institutional funds will continue.

Can policymakers do much against a recalcitrant industry marked by fund houses prompted by big corporate houses? Surely they can – by putting in place more disclosures for on-the-level of corporate investments, and by shut out the tax arbitrage on offer to institutional and well-heeled investors.

For investors in fixed maturity plans, the tax incidence works out to a little over 22% compared to 33% for parking money in term deposits.

The size of the industry may shrink but that should not be the sole concern. Perverse incentives to grow do not help in the medium term except boosting the valuations of some of the fund houses. Over four lakh SIP accounts have been closed over the last few months. And it won’t be a surprise to see some consolidation in the industry over the course of next year. If the pain in the economy lingers, the chances of such consolidation will increase.

In October last year, policymakers worked on a formulation for the industry taking into account the systemic risks involved. The downturn now presents them a good opportunity to chip away at some of that reforms needed for the industry given that resistance could be lower. Otherwise, the bubble will build up again when the good times are back.

3.2 COMMODITY PRICES

The next bull market unlikely to materialise soon

Investors hoping to resume prices of oil and other commodities any time soon may want to keep in mind that demand and supply outlook suggest the best days for commodities prices are behind us and the next bull market in commodities is unlikely to materialise any time soon. An extended spell in the wilderness is consistent with the long-term trend of commodity prices.

In contrast, many analysts who still believe commodities are in 'super cycle' and the violent sell-off recently represents a short-term correction in a secular bull market. The super cycle theory is rooted in the view that emerging markets such as China and India will be large buyers of commodities for a long time to come, given their growth paths towards greater urbanisation and industrialisation.

The conviction in higher future prices is the strongest for oil, which also finds support in the supply argument that the world is apparently running out of black gold. Almost every oil analyst believes the decline in reserves per well is a secular force at work, bound to drive prices only higher.

Even expectations of ever rising oil prices are reflected in both the forward curve and in analysts' consensus expectations. For example, oil for delivery in three years' time is trading at close to $70 a barrel compared to the spot price of around $45 a barrel. Meanwhile, oil analysts forecast the price to be even higher at $90 a barrel in 2012. The predicted path for other commodities from copper to coal is not as strong on the upside but the story is essentially the same: expectations of rising commodity prices are firmly embedded in the forward markets and in analysts' estimates.

It's amazing how till as recently as 2005, the order was exactly the opposite. Spot prices were usually much higher than analysts' forecasts as well as the trend implied by the forward curve.

The phenomenon of spot prices being much higher than forward prices – referred to as 'backwardation' – was long considered to be the norm on the market-price. The most profitable aspect of investing in commodities was that investors could earn money by merely rolling over their expiring contracts at a lower price given the backwardation of the curve. Otherwise, commodities were seen as a losing proposition with prices mostly in decline.

Data running over 200 years suggest commodity prices adjusted for inflation fall over time as extraction costs drop due to technological progress while limited value is added in commodity production leaving selling prices to command little premium.

Yet the parabolic increase in commodity prices following the extraordinary boom in global growth this decade turned all lessons from history on their head. Investors were more inclined to believe that commodity production would struggle to keep pace with permanently rising demand.

The world economy is now in its biggest growth slump since the Great Depression but many analysts find it difficult to shake off the bullish favour that consumed them during the global demand boon.

The 2003-2007 period was an aberration for the world economy with too much easy money fuelling a liquidity-driven growth surge. With that era now over and unlikely to return anytime soon, the demand for commodities will not get back to the elevated levels of 2003-07 phase for the foreseeable future.

It's a myth that growing prosperity of emerging markets like China and India implies rising commodity prices. There have always been some emerging markets moving up the development chain at any point of time, and yet commodity prices have historically trended lower.

In fact, commodity prices tend to outperform during the late stages of the boom when the global economy overheats and demand briefly exceeds supply or else in a period of inflation.

Even commodity prices often fail to gain traction after an economic recovery is underway as it takes a long time for the excess capacity built in the previous boom year to be cannibalised.

Contrary to the current war cry of commodity producers that the sharp price falls is a disincentive for them to maintain higher capacities and so likely to create shortages in the future. The current risk is that producers will just temporarily cut output rather than engage in permanent shut-ins.

Despite the waterfall-like declines of the past three quarters, many commodity prices remain well above their cash cost of production. In fact, inventory levels for most commodities have risen to five or in some cases 10-year highs but spot rates are in several instances still well above prices of a decade ago. Commodity prices haven't fallen more on the hope that China will succeed in stimulating its economy with all the aggressive spending packages its government has announced.

China is the 800-pound gorilla of the commodity marketplace and any sign of a revival in Chinese growth leads to instant celebration in the commodity pits.

However, China suffers from an over-investment problem, with an investment-GDP ratio running at a very high level of more than 40% for many years. Much of the investment it directed towards the sagging export sector and therefore Chinese investment demand is highly unlikely to revive anytime soon. China needs to reorient its economic model more towards domestic consumption and reduce its reliance on exports and investment. Japan was able to successfully make that transition in the early 1970s when its per capita income was similar to China's current levels.

For oil, where arguably the maximum residual bullishness exists, Chinese demand is not so paramount anyway. On an average, China consumes 9% of global oil production while the OECD area represents more than 50% of world demand. The demand for oil is highly sensitive to global growth and given the expected contraction in global GDP this year, oil demand is expected to shrink by more than a million barrels a day in 2009.

It's no surprise then that OPEC spare capacity is fast rising back to 2002 levels, reducing the cartel's pricing power. While compliance regarding production cuts by OPEC members has reportedly been good so far, the incentive for producers to cheat and increase revenue remains high in the challenging global environment. Outside of OPEC, countries such as Russia would obviously like to produce at maximum capacity to earn some badly needed dollars and ride out their credit crisis.

Both the demand and supply outlook suggest the best days for commodity prices are behind us and any material rebound is unlikely to occur soon.

3.3 GOLD PRICES

Another bubble ready to bust

The world over, air has whooshed out of bubbles in stock, crude oil, metals and real estate. But before recovery comes, another bubble needs to bust: the bubble in gold prices. Around $950 per ounce, gold is still, three times costlier than what it had been from 1999 to 2002.

A gold crash sounds like heresy. Deep in our hearts is a belief that gold is the ultimate asset, the final port of call in times of instability. We take our women's jewellery seriously. Selling your wife's bridal baubles would be a last resort, a signal to society of moral and financial bankruptcy.

Historically, gold has been valued for adornment.

Till about 500 years ago, it also had value as currency.

Gold is very dense and heavy. A little cube of gold, measuring one foot on each side weights half a tonne. In the 21st century, there are specialised uses of gold in tiny volumes for scientific working on fuel cells, or semiconductors, or heat resistant fabrics. Gold is inert. It doesn't decay. It's malleable; you can twist it to make any kind of shape, something jewellers have known for ages.

These properties make gold interesting in the labs.

But researchers in labs don't set the price of gold.
Who sets the price of gold is a story with a beginning and end.

After World War II, Europe and large part of Asia were devastated. Factories, roads, railways and bridges had been blown to bits. Most young men were dead or injured and economies were in free fall. Hyperinflation raged, making currencies worthless. The way out was plotted when a group of wise men gathered in Bretton Woods, America, and worked out a plan to save the post-war-world.

The wisest of them John Maynard Keynes, figured that to stop hyperinflation the world had to anchor all currencies to the strongest currency in the post-war world, the US dollar. And for good measure, anchor the dollar to gold, because America then had 75% of the world's yellow metal. So the price of the gold was fixed and the only country that suffered no damage on its soil, the world's strongest economy, said that it would buy gold from anyone and pays 35 reliable US dollars for every ounce of gold.

Then American aid poured into Germany and Asia. Those economies revived, currencies stabilised and, perhaps for the last time in its history, gold was the final arbiter of value.

That lasted 37 years.

By 1968 the world was restive, America was bleeding in Vietnam and Europe had consolidated. Asia, especially Japan, was emerging as a manufacturing powerhouse.

US inflation was soaring. A bunch of European speculators called 'gold bugs' bet that the US, plagued by poor growth, high deficits and rising inflation, would be forced to print money and snap the $35 per ounce anchor with gold. The gold bugs were right. In 1971, President Richard Nixon pulled the plug on the gold standard. The dollar prices shot up to more than $40 per ounce in London.

Through the 1970s and 1980s, the world was clobbered by two oil shocks that hiked crude oil prices 15 times, high inflation and unemployment, and low growth.

People turned to gold for value. The price of gold shot up from $40 to $850 per ounce, a return of about 30% every year.

But nothing is permanent.

After 1980, normalcy returned and gold fell back to $250/ ounce and stayed there for nearly 20 years.

From 2002, when all of today's bubbles began, gold started climbing and now it's right up there looking all pricey and out of reach.

So when will it pop?

It took four months for the bubble in crude oil to burst spectacularly: from $147 a barrel in July 2008 to $40 in November 2008, a loss of more than 70%.

We need oil to drive car, heat homes, cook and power our airlines.

But the yellow metal is intrinsically worthless.

So, it shouldn't take long for gold to come off the highs.

About 150 years ago, John Ruskin wrote about a man who liked gold and turned all his wealth into it before sailing off. In high seas, a storm wrecked his ship. The man strapped his bag of gold around his waist and dived into the water and drowned immediately, dragged under by the weight of gold.

Asked Ruskin:

Now as he was sinking,

Had he the gold?

Or had the gold him?"

TERMINATOR

Financial markets across the world lost a whopping $ 50 trillion, including $ 9.6 trillion in the developing Asian Market. And developing Asian countries, which include countries such as China and India, have suffered more than any other emerging markets in the world due to the recent global economic downturn because the region's markets have expanded much more rapidly.

According to a new Asian Development Bank study, 'Global Financial Turmoil and Emerging Market Economies: Major Contagion and a Shocking Loss of Wealth', recovery can now only be envisaged for late 2009 or early 2010. Most emerging market economies, including in developing Asia and Latin America, are at a crossroads, and the next 12 to 18 months will be very difficult.

ADB president Haruhiko Kuroda said, "This is far the most serious crisis to hit the world economy since the Great Depression. While the crisis originated in the US and some European countries, by now no region or country is insulated. I am afraid things may get worse before they get better". However, Kuroda added, "I remain confident that Asia will be one of the first regions to emerge from it, and it will emerge stronger than ever before".

1. FINANCIAL ADVISORS:

Weigh impact on investors: **Rescue housing**

The deflationary psychology

US President Barack Obama housing plan presupposes that preventing or minimising home foreclosure is a formula for revival. It isn't. However, everyone agrees that a housing recovery is essential for a broader economic upswing, in part because housing's collapse brought on the recession. Mortgage delinquencies triggered the financial crisis. Tumbling home price (down 26% from their peak) ravaged consumer confidence, borrowing and spending. Since late 2007, housing-related jobs – carpenters, realtors, appraisers – have dropped by 1 million, a quarter of all lost jobs.

Housing's distress is too much supply chasing too little demand. Huge inventories of unsold homes have depressed prices and construction. Given that prices rose too high in the 'bubble' – homes were affordable only because credit was dispensed so recklessly – much of this painful adjustment was unavoidable. But that process should be mostly complete.

Here's a little-known fact: housing may be more affordable now than at any recent time, thanks to lower prices and falling mortgage rates (now about 5%). The National Association of Realtors has an affordability index that estimates the family income needed to buy a median-priced house, assuming a 20% down payment and monthly mortgage payments equal to 25% of income. Affordability is now the highest since the index's start in 1970.

Unfortunately, demand hasn't followed affordability. In January 2009, sales of new and existing homes continued prolonged declines. There's a buyers' strike. Why? Shouldn't lower prices spur demand? Well, yes. There are many theories as to why they haven't. Perhaps prospective buyer can't get loans. Or people are so gloomy that they're afraid to buy. But the most important explanation is probably deflationary psychology. If yesterday's $250,000-house is now $200,000, it may be $175,000 after few months. Waiting is better. Unless this deflationary psychology is broken, it becomes self-fulfilling. The more buyers wait, the more prices fall; and the more prices fall, the more buyer wait. The Obama administration essentially ignores this problem, though it can be addressed.

2. FINANCIAL PLANNERS

Value unlocking for all stakeholders: **Unfreeze credit**

The fire sales

Little political enthusiasm exists for further support to the banking sector. One reason is that banks that received money in the initial rescues do not seem to have increased their lending, without which monetary and fiscal stimulus are unlikely to be effective.

We try to understand why banks are still so reluctant? One possibility is that they worry about borrowers' credit risk. A second possibility is that banks worry about having enough resources to meet their own creditors' demands. On the other hand, perhaps bank's reluctance to lend reflects a fear of being short of funds if investment opportunities get even better. Citigroup CEO Vikram Pandit said as much when he indicated that *it was cheaper to buy loans on the market than to make them. And buying may get cheaper still!* Consider, for example, the real possibility that a large indebted financial institution faces a run on its deposits, and starts dumping loans onto the market. The loans' price falls if only a few entities have the spare funds to buy them. Anticipating the prospect of such future fire sales, even strong banks will restrict their lending to very short maturities, and their investments to extremely liquid securities.

This may also explain why markets for some assets have dried up. Some distressed banks clearly possess large quantities of mortgage-backed securities, and are holding onto them in the hope that their prices will rise in the future, saving them from failure. At the same time, buyers expect even lower prices down the line. While there is a price today that reflects those expectations, it is not a price at which distressed bank want to sell. Thus, there is an overhang of illiquid financial institutions, whose holding could be unloaded if they run into difficulties.

For some, low prices would render them insolvent. For others, they would be a buying opportunity, whose prospective return far exceeds returns from lending today. Any voluntary resumption of lending will necessitate reducing both fears and potential opportunities.

Here are some ways to reduce the overhang. First, the authorities can offer to buy illiquid assets through auctions and house them in a government entity, much as was envisaged in America's original troubled Asset Relief Program. This can reverse a freeze in the market caused by distressed entities that are unwilling to sell at prevailing market prices. The fact that once a sufficient number of distressed entities sell their assets, prices will rise simply because there is no longer a potential overhang of future fire sales. It can lead to increased trade in illiquid assets, and unlock lending. *One problem is that this outcome may require significant government outlays.*

A second approach is to have the government ensure the stability of significant parts (regulated and unregulated like hedge fund and private venture capital fund) of the financial system that hold illiquid assets by recapitalising regulated entities that have a realistic possibility of survival, and merging or closing those that do not. For those entities that are closed down, this would mean moving illiquid assets into a holding entity that would gradually sell them off. *The problem is that it can too serve to hold back bank lending if a large proportion of the distressed assets are held in weak institutions there.* Perhaps, therefore, a mix of the two approaches can work best. One lesson from Japan's experience in the 1990s is that the sooner the authorities bite the bullet and clean up the financial system, the sooner the economy will be on the road to recovery.

3. RISK MANAGEMENT CONSULTANTS

Educate – Engineer and Enforce: **Prop up spending**

The lost wealth

Consumers ran squarely into the perfect storm in 2008, and the wreckage will be washing ashore for some time. The three supports that prop up spending have been devastated: income growth, credit availability and wealth. With incomes pinched, access to credit tightened, and wealth dramatically shrunken, American consumers are poised to save more and spend less.

Spending, adjusted for inflation, dropped for the second quarter in a row at the end of 2008, and another decline this winter is likely. Consumer buying has not fallen for three consecutive quarters since record-keeping began in 1947. Households are in the middle of a wrenching adjustment that will not play out quickly – to the great detriment of economic growth at least through the first half of 2009.

Consumers are struggling with years of accumulated debt amid dwindling resources. They are now forced to begin saving a higher percentage of their income, leaving less for spending. From the end of the 2001 recession to the beginning of the current downturn, the funds required to service overall household debt – everything from mortgages to car payments to credit-card balances – increased by 53%, while after-tax income rose only 38%. During that time, savings as a share of income fell from about 3% to zero.

The saving rate is already heading up, reaching 2.9% of income in the fourth quarter of 2008, the highest in seven years. Consumers received two income windfalls in 2008, the tax rebates in the second quarter and the boost to buying power from the plunge in energy prices in fourth quarter of 2008. The corresponding spikes in the savings rate suggest they saved most of both.

The problem right now is that households are trying to save a larger share of their income, even as huge losses in jobs and hours worked are squeezing the life out of pay growth. This effort to save tightens the vise on spending even more. During 2008, inflation-adjusted personal income, excluding government handouts, fell 0.9%, after growing 2.1% in 2007.

Making matters worse, households depends more than ever on income growth as a source of saving and spending. Up to now, consumers had no great imperative to save more of their income. Increases in wealth, mainly reflecting capital gains in home values and stock portfolios, averaged roughly $4 trillion annually from 2001 to 2007. Households felt they were saving in other ways, so they spent more of their income. Now, through the fourth quarter of 2008, household wealth appears to have shrunk by some $10 trillion, dramatically reducing the size of many nest eggs.

Also, when credit was flowing freely, households had less need for liquid savings, since they could readily borrow to meet emergencies or other one-time needs. Now credit conditions have turned sharply restrictive. On balance, banks continued to tighten their lending standards. The drop in wealth relative to income has further to go amid falling home values and moribund stock prices. All the factors that affect saving behaviour are pushing it upward.

Based on historical patterns, many economists expect the saving rate to settle in the 5%-to-6% range last seen in the mid-1990s. One key to when consumers get back on their feet is how fast the saving rate stabilises. Compared with the last two recessions, the rise has been fast, but the stress from lost wealth and tight credit is greater, and it will persist for some time.

4. WEALTH MANAGERS

Map out the details to translate into benefits: **Stay invested**

The payback blues

The economic slowdown is taking a toll on the investor community as well as end users. With the property prices falling, it is a natural corollary for investors to want to exit. But, many now want to exit from property projects that they may have committed themselves to. While the reasons could be different for different people, experts feel that factors such as fall in property prices, execution delays or buyer's financial problems are leading to these premature exists. But, the fact is that developers across the country are refusing to give money back to their investors.

There could be a number of reasons for the consumer opting for a refund. The buyer may have booked the property at a higher price earlier and now want to exit as the property rates have fallen and wish to avail a better offer. Or the buyer may have been facing financial problems and is unable to shoulder the burden of paying the remaining EMIs on the home loan. There could have also been an instance wherein the construction has not started on time and the buyer is looking at an early exit.

Developers, on their part, highlight their difficulties. They say when the market conditions were good; investors had put in their money in the property market to draw good returns later. Unfortunately, the market crashed. The developer by now had already invested the money in the project. It can be given back provided the said apartment is resold to the next end-user. Since the market sentiments are low, at this stage it is not possible to dispose of the apartment and return the money to everyone. The developer in some cases try to renegotiate with the buyer, offering additional parking space or some other incentive that would make him decide to stay invested in the project. Yet, if everyone cancels at the same time, it becomes impossible to pay back all at once.

5. INCLUSIVE CEOs

Innovative responses to problems: **Increase stake**

The pledged shares

Shares owned by promoters are pledged either for their personal borrowings or as collateral against borrowings by the company. If the value of shares drops significantly, lenders ask for more shares or some other collateral. If the promoter fails to furnish the extra amount the lenders can sell the shares in the market. So, when the promoter group pledges a high proportion of its shares, the firm is potentially vulnerable to management changes.

These promoters may even be tempted to manipulate profits of the company to keep the share prices inflated and avoid triggering selling of shares. Market regulator Sebi has made it mandatory for listed companies to disclose details of pledged shares. A study based on disclosures made by listed firm's shows the promoters of a fourth of all companies in the study have pledged more than half of their total shares. Even the promoter group of few companies has pledged more than 90% of its holding. Most of them haven't disclosed either the object or the institutions with which shares have been pledged. It's debatable if companies need to disclose the object, name of lenders and even use of funds.

Yet, this is definitely a case for more disclosure, which will bring in more transparency in the way promoters and companies function.

6. MICRO-FINANCE PROFESSIONALS

Developing alternative credit delivery models: **Sell stake to distress asset funds**

The negative net worth

Promoters of firms in financial distress may be pressurised by lenders to sell their holdings at a discount to distress asset funds and pay off dues. Corporate turnaround experts say, “Banks and financial institutions are likely to mediate talks between distressed asset funds and promoters of firms facing collapse in the economic downturn to prevent them from becoming sick, a stage when the debtor company can seek stay against banks taking possession of their assets”.

Due to the economic downturn, net worth of many companies may turn negative at the end of the fiscal year 2008-09. The August-September period is crucial when most companies finalise their financial statements. (Companies have about six months to file their accounts after the close of the fiscal year) Then the statutory auditor has to certify whether a company is sick or not.

Banks and financial institutions would want a resolution before the borrower company becomes sick because such company is obliged to approach the Board for Industrial and Financial Reconstruction under law, which gives protection against creditor action (taking possession of assets).

The Sick Industrial Companies Act provides protection against creditor action. Banks and financial institutions are entitled to take possession of the defaulting company’s assets under the 2002 Securitisation and Reconstruction law if payment is not made within two months after serving a notice. Promoters would not like banks to go to the extent as challenging such action before the debt recovery tribunal is difficult and costly.

This would encourage promoters and banks to negotiate with Asset Reconstruction Companies and distress asset funds and find resolution which leads to both asset reconstruction and payment of bank dues. Sensing an opportunity in this, private equity funds have started hiring bankruptcy lawyers to buy stake in distressed companies at a heavy discount. Lawyers declined to be identified or name their clients as funds buying stake in distress sale are ruthless in negotiations and prefer to keep a low profile.

Many non-banking finance companies – banks like institutions that do not offer savings or current accounts or check book – are also keen to enter asset reconstruction business (ARC). ARCs are allowed by law to buy non-performing assets from banks, change the management of the company for a possible revival and if not possible, sell the assets.

While ARCs buy non-performing assets from banks, distress asset funds buy controlling stake in the company directly from promoters at a discount in return for paying off his dues to banks. The promoter benefits as he retains a stake, though not the controlling stake, after paying off his debt.

Considering the gravity of the situation, industry chambers have started educating their member firms about how to deal with the grim prospect of a distress sale. For instance the Confederation of Indian Industries (CII), is organising a summit on the “impact of global financial crisis and role of asset reconstruction” where ARCs and distress funds are expected to take part.

The industrial output which shrunk in December and January – the worst performance in 16 years – and declining exports are expected to push the net worth of many companies into the negative.

7. CREDIT COUNSELORS

Resolve convertibility and recompensation issue: **Stop buying**

The US debt

The Chinese government is worried about the safety of it's nearly $1 trillion credit to the US government. Chinese PM Wen Jiabao criticised America's "unsustainable model of development characterised by prolonged low savings and high consumption," and called on the US government to "maintain its good credit, to honour its promises and to guarantee the safety of China's assets."

Washington responded to the Chinese premiere's remark on his worries about US debt with the statement – there is no safer investment in the world than in the United States. But the fact is that the US economy is in the deepest recession in 70 years, its government is piling on an incredible amount of deficit, and most experts think that these deficits would not be enough to rescue the economy from recession. And international investors think that investing in the US is the safest in the world!

Is there anything else the Chinese government could do to ensure the safety of its humungous share of the US debt and take a leadership role in stopping the global economy from plunging further into recession? For a start, it could stop stashing on US treasury bonds. It could use the nation's approximately $2 trillion forex to import goods & services to increase the consumption and welfare of its 1.2 billion people. These reserves belong to the people of the People's Republic of China. Let them enjoy the fruit of their hard work and savings. Don't waste these reserves in providing unlimited subsidised credit to US consumers.

China's government will perhaps not pay much attention to these suggestions, as it's appetite for the US treasury bonds is insatiable. Throughout last year, even as signs of deterioration in the US economy were obvious, China continued to purchase US treasury bonds, in larger numbers than ever before. Since 2007, Chinese ownership of the US debt has doubled. Continued acquisition of the US debt has put China in a precarious bind. If it begins to sell the US debt in any sizable quantity, the treasury market will collapse lowering the value of the Chinese credit to the US. If China keeps an accumulating US debt, the risk to the safety of its reserves will be enormous. The Chinese economy will become linked to vagaries of the US economy even more than ever. While it is unlikely that the US government will ever default on its debt – it can print as many dollars as it wants.

The Chinese and US economies are highly interdependent. Their interdependence is unhealthy for the global financial system. China is America's biggest creditor and trading partner. Americans buy the goods that Chinese factories produce and China lends them the money to do so. For years, the US economy has been running massive trade and current account deficits, appropriating the savings of the rest of the world to satisfy it voracious appetite. But the rest of the world, including China and Japan also happily obliged by investing in the US treasuries. China, India, Japan and other Asian countries need to stop buying US treasuries, and invest in their own or in other Asian economies.

As foreign governments buy US treasury bonds, the dollar gets strengthened making it difficult for the US manufacturers to compete internationally and making international goods cheaper for Americans, thus continuing the vicious cycle in which the rest of the world saves and the US, the richest country in the world, consumes more than it produces. Perhaps the much-needed correction will automatically come with the recession. With the US economy in recession, China has lost its biggest customers. With its export surplus declining, China will have less money to purchase American debt.

8. TECH SAVVY PROFESSIONALS

Take first step to ensure efficient and reliable system: **How to fail to recover**

The US stimulus

Some people thought that Barack Obama's election would turn everything around for America. Because it has not, even after the passage of a huge stimulus bill, the presentation of a new programme to deal with the underlying housing problem, and several plans to stabilise the financial system, some are even beginning to blame Obama and his team.

Obama, however, inherited an economy in free fall, and could not possibly have turned things around in the short time since his inauguration. President Bush seemed like a deer caught in the headlights – paralysed, unable to do almost anything – for months before he left office. It is a relief that the US finally has a President who can act, and what he has been doing will make a big difference.

Unfortunately, what he is doing is not enough. The stimulus package appears big – more than 2% of GDP per year – but one third of it goes to tax cuts. And, with Americans facing a debt overhang, rapidly increasing unemployment (and the worst unemployment compensation system among major industrial countries), and falling asset prices, they are likely to save much of the tax cut.

Almost half of the stimulus simply offsets the contractionary effect of cutbacks at the state level. America's 50 states must maintain balanced budgets. The total shortfalls were estimated at $150 billion a few months ago; now the number must be much higher – indeed California alone faces a shortfall of $ 40 billion.

Household savings are finally beginning to rise, which is good for the long-run health of household finances, but disastrous for economic growth. In short, the stimulus will strengthen America's economy, but it is probably not enough to restore robust growth. This is bad news for the rest of the world, too, for a strong global recovery requires a strong American economy.

The real failing in the Obama recovery programme, however, lie not in the stimulus package but in its efforts to revive financial markets. America's failures provide important lessons to countries around the world, which are or will be facing increasing problems with their banks:

Delaying bank restructuring is costly

Delaying bank restructuring is costly, in terms of both the eventual bailout costs and the damage to the overall economy in the interim.

Governments do not like to admit the full costs of the problem

Governments do not like to admit the full costs of the problem, so they give the banking system just enough to survive, but not enough to return it to health.

Confidence is important, but it must rest on sound fundamentals

Policies must not be based on the fiction that good loans were made, and that the business acumen of financial market leaders and regulators will be validated once confidence is resorted.

Bankers can be expected to act in their self-interest on the basis of incentives

Perverse incentives fuelled excessive risk-taking, and banks that are near collapse but are too big to fail will engage in even more of it. Knowing that the government will pick up the pieces if necessary, they will postpone resolving mortgages and pay out billions in bonuses and dividends.

Socialising losses while privatising gains is more worrisome than the consequences of nationalising banks

American taxpayers are getting an increasingly bad deal. In the first round of cash infusions, they got about $0.67 in assets for every dollar they gave (though the asset were almost surely overvalued, and quickly fell in value). But in the later cash infusions, it is estimated that Americans are getting $0.25, or less, for every dollar. Bad terms mean a large national debt in the future. One reason we may be getting bad terms is that if we got fair value for our money, we would by now be the dominant shareholder in at least one of the major banks.

Don't confuse saving bankers and shareholders with saving banks

America could have saved its banks, but let the shareholders go, for far less than it has spent.

Trickle-down economics almost never works

Throwing money at banks hasn't helped homeowners: foreclosures continue to increase. Letting AIG fall might have hurt some systemically important institutions, but dealing with that would have been better than to gamble upwards of $150 billion and hope that some of it might stick where it is important.

Lack of transparency got the US financial system into this trouble

Lack of transparency will not get it out. The Obama administration is promising to pick up losses to persuade hedge funds and other private investors to buy out bank's bad assets. But this will not establish "market prices," as the administration claims. With the government bearing losses, there are distorted prices. Bank losses have already occurred, and their gains must now come at taxpayers' expense. Bringing in hedge funds as third parties will simply increase the cost.

Better to be forward looking than backward looking

Better to be forward looking – focusing on reducing the risk of new loans and ensuring that funds create new lending capacity – than backward looking. Bygone are bygones. As a point of reference, $700 billion provided to a new bank, leveraged 10 to1, could have financed $7 trillion of new loans.

The era of believing that something can be created out of nothing should be over

Short-sighted responses by politicians – who hope to get by with a deal that is small enough to please taxpayers and large enough to please the banks – will only prolong the problem. An impasse is looming. More money will be needed, but Americans are in no mood to provide it – certainly not on the terms that have been seen so far. The well of money may be running dry, and so, too, may be America's legendary optimism and hope.

9. ONE-STOP-SHOPS

Dedicated to offer related services under a roof: **The shadow of depression**

The Great Depression

We live in the shadow of the Great Depression. Americans' gloom does not reflect just 8.1% unemployment or the loss of $13 trillion worth of housing and stock market value since mid-2007. There is also an amorphous anxiety that we are falling into a deep economic ravine from which escape will be difficult. These worries may prove ill-founded. But until they do, they promote pessimism and the hoarding of cash, by consumers and companies alike that further weaken the economy.

Our only frame of reference for this sort of breakdown is the Great Depression. Superficially, the comparison seems absurd. We are a long way from the 1930s. Unemployment peaked at 25% in 1933. At its low point, the economy (GDP) was down 25% from its 1929 high. So far US GDP has dropped only about 2%. American workers (in the 1930s) had painfully few of the social safety nets that today help families. Until 1935, there was no federal unemployment insurance. At last count, there were 32 million food stamp recipients and 49 million on Medicaid. These programs didn't exist in the 1930s.

Government also responds more quickly to slumps. Despite many New Deal programs, "fiscal policy" – in effect, deficit spending – was used only modestly in the 1930s. Some of the Franklin Roosevelt's extra spending was offset by a tax increase enacted in Herbert Hoover's last year. The federal deficit went from 4.5% of GDP in 1933 to 5.9% in 1934, not a huge increase. Contrast with the present, in fiscal 2009, the budget deficit is projected at 12.3% of GDP, up from 3.2% in 2008. On the top of this, the Federal Reserve has cut its overnight interest rate to about zero and is lending directly in market where private investors have retreated, including housing.

Unfortunately, the similarities (between then and now) are growing more striking every day, say economic historians. They never thought they would say that in their lifetime, "This is the first business downturn since the 1930s that look like the 1930s." One parallel is that it's worldwide. In the 1930s, the gold standard transmitted the crisis from country to country. Governments raised interest rates to protect their gold reserves. Credit tightened, production and trade suffered, unemployment rose. Now, global investors and banks transmit the crisis. If they suffer losses in one country, they may sell stocks and bonds in other markets to raise cash. Or as they "deleverage" – reduce their own borrowings – they may curtail lending and investing in many countries.

The consequences are the same. In the 4Q of 2008, global industrial production fell at a 20% annual rate from the third quarter, says the World Bank. International trade may "register its largest decline in 80 years." Developing countries need to borrow at least $270 billion; if they can't, their economies will slow and that will hurt the advanced countries that export to them. It's a vicious circle.

Just as in the 1930s, there's a global implosion of credit. What's also reminiscent of the Depression are quarrels over who's to blame and what should be done. The Obama administration wants bigger stimulus packages from Europe and Japan. Europeans have rebuffed the proposal. The US has also proposed greater lending by the IMF to relieve stresses on poorer countries. Disputes could fuel protectionism and economic nationalisation. What these confusing crosscurrents produce is defensiveness. No one knows how this epic struggle will end – whether the forces pushing down the global economy will prevail over those trying to pull it up. Boom psychology gives way to bust psychology. The vague fear that something bad, calls it a "depression" causes consumers and business managers to protect themselves by conserving their cash and slashing their spending. They hope for the best and prepare for the worst.

10. CONTINUING LEARNING CENTRES

……….Take informed decisions…………….

Capital protectionism

All causes are beginnings, wrote Aristotle in Metaphysics. The financial crisis that began in the summer of 2007 has produced the biggest global financial, economic & liquidity shock since the 1930s. As a consequences, so much taxpayers money is being spent in US and Europe on bailing out the banks that many of them, once significant global players, will be forced to focus on domestic lending to give taxpayers a bang for their buck. Banks that accept state aid are under a lot of political pressure to expand their domestic loan books. Complying with the instructions of their new political masters will mean only one thing: even faster destruction of foreign credit and capital flows. The result will be tantamount to protectionism against the globalisation and free flow of capital.

Capital protectionism is the worst form of protectionism. It hits the efficient allocation of investment on a global scale, as well as trade financing and trade in every type of goods and services. In contrast to trade protectionism, which normally takes a sniper shot at specific goods, capital protectionism affects every ingredient of globalisation.

The most immediate impact of capital protectionism is likely to be to magnify the damage being wrought on emerging markets by the credit crisis. Over the last ten years, *asset bubbles* have been created in emerging markets by cheap foreign credit compared to that available locally. Now the sudden withdrawal of foreign credit makes the rollover of such debts almost impossible. Many of these asset bubbles have burst (real estate and the stock market). Living standards, growth and currencies will pay the price.

For instance, Asian, giant China boomed on the huge demand for its export created by the high tide of credit-financed spending and illusory wealth in rich countries. And investment benefited from capital inflows that swelled domestic credit and created China's very own asset bubbles. But now many of these asset bubbles have burst. That is why China's economy began to sink well before exports did. More than 20m rural migrant workers in China have lost their jobs and returned to their home villages or towns.

"To believe that there is no way out of the present crisis for capitalism is an error" said Vladimir Lenin exactly 90 years ago, in March 1919, faced with another economic crisis. While discussing the dire straits of capitalism, he made the aforesaid comment and was unwilling to write an epitaph of capitalism. That particular expectation of Lenin's unlike some he held proved to be correct enough. Even though American and European markets got into further problems in the 1920s, followed by the Great Depression of the 1930s, in the long haul after the end of the Second World War, the market economy has been exceptionally dynamic generating unprecedented expansion of the global economy over the past 60 years.

The question that arises most forcefully now is not so much about the end of capitalism as about the nature of capitalism and the need for change. The crisis, no matter how unbeatable it looks today, will eventually pass. The economic difficulties of today do not call for some 'new capitalism' but they do demand an open-minded understanding of the older ideas – that the General Theory also had a deeper more fundamental message about how capitalism worked. It explained why capitalist economies, left to their own devices, without the balancing of governments, were essentially unstable. It also explained why, anti-cyclical policies must not be adopted only when a crisis is under way. Applied in advance – they can be the guarantors of more just and democratic society.

11. GLOBAL OUTLOOK

…..Global pathways……..

Policy blunders

The US is the cause of the present financial crisis. It is, alas, also becoming the cause for the crisis stretching out longer than thought earlier.

The US has not been sure-footed in its response to the crisis. Some people think that the current downturn will be long-down because financial crises always extract huge economic costs. Not true. There are financial crises and financial crises. Not all of them scary.

The IMF's World Economic Outlook (2008) surveyed 113 episodes of financial stress in 17 countries. It found that in 58 episodes financial stress was followed by a slowdown or a recession. The remaining 55 episodes – or nearly half the total – were not followed by an economic downturn.

Secondly, the policy response to a crisis matters. This was best exemplified in the Great Depression that followed the stock market crash of 1929.

It was a series of policy blunders that turned the market crash into a serious economic crisis. One would have thought that policy makers had learnt the necessary lessons over nearly a century of episodes of financial stress - Resort to fiscal stimulus, Cut interest rates, Make liquidity available, Above all, do not let big banks fail, recapitalise them quickly. It appears that the first three lessons have been grasped but not the fourth – about keeping the banking system ticking.

The big failure in Japan in the nineties was not recapitalising insolvent banks adequately. Banks were kept on ventilator support through small doses of capital. As a result, Japan lacked the credit flows required for lubricating the economy. That is what cost Japan a 'lost decade'.

In the present crisis, the US has bungled and dithered over the crucial issue of insolvent financial institutions. The hedge fund, LTCM, was rescued in 1998. It was understood that the failure of any systemically large financial institution can have serious economic consequences. The Fed applied this lesson to Bear Sterns in early 2008. It ensured that JP Morgan acquired Bear. However, when it came to Lehman Brother in September, moral hazard took precedence over systemic risk. Lehman was allowed to fail. The Lehman failure undermined market confidence in a big way.

The US has also failed to act quickly enough to recapitalise large banks. Uncertainty about the solvency of these banks is, perhaps, the biggest factor stretching out the slump in the US economy today. The latest plan envisages a combination of government and private capital coming into banks. But private investment will not be easy to come by. And time is of the essence. The longer the slump stretches out, the greater will be the losses of banks. In October 2008, the IMF estimated total bank losses (US and non-US) at 1.4 trillion. The estimate has risen to $2 trillion since.

There is growing recognition that nationalisation of large, insolvent US banks is the quickest way out. In Europe, governments have had no difficulty in assuming government ownership. But the US finds it difficult to shed its ideological hang-up. Nationalisation may be required not just to restore solvency but to ensure that credit growth picks up. Mere injection of capital may not suffice. Banks may have capital but they are not willing to lend in today's conditions. This nullifies the effects of other policy responses.

12. ISSUES OF THE PRESENT

Freedom to get & fail in the system of free enterprise

New economics, new politics

WTO director general Pascal Lamy while presenting a global outlook for commodities admitted that real challenge going forward will be to *preserve existing cross-border trade opportunities*. As the wave of protectionism is sweeping the developed and developing economies, which clearly imply that the search for now trade potential at the multilateral level may be a far cry for sometime to come.

Increased trade has a positive multiplier effect on global GDP. By the same token, negative growth in cross-border trade could have the opposite multiplier effect on world economic growth.

The World Bank has recently confirmed that growth in world trade has suffered its first annual decline since 1982. Year 2009 could also see economies getting buffeted by negative growth in both trade and capital flows. This will surely impact economies all round the world, and the more recent economic data suggest that things will get even worse before they get better.

The real challenge for developing economies, such as India and China, which still have reasonably positive GDP growth will be to fortify themselves as much as possible through domestically driven activity, and thus minimise the damage that might be caused by declining world trade and capital flows. This would entail very innovative thinking on how to *optimise the use of local savings as well as other domestically driven economic opportunities.* There will be a need to depart somewhat from west-centric macro policy design.

However, first there is a need to understand the threats that might be looming on the horizon. As trade and capital flows worsen, the World Bank has warned that many developing economies may run the risk of not being able to *roll over their foreign debt obligations*. In short, there could be an external sector crises caused by an inability to roll over debt maturing in 2009 for many economies. According to World Bank, concerns are mounting as to how the rollover of maturing debt in emerging markets will be financed given the global credit crunch. The World Bank estimates well over $1 trillion in emerging market corporate debt and $ 2-3 trillion in total emerging market debt maturing in 2009.

Where does India stand on this aspect of the global crises? India has about $ 89 billion of external debt maturing in 2009.

- Of this, the actual medium- to long-term external borrowing by corporates is less than $14 billion.

- There is a short-term – less than a year – debt component of close to $ 40 billion of which well over half may already have got extinguished as they were meant essentially to import crude by public sector oil companies when oil prices were at the peak. With oil prices collapsing and PSU oil companies getting positive recoveries, much of the short-term trade debt will extinguish.

- Of course, there will be some $20 billion plus non-resident deposits maturing in 2009. This is expected to get rolled over as the central bank will surely come up with attractive schemes to retain them. Remember, at the height of financial crisis last October, banks like SBI get good deposits from NRIs who felt Indian Banks were a safe bet, seeing the way Iconic American and British banks were falling like nine pins.

NRIs remain a key component of India's external sector stability as they also account for current account transfers of over $ 25 billion every year. This could come down this year but will remain a source of confidence. Even during the east-Asian currency crises in 1997, when currencies across Asia were weakening, the private transfers by NRIs did not decline. They are the most stable source of dollar inflows, both on current and capital account.

India must launch a special campaign amongst NRIs in order to continue enjoying their confidence. In recent years NRIs too have figured that something is wrong with the way the US is running its economy. They understand that the current crisis originated in America was largely caused by cowboy capitalism. So the basic trend will not reverse as everyone realise that the dollar is strengthening purely because there is panic flight to safety every now and then as more bad news flows about the world economy.

In the short run, the RBI has adopted the right strategy by allowing the rupee to depreciate beyond the Rs 50 mark because this also does the job of making imports somewhat costlier, thus avoiding the highly retrograde act of rising import tariffs. Depreciating currency can import inflation but that is not a threat at all in the short-to medium-term. So depreciating the rupee suits the current circumstances.

Besides, it is always an advantage to keep the currency a bit undervalued because when things begin to normalise and global capital unfreezes a little, India will be a natural destination. Simply because from the medium-to long-term perspective, the rupee cannot do anything but appreciate and give more returns. This sentiment has acquired permanency in the consciousness of global investors. This is India's trump card for all times.

What the government must do now is to think of a hundred new ways to exploit the numerous domestic demands' raising potential waiting to be tapped. The current global financial crises can prove to be the greatest opportunity for India's intelligentsia to move away from looking at economic policy design from the western prism. There is a need to move beyond merely more fiscal and monetary stimulus. That is lazy thinking. It is time to unleash some truly new homegrown ideas! New politics in India will revolve around who does this best.

5. BANKING SECTOR

Where we went wrong

When the global recession started, economists were sure that India, and most other newly industrialist countries (NICs), would escape lightly. They were soon proved wrong. India exports have fallen for four straight months; industrialist production for three. China has fared even worse, and most unexpectedly of all, Japan has fared worst of all, with exports falling by as much as 49% for two straight months.

It soon became clear that the 'decoupling hypothesis' which had predicted that the NICs would fare well because of their high forex reserves and modern booming economies was hopelessly wrong. On March 26 2009, at a meeting of CII, RBI governor D Subba Rao gave a most candid and illuminating assessment of why, in India's case, it had proved so wrong. India had been expected to suffer the least because its economy was the least dependent on foreign trade. But this forecast did not take into account the very rapid pace at which our economy had been integrated into the global economy in the past decade.

The conventional measure of integration – the trade to GDP ratio – told only a part of the story, although this too had had recorded an impressive rise from 21.2% in 1997-98 to 34.7% in 2007-08. A far better measure of integration was the ratio of the total transactions, i.e., trade and capital flows, to GDP. This exceeded the entire GDP, having risen from 46.8% to 114.7%, and caused a sharp appreciation of the rupee.

It was the impact of the recession on non-trade financial flows that was doing the most harm to the economy. The reversal of these flows after the global financial crisis are the cause of the deeper than expected recession into which India is plunging, for it has compounded the impact of the decline in exports by bringing down share prices and the value of the rupee very sharply. These have strengthened the disinclination to invest and spend just when the economy needed the opposite.

Mr Subba Rao outlined the measures that the government has taken to stem the recession. In September and October 2008 it brought down the cash reserve ratio and the repo and reverse repo rates swiftly in order to reduce the cost of borrowings. Since then there have been two fiscal stimulus packages, adding up, to 3% of the GDP. This is over and above the loan waiver to farmers and payments made to civil servants under the Sixth Pay Commission award. All in all, the government has pumped in Rs 390,000 crore of additional liquidity into the financial system. This amounts to a whopping 7% of the GDP.

Why then is there not even a flicker of the response from the economy? Mr Subba Rao has attributed this to the psychological impact of the global recession. Indian bankers are well capitalised and their resource base is sound. But the international banks are not. Their managers, even in India, have therefore caught the flu and are transmitting it to their Indian counterparts. As a result a bunker mentality has gripped the financial sector: no one is bringing down interest rates and no one is lending. As a result in the past five months bank lending has seldom exceeded a third of new deposits. And, apart from token cuts by a few public sector banks, no one is lowering interest rates.

Mr Subba Rao's explanation is not so much wrong as incomplete. The cause of the paralysis is not that banks are not lending but that people are not borrowing. This is because of an all pervasive bearishness, but still rising cost of borrowing. In July 2007 at the height of the Indian boom, the prime lending rate had seen pushed up to 15%, but inflation was running at 6%. The real rate of interest was therefore 9%. Today, measured by the wholesale price index inflation has dropped to below 1% and will soon turn negative. But the prime lending rate is still around 10-11%. This is true of all other lending rates.

Lending rates are not the only ones that have risen in real terms. Deposit rates have barely dipped and are currently 7.75-9%. So while savers have every incentive to park their money in banks, borrowers have no incentive to borrow from them.

These rates have simply got to be brought down or we will continue to slide deeper and deeper into recession. In the past several weeks, first Mr Montek Singh Ahluwalia and then the prime minister himself have made increasingly agitated suggestions to the RBI that interest rates must be brought down, but Mr Subba Rao's recent statement suggests that the central bank believes it has already done enough.

Nothing could be further from the truth. The Reserve Bank simply must bring down the cash reserve ratio to 4%, or even 3%, and the repo rates to 2% and even 1%. These would be unthinkable in normal times. But the times are not normal. A 5% CRR and a 4% and 3.5% repo and reverse repo rate may be appropriate for ordinary times but it is an elaborate exercise in self-denial at a time when the global financial market has failed and the world is sinking into a recession not seen since the 1930s.

Cosy bond deals

A sudden surge in the traded volumes of a few illiquid bonds could well be an indication that some banks are cutting cosy deals at off-market prices to prop up profits before the end of the financial year. Bond dealers are attributing the unusual interest in a few state government guaranteed bonds to such structured transactions, better known as 'sell/buy deals' in the market. This is how it happens:

Step 1: Bank A strikes a deal with another bank or a bond house to sell a security at a price well above the market rate. Assume that bank A had bought the security at Rs 100 – the cost price in its trading book. With the market moving up, bank A spots the paper is trading at Rs 101.

Step 2: Bank A can make a decent profit by selling the paper at Rs 101. But since it wants to make bigger profits, it sells the security to the other bank (or possibly a bond house) at Rs 102.50.

Step 3: On the same day, bank A buys back the security from the entity it sold to at Rs 102.60.

Thanks to an opaque market and its stringent rules, both the parties gain from the two-way deal. How? Bank A earns a profit of Rs 2.50, instead of Rs 1 on the security. More significantly, when it buys back the security on the same day, the paper is parked in the held-to-maturity (HTM) basket in its investment portfolio. Till then, the security was lying in the trading basket of the portfolio. The crucial difference is that securities classified as HTM are not mark-to-market. So, any depreciation in value does not impact the bank's profits. However, in a trading portfolio, full MTM impact is felt by the bank.

So, bank A not only makes an abnormal profit from the deal but also derisks the security by parking it in a basket which is free of MTM accounting. On the other hand, the bond house earns a 10 paisa by simply being a part of a quick deal. Interestingly, even though Bank A buys back the security at a slightly higher price, it does not suffer a loss on account of this. The buy back is actually treated as a fresh investment by Bank A while the profit is made by selling it a higher price.

1. Offshore financial accounts

For Indian tax authorities, who have so far not mustered courage to ask taxpayers to disclose their bank accounts abroad despite speculation over Indians having huge deposits in Swiss banks, here's something to take a cue from. The tax authority in the US has now made disclosure of offshore accounts mandatory even from non-resident individuals or corporates who have significant business in the country. Hitherto, the provision called *report of foreign bank and financial account (FBAR)*, first introduced in October 2008, applied only to US citizens and green card holders. The measure is a part of the US government's efforts to combat offshore tax evasion.

The Internal Revenue Service, the agency responsible for collection and administration of taxes in US, has recently expanded the scope of a provision. The expanded regulation requires **certain non-residents** to declare their 'financial account' in a foreign country if the aggregate value of these accounts exceeds $10,000 at any time during the calendar year.

This has ramifications for Indians working or having business interest in the US and also the subsidiaries of Indian companies registered there. Indians going on work visas like L-1 or H1B and short-term business travelers to US would be required to declare their bank accounts. However, artists, athletes, and entertainers, who are not citizens or residents of the US and only occasionally visit the country to participate in exhibits, sporting events, or performances, are exempted from making this disclosure.

This amendment is likely to cover a large population of Indian IT and other professionals working in the US, who will have to file details of their bank accounts henceforth or face penalties. Apart from bringing individual wealth into the open, the amendment would also increase the compliance costs. The FBAR has to be filed separately and not with tax return. Failure to file an FBAR can be onerous and result in civil penalties, criminal penalties, or both. The civil penalty amount could be as high as $100,000 per violation while criminal violation can result in a fine of up to $250,000 or five years in prison, or both.

A financial account would include securities, securities derivatives, savings, demand, and checking deposit – an account identical to current account in India, used to securely and quickly providing frequent access to funds on demand but account balances do not fetch any interest – or any other account maintained with a financial institution. Individual bonds, notes or stock certificates held by the filer are not covered under financial account.

Countries across the world place various disclosure requirements on their citizens and other residents with a view to combating tax evasion. Individuals who live in the UK have to declare their all taxable income to tax authorities. Indian tax authorities amended the tax return from last year, making it mandatory for filers to disclose transactions such as property purchase or sale above Rs 30 lakh, credit card spend of over Rs 2 lakh, mutual fund investments of more than Rs 2 lakh and investment above Rs 5 lakh in RBI bonds, company equity or debentures. Tax authorities have independent access to information on these transactions through annual information return, filed by third parties or entities such as banks, mutual funds, registrar of properties and other responsible for carrying out these transactions.

However, disclosure of details of bank accounts held abroad in the tax return is still not required in India. A former chief commissioner of Income tax, K V M Pai, recently made a recommendation to the CBDT, the body that administer direct taxes, to include a column in the tax return form seeking information on bank accounts in foreign countries.

2. Terror financing

The US which has linked hawala money to terror financing said India should fortify its legislation that deal with money laundering and terror financing.

A US state department report noted that India recently passed the Prevention of Money Laundering (Amendment) Bill but suggested that legislative amendments should be brought in to further strengthen the provisions and make it in conformity with the Financial Action Task Force, an inter-governmental body that looks at making policies to fight against money laundering and terror financing.

The report in its section on India related to money laundering said, "Given the number of terrorist attacks in India and the fact that in India hawala is directly linked to terrorist financing, India should prioritise cooperation with international initiatives that provide increased transparency in alternative remittance systems." The report, which was compiled by the Bureau of International Narcotics and Law Enforcement Affairs, further recommended that India should work towards becoming a full-fledged member of Financial Action Task Force (FATF).

The report said the Mumbai terrorist attacks had further increased concerns about terror financing in India and the US has appreciated the steps taken by the government after the attacks. But the report said that other measures needed to be taken.

- Among the steps the report suggested includes India becoming a party to UN Conventions against Transnational Organised Crime and Corruption.

- Also India should pass the Foreign Contribution Regulation Bill for regulating non-governmental organisations including charities.

- The report added, "India should devote more law enforcement and customs resources to curb abuses in the diamond trade."

- It should also consider the establishment of a Trade Transparency Unit (TTU) that promotes trade transparency in India; trade is the back door to underground financial systems."

The report said that most of the hawala money in India used for facilitates tax avoidance but criminal activity is also a major contributor. The illegal proceeds come from narcotics trafficking, illegal trade in endangered wildlife, trade in illegal gems (particularly diamonds), smuggling, trafficking in persons, corruptions, and income tax evasion.

The report also quoted RBI estimates that $42.6 billion worth remittances were sent through legal, formal channels in 2007-08. The report further quoted Indian estimates and said that funds transferred through the hawala market were equal to between 30% and 40% of the formal market. In that case the hawala market could amount to between $13 billion and $17 billion.

The report said the hawala system provided the same kind of remittance service as a bank with no documentation, lower rates and faster delivery. It also provided anonymity and security for the customers.

3. Bank secrecy laws

American lawmakers Llyod Dogget (D) and Carl Levit (D), who also chairs the Senate committee that will take up the UBS business practices, have introduced a draft bill before the US Senate and House of Representatives with a view to targeting tax havens such as Switzerland. It blacklists 34 countries, including Switzerland and Liechtenstein, which would affect the business market in Switzerland and make it less attractive to US companies and prevent them from enjoying local tax rates.

Swiss finance minister Hans-Rudolf Merz said, Swiss banking secrecy protects privacy of a client. It is not only guaranteed by the constitution but also defined by Swiss private law and penal law. He added, our experts are working on a strategy on how to develop banking secrecy and not to dismantle it. The Swiss government is also trying to find a political solution; otherwise 30,000 jobs in the US would be endangered as the Swiss banking industry employs that many people.

Renowned business management institute, the IMD Lausanne's Professor of finance Nuno Fernandes has advised the Swiss to buy enough time to get its house in order. Banking secrecy is not about tax evasion and the pressure on Switzerland is a part of the bigger picture, which is a fight by government around the world against tax havens. Fernandes states that banking secrecy and tax evasion are not related at all and that the similarities between the two have been magnified, which confuses people.

The Swiss Cabinet decided to relax its banking secrecy laws

The last bastion of banking secrecy in Europe fell on Friday (13/03/09). The Swiss Cabinet has decided to relax its banking secrecy laws to fall in line with the rules set by the OECD. The OECD put Switzerland, Liechtenstein, Andorra, Austria, Luxemburg, amongst other countries in the list of countries which are tax havens and uncooperative. In these times of financial crisis countries want to impose taxes on those who have accounts in tax havens and are undeclared, in an effort to booster their revenues.

On Thursday (12/03/09), the Liechtenstein government agreed to relax in banking secrecy rules and accept standards on international tax cooperation set by the OECD. Liechtenstein said it would negotiate new rules with other countries so that wealthy foreigners who had undeclared accounts would voluntarily come forward. However, it will not abolish bank secrecy completely.

On Friday morning, Austria said that its banks would be prepared to share information with other countries on a case to case basis if there were "justified suspicion" of tax fraud. Luxembourg's finance minister followed suit and said that his country's banks would be prepared to exchange bank data with other countries if there was "explicit proof of fraud".

Switzerland decision was influenced by that of Lichtenstein to conform to the OECD rules. It does not want to be seen as the black sheep and the fact that it could possibly be put on the black list of the G20 did not give the Swiss government to find alternative, concrete solutions. These decisions follow Singapore announcement last week that it would relax its strict banking secrecy laws.

Qualified company accounts

The era of qualified company accounts is about to end. Companies will have to restate their financial statements if auditors raise objections to any figure in the company's annual accounts, if the government accepts a proposed recommendation of the Institute of Chartered Accountants of India (ICAI). Annual reports would contain financial statements that fully satisfy the auditor's scrutiny.

This far reaching proposal has been cleared by a special group set up by ICAI, who has been asked by the government to submit *recommendations for improving financial reporting of companies*. According to the proposal, a company that does not restate its accounts as suggested by the statutory auditors would be barred from paying dividends or raising loans.

At present, an auditor's scepticism about any portion of the accounts presented by a company is tagged along with the annual report and an investor has to work hard to correlate every auditor qualification with the number or numbers under challenge. If the ICAI special group's proposal goes through, this torture would be a thing of the past. Accounts would become more transparent, and the auditor would be taken far more seriously than the present by companies.

The proposal, which is being made in an attempt to make companies' seriously act on auditors' disagreements rather than merely acknowledging such disqualifications, is, however, not new in India. For a number of years, the Sebi has made it mandatory that companies going in for an IPO will have to adjust their past results to give effect to all audit qualifications. The practice of revising accounts of companies, whose financial data has been questioned by their auditors, is in conformity with globally followed practices. In most developed countries, all potential audit qualifications are discussed with the company's management which revises their accounts to ensure there is no disagreement with the auditor.

Least bad option

Similarly, the tussle between the ICAI and the RBI over loan classification is of a piece with the lack of agreement between the accounting profession and banks over the sanctity of mark-to-market rules.

The accounting profession's contention is that relaxations in the classification of borrowal accounts (as standard or sub-standard) could distort bank balance sheets. They would present a better-than-warranted picture and hence, in the words of the ICAI president, are "not healthy for banking industry". In this he is correct. Where he errs in sticking to technicalities at a time when the fallout of such rigidity could have serous implications that go far beyond accounting propriety.

BUT, some times it is necessary to take one step back in order to take two steps forward. The disarray in the financial world and the slowdown in the global economy is one such occasion. Given the speedy unraveling of growth, many business ventures that made perfect sense in the pre-crisis days may no longer do so and may need some lead time to adjust to the changed realities.

Failure to recognise these changed realities by banks could result in a large number of loan accounts being classified as non-performing with its inevitable implications for provisioning. At a time when bank margins are already under pressure, large loan provisions could imperil their financial health and that of the economy at large. Corporate debt restructuring and the RBI's relaxation - allowing debts that have been restructured some leeway – are nothing but recognition of this ground reality.

7. INFLATION RETREATS: NOW ADDRESS GROWTH

Negative inflation completely different from deflation

Inflation is expected to enter negative territory – the first time since March 1976, driven by a sharp fall in prices of inputs. But there is no reason to fear deflation, characterised by steady contraction of demand. Deflation is when the inflation rate falls below 0%. A deflation in the traditional sense will trigger a downward spiral in the economy as consumers and companies defer buying decisions.

Just as high inflation reduces the real value of money and has negative welfare implications, deflation, though it might seem to increase the real value of money, is just as avoidable from the larger economy perspective. Most economists agree that between inflation and deflation the latter is the worse evil. The effects of modest, long-term inflation are less damaging than deflation. This is because when prices are falling, consumers tend to delay their purchases in the hope they will be able to buy later at still lower prices. This reduces overall demand and economic activity. Deflation also raises real wages at a time when falling demand is gnawing at companies' profits, resulting in layoffs and rising unemployment.

High base effect, lower metal prices pull inflation to 2.43%: Inflation for the **week ended February 28,** fell to 2.43%t. This is the 6th consecutive week for which inflation has shown downward trend. Inflation was at 3.03% in the week before and at 6.21% in the corresponding week last year. The pace of fall in inflation has surprised everyone.

Inflation deflates to near zero level: Inflation skidded to a record low of 0.44% in the **first week of March**. The sharp fall in the latest WPI number is more the consequence of the high base effect – inflation in the corresponding period last year was a high 7.78%. Going forward, we are likely to see a continued fall in the inflation rate, thanks to the sustained increase in the comparable figure till August last year when inflation peaked at close to 13%.

Inflation comes down from o.44% to 0.27%: Inflation continued its downward journey for the **week ended March 14** but the price rise in food items and manufactured products such as cement and metals tamed the pace of decline. Inflation rate stood at 8% the same week last year.

Inflation rises marginally to 0.31%: Breaking the nine weeks downward trend, wholesale price inflation rose marginally to 0.31% for **the week ended March 21**. It has moved up from 0.27% in the week before on account of higher prices of manufactured items such as cement, plastic products and oil seeds. An annual rate of inflation was 7.85% in corresponding week last year.

India's negative inflation patch would essentially be due to a high base effect and supply side issues and is temporary in nature. The trends in auto, steel, cement and retail sales in February 2009 were ahead of industry expectations. The consumer durables segment, which is one of the first sectors to feel the effect of tightening of purse strings by consumers, has shown a decent growth in January and February 2009.

Economists have dismissed the chances of negative inflation affecting the consumer behaviour and pointed out that impact if any, will be marginal. India's chief statistician Pronab Sen, who has been the first to forecast a negative inflationary scenario in the country by March-end, said that this negative inflation scenario is not going to hurt anyone and it is completely different from deflation which we witnessed 33 years ago. Then the deflation was driven by an extremely good harvest season and a subsequent drop in food prices to record lows. Unlike then, this time around, the negative inflation will have a positive impact on growth. The manufacturing stand to benefit as the prices of inputs are coming down at a faster pace than fall in prices of finished goods.

Experiment with complex financial instruments

The Derivatives Market Review Committee appointed by the Sebi has proposed introduction of a series of sophisticated derivative products, the notable among them being OTC products, exchange-traded derivative products and exchange-traded third-party products. Warren Buffet, some years ago, likened them to financial weapons of mass destruction. Developed markets had their fling with them, with mixed results to show. And now it seems to be India's turn to experiment with complex financial instruments, as it aims to move up the pecking order of the global financial system.

OTC products are derivatives contracts that are traded directly between two parties, without going through an official stock exchange or other intermediary.

At present, an OTC market exists in interest rate, currency and commodities derivatives. However, there is no such market in equities. The committee has proposed that to begin with OTC products are to be based on indexes, index futures and index options as underlying, and later on these contracts can also be based on stocks, single-stock futures and single-stock options.

Other proposed products include option contracts with longer tenures, volatility index, exchange-traded currency derivative products and exchange-traded products involving various strategies.

The committee has also proposed introduction of physical settlement in equity derivatives, beginning with single-stock options, and an overhaul of the current margining system.

On the cards is a separate segment for structured products purely for institutions, banks and insurance companies, greater freedom for domestic mutual funds to lend shares, permission for hedge funds to participate in the option market and introduction of market makers.

Often, large institutions owning sizeable equity stakes in companies hold on to their investments for the long-term. This lowers the available floating stock in these companies. To reduce the probability of manipulation in such stocks, the Committee has proposed that these large institutions be permitted to issue structured products based on the shares held by it, as the underlying. Such products can be traded on the stock exchanges.

Sebi seeks debate on derivatives

Sebi has invited comments on the recommendations of its derivatives market review committee. The initial reaction is one of bewilderment. How can the regulator even think of derivatives, which have brought global financial system to near-collapse? But then; what better time to discuss them now; There is no denying that India's financial market needs to evolve at a faster pace to meet the demands of a growing domestic economy, products to address newer needs, greater market depth, and integrity under appropriate regulation to ensure systemic safety.

The recommendations address nearly all these issues vis-à-vis derivatives. Mini-contracts, in general, increase liquidity, while elongating the tenure of options would help long-term investors who roll over short-term options to achieve the same effect as of now. As regulatory systems in the western markets teeters, India has the opportunity to show the world it can create both new market frameworks as well as strong regulations to make them work.

Regulator cracks whip on agents

Errant insurance agents had better watch out. In a first-of-its-kind measure, Insurance Regulatory & Development Authority (IRDA) has decided to penalize agents if life insurance policies are not renewed. The move, aimed at curtailing mis-selling, will entail commission being retracted from agents and credited to the policyholder's account.

One of the main complaints against the life insurance agents has been that they sell regular premium policies, commission for which are in the range of 25-35%, by passing them off as single premium policies, which attract 2% commission.

Since prospective buyers are reluctant to commit large annual payment for 15-20 years, unscrupulous agents position a regular premium policy as a one-time investment scheme, similar to a mutual fund. They also inform the policyholder that he can invest more money in the scheme in the forthcoming year and that, even if she chooses not to, she could exit the policy after three years.

The flip side of such sales is that the buyer usually does not pay the second-year premium. Since charges in an insurance policy are front-ended into the first-year commission, the policyholder ends up with negative return by not paying renewal premium.

IRDA, in a recent circular said: "For the current year (FY09), where products had provided for more than 25% reduction in subsequent premium, the difference of premium should be treated as a single premium and the commission clawed back and invested in the policyholder's account."

This means if a policyholder pays Rs 100 as premium in the first year, against which Rs 35 is commission paid to an agent, and renewal premium of Rs 60 in the second year, the company will have to treat the second-year shortfall (100-60) as single premium in the earlier year and recover the difference. In other words, commission of Rs 40 would be recalculated at 2% instead of 35% and the difference recovered.

The circular has rattled insurance companies that are now worried that this directive could be misused by customers to leverage a rebate of commission from agents.

Regulator wants to keep a track of fund source

IRDA has also decided to crack down on insurance companies that help policyholders launder money. A policyholder can launder money by paying premium in cash by splitting policies. The practice involves parceling large financial transactions into smaller ones to avoid scrutiny by regulators. Going by the anti-money laundering norms, insurance companies can accept premium only up to Rs 50,000 in cash. Any amount beyond Rs 50,000 has to be remitted only through banking channels, as this would help keep a tab on the source of funds.

Insurers, in fact, pitched for a higher threshold, saying that many policyholders in rural areas did not have bank accounts. But the plea was dismissed. The norms also stipulated that for integrally-related transactions, premium amount more than Rs 50,000 in a calendar year should be examined more closely for possible angels of money laundering. This limit is applied at an aggregated level considering all roles of a single person as a proposer or life assured or assignee.

Forex losses & gains part of business

For Indian corporates, losses on forex deals and trying to cope with them are part of the learning process of doing business in a globalised world. The current downturn – one of the most vicious to date – is their first real exposure to business cycles. For many corporates, it might seem like a particularly stiff learning curve with the penalty for mistakes unconsciously high.

Certainly it is the time that they got real.

In the pre-reform days when the rupee was less volatile, their exposure to the rest of the world was also much less, and more importantly there were restrictions on the kind of foreign currency deals they could get into. Consequently, companies were relatively sheltered from market volatility.

Sure, they might not have been able to enjoy the highs but were protected from the lows as well.

Corporates who bet on robust growth continuing indefinitely *(read, the rupee-dollar exchange rate being a one-way street),* ignoring the underlying weaknesses in both global and domestic growth, are now in for a rude shock. Many who got carried away by glib talk from 'smart' bankers and bought exotic products they did not understand have had their fingers burnt. Others who failed to hedge their exposure and have to remit money overseas are now open to the full downside of a weakening rupee. Even those who hedged had probably not anticipated the speed and scale of the fall in the value of the rupee vis-à-vis the dollar.

The point is that at times like the present when the outlook, especially for parameters like exchange rates that are so critically dependent on external factors is so uncertain, it is best for corporates to take a considered view; weigh the risk-reward trade-off and take only those risks they are in a position to bear. In many cases, it might make sense to cut losses and exit rather than hang on in the hope of a reversal in trends. Many Indian companies are looking for an answer on how best to handle forex losses as they prepare to close their books for the year.

Fallout of an unexpected volatile currency market, these are losses on currency forwards and option deals that companies had struck with banks. They had entered into currency contracts to fix an exchange rate at which they could sell the dollar earned from exports. The contracts were signed when the dollar was trading at a much lower level – 47, or 45 or even 42. Currently, the US currency is trading at over 51. A contract that promises the exporter an exchange rate of Rs 45 to the dollar can be a winning deal if the dollar had dipped below 45, to say 42, but it's a losing one with the greenback having surged to 51 since the exporter is tied to an unattractive rate, receiving Rs 45 for every dollar he earns, rather than Rs 51 which the market has to offer.

Thousands of such contracts, which will expire after March 31 2009, will have to be accounted for in the year's balance sheet. If on March 31, the dollar closes at a rate higher than what has been fixed in the contract – the deal, in market parlance, will be "*out of money*". To an accountant, the contract has a mark-to-market (mtm) loss.

The Accounting Standards Board, which is looking into finer points of derivatives accounting, has proposed that mtm losses should be provided only for "speculative contracts". According to S Santhanakrishnan, chairman of the board, widespread mtm losses could cause unnecessary panic and an artificial mtm crisis should be averted.

Under the present rules, which have a few grey areas, no provision is needed for mtm losses if the forex contracts are treated for what is known in accounting parlance as 'hedge accounting'. This does not mean that the corporate can avoid mtm provision only if it has a genuine underlying like actual dollar receivables from exports. There are other conditions that have to be fulfilled for a contract to qualify as a 'hedge' or come under the purview of 'hedge accounting'.

Debate over MTM rules

The Institute of Chartered Accountants of India has deferred on relaxing Accounting Standard 11 (AS11) which requires corporate to report exchange rate related profit or losses on forward exchange contracts in their accounts.

As the rupee has depreciated sharply against the dollar, many corporate are faced with mark-to-market (mtm) losses and have sought relaxation of the rule. Corporates have argued that such profits or losses should be accounted for when the contract matures; as such profits or losses are notional and could change as prices change. On the other hands, the proponents of fair value accounting argue that it gives the stakeholders a true picture of the financial position at a point of time and enables them to make a more informed decision.

While a consensus is awaited, companies could be allowed to publish two sets of accounts, one with MTM rules in operation and another without the rule. This would provide the stakeholders a clear picture of the financial position of their company. These rules must be applied consistently, as MTM rules at time also yield notional gains that inflate profit.

Companies could count out forex losses for 2 more years

The National Advisory Committee on Accounting Standards (Nacas), the government's apex panel that decides on the accounting policies, has favoured suspension of mark-to-market accounting norms on foreign exchange transactions for two years.

The decision comes as a victory for Corporate India as it sits down to draw yearly financial results. The decision taken at the Nacas meet in Mumbai on Tuesday (24/03/09) suggested that the accounting norms, which call upon firms to account for their forex losses, should be kept in abeyance till April 2011. However, it requires notification to this effect by corporate ministry to give it a statutory force. The debate on suspension of this accounting norm was raised by the Confederation of Indian Industry (CII) on the ground that this accounting norm has severely distorted the reported earnings of many companies. It was contended that this accounting standard, which was designed to address normal conditions, should be suspended for the time being as the present market conditions were not normal.

India Inc will end up posting better results if the accounting recommendations are accepted as several companies have taken huge hits following the depreciation of the rupee by around 27% in the last one year. Higher profits would mean higher taxes for the government and higher revenue would help the government bridge its fiscal deficit. A similar debate is also raging in the US on whether the capital market regulator Securities Exchange Commission should suspend the M-to-M accounting rule, which has forced banks to report billions of dollars in asset write-downs.

It is hard for data to come worse than expected

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