finberry quickie

Learning money

Volume 2, Issue 1, January 1, 2009

Editor's Touch

Best wishes for a happy and prosperous 2009.

The former Finance Minister [the father of Securities Transaction Tax (STT), a tax on the value of securities trades in the stock exchange] is now the Home Minister of India. He is considering a new STT, Security Transaction Tax, which will be levied on the amount that people spend in appointing security guards and buying security equipment. Just kidding!!!

Inflation worries have given way to recession woes. Large economies like Japan and UK already seem to have got into a recession. My Recession 2020 Econoview examines some factors underlying the current economic scenario, and a few concerns.

Let us start the new year on a clean and green slate. Mr. Deeshesh Chedda discusses carbon credits, as a capital market route towards a cleaner world.

Sundar Sankaran

Sound of Money

The Recession 2020 EconoView

By Sundar Sankaran

How quickly inflationary worries have given way to recession woes? UK, Japan, Singapore, Taiwan – all have reported two successive quarters of economic decline (technically, treated as a recessionary situation). The United States is hanging on. Growth rate in the two biggie economies, China and India, is already down.

How has this turnaround happened? In a previous column, Inflation EconoView (July 15, 2008), I mentioned the fears of a global recession. I reasoned how, among other things, the US Asset Bubble and Inflated US Dollar had pushed up consumption in the global economy. The article also spoke about the oil bubble, created by a spurt in oil prices.

The bubbles have burst. First to burst was the asset bubble. Defaults in sub-prime mortgages (finberry Quickie, May 15, 2008) were followed by a decline in other security markets. Balance sheets were bleeding. Investors wanted their money back from funds. But funds could not find buyers for the securities they held. Funds, desperate to sell securities – and margin financiers, selling clients' securities to settle margin calls from stock exchanges – exacerbated the fall in asset values.

Bankers' Trust and Lehman Brothers were considered too big to fail. But the US allowed them to go down, under the impact of their poor asset portfolios. Not knowing who would go down next, a fear psychosis got created. No one wanted to have an exposure to anyone else. Liquidity in the market dried up.

Businesses operate as “going concerns”. They presume that inventory will get converted to sale, which would yield cash. Creditors for raw materials would give credit, while credit would need to be given to debtors who buy the finished goods. Gaps in the financing are met by bankers and other financiers. When this normal business liquidity dries up, then businesses are stuck. They can no longer buy raw materials, nor pay their workers, nor run their business. It is easier to sack a worker, than sack a fixed asset. Thus, jobs were lost.

Job loss affects future income. A job loss by itself is bad enough. Wealth loss is worse. It can destroy everything that people have built over the years. Combine job loss with wealth loss - the impact can be deadly.

Today, people neither have the means, nor the will, to buy what can be postponed or avoided. The global decline in consumption has increased the need to cut business activities – and jobs. A bad problem thus became worse. A financial market problem has spread to the real economy. In a globalised world, the US trouble has spread to other countries, through different kinds of linkages:

1. US investors required money, and had to beef up their capital. They sold their investments in the so-far-lucrative emerging markets of Asia. Thus, the decline in US asset prices led to declines in markets across the world. People who felt wealthy when asset prices boomed, suddenly were poor. The ones who took huge loans against inflated asset prices, became paupers. Wealth erosion and defaults are hardly an environment where economies do well.

2. Resource rich countries like Russia, Middle East, Africa and Brazil found that in a recessionary environment, their minerals and oil were less sought. The resulting crash in prices has hit these economies.

3. China finds that its economy, which is so dependent on exports to the developed world, now does not have buyers. Large factories are idle – more job losses.

Where does India stand in all this?

Let us start with a rather prescient view which was expressed in Inflation EconoView (May 15, 2008):
"Unfortunately, the policy response to inflation, in many countries, is not based on ground reality, but the philosophy the policy-maker subscribes to. A widely prevalent economic philosophy is to control money supply / raise interest rates to control inflation. There are two concerns to this approach:

- An aspect that is often ignored is that money supply controls, and increases in interest rates, might stifle supply and thus exacerbate the inflationary pressures, instead of controlling them.
- Monetary policy takes time to take effect. Political realities of coalitions, and looming elections, mean that the Indian Government might be in a hurry to control inflation. A monetary policy overdrive might lead to the parallel of a sick person taking one aspirin after another to get quick relief from head ache – only to see the cumulative effect of all the aspirins hit her later."

Many people praise the Indian monetary authorities for having limited the problem for India. Reality may well be otherwise…

Indian economy is less dependent on exports. The contrast with China in this aspect is stark. As such, decline in global consumption ought to have less impact on India. But the impact is a lot more than what should have happened. Why?

- Local investors have suffered wealth erosion, because of the decline in stock prices and real estate. Can't blame the RBI for this.
- The Mumbai terror made things worse for some industries. Can't blame the RBI for this.
- The RBI may however like to ponder over the aspirin example mentioned earlier. Did the continuous tightening of liquidity through tight monetary policy over several months (which did not make sense when inflation was caused by global factors) cumulatively squeeze Indian industry? Now the RBI is busy undoing everything it did earlier this year and last year. Money is being made cheaper. But then, remember, monetary policy, like aspirin, takes time to yield results.

If one aspect of local economic policy contributed to inflation in India, it was the fiscal policy viz. the government's unproductive spending through populist give-aways. The coalition government did not have the political will to be prudent in its finances. This has left the government finances in a mess. This fiscal mess was being compensated by RBI through monetary tightening.

While monetary policy takes time to take effect, fiscal policy shows quicker results. In the current recessionary situation, a quicker way for the economy to escape would have been a fiscal measure to increase government expenditure. Alas, the already weak government finances leave us with fewer sensible options on the fiscal front.
It will take a few months for the easing of monetary policy to deliver results in the economy. In the meanwhile - money or no money – the government will spend. Don't all governments do that before elections?! This will help boost domestic consumption and the Indian economic recovery.

In April-May 2009, India will have another round of general election. Hopefully, a hotch-potch coalition of minor parties will not come to power. Indian economy will be comfortable with either of the two major parties leading a coalition. Political stability in May-June 2009 might help stabilise the equity market, enhance the feel-good, and improve the Indian economic scenario.

The Concerns

✐ One shudders to think what will happen in India, if the elections throw up political instability. Let me join the majority in wishing this away as a nightmare we may not have to face.

✐ India may not go to war with its neighbor. But it is useful to keep in mind the economics of wars:

* The first Gulf war, led by George Bush Sr. was financed by countries in the Middle East. The US economy grew.

* The second Gulf war, led by George Bush Jr., was financed by the US tax payers. We know how they feel about it.

* Any post-war recovery helps economies expand. Imagine a giant like India in a recovery mode. Let us hope other countries do not look forward to India getting embroiled in a war, so that the global economy recovers faster.

✐ It is always difficult for policy-makers to take a call to temper a booming economy. Even Alan Greenspan, who served as Federal Reserve Chairman for nearly two decades, could not bring himself to reverse the cheap money policy. The asset and consumption bubble that this created, sowed the seeds of the current global economic turmoil.

The same cheap-money and expansionary economic policies of the US, are now being implemented across the world – to avoid a global recession. How many of these governments will have the nerve to reverse these policies when the economy has to be tempered in future? Will the world create a more spectacular bubble than the US created?

The world will survive the current turmoil. Let us not worry about global recession in the next two years. Start worrying about the next global economic turmoil, 12 years down the line. **Recession 2020.**

Carbon Credit
by Mr. Deeshesh Chedda, Subject Matter Expert

Funda

Ever since concern over Global Warming increased, awareness on the need for pollution control has increased internationally. This has lead to the international agreement, popularly known as Kyoto Protocol. This agreement gave birth to the concept of Carbon Credit.

What is Carbon Credit? Quite simply, you pay money to account for each tonne of carbon dioxide; or one of the other 5 common environmental pollutants that you create. 'You' can be individuals, corporations or political entities.

For example, if I generate 10 tonnes of carbon dioxide per year, and each carbon credit costs $20 per tonne. I would have to pay $200 to be carbon neutral; meaning that I am paying a fee for each tonne of greenhouse gases I produce. This fee contributes to products that either remove carbon, or invest in green, renewable energy projects. Effectively, if I produce 10 tonnes of carbon, then I pay to have ten tonnes removed from our atmosphere.

Carbon credits are certificates issued to countries that reduce their emission of GHG (greenhouse gases) which causes global warming. Carbon credits are measured in units of certified emission reductions (CERs). Each CER is equivalent to one tonne of carbon dioxide reduction.

Fact

As nations have progressed we have been emitting carbon, or gases which result in warming of the globe. Some decades ago a debate started on how to reduce the emission of harmful gases that contribute to the greenhouse effect, which causes global warming. So, countries came together and signed the Kyoto Protocol.

The Kyoto Protocol was initiated by the United Nations Framework Convention on Climate Change and ratified by 181 countries and the European Union as a whole, individual entity in 1997, and was put into effect in 2005.

The Kyoto Protocol has created a mechanism under which countries that have been emitting more carbon and other gases (greenhouse gases include ozone, carbon dioxide, methane, nitrous oxide and even water vapour) have voluntarily decided that they will bring down the level of carbon to approximate average of 5.2% below the 1990 emission levels over the period 2008-2012

Member countries are placed into different categories; Annex I countries make up the industrialized nations. Annex II countries are developed countries that provide financial support to the developing countries.

The Clean Development Mechanism (CDM) is a governing set of rules set by the Kyoto Protocol to determine which companies and projects can generate carbon credits.

The Protocol imposes target commitments upon countries, which in turn, set emission quota on companies in their country. In order to fulfill their quota, companies whose emission are above their permitted quota buy Carbon Credits from companies that have excess credits to their account. For each tonne of CO2 avoided, the company receives a carbon emission certificate which can be sold either immediately or through the futures market, just like any other commodity. Allowing such credits to be bought and sold makes it possible for businesses that are unable to reduce their own emissions (either because it is too expensive, or not practical) to compensate businesses that are more favourable towards the environment.

By way of example, assume a factory produces 100,000 tonnes of greenhouse emissions in a year. The government then enacts a law that limits the maximum emissions a business can have. So the factory is given a quota of say 80,000 tonnes. The factory either reduces its emissions to 80,000 tonnes or is required to purchase carbon credits to offset the excess emissions.

Developed countries have to spend nearly $300 to $500 for every tone of reduction in CO2, against $10 to $25 to be spent by developing countries. In developing countries like India, the emission levels are much below the target fixed by the Kyoto Protocol. So, they are excluded from reduction of GHG emission. On the contrary, they are entitled to sell surplus credits to developed countries.

The European countries and Japan are the major buyers of carbon credits. This is what makes trading in carbon credits such a great business opportunity. Foreign companies which cannot fulfill the protocol norms can buy the surplus credit from companies in other countries. This leads to a flourishing trade in Credit Emission Reduction.

The credits can be traded worldwide on exchanges such as Chicago Climate Exchange, Nordpool, European Climate Exchange, European Energy Exchange and NYMEX's Green Exchange and India's National Commodity and Derivatives Exchange Limited and Multi Commodity Exchange of India (MCX India).

Advantages of Carbon Trading

1. Carbon credit trading can open up a new cash source to companies who are able to maintain their emission levels well within the permissible limits.
2. The company or country gets rewarded for applying clean technology in its production process.
3. The environment-friendly companies are able to cultivate a much better corporate and social image which wins public approval
4. It encourages activities like tree plantings which would help reduce soil salinity, improve water quality and enhance biodiversity.
5. The overall ecological balance is preserved, through incentivizing favorable behavior, and penalizing polluting businesses.

Finale

India is the second largest seller of carbon credits in the world with six per cent share in 2007 while China tops the list with a whopping 73 per cent share, a World Bank report said.

India is considered as the largest beneficiary, claiming about 31 per cent of the total world carbon trade through the Clean Development Mechanism (CDM). It is expected to rake in at least \$5 billion to \$10 billion (Rs. 22,500 crore to Rs. 45,000 crore) over a period of time.

The forecasted credits trading in India is expected to touch US\$ 100 Billion by 2010. Carbon Trading has brought huge opportunity for Indian companies. Companies can earn credits by adopting energy saving and environment protecting methods and in turn can earn huge incomes by selling them.

In 2007, the carbon emission market size stood at almost US\$65 billion, and is expected to reach \$115 billion by the 2008 end. According to a report by Global Carbon Emission Market, the carbon emission market has been growing at an astounding rate: over 73% in terms of volume and over 88% in terms of value in the last three years. Short-term growth looks moderate, but the long-term outlook is promising. In an optimistic scenario, the global carbon emission market could reach over US\$2 trillion by 2020 and become one of the largest commodities markets.

Would you like any specific concept or topic to be covered in these columns? Please feel free to send us your preferences at tellme@finberry.info

If you would like to receive this publication regularly, or would like us to send this to your friend, colleague or associate, send us the e-mail IDs at subscribe@finberry.info

finberry quickie is published by finberry academy pvt ltd from its offices at 314 Damji Shamji Industrial Complex (Next to Toyota), LBS Road, Kurla West, Mumbai 400 070 Tel. (91-22) 65905622 / 33, 25138945 info@finberry.co.in