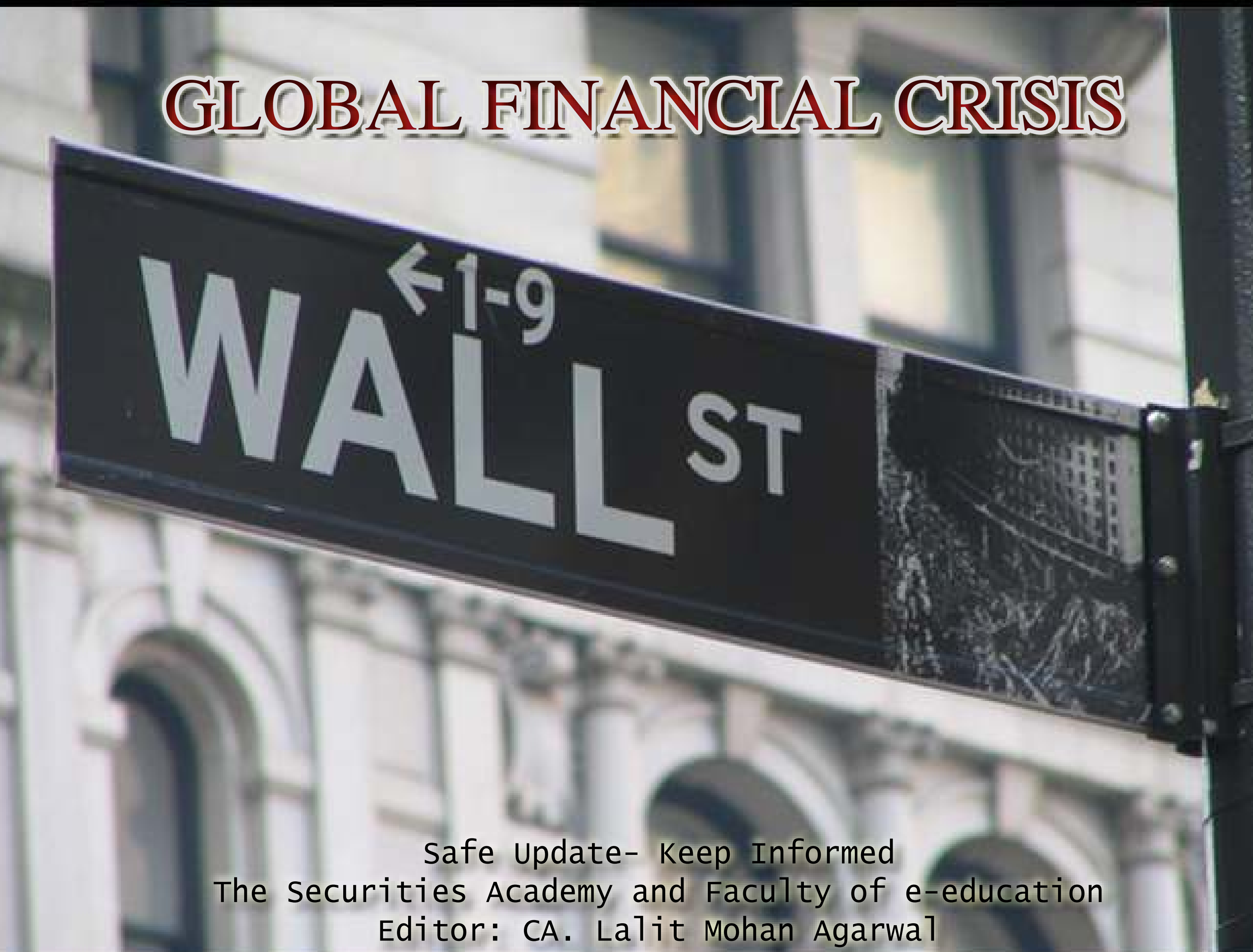
safe eCollege Gateway To The Securities Market

Volume - 22

FINANCIAL ADVISOR PRACTICE JOURNAL

Journal of The Security AcademyAnd Faculty of e-Education

GLOBAL FINANCIAL CRISIS



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The Securities Academy and Faculty of e-education
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With Best Compliments From Indo Adept Creations

Editorial Preamble

1.1 GLOBAL FINANCIAL CRISIS

Survival strategies

Global financial services major tumbled one after other. If it was the oldest and 4th largest American financial institution Lehman Brothers filing for bankruptcy, Merrill Lynch was taken over by Bank of America in a $50-billion stock deal. And US government bailed out AIG by providing $85-billion loan in exchange for a 79.9% stake in the insurance giant.

On 15th September 2008 (Monday), the financial world woke up to two bombshells. One, the Lehman Bros had filed for Chapter 11 bankruptcy. And two, equally blue-chip Merrill Lynch, *brokerage giant whose name is more familiar in India than Lehman, thanks to its long partnership with DSP as DSP-Merrill Lynch*, had been bought over by Bank of America. Two financial deals announced on the same day – but while one saw a venerable name (Lehman) disappears altogether (though it may emerge in another avatar some years hence) the other saw another equally proud name (Merrill) survive; perhaps as a pale shadow of its earlier self, but survive nonetheless.

The cyclical tyranny of the global markets has long been upheld as a trait of the free market economy. The current crisis in the global markets should, however, force us to introspect on the limitations of the free market economy model. Clearly, the heady excesses of the free market model have seen their best years. The doctrine of "*self-interested pursuit of the wealth not being individually satisfying but leading to an aggregate increase in wealth that is in the best interest of a nation*" needs to be re-examined.

Also, we need to solve questions such as: How free are free markets? How do they adjust to major economic downturn / financial crisis? Is it true they happen only 'once-in-a-century'? And, most importantly, the lessons to be learnt by all of us and by the Indian policy makers!

A glance at the current global financial crisis will tell us that some fundamentals free markets take for granted just do not always work, even in the most sophisticated financial markets such as the US. In the traditional world of banking, banks accept deposits and lend monies to long-term clients and pocket the difference. In many parts of the world, particularly in countries like India, which are highly under-banked, that's what they still do. To some extent, in the developed markets these traditional banks have vanished, giving way to institutions like Lehman Brothers and Bear Sterns that undertake complex deals and are referred to as "non-depository" institutions.

There is seemingly nothing wrong with this model, but when it comes to failure / bailout why should any government put the taxpayers' monies at risk?

Policymakers the world over, particularly in developed free markets, always worries as to the consequences of such relief measures as those initiated by either the US Fed or the government. The nervousness is justified as policymakers are painfully aware that such bailouts do sometimes reinforce even more risky behaviour by the markets in the future.

Here, we should remind ourselves that whom to bail out and whom not to is not a decision driven by markets; such complex decisions are taken by policymakers. The more recent bailout after Bear Sterns is that of the world's largest insurer AIG. So what distinguished Lehman from others and hence determined their dramatically different fates? Just one world: Leadership. Leadership is what determined the dramatically different fates of Lehman Brothers & Merrill Lynch.

Different fates of Lehman Brothers & Merrill Lynch

The danger signals were there for all to see and Lehman's chairman and chief executive, Richard Fuld, as an insider, was doubtless privy to much more information than the rest of the world. Huge write-downs had triggered large losses in the second and third quarters; the share price which fell 50% over just two days early September had fallen almost 90% over the year. But he refused to accept anything less than top dollar for his bank, walking away from deals that in retrospect look wishfully attractive.

The problem was Richard Fuld was convinced of Lehman's invincibility, in fairness to him the bank had survived not only the 1998 LTCM (Long-term Capital Management) crisis when the hedge fund collapsed dramatically but also the 9/11 bombing when it was forced to vacate its offices and function temporarily out of a hotel). Richard Fuld, perhaps, mis-calculated. He assumed the US Fed would come to its rescue just as it had with Bear Sterns in March when it brokered a deal with JP Morgan Chase to take over Bear. But there's was key difference he failed to spot. The US Treasury had put taxpayer money at risk by taking over liabilities worth $ 5,400 billion of mortgage giants, Fannie Mae and Freddie Mac in the previous week. It could not risk any more.

Contrast this with what happened at Merrill Lynch. As one of the most powerful brokerage houses in the US, CEO John Thain had reason to be just as cocky as Lehman. But he was also more pragmatic. Though a relative newcomer to Merrill, or perhaps because of it; Thain, who joined only in November '07, was able to adapt to the fast-changing environment.

John Thain was quick to catch on that if Lehman could go down, so could Merrill. So he quickly sealed the deal with Bank of America, which had been toying with taking over Lehman and might even have preferred to do so had the price been right. Fuld's obduracy gave Thain the chance he was looking for. Net result is Merrill survived, Lehman bit the dust. To quote JP Morgan's Jammie Dimon, there is a difference between buying a house and buying a house that's on fire. John Thain recognised that difference; Richard Fuld did not and that made all the difference!

Countries such as India will, over the next 10 to 15 years, need to move towards a far greater integrated global financial world, and policymakers in India need to rethink the framework for such integration. India to a great extent, today, is far less integrated with the global financial markets and is fortunate in its leadership at the policy level.

Our policy makers will navigate India through the present crisis. That's the least of our worries. But what if the degree of integration is far more intense? How should our regulators/ policymakers then protect our markets? In the past, we didn't flinch when the 1970s oil crisis struck – some critics say, though unkindly, that we were too miserable to feel the pain anyway. The crisis in the 1990s - that nearly made the Asian Tigers as endangered as their wildlife counterparts passed us by, without a murmur. But what of the current crisis? Will this too pass? Perhaps yes, but definitely not without a few telling scars.

- In India, there is an ever-growing demand for greater deregulation. But, we need to ensure that we do not get carried away with blind faith in the doctrine that *there is a direct relationship between economic growth and economic freedom.* Typically, in the developed world tens of thousands lose jobs due to crises. However, in the not so well to do economics these crises hurt millions of people who live below the poverty line and the slowdown of growth dramatically affects their quality of life.

- There are several lessons we need to learn from the ongoing global financial crisis. The heart of the crisis lies in the recklessness of the banking system that started giving loans to subprime borrowers in the belief that the real estate boom that had doubled home prices in the US would allow people with even dodgy credit backgrounds to repay the loans that they were taking to buy or build homes. This coupled with the US government's altruism to encourage lenders to lend to subprime borrowers, compounded the damage. It was not the lack of regulation that led to this cataclysm but sheer recklessness on the part of the key players in the financial sector.

- A key lesson is that India needs to continue to develop its own economic model. Definitely far away from the socialistic model, but equally distant from the "free for all market". India needs a modified free market economic model – shepherded, however, by a body of independent regulators. A model that is prey neither to the machinations of the Left or the Right, nor self-serving interests.

It is possible that Indian policymakers are already in a state of alert. They may have to undertake several measures including the setting up of stimulation models (however complex) to sketch 'what if' scenarios relating to what would happen to our major banks or NBFCs if there was a market failure. Without a doubt, the landscape for the Indian investment banking story is about to change. The question in how these banks will adapt.

The point being made here is one of *relationships* and *high levels of stability* which the domestic banks maintain. An investor would like an investment bank which can serve all his needs, across the globe. So intension to go global appears to be in place for most domestic players. And, if relationships are the name of the game, the domestic players should make sure they leave no stone unturned in the process. Promoters value access to senior management in the investment banks who can advise them on key decisions. Given the current turbulent times, clients of investment banks should be treated as virtual gods. This is the time to build strong relationship with clients.

Another factor which will strengthen the position of the Indian investment banks will be people. Hiring the right people is often half the battle won. When the markets were on a roll in 2007, hiring people was the most difficult task. Demand and supply were hopelessly mismatched. People were in scarce supply and the salaries asked for were beyond what most employers could afford. With today's global turmoil, that is expected to change.

For the Indian investment banks, it is all about taking note of the change and putting in place newer business models. Innovation helps a great deal at times like this. Innovative business models should emerge to meet the growing aspirations of Indian corporates. Alliance with global boutique firms would be one of the ways to service requirements of Indian corporates for their international affairs.

As the stage of limbo plays out, the M&A deals and public issues will take a while to reappear. Fee income will halve from last year's level, but investment bankers shall have to live will it. For now, it may be about smaller deals, structured finance and project finance. This may sound different from what used to be the case. After all, it's a changing time and the only thing certain is uncertainty. Opportunities need to be identified and executed with alacrity.

Curtains down on Wall Street I-banks

Goldman Sachs & Morgan Stanley get converted into retail banks

A new chapter was added to the ongoing saga of financial meltdown on Monday, 22nd September 2008, even as it marked the end of an era on Wall Street. This time, it was the turn of the remaining survivors among the Big Five investment banks of the US to eat humble pie. Goldman Sachs and Morgan Stanley, the two most influential securities firms and the arteries supplying capital to Wall Street, decided to convert themselves into retail banks. The decision, born out of compulsion rather than choice, has been approved by the US Federal Reserve.

Cataclysmic events have shaken the financial world two successive Monday in a row. But unlike Merrill, which has disappeared into Bank of America's embrace, Goldman and Morgan Stanley will not have to merge with commercial banks. Instead they have been told to convert themselves into 'regular' banks after a transition period during which the US Fed will provide funds without being too fussy about collateral. The idea is to prevent distress sale of assets / panic unravelling of credit default swaps and other exotic instruments that could imperil other players.

With this, the era of large standalone investment banks finally comes to an end. Unlike the Enron fiasco that dragged down one accounting major – Arthur Anderson – the ongoing financial crisis has now pulled down all major standalone investment banks. The statement issued by the Fed says it approved requests from both I-banks to become bank-holding companies subject to regulation by it.

Both Goldman and Morgan will now be subject to capital adequacy requirements like other commercial banks. They will also be subject to much tighter regulation by the US Fed than in the past when they came under the relatively light regulation of the US Securities and Exchange Commission (SEC).

As banks, both Goldman and Morgan will also have access to savings deposits from the public, reducing their reliance on wholesale funds. But whether this will suffice to restore the health of the US banking system has to be seen. Going by the travails of Washington Mutual, the largest savings and loan institution and the fourth largest bank in the US, there is no such certainty. If Nouriel Roubini of New York University's Stern School of Business is to be believed, there is more pain to come. The next stage, he argues, will be a run on many highly leveraged hedge funds. The only silver lining is that we are finally seeing co-ordinated global action to restore normalcy.

WaMu delivered to JP Morgan Chase

Even as the wrangling in the political establishment continued over the financial bailout package, the US suffered the biggest ever failure in its history, with Washington Mutual, better known as WaMu collapsing on 25th September, 2008 (Thursday). After weeks of rumours about the perilous state of its health and failed attempts to find a suitor, WaMu, the largest savings and loan institution and fourth largest bank in the US was seized by regulators and delivered into the hands of JP Morgan Chase.

Under the government-brokered deal, JP Morgan will pay $ 1.9 billion to the banking regulator and acquire all insured and acquire all insured and uninsured deposits, assets and some liabilities of the WaMu's banking operations, including its mortgage portfolio. The government had no choice. Shares in WaMu, with its large exposure in home mortgages, credit cards and other retail lending products had become almost worthless in the past few months. As retail depositors' fears grew, people began to withdraw money, forcing the Office of Thrift Supervision.

The Federal Deposit Insurance Corporation (FDIC) chairman has assured WaMu's customers there will be no interruption in services and it will be business as usual on Friday morning. But it remains to be seen how badly public confidence in the US financial system is shaken as a consequence. Especially since it is well-known that the FDIC's own resources are under severe strain; indeed one of the reasons for the shotgun marriage is apparently because FDIC would not be in a position to honour all claims were WaMu to go under. For JP Morgan, which has long eyed WaMu's big branch network and $ 143 billion retail deposits, the deal may seem a good bargain. But remember this is the second time it has ridden to the rescue – the first was to take over Bear Sterns. In both cases it is doubtful if it had time to do a proper due diligence. In any case, at times like this when markets have all but evaporated it is next to impossible to do a proper valuation. Only time will tell who the sucker is; the US taxpayer for sure; and all of us too, given the size and clout of the US economy.

Citi to buy Wachovia: Citi-group the biggest US bank by assets, will acquire the banking operations of Wachovia, rescuing the Charlotte, North Carolina-based lender beset by mortgage losses for more than $ 2 billion in stock. The accord may have averted a collapse at Wachovia.

Government versus markets

The current Wall Street crisis should put an end to false debates about government versus markets. Governments create markets, and markets can exit only with regulation. The real trick is to craft good regulations that allow markets to work well. No regulatory structure will be perfect, none will eliminate risk, nor should they. At best they can tame the wildest gyrations of the market economy while maintaining its efficiency. The first task of the US government and Fed remains to bolster confidence. The next is to devise a workable and flexible plan to dispose of the mountains of assets that the government is taking over. Then, after some thought and analysis, should come the fixes needed to better structure America's massive and complex financial markets.

Amid all this gloom and doom, the main reasons the savvy investors are still excited about the Indian economy and its size, its rapid growth and the fact that some sectors of its economy have become truly world class in pretty quick time. India is already the world's fourth largest economy when measured in purchasing power parity terms. Jack Welch, GE's former chief executive officer, perhaps summed it up best with his comment that: "India is already a developed country as far as intellectual capital is concerned". The global financial crisis has brought a fresh focus on the debate about the Indian financials and monetary policy reforms. Percy Mistry and Raghuram Rajan committees' reports present interesting ideas on such proposed reforms. In fact, the global crisis only reiterates the fact that the reform process should be continued to ensure that India becomes the preferred destination for investments. The mistakes in the international financial market need to be studied and understood and the current crisis should not lead to the conclusion that the homegrown decade long effort of understanding the problem of Indian financial markets and steps suggested for solving them must now be discarded.

2.1 SECURITY MARKET

History rewards the brave handsomely

The current turmoil in the global stock markets is not for the faint-hearted. As investors' wealth gets eroded across global markets, it may not be the right time to pontificate but it's pertinent to point out that history rewards the brave handsomely. After two big financial crisis of the past – the 1970s oil shock and early 2000 dot-com bust – investors in the US, the UK, Japan and Germany who remained invested or entered the market during the time of the crisis reaped super-normal profits in the year immediately after the crisis abated.

The Equity Risk Premium (ERP) – *calculated by subtracting the average income return from a riskless asset from average stock market total return* – analysis of US, UK, Japan, and German stock markets before, during and after 1973-74 and 2000-2002 crisis underline this trend of windfall profits in the year immediately after the meltdown. The ERP message seems simple - a crisis may be a good time to invest or stay put, for there could be a pot of gold at the end of the roller-coaster ride.

1st week of September '08 – Side-effect of downturn in other markets

Daily review	29/08/08	01/09/08	02/09/08	03/09/08	04/09/08	05/09/08
Sensex	14564.53	(66.02)	551.35		(150.76)	(415.27)
Nifty	4,360.00	(11.35)	155.35		(56.25)	(95.25)

Weekly review	29/08/08	05/09/08	Points	Percentage
Sensex	14564.53	14,483.83	80.70	(0.55%)
Nifty	4,360.00	4,352.30	7.70	(0.18%)

Notwithstanding two easing factors – fall in inflation rate for the second straight week to close at 12.34% as on August 23 and lower global crude oil prices near USD 110 a barrel – the benchmark sensex surrendered its initial gains on weak global cues and ended down by 81 points during the week under review. Most of the Asian indices as well as Wall Street ended the week in negative terrain on global economic concern. Suspense over the Indo-US nuclear deal also casts a shadow on the market sentiment on the last day of the week when it tumbled by nearly 415 points.

2nd week of September '08 – Equities down, in consolation to meltdown in other markets

Daily review	05/09/08	08/09/08	09/09/08	10/09/08	11/09/08	12/09/08
Sensex	14,483.83	461.14	(44.21)	(238.15)	(338.32)	(323.48)
Nifty	4,352.30	130.00	(13.60)	(68.45)	(109.95)	(61.85)

Weekly review	05/09/08	12/09/08	Points	Percentage
Sensex	14,483.83	14,000.81	483.02	(3.33%)
Nifty	4,352.30	4,228.45	123.85	(2.85%)

Markets ended in the negative territory on sustained FII selling. The biggest negative surprise came from the sharp rupee depreciation which breached the Rs 45 level touching Rs 45.75 to a dollar, which is the lowest ever during the last two years. FIIs were continuous net sellers in the week which resulted in a big dollar demand, putting more pressure on the rupee. This was also why one saw a sharp price correction in the market heavyweights during the week which contributed significantly to the fall in indices.

3rd week of September '08 – Market waits for to see bottom formation in other markets

Daily review	12/09/08	15/09/08	16/09/08	17/09/08	18/09/08	19/09/08
Sensex	14,000.81	(469.54)	(12.47)	(255.90)	52.70	726.72
Nifty	4,228.45	(155.55)	2.00	(66.65)	29.90	207.10

Weekly review	12/09/08	19/09/08	Points	Percentage
Sensex	14,000.81	14,042.32	41.51	0.29%
Nifty	4,228.45	4,245.25	16.80	0.39%

Assurances from Indian Prime Minister Manmohan Singh and Finance Minister P Chidambaram together with positive global cues saw Indian equities markets recover from Black Monday blues to end the week with marginal gains. The recovery on both the exchanges was, however, restricted mainly to the large cap and index component stocks. Midcap and small cap failed to recover enough and ended in the red.

4th week of September '08 – End of an era of Investment-banking on Wall Street

Daily review	19/09/08	22/09/08	23/09/08	24/09/08	25/09/08	26/09/08
Sensex	14,042.32	(47.36)	(424.65)	122.21	(145.34)	(445.00)
Nifty	4,245.25	(22.20)	(96.15)	34.35	(50.70)	(125.30)

Weekly review	19/09/08	26/09/08	Points	Percentage
Sensex	14,042.32	13,102.18	940.14	(6.70%)
Nifty	4,245.25	3,985.25	260.00	(6.12%)

The world has not ended. The international economy has not yet collapsed. But one thing is now quite clear: the US banking system as we know has failed. Following the disappearance of Bear Sterns in March and now the bankruptcy of Lehman Brothers and the surprise plans for Bank of America to absorb Merrill Lynch, three of Wall Street's 5-big independent investment banks have disappeared in 6-months.

After an astonishing week, it is too early to predict the future shape of investment banking with confidence, but business as usual is not one of the possibilities. The future of Goldman Sachs and Morgan Stanley, the last two independent investment banks, is now an open question.

The failure of this independent I-banking business model is not just about the continued impact of US housing but symptomatic of a more fundamental malaise that will continue to damage the US and Europe. From poor governance to flawed incentives, incomplete risk management to foolish strategies, the failures of the financial system have been so widespread as to render a coherent regulatory riposte impossible. The likely outcome is that tight capital requirements will be forced to serve as a catch all response to risk. If so, the US banking system will look more like that of the 1960s – a low-risk, low-return utility business.

US treasury secretary Paulson's proposal to move all the toxic financial assets of tumbling Wall Street banks to a special purpose vehicle has for now abated the crisis of confidence in the America financial markets. A fund of roughly half a trillion dollars may be created to support a comprehensive effort to deal with troubled assets. This is clearly nationalisation of an order that would make any socialist regime look rightist! But it is sorely needed to lend credibility to the markets.

Last days of September '08 – The bubble of commodity prices start busting

Daily review	26/09/08	29/09/08	30/09/08	01/10/08	02/10/08	03/09/08
Sensex	13,102.18	(506.43)	264.68	195.24		(529.35)
Nifty	3,985.25	(135.20)	71.15	29.55		(132.45)

Weekly review	26/09/08	30/09/08	Points	Percentage
Sensex	13,102.18	12,860.43	(241.75)	(1.85%)
Nifty	3,985.25	3,921.20	(64.05)	(1.61%)

End of the era of double-digit growth in China – According to a recent Morgan Stanley report, China has simply grown too big to keep expanding at the 10% rate it has sustained for 30 years, and is likely to slow to 8% at best next year and for the foreseeable future. India iron ore exporters recently warned that demand from steel mills in China had fallen sharply over the past month and that Chinese buyers were defaulting on contracts with suppliers. With coal reportedly piling up in China's eastern ports, the news of steel defaults will fuel concerns about the likely impact on global commodity prices of a slowing Chinese economy.

Analysts say smaller Chinese steel mills are losing money on their output because of weak steel demand and the hefty prices they paid for ore and coal ahead of the Beijing Olympics in August. China's crude steel output fell 5% m-o-m in August to 43 m tones, although at least some of the fall was because of temporary industrial disruption caused by anti-pollution and security measures imposed for the Games.

China's status as a pivotal source of demand for many commodities means even a mild slowing of its economy, which has been growing at double-digit rates for years, has serious implications for global prices. The decisive end of the era of double-digit growth in China will have major implications for the nation and the world. Until now, China had defied the traditional theories of how fast developing nations could grow, and for now long. Its economic growth has compounded at an annual average rate of 10% over the past 30 years, a record that has surpassed the other miracle economies, such as Japan and South Korea. Now the law of large numbers is catching up to China. There are clear sign in China's response to the slowdown that the leadership understands that this moment was inevitable that it is abandoning it old growth-at-any-cost mentality, and will not try to artificially revive double-digit growth.

Monthly review – Sensex struggling at many time tested bottom

Month	March '08	April '08	May '08	June '08	July '08	August '08	Sept. '08
Date	31.03.08	30.04.08	30.05.08	30.06.08	31/07//08	29/08//08	30/09//08
Sensex	15,644.44	17,287.31	16,415.57	13,461.60	14,355.75	14,564.53	12,860.43
Points	Base	1,642.87	(871.74)	(2,953.97)	894.15	208.78	(1704.10)
Percentage	Base	10.50%	(5.04%)	(18.00%)	6.23%	1.45%	(11.70%)

Financial Accelerator

Is there any end of this market bloodbath?

Over the last nine months, every time there has been a glimmer of hope when one saw light at the end of the dark tunnel, it has turned out to be that of an incoming train! It was June 2007 when *HSBC* was the first bank to declare a loss of $2 billion in subprime mortgage assets it held. Fifteen months later, the contagion has spread, taking down with it venerable names on Wall Street and bringing the *world's biggest investment banks* on to their knee. Close to $400 billion has been written off and $350 billion additional capital raised by banks for shoring up their weak balance sheets. The US government has taken on private debt in order to save the system - $29 billion for *Bear Sterns*, a bill for nationalising *Freddie* and *Fannie* for $200 billion, and $85 billion for bailing out *AIG*, the world's largest insurer. Only in last week of September, a unique backstop guarantee was structured, encouraging Citibank to acquire *Wachovia* and the Bush administration has put up a bail-out package bill for a staggering $700 billion.

On the other side of the Atlantic, the UK, still smarting after the nationalisation of *Northern Rock* just last week of September, also took over another struggling mortgage lender – *Bradford and Bingley*. Three European governments stepped in to bail out an ailing *Fortis*, Iceland injected state funds into *Glitnir* and German government gave loan guarantee to *Hypo Real Estate* – the second biggest German commercial property lender. Not a day goes by without one hearing of yet another blow out in the western world.

The super leveraged firms are going through a process of de-leveraging made more complex in the current environment of a total lack of confidence. The spread between LIBOR and Zero Risk Treasury Bills is now over 300 bps, which means banks are not lending to each other out of distrust. Banks, it is said, die of two causes. Cancer (non-performing loans or toxic assets which are difficult to value and a challenge exacerbated by the mark to market accounting) or out of heart attack (liquidity seizure). Through the Credit Default Swap (CDS) instrument banks and institutions have traded bets on the likely default of borrowers to the tune of $62 trillion. The sheer volume of the contracts and the fact that they trade directly between institutions and not through a centralised clearing house, intertwines the fate of multiple players in the financial system.

The markets can only return to normalcy after the process of de-leveraging is over. The financial institutions need to find ways to deal with the distressed assets they bought with borrowed money by either selling (for which there is no market) or write-downs (for which they do not have adequate capital). They need to pay off their debt and rebuild their capital eroded by these assets. The challenge here is that when they try to sell these assets, it will push down their prices and they will need to sell even more. This pushes the company's share lower making it even more difficult to raise capital. This is, as Bernanke put it in his academic days 'Financial Accelerator'. There still remains potential for significant contagion via the unwinding of complex counter-party exposures. The challenges are: shortage of capital, dysfunctional credit markets, widespread de-leveraging and significant asset sales. Declining asset values, debt reduction and asset sales reinforce each other into a negative loop. The Financial Accelerator combined with a negative loop has put the world markets in an uncertain territory which is without precedence.

The raging forest fire will be significantly put out once the Trouble Asset Reconstruction Plan goes well. While one can argue on the effectiveness or the methodology of its implementation, there is no doubt that it will temporarily soothe the market and make an attempt to get the financial system to attain normalcy.

2.2 INDIAN ECONOMY

What next for Indian markets?

The Indian stock market appears becalmed on choppy seas. While international liquidity flows and the global economy remains uncertain, local investors have stabilised the market by not withdrawing capital. Falling oil prices have also helped to bolster the market. Thus the market continues to trade in a relatively narrow 13k to 15k range. Managements and market players seem perplexed about business conditions and profit trends. No aggregate direction seems to have emerged, making this a stock-picker's market.

India's breakneck growth has clearly slowed. I returned to India from the US after just a few months and noticed many important changes. Delhi airport itself seemed much more efficient; however, I was not sure whether this was because GMR was starting to deliver on its airport modernisation programme or because fewer people are flying. Traffic outside the airport soon indicated that oil prices had not had any impact. Still, as I travelled around the country, flying through many airports and travelling on many different airlines, it was clear that airline traffic had come down appreciably. Vehicle traffic was even worse than normal but here the monsoon might be the culprit; creating havoc on both old, crumbling roads as well as the recently constructed "highways".

Malls were emptier. Sale signs were plastered on every shop window. Local bazaars too seemed quieter and less crowded. Most ladies that I spoke to told me that they had cut back on consumption because prices for everyday goods had gone up faster than household income. Consequently, shopping behaviour had once again become much more prudent with a sharp eye for prices and bargains. Real estate firms confirmed that transaction volumes had begun to drop. Many more apartments were available for rent and sale in metro India. However, prices do not seem to have declined very much. Developers' inventory is still at relatively low cost and carrying costs have not yet begun to bite. While customers are waiting for prices to correct, developers are unwilling to sell at fire-sale prices.

A mixed picture emerged when I spoke to company managements across several sectors and industries. Commodity companies were the most uncertain in their outlook. Many managements believed strongly that steel prices were bound to go up. Others felt that steel prices were certainly coming down. It was the same story in oil, coal, and aluminium. Future prospects for the rupee were equally hazy.

In other industries, managements were much more optimistic about their outlook. The infrastructure, power, shipyard, and engineering sectors seem quite comfortable with their order books and expected bid activity to remain strong in India and overseas. Even banks continue to believe that their growth prospects have not been impacted by the higher interest rates and credit slow-down. They expected spreads to come down only a bit. Only auto and real estate companies actually communicated their concerns about the slowing economy and the more frugal buying behaviour of consumers.

Corporate results in the last two quarters seem to bear out this murky outlook. There has been considerable dispersion amongst companies across various sectors. Moreover, managements are finally acknowledging that margins are going to decline from the peak levels witnessed over the last few years. Note that domestic margins for most Indian cos are higher than international margins. As a result, Indian cos tend to be more profitable than their international counterparts. With a slowing domestic economy, rising competition from MNCs, and continuing rise in domestic costs, margins are bound to decline.

In particular, domestic costs are beginning to converge to global levels. Capital costs have clearly gone up with interest rates and equity is much more difficult to obtain in a bear market. Land costs are higher; and construction costs continue to soar with commodity prices and international quality buildings. Only wage costs are moderating, and there is considerable relief that poaching of human talent is likely to come down in a softer environment.

Indian companies are operating at close to full capacity, so additional capacity will be required to sustain volume growth. For instance, investments in the telecom infrastructure have lagged behind subscriber growth. The lack of increased network capacity to meet the growing demands for wireless and high speed data services has recently been leading to poor and erratic connections. This is the first time I preferred to use a land line because of the high incidence of dropped calls.

So we are finally back-to-basics after a long period of momentum investing. Valuations are becoming more attractive after several years. In this environment, company-specific events and factors are likely to drive price action. Stock-pickers will flourish and the easy momentum trade may not work. We might have to wait till we have a new President in the US and a new government in India before fresh winds propel the overall market forward. *(The author is senior managing director, The Blackstone Group)*

Business sentiments: Unduly Pessimistic

The quarterly ET-NCAER Business Expectations Survey shows business sentiment has taken a severe knock to touch a five-year low. The July 2008 survey shows Business Confidence Index (BCI) has fallen to 125.8, almost as that for July 2003, the rallying point for the global economy. There is an increase in number of respondents who had a negative outlook on all four parameters of the survey – overall economic conditions, financial position of companies, investment climate and capacity utilisation. Importantly, while over half the respondents still had a positive outlook, in case of investment climate, the number of positive respondents has dropped to below 50%. – Significant, considering that GDP acceleration has been investment-led over the last few years.

Among the sectors, services have taken the biggest hit, possibly due to the US financial turbulence. Consumer durables continues to be strong, a fact corroborated by the Index of Industrial Production which shows a double-digit growth for the sector. A look at the time series of the BCI shows that the lows correspond very closely with the corrections in stock market, while the highs have come when indices were near their then peaks. Clearly, even while respondents are talking of business environment, the immediate outlook for the stock market appears to weigh heavy. This is why there appears to be a-disconnect between the state of the real economy and the sentiment of the business community.

The global financial turmoil would, at worst, shave off a couple of percentage points from GDP growth. We would still grow at near 7%. Besides, the deceleration is mostly in sectors where there were obvious bubble situations, real estate and financials for instance. The farm sector is poised to grow well. Since the bulk of the population has its livelihood there, this bodes well for consumption demand. Corporate balance sheets are strong. Credit crunch could take a toll on investments, but a more liberal overseas borrowing regime and a more conducive environment for FDI flows should improve overall sentiment. True, there are multiple concerns but we feel the largely domestic-driven Indian economy is expected to come out relatively unscathed. The survey findings, hence, are unduly pessimistic.

2.3 INDIA: CHANGING PROFILE

Educate masses to avoid Singurs

In 2007, Nandigram was being considered for a chemical SEZ. Since then, instead of emerging as a catalyst for West Bengal's industrial growth, the town has slipped deep into the Sunderbans and may be remembered now, only in business school case studies for its protesting and clashing farmers. Apparently pleased with their success at preserving the natural beauty of Nandigram, political parties are now conspiring to repeat the show at Singur, just 35 Km away from Kolkata.

Right from the seventies, militant labour and political unrest have been instrumental in de-industrialisation of West Bengal and have earned a place as 'critical parametres' in evaluating of risk associated with all investments there. All this is a result of parties exploiting the public sentiments to further their personal interests. West Bengal probably is unique to have witnessed the largest number of industrial units and corporate offices shifting out of the state in 60 years of our independence. Despite all such descend; the government has not shown any desire to gain its past glory.

Singur suddenly shot into limelight when Tatas decided to locate its Nano car facility there. Apart from fiscal incentives offered by the state, Singur was the final choice for Nano plant on account of its proximity to Kolkata, its nearness to Tata Steel at Jamshedpur and easy access to Haldia port for tapping the export markets. Initial investment planned was Rs 15,000 crores and it was expected to generate employment of nearly 2,000 at full capacity, with scope for additional investment and employment by vendors. But most importantly, the facility was meant for Nano, slated to be the cheapest car in the world, and many MNCs and international media have been closely following its developments.

This car perhaps the best chance for West Bengal to ride the Nano wave and capitalise on the opportunity to attract further investments in the state. But, what we have instead displayed to the world is, thousands protesting outside the Nano factory for return of their allegedly fertile land, interpretations on whether land acquisition by government for private project can be considered to be in the public interest or not, Tatas threatening to pull out of Singur, other state's interest in offering alternative sites for the project, obvious reactions of industry captains and various chambers of industry and commerce, cost implications of shifting out at this stage of the project, Tata's plan B for plant relocation and the impact of shifting out on cost of the car and likely delay in its launch!

The question now is not limited to the 400 acres of land at Singur or whether Nano rolls out on schedule from Singur or from Pant Nagar. It is about the image of country's industrial climate, political risks in Indian business operations, our concern for timely completion of high profile projects like the Nano car and also lack of understanding of the benefits of industrialisation.

To address this, we urgently need to develop and run a strong campaign supported by extensive promotion to educate the locals in areas likely to be affected by acquisition of land for industrial units. Experience of China, Korea and even some of our states can be shared to demonstrate that agriculture can never match the industry's potential to create and sustain well-paying jobs.

Campaign must explain that every successful project attracts more investment in the surrounding areas, and region as a whole begins to develop. And most importantly, we need to bring out that land resources are limited in supply and can be put to various alternative uses like agriculture, exploration, residential, academics, business / industrial activity etc. The final choice of land use must be decided by projecting its utility/output over a longish period of say 15-20 years and then opting for that use which maximises the cumulative output over a given period. It is only by educating the masses that we will be able to keep them away from the machinations of crafty politicians and avoid the Nandigrams and Singurs in future.

Silver lining in cloud over Singur

In the 1991 reforms marked a turning point in India's economic development, the on-going Singur fracas is likely to mark yet another landmark - changing equation between business and politics.

Consider, Reforms might have done away with licensing in the formal sense, but till recently no industrialist who knew what was good for him could afford to stand up to government, whether at the Centre or the states. The heavy hand of the government is there in almost every sphere of life, business or personal. For instance, government tells sugar mills how much they should pay sugar-cane farmers, the radius from within which they must procure and how long into the crushing season they must buy the cane, how much and when they must release for sale and how they should pack the sugar (only in jute bags unless it is in packs below a certain specified weight).

In such a scenario, 'smart' industrialists who found themselves pitted against vested interests preferred to work behind the scenes either to tweak policy to their advantage or to buy peace with the people who mattered, whether in government or those outside who had the potential to create mischief. Few, if any, were up-front about it. Till now! But then the Tatas have always been an exception to the typical Indian way of doing business. Ironically, the very investment that locals are protesting against holds the key to grater prosperity. But no investor, however eager, can afford to persist in the face of determined opposition. Beyond a point investors will prefer to cut their losses and exit for more hospitable climates. That is the fundamentals rule of market economics.

Remember this is not the first time they have faced opposition in Singur. In late, 2006 too, there were disturbances. This is not the first time either that Left-ruled states like West Bengal and Kerala have seen opposition to industrialisation. Both lag behind in investment and economic prosperity and can hardly afford to turn away potential investors. The post-reform period has already seen a widening of the gap between the richer and the poorer states, as the better-off states were better placed to take advantage of new opportunities. If the gap is not to widen further people in poorer states will need to be convinced that it is in their enlightened self- interest not to oppose such investments. State governments have a major role to play in this. Apart from a human and well-executed resettlement and rehabilitation programme, they need to educate their people.

Endemic labour unrest and periodic disruptions of the kind that Singur has witnessed, thanks to short-sighted politicians like Mamata Banerjee, do not attract modern businesses in a competitive, globalised world. Agriculture cannot support the vast numbers presently dependent on farming. But unless non-farm employment opportunities grow, the burden on land will not be reduced; nor will we see a reduction in grinding poverty. The Nano plant offered just such an opportunity. Sadly, politicians looking to make political capital have failed to read the writing on the wall.

If the Tatas pull out of West Bengal the biggest loser will not be the company but the state and its people, including its political class. Hopefully the tough stand taken by the industry will teach the West Bengal government (and other state government as well) that the days when governments called all the shots are over. Gone are the days when political parties could come up with mutually convenient plans that failed to take industry on board. Industry is central to the deal. State governments can no longer expect a pliant industry to wait for ever for matters to improve. That is, perhaps, the only silver lining in today's unfortunate turn of events. It's a tough lesson but one that our politicians sorely needed.

2.4 INDIA INC

Crunch Time

When a giant tree falls the impact is felt all around. The financial crisis in Wall Street will have its repercussions for Indian corporates and the subsidiaries of the failed blue-chip investment banks such as Lehman and Merrill Lynch in India. I-bankers who could until a year ago choose their jobs are now being rendered unemployed. Bonuses that were paid in stock are now worth nearly 70% less than what they were. It is not the I-banks alone that are feeling the pain. On the back of the subprime crisis, a credit scare has turned lenders extremely risk averse and financing is becoming a serious issue.

Most banks have started going slow on proposals and are looking not only at the best possible returns but also at the safety factor. Financing costs have risen sharply and banks have reneged on financial deals. There have been cases where corporates which had gone to these banks lured by cheaper financing have suddenly found themselves caught on the wrong foot. Banks that had originally promised them cheap financing options reneged on the deals. These corporates had already given firm order for plants on the back of the earlier commitment from banks.

Most Indian and foreign banks feel that the crisis could last till next year and they now want to play safe. Bankers feel that multi-billion takeovers overseas could be few and far in between. Indian corporates are now getting ready for either shelving projects or delaying implementations. The demand of capital in a growing economy is high. New projects require both debt and equity. Liquidity in the international markets for both these sources has dried up. Risk appetite for the banks is very low and the same is a reflection of the negligible volumes in the debt markets. This could impact build up of new capacities thereby adversely affecting the growth projections.

Ride on economic turbulence

Hard times are good for big companies – said media mogul Rupert Murdoch. While he was speaking in the limited context of the possibility of companies gaining market share during turbulent times, the idea has a wider footprint. Difficult times such as the current global financial crisis present the stronger and more resilient players with an opportunity to fill gaps in human resource capability through smart hires, improve their competitive positioning by bridging strategic gaps in their businesses and also gain market share through acquisitions.

Bank of America's acquisition on Merrill Lynch at $ 50-billion in an all stock deal is a case in point. The acquisition adds investment services of Bank of America's core banking, allowing it to offer almost every financial service to consumers.

In times of economic turbulence such a response may intuitively seem to be reckless, but evidence suggests otherwise. Studies in the US show that companies that made acquisitions in the post dotcom crash generated returns in the subsequent boom. There could be two reasons for this out-performance. One, through the market churn process and distress selling, assets have passed over to those who see a better utilisation for them. Two, the shakeout also helps separate the leaders from boys, transferring assets to more capable leaders. In fact, this contrarian streak requires courageous leaders, as in a turbulent period acquisitions can be seriously punished by the market, at least in the short run. Witness how Bank of America's share price fell after it announced the Merrill Lynch acquisition.

Corporate balance sheets have never been so good, particularly in the case of large emerging market companies. Debt has dropped sharply and reserves have shot up. It is a good time for big companies to leverage their balance sheet strength to build scale and capabilities for the coming years. Business downcycle is also a period to further fortify brand and product design.

Meltdown means cheaper buyback for promoters

The collapse of US investment banks such as Lehman Brothers has bought a new opportunity for the promoters of Indian companies in which the foreign entities have investments. The promoters could get an opportunity to raise their stakes through buybacks at discounted prices.

Bankruptcy professionals involved in restructuring of some foreign enterprises said that in most cases, the administrator or receiver in the US or the UK in charge of selling their assets would prefer an existing shareholder to buy the stake even if it is at a discount. This is considered easier than finding a third-party buyer. Losing time in finding a new buyer would erode the value of the assets. Existing shareholders may also feel uncomfortable with an unfamiliar shareholder stepping in.

Insolvency of a foreign company may not necessarily trigger an insolvency of their investee companies in India. In deals between Indian companies and foreign investors, the right of first refusal is a standard clause. Therefore, if the shares held by a foreign investor are put on sale, the Indian shareholder would have the right to buy the shares provided the sale is taking place at India level.

If the sale is taking place at the offshore level, as most investments are routed through tax heavens, or where Indian shareholders does not have the resources to buy shares, there could be a problem. The troubled investors' stake may be sold at a discount to a third party, eroding the value of the enterprise and leaving the Indian shareholder to deal with a stranger.

Globality

Globality is not a new and different term for globalisation. It's the name for a new and different global reality in which we'll be competing with everyone, from everywhere, for everything" – say Harold I Sirkin, James W Hemerling and Arindam K Bhattacharya in their new and interesting book "Globality". This book from three Boston Consulting Group (BCG) consultants suggests that the future of competition if far more complicated and unpredictable.

Ever since Goldman Sachs published its famous BRIC report, the conventional way of viewing the future of global competition has been to track what Brazil, Russia, India and China are doing. This notion seems to fit in well with Thomas Friedman's popular book 'The World is Flat' that made the narrow point that global dominance is no longer the prerogative of the West.

Companies in the BRIC countries may certainly be emerging strong contenders to the hegemony of western multinationals, but they're not the only ones. Whether it's Mexico, Egypt, Hungary or Chile, potential world-beating corporations, their research shows that the spread of globalisation has meant that competition can emerge from pretty much anywhere. This is being called "globality".

India is uniquely positioned to benefit from this globality. The huge educated manpower India possesses can be a source for world beating innovations. The culture of investing in developmental activities and in newer technologies needs to be continuously nurtured by the government and the private sector for harnessing this potential.

2.5 FOREIGN INSTITUTIONS

Financial hurricane hits Wall Street

Some events leave their mark on the history of money and change the rules of the game forever. Is this the financial apocalypse the world has been dreading since the subprime crisis first hit the global economy more than a year ago? Or is there more to come? That's the question uppermost on most minds as nothing more the US administration can do, including the once-unthinkable nationalisation of two big financial institutions, Fannie Mae and Freddie Mac, seems able to stem the slide.

If only we could be sure is indeed apocalypse then maybe we could expect things to improve. Unfortunately the world has no such luxury – instead there is mind-numbering uncertainty about how many more financial giants may finally go down as the crisis unravels.

On 15th September 2008 (Monday), announcements by 158-year-old investment bank Lehman Brothers Holdings, once the bluest of investment banks that it would file for Chapter 11 bankruptcy protection and by Bank of America that it had agreed to buy Merrill Lynch in an all stock-deal worth $ 50 billion only add to the sense of foreboding.

It remains to be seen whether the sale of Merrill and the controlled demise of Lehman will be enough to finally turn the tide in the financial crisis that has crippled Wall Street. Reports that American International Group, (AIG) the largest US insurer by assets and Washington Mutual, the largest S&L institution are also seeking Fed support suggest it might not.

There is also dander that the winding down of the 158-year-old investment bank could expose other banks to losses on its assets, risking more bank failures even as the Federal Deposit Insurance Corp exhausts its reserves, raising the spectre of a repeat of the savings and loan meltdown. The only difference is that this time the rest of the world is hitched on to the US economy in a way that was not the case earlier.

On Monday, when traders watched in shock and horror at the news tickers, they sensed that history was unfolding before him. "Lehman failed, Merrill sold and AIG trying to raise $ 50 billion before the opening bell" – it was surreal. Wall Street will never be the same again. Its oldest and fourth-largest investment bank Lehman Brothers Holding Inc has gone bust while Merrill Lynch, famous for its iconic bull statue in the New York City financial district, sold out before it's too late.

Over the weekend, two of the biggest banks have become history with Lehman going for the biggest bankruptcy filing and Bank of America buying Merrill in a $ 50-billion stock deal.

The enormity of the fiasco forced some of the central banks to swing into action. Central banks are frantically spraying dollars by the billions into the financial markets to calm investors as well as save some of the venerable institutions from the untimely demise. The US Federal Reserve has nearly quadrupled the amounts of dollars that the European Central Bank, the Bank of Japan and other counterparts can auction, from $ 67 billion to $ 247 billion.

People's Bank of China cut interest rates for the first time in six years and lowered reserve requirements for smaller banks. Inevitably the ripple effects are being felt in markets round the world. In Russia, President Drnitry Medvedev pledged $ 20 billion to support the Russian stock market and cut oil taxes to stem the country's worst financial crisis in a decade. No one knows how markets will pan out over the next few weeks. How events will finally pan out is hard to predict but they are bound to hit the broader US economy and the world, including India, pretty hard.

A new institution

On Friday (19/09/08), US Treasury secretary Henry Paulson and the Federal Reserve have proposed to move troubled assets from the balance sheets of American financial companies into a new institution. All this would cost hundreds of billions of dollar, and the Fed is readying a plan to tap hundreds of billions of dollars in taxpayer funds to buy up toxic mortgage-related debt. Paulson urged Congress to quickly agree on a programme for huge purchases of bad debts held by banks and other financial institutions.

War on short sellers

Responding to consensus view that speculators had aggravated the collapse of financial institutions like Lehman and AIG, stock market regulators declared war on short sellers. SEC said it will halt short sellers of US banks, insurance companies and securities firms – about 800 stocks in all – till October 2 while the Financial Services Authority in the UK banned short sales of financial shares for the rest of the year.

All-out attack on credit crisis

US President George W Bush told reporters in the White House Rose Garden, late on Friday that losses on these debts have choked the financial system, forced lenders into bankruptcy and led the economy to what Bush called a ‘pivotal’ moment. America’s economy is facing unprecedented challenges, and we are responding with unprecedented action. After having taken a series of other emergency steps that failed to erect a firewall against spreading credit turmoil, US authorities turned their attention to the underlying problem – the rising tide of bad mortgage debt.

The mistake of ‘81

We hope that the US government does not repeat mistakes committed in 1981 – when a situation similar to now prevailed in the US mortgage industry in the form of savings and loan crisis. One hopes that whatever measures they announce now addresses the fundamental issues and helps the overall economy. It should not create unproductive work for the industry, as it did in 1981.

Back in 70s, most of the US housing loans were made by what used to be known as ‘savings and loans’ or ‘thrifts’. These entities were giving long-term loans for housing, but were funding their loans with short-term liabilities. When rates went up after the Fed lifted interest rates in October 1979, they had to pay more on their liabilities which they could not pass on to housing borrowers. This made thrifts, a one trillion dollar industry, bleed, leading to a huge crisis in the housing finance industry.

To address this problem and to save these bleeding institutions, the Fed in October 1981, announced a piece of legislation, which in retrospect looks like an ill through-out plan.

Massive tax reliefs were announced for thrifts. The internal revenue department would return taxes paid by thrifts in the past to the extent of losses reported by thrifts in their books. This meant, there was a perverse incentive for thrifts to show losses. Thrifts were rushing to Wall Street in desperation trying to sell their loans. The desperation was evident as loans were sold a-65-cents to dollar (35% discount).

This helped them show losses in the books. This well-intentioned move on the part of the government and the Fed did not help the mortgage industry. Loans were simply being traded by thrifts among themselves and the loans were moving from one-thrift-to-other. The only community that benefited hugely from the crisis was Wall Street bond traders, who made a killing from the ruins of history’s worst financial crisis.

That time, the legislation did not address the industry's fundamental problems. On the contrary, it led to huge amounts of unproductive paper work and costly administrative difficulties. Substantial amount of administrative work is called for when loans move from one organisation to the other. The thrift which acquired loans had to establish relationship with borrowers from scratch.

Instead of trying to help thrifts in a convoluted way through tax breaks, the government could have used the money to simply recapitalise thrifts. This would have been far more elegant and would have reduced wasteful expenditure for the economy. This time round, one hopes that the measures are well thought out as to how it will play out once introduced.

A bailout

Fundamentally, the term bailout refers to the practice of injecting liquidity to the business when it is bankrupt or close to the point of bankruptcy. There are multiple ways in which this could be done. The money could be given as a loan to the company which it needs to repay on reaching solvency. Alternatively, the bank buys the distressed assets of the company and gives it cash in return. It could also be done via the trading of stocks and bonds. It can be undertaken by a group of investors or in certain cases by the government. A group of investors may pump in the money and get a stake in the company. However, intervention from the government generally happens in a case when it is expected that the downfall of the company could have larger repercussions on the economy.

The month has seen some of the largest investment banks in the US taking a downturn or seeing a change in their status. Lehman Brothers filed for bankruptcy; Merrill Lynch was taken over by Bank of America; AIG declared it was near bankruptcy; and requests by financial big-wigs like Morgan Stanley and Goldman Sachs being given the status of depository institutions by the US Federal Reserves. Earlier in the year, Bear Sterns was acquired by JP Morgan Chase. In lieu of these events, the US Federal Reserve has devised a $ 700 billion bail-out package to buy the bad debts which caused the credit crisis. The US government has already run up a bill of $ 1 trillion in recent weeks as it rushed to stabilise its financial institutions, including the seizure of Fannie Mae and Freddie Mac.

A landmark $700-billion bank bailout

Although the Congress initially refused this bailout plan, they reconsidered of their decision and have now said that the $700 billion will be disbursed in stages over two years: initially $250 billion will be given to purchase risky assets from banks, another $100 billion could be requested by the President and the final $350 billion will need another approval from Congress. The Congress has also introduced the Emergency Economic Stabilisation Act 2008, based on which the US Treasury can get a stake in the companies involved and if the company fails, they will be amongst the last investors to incur losses.

The US government enacted a landmark $700-billion bank bailout on 3rd October, 2008 (Friday). The US House of Representatives approved the rescue plan by a vote of 263-171. President George W Bush quickly signed it into law, concluding two weeks of high-stakes haggling over the plan that had roiled and captivated global markets. Bush said: "We have shown the world that the United States of America will stabilise our financial markets and maintain a leadership role in the global economy."

US Treasury Secretary Henry Paulson, who had been the administration's chief lobbyist for the plan, said he would move quickly to buy up distressed assets from banks.

2.6 WARNING SIGNALS

Why US sovereign debt still enjoys AAA rating from Moody's

In the 1990's, countries such as Japan and some Scandinavian countries, who were caught in more or less a similar situation like the US now, were downgraded by the credit rating agencies. The US is now facing one of the biggest challenges ever after the seizure of the credit market and the collapse of giant financial firms. Yet, global rating firm Moody's is not keen on revising US sovereign ratings.

The firm has said, "The measures that have thus far been implemented and the proposal announced involve a significant expansion of the public sector balance sheet… despite a considerable degree of financial stress and risk socialisation, the foundations of the US rating remain unshaken." The US sovereign debt enjoys 'AAA' rating from Moody's, which is the topmost investment grade rating indicating highest level of safety.

The combination of asset purchases (up to $ 700 billion), support for Fannie and Freddie (up to $ 200 billion), and some revenue shortfalls could amount to $ 1 trillion. The US Federal outstanding debt including intra-governmental holding is estimated approx $ 9.7 trillion as on September 19.

However, the rating agency has defended its view on the grounds that ratings are primarily ordinal ranking of credit risks, and the US government will continue to display a globally unmatched ability to generate resources, even in difficult circumstances. It said, 'Should the dollar lose its standing and the policy response to the crisis lose its determination, debt affordability would diminish because of higher borrowing costs and an erosion of the revenue base. That would be the main medium-term risk the US government rating.'

Muddy's, in a special comment said that, 'the resilience of the US economy – any public debt is ultimately a claim on the country's wealth and revenue growth – has been successfully tested over the recent decades. For reasons that take their roots into the large size and wealth of the economy and, ultimately, the US military power, the US government faces very little liquidity risk – its debt remains a safe heaven.

There is a large market for even a significant increase in debt issuances. It said that governments that are not liquidity constrained can manage their balance sheet to protect their power to tax. Protecting the vitality of the economy is extremely important from the rating standpoint.

Letting gross debt increase temporarily, even materially, puts the AAA rating less at risk than potential inaction or prevention of necessary adjustments (such as loss recognitions) which could damage the underlying fundamentals of the economy.

Likewise, "nationalising" the GSEs makes more sense from the standpoint of protecting the government balancesheet than precipitating a collapse of the housing market (on which part of the revenue base is indexed).

The analysis is based on the assumption that the dollar and the US government debt maintain their current status in the world economy and that the authorities will maintain their aggressive and resolute crisis management status, which ultimately protects the medium-term vitality of the economy.

Teachers are not that excellent

Use own mind more, while designing a financial system, next time

Eighteen months ago, US Treasury Secretary Henry Paulson told to audience at the Shanghai Futures Exchange that China risked trillions of dollars in lost economic potential unless it freed up its capital markets. An open, competitive, and liberalised financial market can effectively allocate scarce resources in a manner that promoter's stability and prosperity far better than governmental intervention.

That advice rings hollow in China as Paulson plans a $700-billion rescue for the US financial institutions and Securities and Exchange Commission bans short sales of insurers, banks and securities firms. Regulators in the fastest growing major economy say they may ditch plans to introduce derivatives, and some company bosses are rethinking US business models.

The US financial system was regarded as a model, and we tried our best to copy whatever we could, said a former adviser to China's central bank. Suddenly, we find our teacher is not that excellent, so the next time when we're designing our financial system we will use our own mind more. The recent moves by Paulson, contradict what the US told Asian Governments over the past decade. Thailand, South Korea and Indonesia were urged to let unviable banks fail during the 1997-98 Asian financial crises.

Turning Left – It's the end of an era. In 1989, when the Berlin Wall fell, socialism was discredited and the whole world turned right. Now financial capital has been discredited and the whole world, including the US, is turning left. Globally, banks have written down more than $520 billion as the credit crisis led to the demise or makeover of Wall Street's five biggest investment banks. In response, the US government nationalised insurer American International Group (AIG), as well as mortgage giants Fannie Mae and Freddie Mc. A finance specialist at World Bank in Beijing said that "It's ironic Paulson has become the manager of many large financial institutions. He will have to learn from Chinese leaders about their experience of managing state-owned assets."

China's economy has grown an average of 9.9% a year since former leader Deng Xiaoping ditched hard-line Communist policies and began moving toward a free market in 1978. Since joining the World Trade Organisation in 2001, China has gradually opened its markets to foreign competition, allowing international investment banks to form joint ventures with local partners and permitting the biggest state banks to sell shares on overseas stock exchanges. In the past three years, China dropped a decade old currency peg to the dollar, introduced foreign-exchange swaps and forwards that allow investors to hedge or bet on currency fluctuations and expended the bond market.

China has yet to allow margin trading – where investors borrow money to buy shares – or futures contracts based on equity indices. Since China permitted securities backed by assets such as mortgages in 2005, only 14 such instruments have been approved for sale. China's financial institutions were slow to buy the mortgage-related securities that triggered the US meltdown, incurring just $4.3 billion in losses and writedowns. Plans to introduce many financial products, including derivatives, may be shelved as China focuses on improving risk-management. Financial innovation is a double-edged sword said another finance specialist. China can't just concentrate on product innovation and overlook the need to build the financial system. The China will create "a new road". That road may be different from one Paulson proposed 18 months ago. China made it clear it won't listen to these snake-oil salesmen who come from Wall Street, even if they're wearing suits issued by the Treasury Department.

3. MUTUAL FUND INDUSTRY

Wary investors moving away from FMPs

The turbulence in the global financial markets and worries over the credit quality of some assets in the portfolio of fixed maturity plans (FMPs) has prompted some large corporate investors to move to safer investment options such as fixed deposits.

FMPs had emerged as one of the most popular products offered by fund houses over the past 12 months. The product was attractive considering that it offered a better yield compared to fixed deposits in a rising interest scenario without any major risks. The fact that FMPs were a hit, especially with corporate treasuries, is reflected in the fact the assets under management in this category alone are over Rs 1 lakh crore. The Indian mutual fund industry now manages assets close to Rs 5.5 lakh crore.

But not anymore; with interest rates on the boil and the overall slow down in the economy, the credit-worthiness of several Indian companies has taken a hit. This is bound to impact some asset management companies that have been aggressively pushing FMPs. For a better part of this year, several fund houses had been falling over each other to sell FMPs to cash rich corporates.

In an effort to boost returns, they have been investing in debt paper of firms that carry slightly higher risks – such as realty companies, aggressive Non-Banking Finance Companies (NBFCs) and manufacturing companies whose balance sheets have not exactly been robust. Although there has been no default in the Indian Markets as yet, most market watchers say investors will have to assess the present scenario before taking any decision.

Mutual fund houses offering FMPs invest the proceeds in corporate debt, securities paper, certificates of deposit and commercial paper. On an average they have been offering a return of over 11% for FMPs of a maturity of 13 months. Since post tax returns on this instrument is higher than that of fixed deposits, many investors chose to park money here. Industry sources say that there are concerns relating to the investments made by some fund houses.

SIPs feel the heat of market downslide

Investors have now begun to bet safe. The downside in the stock market has resulted in many investors discontinuing their Systematic Investment Plans (SIPs) and entering into safer investment modes.

From the beginning of Jan-08 to the end Mar-08, the assets under management including SIP investments have come down by 2.09% whereas the time deposits, which include Fixed Deposit (FD) investments of scheduled commercial banks, have increased by almost 7%, according to Amfi and RBI data. This is a reflection of how funds are flowing back into the conservative financial instruments.

Financial planners, noticing the trend, have urged that discontinuation of SIPs have not become a major trend as yet. “Our experience tells us that most of the fall in growth or even discontinuance is in the lower range of Rs 1,000 to Rs 5,000 per month. The major reason is that most of the retail sales are not well serviced, and the advisors lose interest if it comes to just convincing or educating the client without achieving a new SIP subscription.

4. FINANCIAL SECTOR: TRANSFORMING TOMORROW

Financial inclusion

The banking industry has shown tremendous growth in volume during the last few decades. Despite making significant improvements in all the area relating to financial viability, profitability and competitiveness, there are concerns that banks have not been able to bring vast segment of the population, especially the underprivileged sections of the society, into the fold of basic banking services.

Internationally too: efforts are being made to study the cause of financial exclusion and designing strategies to ensure financial inclusion of the poor and disadvantaged. The reasons may very from country to country and hence the strategy could also vary but all out efforts are being made as financial inclusion can truly improve the financial condition and standards of life of the poor and the disadvantaged.

Speaking about the need for financial inclusion, Dr C Rangarajan, chairman, Economic Advisory Council to the Prime Minister, GoI said, “Financial inclusion is no longer an option but compulsion and self help groups and NGOs can play a big role in making it a reality.” He also stressed upon the need for larger spread of the business correspondent model for the penetration of financial services in rural areas. Under the business correspondent model, banking and non-banking finance companies (NBFCs) employ local people to carry out the activities of a banker in their villages so that a villager need not travel to bank branches for every small transaction.

1. FINANCIAL ADVISORS:

Weigh impact on investors

Understanding of benefits

With an appropriate business model, the formal financial system can realise the huge business potential coming from the unmet demand for financial services from the ‘excluded’. Focus thus should be on creating customised, composite and simple products. However, the financially excluded section needs to be educated the benefits of being a part of the organised financial system. Better financial inclusion would lead to increasing economic activity amongst those who have been excluded till now. A higher disposable income at their end would lead to greater savings. These savings would provide a wider deposit base to banks to lend to a variety of ECONOMIC activities thus further fuelling economic growth.

2. WEALTH MANAGERS

Map out the details to translate into benefits

Inclusive financial behaviour

Financial literacy is the need of the hour if formal financial system is to extend its reach and deliver on its goal of financial inclusion in India. Financial behaviour is liked to financial literacy. Things like showing them how a compound interest works would go a long way in creating an informed environment for financial services among the rural populace and this would reflect in both the reach and inclusivity of the financial system in India.

The factor which is a major obstruction in the way of financial inclusiveness is the lack of relevant financial products for the rural poor. The credit requirements are a major encumbrance in meeting even some of the basic financial needs of the people. There has to be a focus on removing caps, increasing transparency and facilitating consumer inclusion. Financial inclusion in India is likely to remain stunted if approached through a purely market-driven, profitable model.

3. CREDIT COUNSELORS
Resolve convertibility and recompensation issue

Need for a Credit Bureau

The biggest stumbling block for formal financial system, which seeks to tap the customer at the bottom of the pyramid, is the lack of information about the credit worthiness of the borrower. This is because such customers do not have formal linkages with the financial institutions. And therefore, there is no record of their transactions like loans or saving account with the bank or NBFCs.

Financial system faces the issue of ascertaining the credit worthiness of the borrowers in an objective way. The staff and officers at such institutions try to judge the credibility but the process is heavily dependent upon subjectivity. The lack of information and dependence upon subjective parameters can be addressed by having a database of the credit history of borrowers in form of a formal agency, which is often termed as credit bureau.

Such a bureau is beneficial both to the lender as well as borrower. In the absence of such a bureau, good borrowers tend to subsidise for bad borrowers, as credit appraisal is subjective. This is not likely to happen when credit assessment is purely objective and data driven. The lender gets vital information about the credit history of the potential borrower. The borrower, in turn, can bargain a deal with the lender citing the better credit record.

There are various roadblocks in setting up of an agency like a credit bureau. The foremost issue is of gathering data on the credibility when more than 50% of the country is unbanked. The problem becomes acute in rural areas where KYC is more difficult. Lack of unique or a national ID is the single most important issue to address. Globally there have been instances of improvement in credit penetration with the setting up of credit bureau. Its benefits are redoubtable and it is only with time that the potential of such an agency will be realised.

4. FINANCIAL PLANNERS
Value unlocking for all stakeholders

Performance of BC Model: A Mixed Bag

When RBI allowed banks to use mediator to reach out to the rural poor population in 2006, the business correspondent (BC) model offered a ‘win-win’ situation for lenders, borrowers and mediators. On one hand, the bank does not have to invest in infrastructure to reach the unbanked areas and on the other hand, borrowers are assured of easy access to financial services.

However two years down the line, the flaws in the system have proved to be a stumbling block. Banks usually identify correspondents, who are locally settled retired post-masters, schoolteachers, bank staff and even defence personnel. An ideal BC model envisages large cost reductions while including the poor in the financial system. However, the model has not achieved the desired results.

The requirement of a BC to be within 15 km radius of a rural branch as notified by RBI was a hindrance for banks that do not have many rural branches. Besides, the model brought an added risk into the picture. Policies regarding the BC model put reputation, legal and operational risk for a bank. Limited choice to select an eligible BC discourages banks to initiate the model. Banks also see it as a tough job to identify and train such a large number of non-bank professionals to reach out to the poor.

In addition to operational problems there is a question mark over the viability of the model itself. One of the key issues constraining the reach of banks to the unbanked areas is the prime lending rate (PLR) cap on bank's lending. Experts point out that PLR lending is not viable. The economic viability of BCs is yet to be established, and technological service providers have an important role to play. Technology service providers feel there is a need for innovative partnership and convergence in the field of micro-finance and asset building which could make the BC model work. Growth pattern of the banking sector through BC model can be as robust as that of the telecom industry. The scheme with the 'trial and usage' methodology will fetch customers and take it forward.

5. INCLUSIVE CEOs

Innovative responses to problems

Mobile banking for financial inclusion

Mobile banking can be a tool to increase financial inclusion provided the regulatory hurdles are cleared. In fact, mobile banking has already been a success in numerous countries including the Philippines and Kenya and this can be replicated in India as well. With a large section of the employed being in the informal sector whose needs are funded by NBFCs, the need of the hour is new innovative and cheaper ways to increase financial inclusion. We are looking at the bottom of the pyramid to bring the lower strata of the society into the banking scene of the country. Out of the 321 million wage earners, all carry mobile phones, but only 40% are involved in banking activities of the country. There is a huge scope for growth.

6. MICRO-FINANCE PROFESSIONALS

Developing alternative credit delivery models

Individual lending - opening up new vistas at the grass-root level

Individual lending of microfinance is gaining speed and in the process changing many lives, that too within two days. A wayside tea stall owner in Gujarat wears a big smile. His loan of Rs 20,000 has been sanctioned within 48 hours, without which he would have been literally on the streets. He's not alone. There are several others including a ladies garment storeowner, a bakery owner, snake shop owner and vendors who are happy for a similar reason.

Microfinance Institutions such as MAS Financial Services and Bandhan target a group of people just above 'the poorest-of-the-poor' and help them gradual upwards while maintaining a high repayment rate of 98-99%. They cater to people who are in dire need of funds and services.

In a face of multiple challenges such as infrastructure and inadequate skilled workforce, groups such as Manndeshi Mahila Bank, the first to receive cooperative licence from RBI, have penetrated into the remote areas of Maharashtra to provide financial support to woman. Earlier these women went to moneylenders who used to lend at high rates. Until now, the organisation, which is sponsored by HSBC, has disbursed Rs 15 crore cumulatively through microfinance and given loans to 82,000 women in Maharashtra. The Mahila Bank also runs a business school to develop entrepreneurial skills in them.

Besides the higher risk in individual lending compared to group lending, there are many other challenges for individual microfinance lending, and organisations are looking at various solutions. One such step taken by the Manndeshi Mahila Bank is providing services to women at the doorstep through daily collection agents. MAS too works from the ground level where its marketing executives make frequent visits to the market to make their service accessible to potential borrowers.

It's only a case of value for society – In fact the way a manager looks at the success or failure of a commercial enterprise is entirely different from how he looks at an investment in MFI. Apart from financial return, there is a case for considering the value, which such MFIs create for society. This is more important as these institutions have a huge role to play in social development. Due to such inherent differences between investments in MFI and other kind of investments, the fund managers do not think that there can be a target rate of return from such investments. It is obvious that when MFI targets customers with no recorded credit history, it increases the risk for its business as well. As these investments are considered highly risky, only soft money finds its way into such investments. Experts also believe that there is a possibility of allowing only non-profit organisations to invest in MFI.

It's an innovation in product delivery – Banks today are using multiple platforms to reach the 'bottom of the pyramid'. Finding a low cost approach to financial inclusion is the most significant challenge faced by the banks. There is need for innovation in delivery of banking products to the masses. One such solution to reduce cost of delivery was to leverage the channel to offer a full range of financial services, including savings, short-and long term credit, mortgages, insurance, pensions, remittances, and leasing. That would involve an overhaul of the nature of financial products and delivery mechanism.

While most public sector banks are taking initiatives to provide bank accounts in unbanked areas, the migration from informal sources could take a long time. This is evident from the fact that the share of no-frill bank accounts is less than 1% of the total accounts.

It's only a matter of scale and time – The scale of operations is really important for such institutions. Till it reaches a critical stage, it can not use technology and best available human resource. It is fact that some of the MFIs have done much better than envisaged. It's only a matter of scale and time. As scale of business widens, the cost would come down and the business of running an MFI would become economical. There was a time when donor agencies and a handful of private individuals were the only source of funding for MFI. A lot has changed since then. Today, a number of funds invest in such institutions. The potential is business is huge as more than 50% of India still does not have bank account. This made various professional investors consider investments in MFI. As the MFI matures, more opportunities will be created for domestic and international finance players to enter the market profitably while contributing to poverty reduction.

It's only creating greater market linkage – Over the last few years, several organisations have attempted to offer financial services to the poor through other channels. ITC's initiative - e – choupal – is one of the examples of creating greater market linkages for farmers. Experts stress on the need for finding the 'last mile solutions; "Reading customers' mindset presents a tough task ahead for banks that need to reach unbanked areas. Banks are culturally seen as a foreign entity, thus, the technology that the bank chooses is crucial in approaching the poor".

Valuation of investment in MFIs – Financing of micro-finance sector is an uphill task though, as markets have not reached a consensus with regard to valuation of investment in MFIs. This is because such investments are not traded and there is no market for the same. In the absence of a market, such investments are valued on the basis of their net-worth and the potential they have in a lifetime. The investment community has been trying to find out ways and means to evaluate investments in MFI. However, the visibility in terms of expected returns is still very low. "The returns of MFIs do not come directly to us, the only way to realise them is to sell off the investment as MFIs are not listed."

8. ONE-STOP-SHOPS

Dedicated to offer related services under a roof

Financial Inclusion Corporation of India

Five financial institutions, including some big banks are coming together to form an entity that will lend to people untouched by highstreet banks. The move reflects a new approach to financial inclusion – tapping potential customers at the bottom of the pyramid. The institutions floating the joint venture are Life Insurance Corporation, National Housing Bank, Standard Chartered Bank, IFC (a part of the World Bank group) and Union Bank of India. The five big entities will pick up sake of around 15-20% each. The move has been initiated by IFC Washington, which has also approached the country's largest State Bank of India to invest in the company.

The proposed entity, to be christened Financial Inclusion Corporation of India (FICI), will be a non-banking finance company. FICI will primarily finance micro finance institutions (MFI). An equally important objective of the company will be to influence policy and regulations on functioning of MFIs. The aim is position FICI as the coordinating agency for promoting financial inclusion. Another objective of FICI is to integrate MFIs with the mainstream financial service players and linking them to global investment communities. Significantly, the proposed company will channelise donations and grants on behalf of local and overseas donors to MFIs.

9. CONTINUING LEARNING CENTRES

Take informed decisions

New pension scheme for all

India's pension sector has been opened up a notch wider, with the New Pension Scheme (NPS) – currently restricted to government employees – set to be extended to individuals outside the government. Finance minister P Chidambaram announced that the finance ministry has advised pensions-regulator PFRDA to open up the scheme to private citizens too. The plan is to allow pension fund managers licensed by PFRDA to offer schemes to individuals across the country, using the vast network of banks and other agencies to collect the subscriptions.

NPS now covers all those central government employees who joined service on or after January 1, 2004. The scheme is based on defined contributions unlike the present system, where the pension benefits are based on a formula linked to the last-drawn salary. In NPS, the payout on completion of the scheme or on retirement will hinge on the returns generated from the contributions made by the subscribers.

The key difference in NPS compared to the old pay-as-you go scheme is that the benefits are not defined or assured. This reduces the liability of the government or the employer to that extent. The new scheme is not financed with taxpayer money. Rather, it is financed by contributions from the employee (with a matching contribution from the employer), much like the existing Employees Provident Fund (EPF) scheme applicable to non-government sector employees.

Hence, there is no earthly reason why it should be limited to bureaucrats. Unless government thinks old-age security is a peculiar need only of those who served the government in their younger days! Since that clearly cannot be the case and also because no country can afford to have a growing number of destitute among its senior citizens, it is essential that government fulfils its role of facilitator and offers citizens the means to provide for their sunset years.

This is precisely what the new pension scheme that came into existence from January 1, 2004 for new recruits into government service seeks to do. On retirement, subscribers receive 40% of the corpus to their credit while the balance is used to buy annuities on which they will get a regular monthly income. Of course, the quantum they actually receive will depend on the acumen of those who manage the corpus. But to the extent that competition among fund managers will ensure high performance, individual subscribers will be free to switch between fund managers and if there is proper oversight by the pension fund regulator, there is no reason why subscribers should not look forward to their retirement years with confidence. There is also no reason why this comfort should not be extended to a larger section of the population, both salaried as well as self-employed.

National Securities Depository (NSDL) is the central record-keeping agency for the new pension scheme. According to the finance minister, with rising life expectancy, it is all the more important to ensure social security for the country's citizens. The average life expectancy of a person retiring at 60 has now risen to 78. With better living conditions and nutrition, this period of retirement is bound to increase further; possibly even to the extent of equalling the years spent working.

10. TECH SAVVY PROFESSIONALS

Take first step to ensure efficient and reliable system

Manpower roadmap for RRBs

The recruitment ban has prevailed in regional rural banks (RRBs) for over 13 years between 1991 and 2004. Although, the ban was withdrawn technically in 2004, but for all practical purposes, there was no hiring till very recently, barring sporadic attempts by a handful of RRBs in the past 12 months. The finance ministry has just lifted the virtual freeze on recruitment in regional rural banks. This will pave the way for fresh induction of 18,653 people across the 88 RRBs over the next four years. The latest government move will enable RRBs to plan their own promotion policy. The Centre has also cleared outsourcing of non-core functions normally undertaken by subordinate cadres.

There are some suggestions put forward by the YSP Thorat Committee on the human resource development at RRBs. The government has cleared the essence of the committee's report with modifications. Former Nabard chairman, Mr. Thorat, has prepared a manpower roadmap up to 2015 for RRBs. The committee has observed: "There is a need to rationalise the promotion policy to ensure career progression in all employee categories. It would reward and motivate good performers and arrest attrition.

Interestingly, no RRB officers get promotion to the general manager level at present. Sponsor banks used to depute their officers to fill these slots. Now, the government has removed this barrier too. In fact, RRBs are envisaged to be managed fully by their own personnel by 2015. It projected that per employee productivity in RRBs would rise to Rs 2.70 crore by 2011 from 1.93 crore in March 2007. With setting up more branches by RRBs, the number of districts without banking facilities has reduced to 36 from 52 a year ago. During the past one year, RRBs opened over 400 branches collectively while they have nearly 550 licenses from the Reserve Bank of India.

The All India Regional Rural Bank Employees Association in RRBs welcomed the move. It has demanded computerisation in RRBs to ensure business growth. The association has also requested the finance minister to consider setting up rural national software for the proposed core banking solution in RRBs. Setting up of a technology platform, reduction in non-performing assets, branch expansion, financial inclusion and recapitalisation support are some core issue.

Why poverty reduction lags economic expansion

Even as a recent World Bank report claims that poverty level in India has declined sharply since 1981, the truth is poverty reduction here lags economic growth. The rapid economic expansion over that past two decades has not resulted in matching reduction in poverty, a working paper published by the International Labour organisation has said, reaffirming the widely held view.

That is because employment grew at a sluggish pace even as the economy moved into a higher trajectory. Although some of the dynamic sectors grew rapidly, generating employment opportunities, these activities were less likely to absorb the poor, who are mostly unskilled.

Economic growth and employment generation have both been more beneficial to the upper income strata of the society than the poor. In other words, employment was generated more for the educated labour force than for poor with lower levels of human capital, during the current phase of economic expansion. What would be worrying is that such skewed growth of employment tends to widen inequality.

It is, thus, no surprise that agriculture continues to be primary source of employment for more than half the population and the share of manufacturing has experienced a marginal rise over the past two decades. The report also underscores the fact that the shift away from agriculture did not lead to significant increase in the manufacturing's share of employment. Rather, even at low levels of per capita income, the share of services in employment and value addition rose. Thus the corollary, the shift in India is away from agriculture and more towards services than manufacturing.

HARMONIUS GROWTH

Entire South East Asia is currently evaluating and emulating relevant lessons from "Thaksinomics" made famous by ex-Prime Minister of Thailand, Thaksin Shinawatra. His bottom-up approach to economics has gathered widespread appeal across the developing world.

Thaksin's approach – that access to capital, employment opportunities and basic social services can transform disadvantaged regions into growth engines – is now an accepted wisdom.

Chinese President Hu Jintao called for "harmonius growth" when the Chinese National People's Congress met last March. Recently, the Chinese and the Hong Kong press have been speculating that Beijing would soon declare a massive fiscal stimulus package targeting disadvantaged sectors of the economy.

The income disparities and structural flaws are particularly apparent in the fast developing BRIC nations. India, China, Russia and Brazil all suffer from these flaws. A massive oil discovery and investment grade credit ratings fuelled expectations that prosperity for Brazil's 185 million people was only a matter of time. But a historic neglect of education is a major roadblock in Brazil's quest to join the big leagues of developed economies.

Many critical structural reforms are still awaited in India and need to be carried out without any further delay to ensure political, economic and social harmony. The proposed pension, commodity market, banking and other financial sector reforms, rural education and development initiatives need to be put on an accelerated growth trajectory. The real task of balanced nation building needs to start without any further delay.

Going, going, gone!

The month of September marked the end of an era. That was the day Goldman Sachs and Morgan Stanley, the last two of the original five investment banks on Wall Street, became history. Rather they became regulated banks or as some papers put it, they became 'ordinary' banks.

What does this mean? It means they no longer jet set round the world, talking down to gullible corporates and policy makers about the wonder-world of derivatives and how they can buy failsafe protection against risk, their eyes on the fat fees they would earn in the process.

At the more serious level, these developments are the last nail in the coffin for investment banks. These are banks whose main business was to help companies and governments raise money in the capital markets and provide advice on mergers and acquisitions etc. But over the years they had increasingly begun to buy and sell on their own account. And with borrowed funds!

Now, I-banks will have to transform themselves into commercial banks that do the business of taking deposits from the public and lending them to borrowers and be subject to regulation if they wish to continue in business. In some ways the Fed's action is very similar to what the Reserve Bank of India did with ICICI Bank in 2002. When the erstwhile term-lending institution's balance sheet was found to be seriously impaired, thanks to its aggressive lending. It was allowed to merge into ICICI Bank, giving it the benefit of access to the latter's retail deposit base.

However, the change in name did little to change the culture of the merged entity. The result is not only does ICICI Bank have the largest exposure among domestic banks to exotic products whose value is suspect, if not downright worthless. It is also the only one to be repeatedly buffeted by rumours about its health. Indeed matters might have been much worse had it not been for a prescient regulator.

But how wise is to have commercial banks support I-bank activity? The logic seems to be that retail deposits of commercial banks are far more stable than wholesale deposits, the funding base of I-banks. At the same time the bulk of their assets consist of loans that do not have to be marked-to-market, unlike in the case of I-bank whose assets – both plain vanilla securities and other exotic products – have to constantly be marked-to-market. Hence both on the assets as well as liabilities side, commercial banks balance sheets tend to be less volatile.

From the regulatory point of view, commercial banks are also more tightly regulated; they have strict capital requirements – it would have been impossible, for instance, for commercial banks to have leverages of 30 – so there are less chances of a repeat of what we've seen in this month.

It will be naïve; however, to assume that giving I-bank a 'deposit daddy' will be an answer. It will not unless I-banks are sufficiently chastened to change their ways and their activities are more closely regulated. But if they are allowed to carry their cowboy culture to the new entities and use their 'deposit daddy' as a base for the same kind of punting that they have done in the past, then next time round the pain will be much deeper. It have to be borne by the same hapless public, but twice over, once as taxpayers and then again as depositors if their deposits are gambled away.

5. BANKING SECTOR

Central banks strain to contain market crisis

The Wall Street is betting on a government bailout of the US insurance giant AIG and a possible rate cut by the Fed, but far from the epicentre, India is not taking any chances. Late Tuesday (16/09/2008), the Reserve Bank of India steeped in with measures to support the rupee – which has been battered to almost 47 – and supply cash in the money market, where overnight rate has shot to 16%. The move, which marks Duvvuri Subbaro's first announcement after taking over as governor, will increase the supply of dollars in the currency market and lower the cost of banks borrowing in the overnight call money market.

So on Tuesday, the RBI joined to global rescue act mounted by central banks across the world. Unlike the US Fed which is in the ignominious position of having to bail out one financial institution after another, the latest being insurance giant AIG, RBI's rescue act was far less drastic. It is aimed at addressing liquidity fears. The central bank has raised the maximum interest that banks can pay on deposits parked by NRIs. The interest ceiling as been hiked 50 basis points for dollar (or FCNR) as well as rupee deposits.

Once the currency market stabilises a little, this could prompt many NRIs to park more deposits with banks in India – a possibility that RBI is banking on to increase dollar supply. Significantly, the RBI release states that RBI will continue to sell dollar through agent banks to augment supply in the domestic forex market or intervene directly to meet any demand-supply gaps.

Given the troubled times, RBI, as a temporary measure, has also allowed banks to borrow from it even if they don't have idle government securities lying as reserves with RBI. This can be up to 1% of their net deposits. Under normal circumstances, a bank can borrow only if it has securities in excess of 25% of net deposits with RBI. Now, it can use of 1% of this to borrow, and even if actual reserves slips to 24%, no penal interest will be charged.

This amount to an indirect cut in the Statutory Liquidity Reserves, and could enable banks to raise up to Rs 10,000 crore. Over and above this, banks will be allowed to borrow twice a day from the RBI repo window at 9%. This will help many banks which are forced to borrow at 12-16% in the inter-bank market.

On paper, its multi-pronged attack has the right touch, aimed at calming frazzled nerves without going overboard. But whether it will have to be followed up with more aggressive steps -a cut in interest rates *a la* the People's Bank of China - remains to be seen. Much will depend on whether the US government's bid to contain the ongoing financial tsunami succeeds.

The decision to shore up AIG by agreeing to lend up to $ 85 billion in emergency funds in return for a stake of 79.9% and effective control of the world's largest insurer is a marked departure from the hands-off approach on Sunday's collapse of Lehman Bros. But then the US administration had no choice.

Whether this will reduce 'already significant levels of financial market fragility' and ward off 'materially weaker US economic performance' remains to be seen. The Fed is clearly hopeful, which is why it held the Fed funds rate (indicative overnight interbank rate) unchanged at 2% in its meeting on Tuesday.

Regulators in various markets are trying to ring fence their institutions from Lehman. RBI has barred Lehman's Indian arm from remitting money to the parent, while Japan's Financial Services Agency has ordered Lehman to retain sufficient assets in Japan to cover its liabilities in the country. Meanwhile, British bank Barclays has said that it mat only buy parts of Lehman's assets and not the entire bank.

ICICI Bank to take $28-m hit on Lehman investments

The move by Lehman Brothers Holdings, the fourth-largest investment banks in the US, to file for bankruptcy will partly impact ICICI Bank. ICICI Bank – the second-biggest lender after State Bank of India – will have to take a hit of $ 28 million on account of the additional provisioning that its UK subsidiary will have to make. The Indian bank's UK subsidiary had investments aggregating around $ 80 million in senior bonds of Lehman Brothers. It has already made a provision of close to $ 12 million against investments in these bonds. ICICI Bank joint MD and CFO Chanda Kochhar said: "Assuming a recovery of 50% of these investments, the additional provisioning required would be about $ 28 million".

RBI meets bank treasury heads on Lehman effect

The RBI had an urgent meeting with the treasury heads of large banks on Tuesday to find ways to sort out their swap deals with Lehman. The possibility of all banks coming together to unwind the positions at one go was discussed at the meeting. A quick solution to the swap exposures is aimed at ending the lingering uncertainty of keeping live derivative positions of the failed bank on the books of local banks.

Lehman had struck derivatives deals like interest rate swaps with banks through its primary dealership subsidiary. Lehman's rate swap positions in India are estimated to Rs 500-600 crore. In the course of the meeting, some bankers suggested that all deals with Lehman could be terminated on the same day. However, not all present agreed to the proposal. What has come as a relief is that Lehman is a net receiver of interest rate swaps in the domestics market. This means that if the derivatives exposure of Lehman is calculated on a mark-to-market basis for closing the deals immediately, counter parties have to pay Lehman. Bankers said Lehman would receive around Rs 20 crore on a net basis. RBI also hinted that some of the large banks could take over the Lehman exposure on their books. However, no bank present in meeting agreed to this. It appears that each bank will have to find a counter party to replace Lehman. The meeting was inconclusive. Banks will meet again next week.

Meanwhile, RBI issued a directive to Indian banks to unwind the interest rate swap (IRS) transactions with Lehman Brothers. RBI has had talks with banks to find out Lehman's exposure in the local IRS market. The bank will unwind the IRS transaction by cancelling the position with Lehman and will cover the transaction with a fresh counterparty.

Centre to provide liquidity support

The Indian economy could see a tightening in credit supply due to the recent finance debacle in the US. However, the government will step in to provide liquidity in the system to tackle the problem. Finance minister P Chidambaram said there is no cause of excessive concern. He also said that the country's banks and financial institutions are properly insulated from the present crisis.

The finance minister also reiterated that there would be no effect of the present turmoil on the country's GDP growth and it would grow at about 8%. He also said that the present turmoil would not affect the government's reforms initiative in the financial sector in any form and the government would take it up. As long as regulation remains a step a head on innovation, there is no reason to fear that financial sector reforms will cause us difficulties or problems. Mr Chidambaram also assured that the country's central bank will take appropriate steps to ensure orderly movement of the rupee versus the green-back. He said the country should learn to live with the foreign institutional investors (FIIs) taking money out.

Banks halt credit to US Companies:

Indian banks which have extended lines of credit (LoC) to subsidiaries of US financial majors like Merrill Lynch and Lehman Brothers are no longer willing to risk such exposure. The move may result in cancellation of deals worth about Rs 2,000 crore.

Gradual reforms is recipe to avoid turmoil

Planning Commission deputy chairman Montek Singh Ahluwalia has said the US financial turmoil would not have a significant impact on India as the domestic financial system remained largely controlled, preventing it from getting exposed to new and innovative instruments that triggered the meltdown.

There are merits to proceeding slowly (on reform programme). The Indian financial system is still not exposed to the new and innovative instruments that have been largely responsible for the financial distress. We should continue with the gradual pace of reforms.

Defending the slow progress of financial sector reforms, Plan panel deputy chairman said the government policies should draw a long-term roadmap for the sector rather than react every time there were changes in the business environment.

He said there was a need for good regulation in the country to prevent a crisis from destabilising the financial system. The idea is not to insulate the country from the rest of the world, but we should not run into a situation of regulatory gap. In short, there was need for having sound regulatory systems. It is not just a question of tightening screws of the regulatory systems but to have sound regulation.

Allow smaller companies in banking

This should sound sage advice in the aftermath of financial turmoil. The Raghuram Rajan panel has suggested that the RBI should consider entry of smaller players into the banking sector as failure of small banks will not have systemic consequences created by failure of a giant banking entity. There is no need to believe that smaller banks would fail and historical evidence is not relevant since situation has changed.

The panel urged the regulator to "allow more entry to private well-governed deposit-taking small finance banks offsetting their higher risk from being geographically focused by requiring higher capital adequacy norms, a strict prohibition on related party transactions, and lower allowable concentration norms."

This means that these banks, if allowed, would be entitled to advance a lower percentage of their deposits as advance in comparison to larger banks. Such norms would minimise the risk of any of the entities going bust. The panel has also questioned the honesty of the large banks, saying there is "no necessary link between size and honesty, as the recent experience with large banks suggests". It has, however, suggested that the regulator should be more selective and find "fit and proper" criteria for giving licenses to the smaller banks. The intend behind the need of such banks is to bring local knowledge to the bankers so that they are able to take decision quickly in conformity with their customers whom they would personally know. The entry of such financial entities would also help in achieving the government's goal of financial inclusion. The committee has clarified it does not recommend smaller banks based on earlier models where governance structure was poor, political and government interference was excessive, besides unwillingness to take corrective regulatory measures.

Wall Street facts and fiction

In the barrage of comments on the collapse of Wall Street's investment banks, it's sometimes hard to distinguish fact from fiction; the gray areas are easily overlooked. Here's a guide to some of the issues:

1) ***The top investment banks have vanished as a class because they were highly leveraged***: This is only partly true. In financial institutions leverage or the ratio of debt to total assets can be misleading as a measure of financial risk. The management of asset risks is equally important. A financial institution can be highly leveraged but if its assets are of high quality or are highly diversified, the institution is not exposed to high risk. The trouble with the investment banks was not so much leverage as poor asset quality and heavy dependence on short-term funds. Lehman's problem was not that it had $600 billion in asset at a leverage of 20:1. Its problem was that it had (by one estimate) around $80 billion in toxic assets and it raised funds in the wholesale market. The moment the market sensed that it had more toxic assets than was known, confidence fled and nobody was willing to provide finance.

2) *Short-sellers were right on Lehman, so short-selling should not be banned*: Yes, short-sellers were right in sensing the Lehman had more problems than it had disclosed. But, in times of crisis, it makes sense to ban short-selling because a fall in share prices sets off a vicious spiral that pushes an institution quickly into bankruptcy. A fall in the value of equity causes leverage to rise, which causes the debt rating to fall. This, in turn, prompts demands for higher collateral, which forces distress sale of assets, which erodes equity value. In financial crises, as in times of war, the normal rules of information must stand suspended and this applies to price discovery affected by short-sellers.

3) *Goldman Sachs and Morgan Stanley were issued banking licences because they can survive as banks*: Correct, but it does not follow that the two firms can become successful banking operations by themselves. Access to retail deposits requires a large branch network and this is not created overnight. The decision to issue banking licences was intended to tell the world that they had access to unlimited liquidity at the central bank as distinct from the limited liquidity facility the Fed had created earlier for investment banks. In other words, the Fed move was meant to spare them the fate of Bear Sterns and Lehman Brothers. But it does not follow that the two firms can succeed as banks on their own. The odds are they will have to be acquired by banks.

4) *The disappearance of the top investment banks shows that there is no future for investment banks*: Wrong, It only shows there is no future for full-scope investment banks of the Wall Street variety. There is room for investment banks that specialise in the traditional activities, such as underwriting of issues, advisory services, brokerage and custodian services. The top firms came a cropper because they ventured in a big way into proprietary trading and private equity.

5) *Wall Street investment bankers were a talented lot whose risk-taking skills will be missed*: We know now how well they managed risks. They did have some highly qualified people. But it's interesting that the people at the top at these banks tended to come from trading, a field that requires little formal training or educational background. Trading is about taking risks. In the presence of leverage, the incentives to take excessive risks are high. If the gambles work out, there are millions to be made in bonuses. For jobs that often did not require very high skills, investment bankers ended up getting paid astronomical sums. Seldom in history has so much money been made by so few with such little talent.

6.1 TAX UPDATES

Tax department must accept companies audited accounts

The Supreme Court has said the Income-Tax Department has to accept the authenticity of the accounts maintained in accordance with the provisions of the Companies Act and certified by the auditors. The assessing officer cannot go beyond the net profit shown in the profit and loss account, except to examine whether the books of accounts were duly certified by the authorities and properly maintained.

A bench comprising Justice S H Kapadia and Justice B S Reddy said: "The AO (assessing officer) has to accept the authenticity of the accounts maintained in accordance with the provisions of Part II and Part III of Schedule VI of the Companies Act, which are certified by the auditors and pressed by the company in general meeting. The AO has only the power of examining whether the books of accounts are duly certified by the authorities under the Companies Act and whether such books have been properly maintained in accordance with the Companies Act."

"The AO does not have the jurisdiction to go beyond the net profit shown in the profit and loss account except to the extent provided in the explanation (appended to Section 115J of the Income-Tax Act)." According to explanation of the Act, the "book profit" means the net profit as shown in the profit and loss account for the relevant previous year prepared under sub-section (2) of the Act.

The court further said, Section 117JA of the Act, which refers to 'deemed income relating to certain companies' has an overriding effect upon other provisions of the Income-Tax Act. It is applicable only in the case of a company. As per Section 115JA, the AO has to first compute the total income of the assessee as per the provisions of the Income-Tax Act. Thereafter, ha has to compute 30% of the book profit. Then he has to compare the total income as computed as per the provisions of the Income-Tax Act with 30% of book profit computed as per Section 115JA.

Discontent among IRS officials may hurt tax collection target

Simmering discontent among the a large section of Indian Revenue Service (IRS) officials may hurt the government's ambitious plan to collect a whopping Rs 395,000 crore as direct taxes during 2008-09. There are several grouses that the IRS officials hold against the government.

Though the 6th Pay Commission proposed to upgrade the post of member in Central Board of Direct Taxes (CBDT) to the level of secretary, the government did not accept their recommendation. Also chief commissioners of income tax are now placed below director general of police or principal conservator of forests in a state. Tempers have been running high in the revenue service, and about 15 IRS officers have already put in their papers after the revised pay for government employees were formally announced.

In a service of 4200 officers, no IRS can move to the level of secretary or special secretary. In case of the coveted Indian Administrative Service (IAS), which has strength of 5000 officers, 4.2% of their cadre are either secretaries or special secretaries. Even other services are better placed. The Indian Police Service (IPS) has 1.21% of its officials at the secretary level. For Indian Forest Services and Indian Foreign Service, the percentage is 1.23 and 3.91 respectively.

IFRS: Are Indian banks ready?

While regulators, standard setters and law makers sit together to rollout the road map for implementation of International Financial Reporting Standards (IFRS) in India, a wide section of the industry is already debating the impact and the implementation challenges of transitioning into IFRS. A remarkable and important element of smooth transition into IFRS is the convergence of RBI guidelines with the principles laid down in IFRS. In other words, the successful adoption of IFRS is based on flexibility and acceptability of IFRS by RBI. Banks will have to soon adjust to accounting changes that are enforced by IFRS. Following are the few areas of impact:

Loans / Investment impairment: Currently, banks consider provisions on loans based on RBI guidelines, which are very prescriptive and require limited use of judgment. However, IFRS require a case by case assessment (for significant exposures) of the facts and circumstances surrounding the recoverability and timing of future cash flows relating to the credit exposure. For investment, fair value is also considered as an input in addition to the financial/ credit standing of the issuer.

Fair Value: Under IFRS, a significant percentage of the balance sheet would have to be fair valued compared to the current practice of carrying it at historical cost /lower than the cost or fair value. Accordingly, fair value methodologies and practices would need to be re-examined to ensure that they are current, up to date and validated and back tested in current market conditions.

Derivatives and hedge accounting: Application of hedge accounting will entail onerous and stringent documentation requirements, mandatory effectiveness tests and determination of fair value based on observable inputs. This will also call for a much heightened awareness of rules for hedge relationships and certain processes and system changes.

De-recognition of financial assets: Under IFRS, de-recognition of financial assets is a complex, multi-layered area that follows the principle of transfer of risks and rewards. In the Indian context, this will impact mainly the securitisation activity. Securitisation transactions – where credit collaterals are provided or guarantee is provided to cover credit losses in excess of the losses inherent in the portfolio of assets securitised – may not meet de-recognition principles enunciated in IAS 39. This will result in failure of de-recognition test under IFRS and lead to collapse of securitisation vehicles into the transferor’s balance sheet. Banks will need to assess the impact and consider the potential impact on capital adequacy and ratios such as return on assets.

Consolidation: Under IFRS, consolidation is not driven purely by the ownership structure of an entity but will have to focus on the power to control an entity to obtain economic benefit. IFRS provides more rigorous consolidation tests and in practice can result in the consolidation of a larger number of entities as compared to under Indian GAAP. Banks will need to perform consolidation assessment as early as possible, particularly for non-shareholding related factors that impact consolidation, to assess its impact.

Are banks ready? Convergence to IFRS is likely to pose significant challenges for banks, as shown by global experience. Certain large Indian banks, which have the benefit of going through the process of international GAAP such as US GAAP in the past, have recognised the challenges of convergence and have already started planning their detailed roadmap to achieve a smooth convergence. It is time for other banks to take the cue and follow suit. Critical to the successful implementation of IFRS would be the level of regulatory sponsorship, the appropriate level of investment in systems and processes and consistently in market practices for areas where judgment is critical. A move to IFRS can be a compared to the mountain peak which can certainly be scaled if well planned and appropriately executed!!

7. IS INFLATION THE RIGHT BATTLES?

Dip in inflation inevitable

The new RBI governor's immediate concern will naturally be high inflation. But his tenure will also be judged on the basis of what he does to open up the financial sector and change the way RBI operates. Just three days after taking over as the governor of RBI, Duvvuri Subbarao sounded positive on growth and a little less hawkish than his predecessor on inflation. He described the immanent drop in the headline rate as a mathematical inevitability. The sustained rise in prices would require policy intervention while monetary measures were to take care of temporary rises.

He indicated that part of the price rise could be of a temporary nature. Origins of inflation lie largely in prices of food, metals and crude. Food is an annual, if not a biannual, phenomenon and responses have already kicked in. Even in metals such as steel although the supply response is lumpy, I think both around the world, supply response has kicked in. The movement in crude prices has been in response to the supply-demand factors and US situation and position of the dollar. So those responses have also come in.

Speaking on the financial sector reforms, he said: "I believe in the process of financial sector reforms all derivatives are important – currency derivatives, interest rate futures and credit derivatives. … But when these will be introduced and in what sequence will depend on the inflationary situation. We have to take lessons from the international situation and I am not even sure whether the lessons are clear".

The new RBI chief, who is perceived to have the mandate to push reforms, said financial sector reforms would have to follow reforms in the real rector. In this context Mr Subbarao said there was no shortage of analysis and advice. "There are a number of reports, notably the Patil Committee report on bond markets, the Percy Mistry committee report on Mumbai as an international financial centre and the Raghuram Rajan committee on financial sector reforms. What we need to do is to use available analysis and advice to draw a roadmap that responds to our immediate and medium-term needs.

Speaking on the exchange rate management, he said the rupee cannot defy economic fundamentals. One key issue is the rupee valuation vis-à-vis US dollar. The rupee's downward slide is seriously bad news when inflation is, as now, high. Roughly, a 1% depreciation of the rupee leads to a 0.2% increase in the inflation rate based on the WPI. The rupee has depreciated by more than 10% since December last year.

Economic theories on relative strength of currencies and their impact need to be considered in the context of today's globalised world. The global economic development is not a zero sum game where one country gains only if the other one loses. Growth in one country should create an even larger market for goods and service of other countries and become a continuous source of capital for them. We need to benefit from China's growth and not worry about currency pegging, relative strength of currencies, etc.

In March 2006, reserves were at $ 134 billion. From there, reserves expanded to 300 billion in March 2008. Over these 24 months, on average, RBI purchased $ 7 billion a month. This distorted monetary policy. Short-term interest rates were negative in real terms owing to the injection of huge liquidity into the system. This expansionary monetary policy induced inflation with a lag.

Rupee appreciation is a better anti-inflationary tool. The focus on controlling rupee prevented RBI from delivering low inflation. Since India is a net importer of commodities and services, it will reduce the overall pressure on prices. RBI holds nearly $ 300 billion in reserves. RBI should probably look at selling dollars to make the rupee stronger. Reduction on capital controls has been on the agenda for a long time. However, controls were not eased because there was an upward pressure on the rupee. It is now time to ease those controls and help boost growth and lower inflation.

Core growth slows to 3.7%

The country's core infrastructure industries logged a sluggish growth of 3.7% in April-July 2008 compared to 6.6% in the corresponding period of the previous fiscal. The growth rate of the sectors, with a combined weightage of 26.7% in the IIP, dropped to 4.3% in July 2008 from 7.2% in the corresponding period last year. The six core infrastructure industries consist of crude oil, electricity, petroleum refinery products, coal, finished steel and cement. Crude oil was the worst performer among the six sectors - The sector posted a negative growth of 3% in July 2008 against 0.9% in same month last year.

Inflation dips to 12.1% for third week in row

Inflation continued its downward movement and slipped to 12.1% for the week ended August 30 from 12.34% in the previous week. This is the third successive week inflation has declined. But it still remains way above the 3.2% level a year ago and more than the target set by RBI.

Industrial output growth recovers to 7.1% in July

Buoyancy in the production of consumer durables and capital goods helped industrial growth bounce back to 7.1% in July, from 5.4% in the previous month. However, the rebound was not enough to prevent slower industrial growth of 5.7% during the first four months of 2008-09 compared to 9.7% during the corresponding period last year.

Inflation inches up to touch 12.14%

Reversing the three-week downward trend, Inflation went up marginally to 12.14% for the week ending September 6 from 12.1% in the previous week. A finance ministry release pointed out that though year-on-year inflation continued to remain high, the average inflation for the last 52 weeks, which it feels is a better measure, is a lot lower than that for the 52 weeks ending September 8, '2007.

Inflation stays stable at 12.14%

Inflation for the week ending September 13 remained unchanged at 12.14%. The WPI-based inflation has stabilised on a y-o-y basis though it remains well above the 3.5% for the corresponding week last year.

Inflation down to 11.9%

After staying above 12% for 12-weeks, inflation for the week ended September 20 moved down to 11.99% following the drop in prices of primary articles. While the WPI-based inflation has moved below the 12% mark, it still remains considerable above 3.5% for the corresponding weeks last year.

Steel companies feel heat, to match imported flat products prices

The steel prices are softening. Demands for steel from the domestic market have now started getting affected due to cheap imports. Fearing dumping of cheap steel from countries like Thailand, China and Ukraine, domestic steel companies are offering huge discounts on sale of flat steel products (hot-rolled coils). The present offer of discounts from steel companies comes months after government had to intervene to check spiralling price of steel. In fact, in May steel ministry brought steel companies on the negotiation table and got a voluntary commitment from them to cut steel prices and hold it at the same level for period of three months. Now, the steel cycle has changed substantially from what was prevailing in the first half of current year.

8.1 MISCELLANEOUS UPDATES

PC allays financial sector health fears

As impact of the US financial turbulence spread to various parts of the world, finance minister P Chidambaram and capital markets regulator Sebi sought to assure investors that the Indian market is sound and attractive, and promised action against violators. He assured that the authorities were keeping a close watch on the developments and that if any policy tweaking was needed, it would be done.

Sebi chairman C B Bhave said: “If Sebi finds that any institution has violated the short sale rule, Sebi will take the most stringent action against such entity. At present, there are no indications that such a violation has occurred. Now institutions are allowed to short-sell only if they have borrowed the stock on the stock exchanges. There are no volumes in the borrowing/lending market. Therefore, there is no concern that institutions are short-selling. Short sales by retailers are permissible but the stock has to be delivered on a T+2 basis. If any entity delivers short, the position is auctioned.

PM admits India not safe from US crisis

In the first acknowledgement from the government that India cannot remain insulated from the US financial meltdown, Prime Minister Manmohan Singh said the country will be affected if all the major economies go into a recess. Mr Singh, who had earlier expressed confidence about the resilience of the Indian economy, acknowledged that finance development and imports could be affected if the crisis continued. Mr Singh’s comments came even as finance minister P Chidambaram tried to allay concerns of investors, saying that the Indian market is sound and attractive. But, Mr Singh pointed out that Indian value markets were open to the world and were susceptible to global trends. “Our value markets are opened to the world and, if they are affected, this will affect our capacity to finance our development”. If the financial crisis causes a recession in the main economies, this will compromise our exports. The prime minister further added that the ongoing crisis, which is leading to the collapse of top financial institutions, is bound to spread to the rest of the world.

The Lehman effect could hurt Indian BPO players

India’s outsourcing story has become the unintended victim of the collapse of some of the most venerable Wall Street firms such as Lehman Brothers and Merrill Lynch since the subprime crisis began to unravel. India can no longer claim that BPO/KPO operations will escape unscathed from troubles of the US financial sector. Already, hundreds of jobs have been lost following the downsizing of operations and closing down of back offices in India – the toll of the collapse of Lehman is reportedly about 2,200 jobs.

Several other global financial services companies too have been forced to cut the strength of the back office operations in India, laying off people across various functions as their incomes were hurt by the crash of the stock markets. Software majors such as TCS, Infosys, Wipro and Satyam that earn a significant portion of their revenues from banking, financial services and insurance (BFSI) sector would need to be prepared for loss of business. Needless to say, the loss of several well-paying jobs would dampen demand in some product-segments as well as the real estate, which is already suffering due to sluggish sales. Indian companies which have partnered these institutions for business collaborations or funds would have to be prepared for a change in partners and even stake sale by the distressed institutions.

Lehman effect

Lehman Brothers' bankruptcy is likely to cost Indian real estate dear. It may impact the financial major's existing investments worth $ 500 million in realty firms, including DLF and Unitech, besides drying up another $ 500-million worth of potential investment which was expected to flow into Unitech's Mumbai projects. The news of Lehman's collapse brought the BSE realty index down by 7.65% on Monday (15/09/2008), while the benchmark Sensex declined 3.35%. Both DLF and Unitech fell 7.5%.

Lehman's fall signals a deepening of credit crisis for Indian developers, who have lately been battling falling sales, rising cost of construction and tightening credit. It is expected that the US-based firm is likely to go for a fire sale of its assets. The financial service major was very bullish on India and was among the active investors in Indian real estate.

Lehman departure will impact future cash flows of real estate companies. In a market situation like todays, it will be all the more difficult for the firm to raise funds. Lehman invested $ 200 million in DLF promoter group company DLF Assets last year and bought 50% stake in Unitech's Mumbai project for $ 175 million a few months ago. It had also invested $ 80 million in Bangalore-based SEZ Gandhi City and was likely to hike its share to $ 300 million. Lehman's other investments include a 40% stake in an IT park project of Peninsula Land in Hyderabad for an initial investment of Rs 50 crore. It had also teamed up with Mumbai-based developer HDIL to bid for the redevelopment of Asia's largest slum Dharavi.

Whatever the developers had received fund, they are safe. But where the funds are yet to come, the developers could get stuck. Some analysts say a distress sale of Lehman will impact the valuation of existing projects. While FDI norms of a three-year lock-in period may prevent Lehman from making an immediate sale. But analysts argue that the lock-in period in case of bankruptcy may not hold.

The finance ministry and the RBI, concerned over a real estate bubble, have put in place several policy restrictions on FDI in real estate to attract only long-term investors. They have held the view that hot money, mainly represented by hedge funds and foreign venture capital funds, is likely to destabilise real estate sector. This time round, the government, however, is faced with a different situation where a major global entity has gone bust.

Apac property markets enter correction phase

According to the global real estate consultancy Jones Lang LaSalle (JLL), the Asia-Pacific property markets are entering a correction phase that will continue over the next 12 months, It also suggests that the rapid run-up in rents and capital values seen in recent years has come to an end in most of the markets. Property markets across India will also witness a price correction in the months ahead.

Factors such as rising inflation, the impact of sub-prime crisis on the global banking sector, slower GDP growth, rising interest rates and the general skepticism in the business world are directing occupiers to re-strategies their expansion plans. This may lead to demand rationalisation over the next few quarters and may cause vacancy levels in these micro-markets to rise. The housing sector in India is a direct reflection of the interest rates and housing loan availability. Due to rising interest rate, residential demand has been affected. The high interest rates have acted as quite a dampener, leading to a drop in demand from investors/genuine buyers. As money is drying out, investors in the market are diversifying in their investment portfolio. Even end-users have become cautious in their investment decisions.

Rising land prices hit developers:

The property market is desperately seeking a silver lining – but that seems to be evasive. In fact, real estate developers are facing double whammy of a dip in prices of residence across the country, even as land prices are going up. An increase of 15-30% in land prices over the last eight months is causing sleepless nights for developers. Besides cash crunch, what's worrying real estate players is that with land prices going up, they are not being able to add to their landbank. In fact, the number of land deals had dried up, with barely any land changing hands in this sector.

PNB stops loans against property

Banks have started taking proactive measures to prevent defaults in their real estate portfolio by cutting exposure to loans against property. State lender Punjab National Bank (PNB) has taken a lead and has stopped giving such loans. While banks have always been cautious and selective on real estate loans, this is the first time a bank has taken a decision to avoid this business. Banks' real estate exposures include loan against property, and loans to builders. Although home loans are a part of real estate exposure most of them constitute priority sector loans and not a part of bank's exposure to sensitive sector.

Red card warning to mall developers:

The heat is on. If the downturn in the residential sector was not enough, real estate developers are now fighting a losing battle to retain their retail clients in malls. High rentals, coupled with low conversion ratio, have forced retailers to issue a red card warning to mall developers – "either reduces the rental or we are on our way out. The year saw the opening of a few mega projects that had been awaited eagerly by retailers and industry alike. Some of these projects had been able to justify the expectations of the retailers and customers but by and large, most of them have not been able to deliver on the promises of high conversion ratios and revenues. High rental rates have put tremendous pressure on the topline and bottomline of most retailers, who had aggressively expended into multiple stores in the same catchments, banking on the high growth rate of the economy.

Watch out for retail, real estate balloons bursting

The BJP leader of the opposition in the Rajya Sabha Jaswant Sing cited two specific areas which could bear the burnt of the global economic crisis – real estate and consumer retail credit, both of which went through an artificially-created and sustained boom, but which were under severe stress now. The artificially-created and sustained real-estate bubble is now collapsing and with very serious consequences. For one, by eroding the confidence of saving and investment cycle in India. Real estate prices, during the last 3-years, have grown by factors of 300% to 1000% in about 50 metropolitan cities across the country.

The boom in the real estate sector, he maintained, was accompanied by a multiplication of companies dealing with housing, and various industrialists, even state governments, political leaders and a variety of operators entered this market to manipulate and to exploit. The artificial real estate market brought with it, a huge influx of foreign money, which flowed in through nominee names and other such devices." No steps were taken to control this organised loot". The other area which saw an unnatural growth was consumers' retail credit. "Every one was encouraged to ape the western lifestyle – buy well-built houses, cars and other consumer durables, most of which were acquired only through borrowed money. This created an artificial market which now collapses on itself".

9.1 INDIAN INSURANCE BUSINESSES

Uncertainty over AIG in the US

Uncertainty over the fortune of AIG in the US continues to cast a shadow over its Indian business. Customers of AIG's main businesses in India – Tata AIG Life and Tata AIG General Insurance are unlikely to be impacted as the Tata's hold majority of 74% in both the companies.

Meanwhile, Insurance regulator IRDA has called for a report from Tata AIG Life and Tata AIG General Insurance to access the business implications, if any, here of its joint venture partner AIG's move to access the US Fed's borrowing window. According to R Kannan, Member, IRDA "The solvency ratio for both the life and non-life ventures of Tata AIG are comfortable, going by an analysis in the first quarter of the current fiscal. Solvency is the ability of an insurer to pay claims.

***Local non-life insurers keep eye on reinsurance arms of AIG* –** India non-life insurance companies are anxiously waiting to see the impact of AIG's troubles on the ratings of its reinsurance arms. Any downgrade of the parent would have a ripple effect on its arms. If the reinsuring arm's rating falls below the BBB prescribed by IRDA, local insurers will have to look for a new reinsurer.

As a reinsurance group, AIG provides significant reinsurance capacity for the Indian market. World-wide the AIG group provides reinsurance support through different entities. AIG has issued a statement that it's direct and reinsurance arms are separate entities. But insurers are not fully comfortable. The fountainhead of AIG's global programme is in New York where the problem has arisen. Given that AIG has been using its group strengths to provide reinsurance support, the reinsurance entities cannot remain completely insulated from a downgrade.

Indian insurers can buy protection from any company with a BBB S&P rating. However, there is fear that AIG might default. Default concerns were reflected in trades of AIG's credit default swaps which saw a pricing reflecting a 95% chance of default. Credit spreads worsened after a downgrade of the insurance giant by rating agencies worldwide. Moody's Investors Service cut AIG's rating to A2 from Aa3, a two-notch downgrade. S&P lowered the rating to A-minus from AA-minus, a three-peg reduction, and Fitch Rating reduced its standing to A from AA-minus, a two-notch cut.

While insurers are keeping a close watch on the news screens, they are not making any moves to make changes to their reinsurance programme yet. Insurers say AIG is the most global of all insurers and there is a possibility of a financial package being announced.

***Global Rescue Mission under way* –** The US government bailout of AIG – the biggest nationalisation in history –involves the US government extending an $ 85 billion loan in exchange for a 79.9% stake in the giant insurer. The two-year loan will enable AIG meet some of its obligations.

Even after the announcement, the financial contagion was spreading across the globe, failing to assuage investors in most Asian and European markets who feared more bankruptcies and desperate mergers. Russia poured $44 bn into its three largest banks and halted stock trading for the second day. For Russia, it's the most severe financial crisis since its devaluation and debt default a decade ago. Central banks in Japan and Australia injected $33 bn into their financial systems amid ongoing efforts to restore investor confidence. The fear and distrust was pervasive across markets.

9.2 KNOWLEDGE RESOURCE

Nuclear power

The phrase **'nuclear power'** denotes nuclear technology designed to produce unable energy from atomic nuclei via controlled nuclear reactions. The most common method currently is by way of ***nuclear fission***, to generate electricity. The basic process in all utility-scale reactors is to heat water to produce stream, which is then used in a turbine to generate power.

Today, more than 15% of the world's electricity comes from nuclear power; it's about 2% for India. The US, France and Japan account for over half the nuclear power produced world-wide. France produces the highest percentage of its power from nuclear reactors – 80%.

Nuclear fission

When a critical mass of *fissile* atomic nucleus (usually uranium with atomic mass number 235 or plutonium-239) is struck by a neutron - a sub-atomic particle, it forms two or more smaller nuclei, releasing energy and neutrons in a process called nuclear fission. The neutrons then trigger further fission.

Atomic mass number refers to the number of protons and neutrons in the nucleus. When the chain reaction is controlled, the energy released can be used to heat water.

Nuclear fuel cycle

Also termed *nuclear fuel chain*, denotes the progression of nuclear fuel through a series of stages. The process by which uranium ore is mined, processed, enriched, used, possibly reprocessed and disposed is known as the nuclear fuel cycle. It consists of 'front end' steps involved in the preparation of fuel, steps in the 'service period' during which the fuel is used during reactor operations, and steps in the 'back end,' so as to safely manage, contain, and either reprocess or store spent nuclear fuel.

If spent fuel is not reprocessed, the fuel cycle is referred to as an 'open fuel cycle'; if the spent fuel is reprocessed, it is called a 'closed fuel cycle.'

Nuclear fuel

The only 'isotopes' currently used as nuclear fuel are uranium-235 (U-235), uranium-238 (U-238) and plutonium-239 (Pu-239).

Thorium is a very promising fuel and we have lots of thorium deposits.

An isotope denotes one of two or more atoms that have the same atomic number (the same number of protons) but a different number of neutrons, so different mass numbers.

Naturally occurring uranium consists of over 99% of U-238 and 0.71% of U-235. The atomic nucleus of U-235 will nearly always split when struck by a neutron, and the isotope is therefore said to be a '***fissile' isotope***. The nucleus of a U-238 atom will nearly always absorb the neutron and yield an atom of the isotope U-239. This isotope then undergoes natural radioactive decay to yield Pu-239, which like U-235, is a fissile isotope.

In the thorium fuel cycle, thorium-232 (Th-232) absorbs a neutron to form thorium-233. And Th-233, after a two-stage radioactive process decays to uranium-233, which in turn is used as fuel.

Nuclear enrichment

Less than 1% of the uranium found in nature is the easily fissionable U-235 isotope and most reactor designs require enriched fuel. Most BWR and PWR reactors use uranium enriched to about 4% U-235. But at least 100 research reactors in the world are fuelled by highly enriched (defence-grade 90% enrichment uranium). Plutonium is fissionable with both fast and thermal neutrons.

Nuclear reactors

Now a nuclear reactor is a system in which nuclear chain reactions are initiated, controlled, and sustained at a planned rate.

- Most power reactors make use of 'slow' or '***thermal neutrons***.' They are characterised by 'neutron moderator' materials, like water, that slow neutrons until they approach the average kinetic energy of the surrounding particles. Thermal neutrons have a far higher probability of fissioning uranium-235.

- In contrast, the less common fast-neutron reactors are characterised by an absence of moderating material. But the chain reaction here requires enriched uranium (and/or enrichment with plutonium-239) and so is more expensive to operate. They produce far less uranic waste though. In the future, they could become all the more viable.

Current nuclear technologies

- The majority of current thermal reactors are the ***Pressurised Water Reactors (PWR)*** type, which are cooled and moderated by high pressure liquid water.

- A ***boiling water reactor (BWR)*** is cooled and moderated by water like a PWR, but at a lower pressure. An advanced boiling water reactor can improve thermal efficiency.

Pressurised Heavy Water Reactor (PHWR), of Canadian design or 'candu,' is heavy-water cooled and-moderated pressured-water reactors. PHWRs are fuelled with natural uranium and can be refueled while at full power, which makes them very efficient in their use of uranium.

India operates several PHWRs. In fact, the next generation PHWR is the ***Advanced Heavy Water Reactor***, under development at the Bhabha Atomic Research Centre.

Also under development is ***fast breeder reactors*** that are capable of enriching uranium during the fission chain reaction (by converting fertile U-238 to Pu-239) which allows an operational fast reactor to generate more fissile material than it consumes. Thus, a breeder reactor, once running, can be re-fuelled with natural or even depleted uranium.

A fast breeder thorium reactor could harness power with the use of our extensive thorium reserves.

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