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SAFE UPDAT- KEEP INFORMED

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Editor: CA Lalit Mohan Agrawal

How hard is it for companies to create lasting value? Consider this: of the original Forbes 100 created in 1917, only 18 companies are around today and of these, only GE is in the top 100. Why is it that a select few survive the test of time and what is the secret of their longevity?

In today's hyper-competitive world, with highly involved customers, breakthrough technological innovations, changing regulatory requirements and a globally connected mesh of markets, supply chains and people, creating value is only going to get harder.

Innovation is clearly the engine most organisations employ to distinguish and sustain their existence. But is it enough? Our analysis suggests the lasting value results when continuous evolution become core to an organisation's DNA and not a discipline on to itself. It goes beyond economic value generated for its shareholders and encompasses the needs of all its stakeholders – its customers, its employees, its suppliers and the society in which it operates. Companies like GE realise that all their stakeholders are inextricably linked and that they need to create value for all, else they may not be able to sustain value for any.

Continuous evolution also implies disrupting the status quo in how organisations go to market and serve the changing needs of its stakeholders. Ingraining such principles is not easy. It requires accepting the broader purpose of an organisation's existence, taking a longer term view on value creation and fostering a culture of continuous innovation.

Let us examine each of the key stakeholders and how companies are utilising their unique needs to generate mutual and long lasting value.

1. Customers

Placing the customer at the core of the innovation process helps identify and manage unmet needs, design products that are truly needed and deliver exceptional customer experience. A customer centric company designs its organisation around customers and rewards employees based on customer satisfaction and experience. Besides creating direct economic value, customer centricity helps build long lasting brand loyalty and more importantly influence and shape the customer expectations.

Amazon and Best Buy are great examples of organisations that run their business on a relentless customer centric orientation. In India, Hero Honda became the largest selling motorcycle company by capitalising on serving unmet needs and focusing on the life cycle of customer experience, through innovative finance and loan services, efficient dealer network, and mobile workshops.

2. Employees

Employee driven innovation to date has been a “nice to have” and not fully capitalised on given the role employees play in realising value for an organisation. Companies globally are increasingly recognising the need to create an organisational culture that inspires employees to innovate and take calculated risks. International companies like Pixar, P&G, GE, Google, IDEO and 3M are renowned for providing employees space and motivation to innovate.

Employee focused companies put employees at the top of the organisational pyramid, provide them entrepreneurial opportunities, create customised career programmes, tolerate failures (but not mediocrity) and effectively reward employees for their innovation and contribution to the company. Besides fostering a culture of innovation, companies also need to build systems and processes to efficiently capture innovation ideas and implement them.

Indian companies have also realised the importance of empowering employees and providing them with right incentive to innovate (e.g., HCL Technologies' unique management philosophy of "Employee First" is widely recognised for empowering employees to become drivers of growth and creators of value for all stakeholders.

3. Suppliers/Partners

Sustainable value can be derived through strategic suppliers' partnerships that look beyond the immediate economic value of the partnership. They seek to leverage each partner's capabilities in unique ways and foster an inclusive collaborative approach. For example, Tata developed its revolutionary and market-defining product Nano by building strong and mutually beneficial relationships with suppliers. Similarly, Apple created its immensely popular iPhone App Store by tapping into the skills of software programmers around the world.

The key to successful strategic supplier partnership lie in very carefully choosing suppliers (quality and service take priority over cost) and then sharing relevant financial and operational information with these suppliers. Companies like Toyota and Starbucks are known to share unusual amount of financial information with their suppliers which helps them to effectively manage their supply chain and provide superior value to all stakeholders.

4. Society

While many companies profess their allegiance to corporate social responsibility, the companies that benefit most are those that make it a key and integral part of their overall strategy. Tata Group is a great example of a company that has successfully integrated social responsibility into its core values.

Besides making social impact integral to overall strategy, companies can also create value for society and other stakeholders by identifying social issues that coincide with company's economic or regulatory interests (e.g., DuPont, McDonalds, Wal-Mart) and by mitigating existing or anticipated adverse effects from their business activities (e.g., mining companies, chemical manufacturing companies, product recalls by companies like Sony).

As markets become more global and pace of change increases dramatically, companies will find it increasingly difficult to manage the demands of its various stakeholders and create lasting value. Those companies who nurture a culture of multi-pronged, creative and disruptive innovation and link their strategy proclamation to day-to-day behaviours at all levels of the company will not only survive but thrive. These companies will continue to feature in Forbes 100 list and redefine the standards of corporate excellence.

Retail investors may take some more time to regain confidence in the primary market but they seem to be gradually making their presence felt in the secondary market. The only difference this time around is that the investors quickly booking profits even if they are not large.

Growing retail investor interest can also be gauged from the fact that indices tracking the SME (small and medium sized enterprises) space have outperformed the key indices in the run-up to 5k level touched by Nifty. An analysis of the comparative returns of Nifty and its midcap counterpart Nifty Midcap 50 shows that while the former gained 1000 points, or 25%, between July 13 and September 17, the latter, in fact, recorded a sharper up-move, gaining 32% during the period.

Another indication of growing retail participation is the rising trading volumes in the BSE's B-group which mostly houses SME stocks. The segment attracted daily average volume (quantity of shares traded) and turnover (value of shares traded) of 30 crore shares and Rs 1,753 crore respectively up-to 3rd week of September, compared to 23.5 crore shares and Rs 1,535 crore in August and 16.6 crore shares and Rs 1,005 crore in July. Brokers claim growth in business from small investors. However, they feel it would take some time before one sees the kind of retail participation that was there in 2006 and 2007.

There exists huge appetite for equities as only a small percentage of household savings is invested in the stock market. A large number of companies from SME space have a vast potential for growth and offer good opportunity for investment. However, have a word of caution; investors should avoid risking their portfolio by putting in money in companies without checking their credentials. Like in the past, shares of many fundamentally weak companies have climbed to abnormally high levels only to mislead investors.

3rd week of September – Sensex, Nifty hits nearly 16-month high

Biggies not in step with Nifty ride to 5k: Benchmark Nifty-50, an index of National Stock Exchange (NSE), that once again touched the psychological mark of 5,000 points, saw heavyweight underperform in the bull-run. While 30 stocks have outperformed the index, 20 stocks have underperformed since its March bottom. Underperforming scripts include heavyweights like RIL, ONGC, Bharti Airtel, BHEL, ITC and HUL, while better performing scripts are Infosys, Tata Steel, ICICI Bank, L&T, TCS, SBI and others. After the long bear phase that began in January 2008, the Nifty touched a four-year trough of 2,620 on March 6, 2009. Since then it has touched to an 18-month high level of 5k on Thursday.

Daily review	11/09/09	14/09/09	15/09/09	16/09/09	17/09/09	18/09/09
Sensex	16,264.30	(50.11)	240.26	222.59	34.07	30.19
Nifty	4,829.55	(20.95)	83.50	66.30	7.15	10.50

Weekly review	11/09/09	18/09/09	Points	%
Sensex	16,264.30	16,741.30	477.00	2.93%
Nifty	4,829.55	4,976.05	146.50	3.03%

Sharp rally to most of the sectors paved the way for both the key indices, Sensex and Nifty, to hit nearly 16-month highs and improved further by 3% during the week under review, stimulated by a host of positive factors. Sensex was in the vicinity of 17K-mark, while Nifty pierced through 5K-mark during the intra-day trade. Reports of higher advance payments by some big corporates for the second quarter, indicating revival in the economy amid heavy portfolio inflows, mainly boosted the market sentiments.

Firm global cues also helped local bourses to keep the tempo upbeat. Inflation turned positive for the first time in 13 week, rising to 0.12% during the week ended September 5.

Most of the world market closed the week up on encouraging rise in US retail sales in August and hopes of global economic recovery after the US Fed Chairman, Ben Bernanke, said the worst US recession since the 1930s has probably ended. Signal of the apex bank not to hike interest rates till the economic recovery is on a strong footing, too supported market. FIIs pumped IN Rs 6,471.28 crore in the week.

4th week of September – Market undergoes marginal correction

Daily review	18/09/09	21/09/09	22/09/09	23/09/09	24/09/09	25/09/09
Sensex	16,741.30		145.13	(166.93)	61.63	(88.43)
Nifty	4,976.05		44.15	(50.25)	16.50	(27.60)

Weekly review	18/09/09	25/09/09	Points	%
Sensex	16,741.30	16,693.00	(48.30)	(0.29%)
Nifty	4,976.05	4,958.95	(17.10)	(0.34%)

Indian bourses underwent a downward correction after the key indices Sensex and Nifty hit fresh 16-month highs amid hints of caution about stretched valuations and fears of liquidity shortage. The bellwether Sensex had virtually touched 17K mark while Nifty crossed the 5,000 psychological level on September 22 on sustained capital inflows. Though the rollover to October series was quite healthy and the market technically very strong, investors preferred to be cautious due to stretched valuations.

Continued offers of equity and equity related instruments by companies to raise funds also cause concerns that this will suck liquidity from the secondary market. The market, however, was well supported by growing optimism about second quarter corporate earnings prompted by positive growth in advance corporate tax payments in September quarter, an indication of revival of economic activity. Reports that 'the Sebi was planning to further relax norms for governing foreign portfolio investment in country' also seen as a positive factor for the market. Foreign Institutional Investors were heavy buyer in the market during the week. They have injected Rs 14,630 crore between September 7 and 24.

Lat week of September – Sensex at 17,000

Daily review	25/09/09	28/09/09	29/09/09	30/09/09	01/10/09	02/10/09
Sensex	16,693.00		159.91	273.93	7.71	
Nifty	4,958.95		47.90	77.10	(0.55)	

Weekly review	25/09/09	25/09/09	Points	%
Sensex	16,693.00	17,134.55	441.55	2.65%
Nifty	4,958.95	5,083.40	124.45	2.51%

BSE's bellwether index Sensex swept past the 17,000 mark on Wednesday, buoyed by the powerful ride of liquidity sloshing around equity markets globally. Though many players are worried about valuations, the consensus appears to be that liquidity would continue to drive markets higher in the short term. In Europe too, the broad trend was positive. News from the US continued to be encouraging with the economy having shrunk by a lower than expected 0.7% in the second quarter of 2009.

India was the best performer among Asian markets. So far in 2009, the Sensex has risen 73% and is now trading at a 12-month trailing price-to-earning multiple of little over 22 times. This is much lower than the ratio of 29 times just before the market peaked in January 2008, and 34 times at the peak of the dotcom rally at the turn of the century. But many market watchers are sceptical if this is any sign of reassurance.

“That we are cheap compared with the peak valuation does not mean anything. Just because people made a mistake once, it does not mean that they will wait that long the second time around.”

Market breadth was positive, but not emphatic, as investors chose to cash in on the recent gains. On the BSE, there were 4 gainers for every loser. It seems that we are in a bull market. The cause of concern is a flood of issues waiting to hit the market, and that could suck liquidity out of the secondary market. Also, the composition of the Sensex has changed from the time when it had last been at 21,000 and so the stocks are unlikely to move as seen in previous rally.

Monthly review

Month	June '08	June '09	July '09	Aug '09	Sep '09
Date	30.06.08	30/06/09	31/07/09	31/08/09	30/09/09
Sensex	13,461.60	14,493.84	15,670.31	15,666.64	17,134.55
Points			1,176.47	(3.67)	1467.91
%			8.12%	(0.02%)	9.37%

Sensex at 17000

The BSE sensex has crossed the 17,000 mark, as shares rise on the deluge of liquidity. Since the big governments are unanimous that this is not yet time to withdraw the stimulus, cheap money and surplus liquidity would continue to drive equities even though they look expensive on the traditional price-to-earnings valuation measure. Short-term interest rates are close to zero in most of the developed world including the United States, making investment in money market funds almost futile. Those funds are now beginning to move to equities as the global economy recovers and risk appetite improves.

In fact, the low cost of funds in the US has even encouraged talk of the dollar now being the currency of choice for carry trades – investors borrow in low interest rate currency to invest in high-yield ones. However, despite the risks of cheap money fuelling bubbles, neither central banks nor governments are likely to act till the time they are sure that the global economy can roll along without the stimulus, ensuring in the process that the liquidity-driven party continues for a while. In such a situation, over the short-term, an increased supply of shares can help check runaway prices. A number of private companies have already lined up initial public offers to raise money. The government should also move quickly to disinvest in state-owned companies to take advantage of the good market condition. It should also firm up its proposal that requires listed companies to have at least 25% public holding.

Decoding links

On-again-off-again relationship: The dust has not yet settled either on sub-prime crisis or the fierce decoupling/ re-coupling debate that followed in the aftermath of the crisis. But economists have already produced a paper on what could possibly explain the on-again-off-again relationship between developed and emerging markets. Why did emerging markets first seem insulated (de-coupled) from developed markets only to track them closely after September (when they re-coupled)? The authors, Michael P Dooley & Michael M Hutchison look at selected equity, debt and foreign exchange markets for a sample of emerging markets (India is not included) in the three phases of the financial crisis:

First phase: 27 February 2007 to 18 May 2008;
 Second phase: 19 May 2008 to 14 September 2008; and
 The Third phase: 15 September 2008 to February 2009.

Equity markets

In the US, the start of the subprime crisis in mid 2007 was also the start of a long but gentle decline in US equities through September 2008. A spectacular decline in September was followed by extreme volatility but no clear trend. In contrast, most emerging markets (across regions) had recovered by August 2007 and continued to perform quite well for another 12-14 months. It was during this time that the decoupling hypothesis gathered momentum.

However, in late May 2008, equity markets again started moving together. This close relationship became even more pronounced in mid September when the Lehman crisis led to a spectacular fall in all markets through mid October. In the first three months of this year, markets have again moved together but with no clear trend. Co-relation increased markedly between the second and third phases of the crisis for most emerging markets (11 of 14), indicating stronger linkage between the markets.

Exchange rate

Exchange rates followed a similar general pattern to equity prices; they appreciated relative to dollar, at times rapidly, until September 2008 and then depreciated very sharply. Emerging markets initially appeared to be de-coupled from the US financial crisis and then experienced large depreciations that greatly exceeded the initial appreciation of their currencies from early 2007 through mid-2008.

The paper – *Transmission of the US Sub-prime crisis to emerging markets: Evidence of the De-coupling, Re-coupling Hypothesis (NBER Working Paper 15120)* – possibly suggests that market forces were moving these markets apart for the early part (phase 1 and 2) and then linkages re-emerged in the later part (phase 3). However, the jury is still out.

The paper also find clear evidence that US financial and real news transmitted strongly to emerging markets over the whole sample period as reflected in five-year credit default swap (CDS) spreads on sovereign bonds. US news announcement such as writedowns of financial institutions, the Lehman bankruptcy, swap arrangements, and news on the US real economy had uniformly large effects across all emerging markets and moved CDS spreads in most markets. However, major news announcements by the US Federal Reserve and US Treasury on plans to stabilise the US financial system had little effect on emerging market CDS spreads.

India's Experience with Fiscal Rules
An evaluation and the way forward

In the realm of public finance and government budgets, what's required is fiscal prudence for overall macroeconomic balance. A recent working paper at the IMF is on "India's Experience with Fiscal Rules: An Evaluation and the Way Forward".

The paper opines that the resultant policy outcome has been mixed. What suggested is the need for a medium-term governmental debt target and 'annual nominal expenditure growth rules' so as to keep the fiscal deficit proactively under check.

- ♦ Alongwith numerical targets for government borrowing and outlay, what's proposed is structural reforms to rev up revenues and keep tab on expenditures?
- ♦ Also recommended is bringing all subsidy-related expenditure 'above the line'. Note that subsidy-related bonds issued last fiscal in the face of record oil prices were kept off-budget, so as to suggest a lower fiscal deficit figure than was really the case.

Anyway, in the domain of policymaking, there's a strong case for fiscal consolidation for sustained, long-term economic growth. Such a goal is necessary to remove the constraints imposed on the domestic financial system by the government's massive financing needs.

It was precisely to arrest the deteriorating state of government finances that The Fiscal Responsibility and Budget Management (FRBM) Act, 2003 was enacted at the Centre. The FRBMA does call on the government to ensure proper fiscal management and sustainability, for long term macroeconomic stability. In tandem, Twelfth Finance Commission proposed incentives for the states to have their fiscal responsibility legislation in place. It did lead to reasonable fiscal success.

Between 2003-04 and 2007-08 the Centre's fiscal deficit – as per provisional estimates – declined from 5.1% to 2.8% of GDP, achieving a year in advance the medium-term target of 3% of GDP. More than two-thirds of the fiscal adjustment was due to revenue gains, improved tax performance and buoyant growth. Since then, government finances are over-extended yet again, given the global financial crisis and the need for domestic fiscal stimulus.

Weakness in the FRBM norms

The FRBM rules set targets only up to March 2009 and the Thirteenth Finance Commission is reviewing the fiscal rules. The paper outlines the extent weakness in the FRBM norms:

1. Absence of well-defined accounting definitions

There's absence of well-defined accounting definitions for the target fiscal indicators. The lack of 'exact definitions' have meant much recourse to subsidy-related bonds.

2. Insufficient transparency in budget preparation

There's insufficient transparency in budget preparation, vouches the paper.

3. No independent assessment of compliance with FRBMA

There's also no independent assessment of compliance with FRBMA, the paper notes.

4. Lack of expenditure rules and a debt-target

There was no real comprehensive, medium-term plan for expenditure control. The paper avers, 'there's lack of expenditure rules and a debt-target. Debt at 80% of GDP as of March '08 is way too high.

5. Insufficient discussion of 'fiscal risks'

The study notes that ongoing infrastructure investment in the public-private partnership mode would give rise to contingent liabilities and the like. Yet there's insufficient discussion of 'fiscal risks.'

Reforming the FRBMA

1. Doing away with scope for 'creative accounting'

Reforming the FRBMA would specifically require doing away with scope for 'creative accounting' to get around fiscal rules.

2. Empower an 'independent scorekeeper'

Also, what's necessary is to empower an 'independent scorekeeper' such as the Controller and Auditor General, 'before creating a new one for this purpose,' the paper adds.

3. Concrete supporting plans to numerical targets

The new FRBMA numerical targets ought to be supported by concrete supporting plans of short-term and medium-term policy measures for both revenue and expenditure.

4. Additional assumptions underlying the budget

Besides, the assumptions underlying the budget should invariably include annual forecasts 'over a medium-term horizon' for key variables such as:

- ◆ GDP growth,
- ◆ Inflation,
- ◆ Imports, exports and
- ◆ The exchange rate.

5. Independent fiscal council for monitoring

The paper concludes that an 'independent fiscal council' to assist with monitoring of fiscal rules both ex-ante and ex-post, would make ample sense.

Are companies ready to spend? As the economy went into a tailspin last year, many companies stopped investing in their operations. For months they've refused to buy new computers, trucks, and other capital goods in an effort to save off losses. Companies generally don't shell out money unless they think demand is picking up and profits are sustainable. Now some corporations are increasing capital expenditures. And those that continue to cut spending are doing so less drastically. The changing sentiment is glimmer of hope for the economic recovery. Capital spending will be a critical growth driver in the coming years, especially given the dire state of consumers.

Bend on recovery road

With global economy on the mend, India has reached that bend on Recovery Road from where it can step on the pedal and move into top gear. It is not the time to sit back and squirm. Instead, it's time for action, bold leadership and adventurous contrarian thinking. A new global economic order is being forged after one of the worst slowdowns in living memory, and India and Indian companies can play a big role if they seize the opportunities on offer and look for new ones. However, businesses in India will have a lot to learn from the recession:

1. Consumers and investors are still adjusting to the turmoil, and this will take time.
2. Besides, consumers and investors, businesses were still adjusting to the recession and the focus was on cost cutting and optimal human resource management. So it would be a while before fresh hiring begins. There are signs of recovery in many economies. The question is: Will there be a jobless recovery before growth? The continuing unemployment at the global level is one factor that might hinder a good recovery.
3. The global recovery would be accompanied by some problems too. Government around the world will have to repay the \$2-3 trillion borrowed to finance the economic stimulus delivered in the past year or so. All the monies pumped in by the governments must be re-earned by society. There is no free lunch, after all. It is not for nothing that US Fed chief Ben Bernanke recently said his biggest challenge will be how to withdraw excess money from the system once recovery gets underway. This process is yet to play out.
4. In the long run, recession tests businesses, and it also forces you to innovate. By innovating, companies can emerge stronger. A tough environment gives competitive benefits to innovation. The most innovative solution comes out during the most disruptive periods. We will see tremendous transformation and changes by the time recession ends. In tough times like these, innovations and investments need to be continued. Invest in R&D, and there will be results.

In fact, the recovery is for real in India. India is the country that is balanced well between investment and consumption. There are no grey zones here; and no room for doubt. While there's good news trickling in from the west, India is set to zip ahead with renewed vigour.

Companies in India are shooting ahead. Things are certainly stabilising. There are no more risks in the system too. Green shoots are here to stay. There is reason to confident and there is certainly no reason to be afraid. We are much more resilient economy than we think we are. The need is to adopt innovative and efficient market segmentation strategies and have a greater focus on market development.

The problem of the burgeoning government debt is mainly political, but the adverse consequences may be economic. The trouble is that we don't know what those consequences may be, when they may occur, or even whether they will occur. Without some impending calamity, politicians of both parties recoil from doing anything unpopular that might bring the budget into balance over, say, the next six or seven years. The idea of anticipating and pre-empting future problems is not on their agenda.

Although the recent surge of budget deficits – the annual gaps between outlays and revenues, resulting in more federal debt – reflects the savage recession, the true cause is political. Deficits allow liberals and conservatives to maintain self-serving public positions. Liberals claim we can have more government (more health care, more education, more transportation) without taxing anyone but “the rich.” Conservatives promise that taxes can be cut without depriving anyone (retirees, veterans, cities and states) of existing government benefits.

Neither claim is remotely believable under the assumption that, over the long run, government benefits and programmes ought to be paid with taxes. The truth is that government again under both parties has promised far more in benefits than can be covered by existing taxes. Only borrowing could reconcile the rhetorical claims with underlying economic realities. There have been 43 deficits in the past 48 years.

Until recently, the borrowings, though usually undesirable, were not alarming. But the recession and an ageing population signify that we have crossed a threshold where actual and prospective borrowings are so huge that no one can foresee the consequences. The best measure of debt burden is its relation to the nation's annual income, or gross domestic product. The same approach applied to a household with \$25,000 of debt and \$50,000 of income would produce a debt-to-income ratio of 50%.

In 1946, after World War II, the ratio of publicly held federal debt to GDP was 108.6%. Since then, the economy (our income) has generally grown faster than the debt. In 1974, the debt-to-GDP ratio reached a post-World War II low of 23.9%, and even in 2007, it was only 36.9%. That was manageable.

By contrast, today's prospective colossal borrowings dwarf likely economic growth. The Obama administration's latest projections show nearly \$11 trillion of borrowing from 2009 to 2019. In 2019, the debt-to-GDP ratio would be 76.5%. This could be too optimistic, because it assumes some spending restraints and tax increases. A projection by the Concord Coalition, a watchdog group, adds about \$5 trillion in borrowings in that period. In 2019, the debt-to-GDP ratio could be roughly 100 percent.

Because such borrowings would be unprecedented in peacetime, they might go badly. It's easy to imagine problems. Some might become full-blown crisis. It might be impossible to refinance maturing federal debt (average maturity: 51 months) except at much higher interest rates. The Federal Reserve might be pressured to inflate away the debt by buying boatloads of Treasury bonds; high inflation would be ruinous, as it was in the 1970s. The mere fear of uncontrolled deficits might trigger a flight away from the dollar on stock, bond and foreign exchange markets.

But none of these calamities has yet occurred. Precisely the opposite; Low interest rates on 10-year Treasury bonds, about 3.5%, suggest ample investors. Though huge deficits pose long-term hazards, cutting them sharply now might threaten economic recovery. Any action – spending cut or tax increases – ought to be prospective. Facing few insistent to confront deficits, politicians don't.

What unites Democrats and Republicans is an unwillingness to have a serious debate about how big government should be. Spending is the crucial issue, because it determines taxes and deficits. If they become too large, the resulting depressed economy may make paying for government even harder. Ideally, liberals would see that spending needs to be cut substantially; if it isn't, tomorrow's tax increases or deficits will be horrendous. Ideally, conservatives would accept that taxes must ultimately rise; no plausible spending cuts can bridge the gap between government's promises and its tax base.

There is no sign of this. Liberals and conservatives agree to evade. Spending for the elderly dominates the federal budget, but no one discusses who among retirees deserves government subsidies and at what age. Liberals would increase spending (aka, President Obama's health proposal) even before addressing existing deficits. President Bush and congressional Republicans could have curbed spending. But they increased it even while cutting taxes and Obama would keep most tax cuts except for people making over \$ 250,000. Placid deficits have abetted all these evasions and inconsistencies. As the path of least resistance, they encouraged permissiveness. But with deficits swelling, this easy road may soon close.

We may learn how much debt is too much.

World Coming Back on Its Feet

The International Monetary Fund (IMF) said that the global economy is bouncing back from the slowdown blues and will clock a growth of 3.1% in 2010. The rebound will be led by emerging economies, especially India and China that will grow at 9% and 6.4% respectively. In July this year, IMF's growth projection for 2010 was lower at 2.5%. IMF chief economist Olivier Blanchard said, "The recovery has started. Financial Markets are healing. In most countries, growth will be positive for the rest of the year, as well as in 2010." According to the report there were "some signs of gradually stabilising retail sales, returning consumer confidence and firmer housing markets".

But the 'World Economic Outlook' released by the fund added a note of caution and said that the recovery is expected to be slow and hence reversal of expansionary monetary measures has to be slow. It emphasised that the upswing was mainly a result of aggressive crisis management in the United States, Europe and Asia, and is not a self-sustainable recovery. Premature exit from accommodative monetary and fiscal policies seems a significant risk, because the policy-induced rebound might be mistaken for the mistaken for the beginning of a strong recovery in private demand.

Sustaining healthy growth over the medium run will depend critically on addressing the supply disruptions generated by the crisis and rebalancing of the global pattern of demand. To accommodate demand-side shifts, there will need to be changes on the supply side. We will require actions on many fronts, including measures to repair financial system, improve corporate governance and financial intermediation, support public investment, and reform social safety nets to lower precautionary saving.

With all talks of “green shoots” of economic recovery, America’s banks are pushing back on efforts to regulate them. While politicians talk about their commitment to regulatory reform to prevent a recurrence of the crisis, *this is one area where the devil really in the details* – and the banks will muster what muscle they have left to ensure that they have ample room to continue as they have in the past.

Too big to fail

The old system worked well for the banks (if not for their shareholders), so why should they embrace change? Indeed, the efforts to rescue them devoted so little thought to the kind of post-crisis financial system we want that we will end up with a banking system that is less competitive, with the large banks that were too big to fail even larger.

Too big to be managed

It has long been recognised that those America’s banks that are too big to fail are also too big to be managed. That is one reason that the performance of several of them has been so dismal. When they fail, the government engineers a financial restructuring and provides deposit insurance, gaining a stake in their future. Officials know that if they wait too long, zombie or near zombie banks – with little or no net worth, but treated as if they were viable institutions – are likely to “gamble on resurrection.” If they take big bets and win, they walk away with the proceeds, if they fail; the government picks up the tab. This is not just theory; it is a lesson we learned, at great expense, during the Savings & Loans crisis of the 1980s. When the ATM machine says, “insufficient funds,” the government doesn’t want this to mean that the bank, rather than your account, is out of money, so it intervenes before the till is empty.

Too big to be financially restructured

In a financial restructuring, shareholders typically get wiped out, and bondholders become the new shareholders. Sometimes, the government must provide additional funds, or an investor must be willing to take over the failed bank. The Obama administration has, however, introduced a new concept: too big to be financially restructured. The administration argues that all hell would break loose if we tried to play by the usual rules with these big banks. Markets would panic. So, not only can’t we touch the bondholders, we can’t even touch the shareholders – even if most of the shares’ existing value merely reflects a bet on a government bailout. I think this judgement is wrong. I think the Obama administration has succumbed to political pressure and scare-mongering by the big banks. As a result, the administration has confused bailing out the bankers and their shareholders with bailing out the banks.

Restructuring gives banks a chance for a new start; new potential investors (whether holders of equity or debt instruments) will have more confidence, other banks will be more willing to lend to them, and they will be more willing to lend to others. The bondholders will gain from an ordinary restructuring, and if the value of assets is truly greater than the market (and outside analysts) believe, they will eventually reap the gains. But what is clear is that the Obama strategy’s current and future costs are very high – and so far, it has not achieved its limited objective of restarting lending. The taxpayer has had to pony up billions, and has provided billions more in guarantees – bills that are likely to come due in future.

Ersatz capitalism

Rewriting the rules of the market economy – in a way that has benefited those that have caused so much pain to the entire global economy – is worse than financially costly.

Most Americans view it as grossly unjust, especially after they saw the banks divert the billions intended to enable them to revive lending to payments of outsized bonuses and dividends. Tearing up the social contract is something that should not be done lightly.

But the new form of ersatz capitalism, in which losses are socialised and profits privatised, is doomed to failure. Incentives are distorted. There is no market discipline. The too-big-to-be-restructured banks know that they can gamble with impunity – and, with the Federal Reserve making funds available at near-zero interest rates, there are ample funds to do so.

Socialism with American characteristics

Some have called this new economic regime “socialism with American characteristics.” But socialism is concerned about ordinary individuals. By contrast, the United States has provided little help for the millions of Americans who are losing their homes. Workers who lose their jobs receive only 39 weeks of limited unemployment benefits, and are then left on their own. And, when they lose their jobs, most lose their health insurance, too.

America has expanded its corporate safety net in unprecedented ways, from commercial banks to investment banks, then to insurance, and now to automobiles, with no end in sight. In truth, this is not socialism, but an extension of long standing corporate welfarism. The rich and powerful turn to the government to help them whenever they can, while needy individuals get little social protection.

We need to break up the too-big-to-fail banks; there is no evidence that these behemoths deliver societal benefits that are commensurate with the costs they have imposed on others. And, if we don't break them up, then we have to severely limit what they do. They can't be allowed to do what they did in the past – gamble at other's expenses.

This raises another problem with America's too-big-to-be-restructured banks; they are too politically powerful. Their lobbying efforts worked well, first to deregulate, and then to have taxpayers pay for the cleanup. Their hope is that it will work once again to keep them free to do as they please, regardless of the risks for taxpayers and the economy. We cannot afford to let that happen.

The world at large may be bearish, or at best neutral on equities. But this is the market that will outperform the rest over the next 9 months. Timing the market is as important as fundamental research.

The buy and hold investment strategy used in the 80s and 90s. But now we are in a very different market. Earlier, it was a strategic market, now it is a tactical one. The problem really started when the tech bubble burst in 2000. The world has been in one large trading range since then.

Long term is now not measured in decades; it is measured in months. So I can be bullish, and I am bullish, till the end of this year, or early next year. After that I am not sure. The bull run that began Timewise in March this year could last till December or next March. In the next years you may see this kind of a market again; so if you are a long time investor, at the end of say 5 years you may end up pretty much where you started from. So, it is equally important to time the market.

We think the strength of markets globally since March tells us that things are going to get better, though they may not be perfect. So now we are beginning to see China correct, India correct, because these markets have got a bit ahead of themselves. So here, we could see any correction as a buying opportunity.

Emerging markets are likely to correct more than developing markets. Coming out of the March lows, the US markets lagged and so doesn't look as extreme (as the emerging markets). If your investment horizon is 6-8 months, buy on declines. Between now and March, we see a big up move in the US market.

The US market is showing good breadth (the difference between advancing stocks and declining stocks) despite more people expecting it to go down rather than go up. This tells us that money is coming in.

It is August and most portfolio managers have not performed well this year. That money has to come in. So we are expecting a 'melt-up'. The S&P 500 is right now around 1000, it could go up to 1100, or even 1200. We expect the Dow (Dow Jones Industrial Average) to go up to 11,000 (it is right now 9,500).

We know the market is overbought, and there is bad news coming in. But it is not about what we see, but what we do not see. And what we do not see is declines.

When bad news cannot push the market down, it is good news.

Long term investor may question that most famous analysts on Wall Street happen to those doing fundamental analysis. Does it prove that fundamental analysis leads to better investment picks than those based on technicals?

There is a history to it. In 1949, the Securities Exchange Commission came out with a rule that all Wall Street research has to be rooted in sound fundamental principles. So for many years you had analysts doing only fundamental analysis. In the 1960, the CFA (chartered financial analysts) institute was set up, because they wanted to raise the calibre of analysts; again, all fundamental analysis, because of the SEC rule. In 2004, the Sarbanes Oxley law required that all analysts on Wall Street have to have a CFA certification. In March 2005, the SEC first time recognised technicals, and changed the rule. So now you have two types of analysts in the US – CFA and CMT (chartered market technician). So from all always fundamentals, it has changed to fundamentals and technicals.

When will gold touch \$ 1000/oz? That's a tough one. Not because we are dumb. It's because we are actually too smart. Despite the charts and technical analysis, isn't it astonishing your broker or portfolio manager always has the right explanation after gold has moved and never a minute before? As an investor, you may find this exasperating. But for a journalist, to have no clue how gold will move on any given day can be galling. So we decided to wise up. And guess when we found. It is irrelevant how much you know as long as everyone else knows the same things too.

Gold is the luxury resort spa where all weary, scared or lazy investors go for a rest. The more tired or nervous people there are, the more expensive it gets to book a room there. So anyone who wants to head for gold watches all the indicators that measure how afraid everyone else is. Greater the perception of threat from virtually anywhere, greater is the desire to go cowering towards gold, and even greater is the premium on each room. The most closely watched indicators include the exchange rate of the dollar with various currencies, especially the euro; US bank interest rates; and perception of how well USA, the world's biggest economy, is performing. Indian investors also track the rupee-dollar exchange rate because they buy dollar-denominated gold with rupees.

Gold has several demand-supply fundamentals such as how much gold government-owned central banks may sell to shore up coffers; how much gold is being mined and how much bought by investors such as exchange traded funds and the European rich, and consumers such as fathers of Indian brides-to-be. Everyone knows gold demand and prices rise near auspicious dates on the Hindu calendar.

As gigantic hedge funds, index funds and banks are buying and selling gold on paper through futures exchanges, their positions and the amount of money they pump are equally important to watch.

There are few less obvious factors too, such as margin calls. When brokers make margin calls on funds, managers without the cash to deposit in their accounts sell off their positions to stay in the black, pushing down gold prices. Similarly, if one large fund decides to book profits, several others may follow.

An analyst says he keeps a close eye on when US funds declare bonuses. "Fund managers tend to book profits before the bonus is announced to boost earnings. Similarly, there is profit booking in June but very little in August, which is typically vacation time in the US. The other big sell-off time is November, just before Christmas," he says.

Risk appetite of individuals fund managers is another imponderable. A futures contract is completing only when there is a seller for every buyer of gold. But the punter selling gold is not really bearish. He has simply fixed an exit price for himself based on his risk-taking ability. He may well enter the market again at a different price point. These continuous entries and exits keep things off kilter.

Yet none of these factors are hard to track. A basic market report on gold has most of them. Therein lies the real problem. The gold market is so well tracked, so full of extremely well-informed people – analysts, brokers and investors alike – that it is impossible to surprise. Everything that could possibly be factored into the gold market by these millions of well-informed people already is there. Since all the trends are predicted, ultimately there is nothing predictable left in the market. *The only thing that can move the gold market is a bolt from the blue or completely random events.* The nub of the matter is that while smart investors have created an unpredictable gold market, the market doesn't give them extra brownie points for being so smart. You just have to take your chances. When will gold touch \$ 1000? If anyone knew the answer for sure, you won't be asking this question.

The global financial and economic crisis besides attracting policy response at the national and international levels in the form of massive stimulus packages and discussions at the G-20 and the UN Conference, has also led to a considerable rethinking on the roles of markets and states. A perspective analysis of the crisis has been articulated at a recent public lecture under the auspices of the United Nations Economic and Social Commission for Asia and the Pacific.

Joseph Stiglitz, the Nobel Laureate, convincingly argued that the global crisis was not an accident happening once in 100 years as it is being portrayed but was a manmade crisis resulting from the 'flawed policies' promoted by some 'flawed institutions' driven in turn by too much faith in the ability of markets. Despite repeated failures even of 'too large to fail' banks and financial institutions throughout the history, there was over reliance on self regulation of the banks. And if the financial deregulation led to the crisis, the liberalisation of capital and financial markets were responsible for spreading the crisis, emanating in the US economy, across the world quickly.

4.1 FINANCIAL ADVISORS:

Weigh impact on investors:

Decoding the Crisis

1. The Economic Theory argues that markets produce outcomes that are efficient. But, Stiglitz argued that markets in general are not even efficient without government regulation. It is demonstrated by the present crisis. The governments have been held to ransom and had to bail out the large failing banks because of their impact on the rest of the economy, or the externalities.
2. The poor handling of the East Asian Crisis in the 1990s by the IMF prompted the Asian countries to run current account surpluses and build reserves creating weaker aggregate demand. Today the world has a situation of trillions of dollars of foreign exchange reserves of Asian countries co-existing with huge unmet demands for basic goods and services that get reflected in the form of high levels of poverty and social development across the world and infrastructure gaps. Addressing the inequalities may be one of the key policies to augment aggregate demand within and across the countries. Similarly in the US, millions of houses are in the process of being foreclosed leading to a situation with hundreds of thousands of homeless people coexisting with millions of empty houses
3. Over time, the worsening of income inequalities in the US has left the majority of the Americans with falling incomes. Yet the consumption boom was fostered by public policies. The over-consumption of Americans which was sustained by borrowings is under a question mark as the lenders begin to get concerned about the safety of their resources.
4. An effective response to the global crisis has to be a global and inclusive one. Stiglitz argued that due to significant externalities, uncoordinated national actions will be suboptimal due to free rider problem and the tendency to be driven by policies that maximise a country's own welfare. In that context, the call for shunning protectionism was important.

To conclude, the crisis has given an opportunity to question the relevance of the conventional wisdom with respect to management of the global and national economies and on the relative roles of markets and governments. Hopefully, a new development paradigm will emerge from the rethinking for building a more equitable and just global economic order for the 21st century.

4.2 WEALTH MANAGERS

Map out the details to translate into benefits:

Lessons form the crisis

The second anniversary of the beginning of the virtual collapse of the global financial markets leading to the bankruptcy of several marquee names in business is a good time to take stock and assess if there have been any positive outcomes at all from the crisis. The human cost borne by creditors, investors, entrepreneurs and employees, as also society at large has been unprecedented, at least over the last few generations, in sheer scale and intensity. While the negative effects of the crisis have been well documented it is probably now the opportune time to examine the lessons that need to be learnt from the experience of the crisis years, though it may be a bit too early to use the past tense here.

1) For nation states, the notion that the issuer country of a widely accepted global currency like the US dollar is somewhat largely exempt from the normal laws of economics has been demystified. It is now obvious that the good old virtues of thrift and balancing of trade have not really become passé and nations including the US need to save because there are clearly limit up to which a nation can live out of others' savings and continue to indulge in unbridled consumption.

2) Economics is far from being an exact science and the rigorous econometric models linking factors like GDP growth, level of indebtedness, credit growth, inflation, monetary and fiscal policy, etc., may not be entirely reliable, and much less have precise predictive capabilities. Since macroeconomics ultimately deals with human behaviour and their myriad economic decisions which may not be always rational, the outcome from any policy action may not necessarily be the most obvious logical one that snugly fits into our rigorous and well thought out economic models.

4.3 FINANCIAL PLANNERS

Value unlocking for all stakeholders

Lessons for markets

1) As far as markets are concerned, the crisis years have helped conclude that the rational assumption that market prices incorporate all available information may not be always true. On a more general note, it is now clear that factoring in a high enough probabilistic confidence level which constructing financial models by ignoring potential outliers or tall risks – whether in risk management policies or in credit rating – is fraught with unacceptable levels of danger.

2) The concept that offered a measure of comfort to generations of investors and creditors alike, the concept of “too big to fail” has eventually ended up in some cases as “too big to save” resulting in the bankruptcy of some of the largest global investment banks and automobile companies.

3) Another take away from the crisis years is that irrespective of the most rigorous risk management techniques, prudential limits to financial leverage need to be respected even in the case of the mega investment banks that appeared to be exceptions for several years before the crisis hit them.

4) It is also about time that market participants should reconcile themselves to the fact that the world is not entirely a fair place because when it comes to government largesse in bailing out failing businesses: As Lehman Brothers is allowed to go bust whereas several others are bailed out with tax payers' money.

4.4 TECH SAVVY PROFESSIONALS

Take first step to ensure efficient and reliable system

Lessons for Creditors

The lessons from the crisis have of course been learnt by investors and creditors alike but more importantly, our understanding of macro economics and the dynamics of a unipolar world have undergone momentous changes over the last couple of years.

- 1) The starkest lessons from the crisis years are reserved for creditors. A lesson well learnt is that lending requires superior skills in assessing and monitoring creditworthiness of borrowers on a continuous basis: The realisation that one cannot reduce the credit risks of a pool of debt obligations only by slicing them into segments with different risk characteristics is a key takeaway from the crisis.
- 2) Emerging facts on the ground relating to the borrowers and the broad economy need to be factored into credit assessments and it cannot be entirely substituted by an abject reliance on credit rating agencies. It is worth reiterating that lending on the basis of an assumption of continuous appreciation of the underlying collateral at the expense of an assessment of the creditworthiness of the borrower was essentially at the root of the global meltdown.

4.5. MICRO-FINANCE PROFESSIONALS

Developing alternative credit delivery models

Lessons for Investors

- 1) Getting back on the basics of investing is a simple lesson for investors from the crisis, irrespective of liquidity surges and raging bull markets.
- 2) The inexorable fact is that valuations do eventually matter and “reversion to the mean” – despite extreme swings on either side – is a salutary guiding principle in investment.
- 3) Bubbles may grow for extended periods but are ultimately meant to burst and investors need to be wary of specious theories and *post facto* efforts at rationalising market excesses.
- 4) Equity offer value to investors only when they generate cash flows with an embedded growth option. It is time investors recognised that the financial world does not represent a stable and predictable terrain and the intellectual framework for forecasting the future with any degree of confidence is quite simply weak.
- 5) It is essential to do a reality check on typical bull market terminologies like increasing eyeballs and footfalls, the immense size of the business opportunity; replacement cost valuation, etc., because in the final analysis they should lead to decisions that generate superior investment returns within a finite time frame. Hoping to find a greater fool who will buy worthless stock at ever higher prices cannot be the basis of an intelligent investment philosophy.
- 6) A serious appraisal of the ability of a company to leverage on the three basic drivers of value – expanding the top line, increasing margins and reducing asset intensity – should be at the root of every investment decision.
- 7) It is worth recalling Warren Buffet’s investment adage that one should aim to buy stocks that are worth holding even if the stock markets were to close immediately after the purchase.

4.6 RISK MANAGEMENT CONSULTANTS

Educate – Engineer and Enforce

New knowledge for decoding links

The first anniversary of Lehman Brothers' bankruptcy, and the liquidity flows among the top Wall Street banks, is upon us. At the time of the crisis, the balance sheet size of some ten troubled banks on Wall Street exceeded the combined GDP of all emerging Asian economies. So the reverberations of the Wall Street had to be felt across the global banking system.

Last September, the world economy seemed to be hurtling down in a way that had initially raised the spectre of the Great Depression in America of the late 1920s. After a while, the consensus view that finally emerged was that the world was possibly facing the worst recession since the Great Depression. Economists in reputed western research institutions studied recessions of the last 100 years and broadly concluded that the global economy would take two or three years to fully recover.

Of late, some of those who had completely missed the financial crises building up under their noses have begun to talk about a V-shaped recovery in the global economy! Mind you, this is based largely on the performance of stock markets which are supposed to reflect future trends in the real economy.

However, such knowledge embedded in the markets can be imperfect, as we have learnt by now.

Commenting on the way the global stock markets were shooting up in recent months, the head of a Mumbai broking company said "there was absence of knowledge in the short run". What he had meant was that it was difficult to explain rationally why the stock markets were furiously running up even as company balance sheets were still bleeding.

The Mumbai broker may have been quite charitable in suggesting there was an absence of knowledge in the short run. Quite possible, the world economy may well be faced with a situation where there is an absence of knowledge in the longer term as well. This is very clear from the way governments and central bankers have so far responded to the global economic crises.

In some ways, policy makers and central banks have done the only thing they could think of – inject massive fiscal and monetary stimuli. But this is old knowledge. For there is a consensus that the fiscal and monetary stimuli of \$3 to \$4 trillion across the world may be just about preventing the global recession from deepening further. There is immense comfort in the knowledge that we are not falling any further!

The US banking system appears to have seen its worst and the economy too has shown tentative signs of bottoming out. But is this recovery durable? No one wants to answer this question yet.

To answer this question you need new knowledge. Old will not do.

The Fed chief Ben Bernanke had humility to concede this point when he said his biggest challenge would be to rightly time the withdrawal of the massive liquidity injected into the system. This has to be done just about the time a sustained recovery is anticipated on the horizon.

What if you don't see a sustained recovery at all?

INDEED, if a sustained recovery is not seen in the US economy, it could well get into a long-term liquidity trap, of the kind Japan did in the 1990s. Many economists increasingly subscribe to this theory. Japan experienced a low growth trap for well over a decade as the government kept bailing out banks and injected enough liquidity to bring interest rates to zero.

Indeed, it was never anticipated that even at virtually zero interest rates investment and consumption would not pick up. This was new knowledge at that time.

Many believe the United States too is losing its memory and DNA of creative destruction on which it had built its robust capitalist economy in the mid-20th century. With a much expanded and politically empowered middle class, the United States has made creative destruction a difficult proposition now. This can be seen in the way the US government has bailed out the banks and other inefficient parts of the economy such as the automobile sector. Much of EU is already in this mode.

Indeed, Karl Marx had spoken about advanced capitalist societies developing socialist tendencies as the laws and regulations to protect workers become deeply institutionalised.

To understand this, you just have to compare the number of hours factory workers in the US and EU put in with that of workers in China, India or Brazil. So, what have these deeper tendencies got to do with the global financial crises and the consequent recession that gripped the world? The fundamental shift in the capitalist growth impulses from the developed North to the developing South has caused serious imbalances in the global economic system.

RBI governor D Subbarao recently said that not much has been done by nations to debate the fundamental imbalances in the global economic system which could in fact have been the primary cause of the Wall Street financial crises. This imbalance essentially made the United States merrily borrow from the rest of the world to consume. Of course, in the past year or so some of this imbalance is partly correcting with the US current account deficit dropping and its savings rate going up.

But is this enough? The US needs to recover its real growth impulse by becoming a prime exporter of high technology goods – it is no more competitive in the manufacturing sector – if it wants to reduce its borrowing from the rest of the world. If the US fails to do this, it will again be tempted to use financial capital as a steroid to create an illusion of growth. Wall Street helps in doing this. But, you don't sustain long-term growth with pure finance capital play.

Finance capital works only when complemented by dynamic elements of the real economy. This was the big lesson of last year's crises. Another crisis will surely occur if this lesson is not internalised.

4.7 INCLUSIVE CEOs

Innovative responses to problems

Decoding India's economic outlook

Our 'goldilocks globalisation' (not too much, not too little) is likely to see us emerge as the second-fastest growing economy after China. But will be able to put Lehman behind us and return to the 'nice' (non-inflationary continuous expansion) period of 9% GDP growth and 3% inflation a year from now?

No! The global economy and its financial under-pinning have changed in fundamental ways. As far as India is concerned these changes can be categorised under six broad heads.

First, and foremost, the crisis has brought us down to earth. The irrational exuberance that saw the sensex zoom past the 21,000 mark (intra-day) has been replaced by a welcome sobriety. From the highs of 9% GDP growth we are now down to 6% or thereabouts. And though there is no doubt growth will improve in tandem with global recovery, there is now much greater realisation that if high growth is to be sustained, we need to do more. Trickle-down will not work. We will have to pay more attention to long-neglected areas like infrastructure, physical and social, agriculture, governance and so on.

Second, it has brought home the importance of fiscal discipline. Good times are meant for governments to build nest eggs so that they have the fiscal space needed to embark on counter-cyclic policies in bad times. In a crunch when private spending dries up, government have to step into the breach. This means governments like Chile (which saved the equivalent of 12% of GDP during the boom) are on a much stronger wicket than India where the government used higher tax revenues in good years to boost (wasteful) spending. Hopefully, we've learned our lesson; even if it is the hard way.

Third, while the dominance of fiscal policy over monetary policy will continue (and is, perhaps, inevitable in an elected democracy that has so many poor people), the moral authority of the RBI has been strengthened. There is a subtle shift in the tide of opinion. After all, even its worst enemies will find it hard to fault a central bank under whose watch not a single bank has collapsed (contrast this with the US where close to 100 banks have gone under). So unlike in the past, when the finance ministry was seen as reform-oriented and the RBI as the spoiler, there is empathy for the latter's concern.

Fourth, asset-price inflation and macro-prudential supervision (jargon for monitoring the health of the financial system) of central banks, have acquired a new respectability. For now, multi-tasking central banks have become the favoured model. Needless to say, this could be a mixed blessing. There is a fear, that if the RBI remains in its present self-congratulatory mode, we could regress in many areas where we need to move forward. The governor may aware of this and talks of the dangers of excessive caution coming in the way of innovation. But the RBI's bureaucracy is yet to internalise this.

Fifth, while exports will continue to be encouraged, some of the luster attached to the export-driven growth model of the Asian tigers and China has faded. As global markets capsised and export demand in western markets shrank, China's excessive dependence on exports became a liability rather than an asset while our large domestic market turned out to be our trump card.

The last, and no less important, change as far as India is concerned is in the international arena. To the extent the crisis has focused minds everywhere on global imbalances and related reform of multi-lateral institutions. The G20 with India a key member of the grouping has at last found its place in the sun.

Of course, nothing will change overnight.

But thanks to Lehman, long-pending issues that had been discussed only desultorily in the past have acquired a new prominence and urgency. So, as and when a new financial architecture does take shape, we will have a say in it. Like in the WTO, where we punch much above our weight, we will be heard with new respect – the respect due to an economy that sailed through stormy seas even as many supposedly stronger economies were brought down to their knees.

4.8 CREDIT COUNSELORS

Resolve convertibility and recompensation issue

Decoding recovery: China and India

There is a curious symmetry in the strategies that China and India are following to fight the global recession. On second thoughts, asymmetry might be a better word, for which China is fighting by ramping up investment; India is doing so by ramping up consumption.

The symmetry lies in the fact that both are doing the wrong thing. It is China that needs to push up domestic consumption to fight the recession and India that needs to invest heavily in its sub-Saharan infrastructure. Both countries know it: both are even making token efforts to do so. But neither has any heart in it. Therein lies the other element of symmetry.

China's response to the global economic crisis was to announce, in early November, that it would spend an additional 4 trillion Yuan (\$586 billion) by December 2010. The announcement was greeted with both relief and scepticism: relief because it offered a ray of hope of a revival of global demand, scepticism because many doubted the China's capacity for fudging its figures. But China has utterly, and crushingly, confounded the sceptics. In the January to March quarter of 2009, the first full quarter after the announcement of the stimulus package, total spending under the package rose by 3.6 trillion Yuan!

How, one may well ask. The answer is much the same as it would be for the India: the most unambiguous yardstick of a jump in spending is the aggregate rise in bank credit. In China this rose by 4.6 trillion Yuan more in January to March 2009 than it had rising the same quarter of 2008! This was three times as much as the 'normal' increase in outstanding loans in the same quarter of 2008. But this year prices falling and production slowing down sharply the normal increase in credit should have been much smaller. In sum, China has come close to meeting a stimulus target set for 27 months, in three months!

How has China achieved this miracle? The answer reveals both the short-term strengths and long-term weaknesses of its peculiar economic structure. China has been able to do this because the central government has only limited control over investment in the economy.

Much, if not the major part, of the investment is done by four tiers of local government: the *provincial governments, prefectures, counties and urban municipalities/townships*. What has made this possible is the central government's directive to the banking system to provide funds liberally for the projects submitted to them by the local governments.

According to the blueprint that the National Reform and Development Commission (NRDC) had prepared, two thirds of the investment had to be made by the local governments. To maintain a degree of co-ordination they were asked to submit their projects to the NRDC, and to do it as soon as possible. The provinces treated Beijing's sense of urgency and their renewed freedom to borrow almost at will (that had been taken away, in theory at least, by banking reforms in 1997) to indulge in an orgy of wish fulfillment.

By the end of December, 18 provinces (out of 31) had already submitted projects worth 25 trillion yuan. The NRDC has winnowed the wish list. As a result, the actual investment till March has been three times the 1.2 trillion yuan budgeted for till the end of 2009! There is only one small hitch. Only 9% of this money is going to support the incomes of those who have been hit by the recession. In all, barely a fifth of the investment will reach the rural areas, where two-thirds of the people still reside.

India, by contrast, has poured money, also borrowed ruthlessly from the banking system, into consumption. Against a budgeted borrowing of Rs 132,000 crore in 2008-09, this year it has budgeted for Rs 401,000 crore and is likely to end up borrowing Rs 500,000 crore. Thus the net fiscal stimulus, i.e., the amount that the government would not have borrowed had there not been the excuse of the global recession will amount to about Rs 550,000 crore or Rs 115 billion.

Given that India's GDP is only 40% of China's, the jolt being sought to be given to the economy is comparable. But of this, the share of investment is even smaller than the share of consumption in China: It is paltry Rs 25,000 crore or 5 billion dollars. This is not even 5% of the total. Nor is private investment filling the gap. On the contrary, the growth of aggregate bank credit has been a paltry 15% in the past year, a full 10% below what it was in 2007-08. Since most of this goes into meeting working capital needs, it is a safe bet that private investment has actually contracted in recent months.

Both countries are on the wrong track. China desperately needs to increase income levels and social security payments in the rural areas and among its migrant labour force, to stem a further rise in political discontent. India needs to at least quadruple its annual investment in infrastructure if it is ever to emerge as a first rate economic power. If neither can do it, the reason lie not in the understanding or aims of their leaders, but in the way that politics has locked their economies on potentially dangerous economic paths.

4.9 ONE-STOP-SHOPS

Dedicated to offer related services under a roof

Coordinated exit

This G-20 (the group of countries representing 85% of the world economy) takes credit for helping tackle the global financial crisis. At its April 2009 meeting, it called for coordinated fiscal and monetary stimuli by all countries to stop the Great Recession from becoming a Great Depression. Today, the global economy shows encouraging signs of recovering. So, the G-20 is getting ready to call at its next meeting at Pittsburg on September 24-25 for, among other things, a globally coordinated exit from the earlier stimuli. Enormous fiscal deficits and loose monetary policy cannot continue forever – already these are threatening inflation and new asset bubbles. And so the G-20 is reportedly preparing to call for countries to coordinate their exit, just as they coordinated their earlier entry into stimulus.

The main problem with this approach is mendacity. It is simply not true that all countries of the world solemnly agreed on a coordinated stimulus. The Great Recession began in December 2007, triggered by the US subprime mortgage crisis, and there was no question of coordination – Europeans patronisingly saw it as a peculiarity of the unregulated US markets. Third World countries had little exposure to toxic US assets, and they too sniggered at US discomfiture.

President Bush proposed a major stimulus package in late 2007, and one was passed into law in February 2008. No European or Third World country followed suit. The US housing situation continued deteriorating, further eroding prices of mortgage backed securities and credit default swaps guaranteeing such securities. This culminated in Black September in 2008, when Fannie Mae, Freddie Mac, AIG and the four top US investment banks were laid low. Panic seized global finance at the realisation that not even the most exalted triple-A corporates could be trusted to honour their commitments. Lending of all sorts froze, risk premiums on all securities went through the roof, and securities galore turned illiquid as trading ground to a panicky halt. The rest of the world could no longer smile patronisingly at US troubles: the problem had become global, horrifyingly so.

Every country then reacted on its own, without coordination. Economists everywhere knew Keynesian economics, and launched stimulus packages tailored to their own conditions. India, for instance, came out with its first stimulus package in Dec 2008, a second package in January 2009, and a third in the form of the budget. These packages were devised by India on its own, not in coordination with anybody else.

Then in April 2009 the G-20 met in London, and issued a call for a globally coordinated stimulus. This was really a bit rich. Every country had already come out with a national stimulus package, but here was an international summit implying this was a challenge for the future. In fact, by the April meeting of the G-20 the Great Recession was already bottoming out. Global markets had touched rock bottom in March 2009, when Citibank looked for a moment like collapsing. After the US made it clear that neither Citibank nor any other giant company would be allowed to go into liquidation, the global market mood changed. Markets decided that the worst was over, and it was time to shift tens of billions from safe havens to all kinds of securities that had become basement bargains in the earlier scare.

India had suffered a withdrawal of \$12 billion by FIIs from its stockmarkets in 2008, but the tide turned in April 2009 as no less than \$1.3 billion flowed in. This was followed by another \$4.4 billion in May. Huge sums raced globally into all securities earlier shunned as risky, including junk bonds.

So, the G-20 call for coordinated global action in April actually came after individual countries had already launched uncoordinated action that had largely solved the problem already. Possibly the G-20 summit itself helped: the announcement of \$850 billion for the IMF may have helped assure markets that rescue loans would be available for distressed countries in Eastern Europe. The IMF funding could be hailed as coordinated action, but not the earlier national stimulus packages.

With economies recovering, the G-20 will now consider exit from fiscal and monetary stimuli. But is there any reason why this should be coordinated? After all, conditions in different countries vary markedly.

The latest data suggest fears of deflation in the US, Japan and China where consumer prices are falling at the rate of 2.1%, 2.2% and 1.8% respectively. But India is suffering from high consumer inflation of 11.6%, Russia of 11.6%, Egypt of 9% and Brazil of 4.5%. Surely this second group of countries needs to worry about curbing inflation while the first group has the opposite worry. Again, unemployment in some countries is quite low (3% in Norway, 3.3% in Singapore, 3.8% in Korea and 4.4% in Austria) but is very high in others (23% in South Africa, 18.5% in Spain, 9.7% in the US and 12.3% in Belgium).

GDP growth in the second quarter of 2009 was relatively high in some countries (China 8.1%, India 6.1%, Korea 9.7%, Singapore 20.7% and Thailand 9.6%) whereas it was still negative elsewhere (-1.0 in the US, -2.6% in the UK, -4.2% in Spain).

When growth, unemployment and inflation are so markedly different in different countries, why should they plan a coordinated exit/? Surely exit is far more urgent for some countries with relatively high inflation and relatively high growth. Central banks in the US, UK and Japan will be very cautious about exit, and rightly so. Their recovery is still weak and uncertain, and consumer prices are falling. But India surely needs to be among those worry about inflation, not deflation.

India needs to start tightening monetary policy long before US or Japan does. It should give advance notice of a phased rollback of the huge excise duty cuts announced at the depth of the crisis, starting maybe in January 2010. It shouldn't even think of coordinating such action with other G-20 members.

4.10 CONTINUING LEARNING CENTRES

Take informed decisions

G20 for acting tough with fin community

The G-20 leader's statement from Pittsburgh has a tough message for the finance community. They have to raise far more capital, say bye-bye to bonuses that soar even if medium term profits of the institutions they worked for do not, and face tough regulation, starting with full compliance with the enhanced Basel II Capital Framework by 2011, including a limit on borrowing. The leaders' statement is unequivocal and tough, "where reckless behaviour and a lack of responsibility led to crisis, we will not allow a return to banking as normal." With this bare-knuckled preface, the communiqué goes on to:

- ◆ Identify charges needed in regulation;
- ◆ Coordination among regulators across nations;
- ◆ Increasing capital adequacy and raising the capital requirement of banks that fail to implement sound compensation policies and practices improving over the counter (OTC) derivatives markets;
- ◆ Reforming compensation to remove incentives for risky short-term behaviour, bringing compensation under the purview of regulators, and fixing a ceiling on remunerations as a proportion of net revenues;
- ◆ Tightening accounting norms and harmonising them globally.

There are timelines for achieving each one of these changes. The G20 also wants commodity exchanges to become more transparent, collect data on large trader positions on oil futures and derivatives markets and to comply with the recommendations of the International Organisation of Securities Commissions

The biggest takeaway is that G-20 will effectively replace the G-8 as the new body of self-appointed policemen. It will be "premier forum for our international economic co-operation."

But, if we look more closely at the 23-page statement released at the end of the two-day meet or the track record of the G-8 in a similar role, there's not much reason to pop the champagne. The statement does not say how the G-20 is to go about its new role. Many of the trickier areas have been left to the Financial Stability Board. A yet to be reformed IMF has been given pride of place in evaluating how "respective national or regional policy frameworks fit together." Given that these are often likely to be in conflict with one another, it is not clear how much clout the IMF will carry either when it comes to disciplining more powerful nations, or how much credibility it will carry with developing ones.

There is no fresh thinking on the largely discredited Basel norms of capital adequacy nor is there any mention of how banks will be prevented from gaming it. For now the agenda reflects the concerns of the developed rather than the developing world. The two main issues – how much capital banks need to hold and bankers' bonuses – are not major issues in the non-G8 part of the grouping, most of whose banks are in a relatively better shape. But to the extent events in the developed world have a disproportionate impact on the rest of the world, it is but inevitable that it should set the agenda.

The promise of a 5% shift in voting rights in the IMF from "over-represented to under-represented countries" without spelling out the details (which are these over-represented countries that are to make the necessary sacrifices and by how much?) is vague and inadequate. Likewise the promise of 3% increase in voting power of developing countries in the World Bank. We must demand, and get, more.

4.11 GLOBAL OUTLOOK

Global pathways

Tame the economy, if not the banks

The G-20 meeting in Pittsburg made all the right noises on reform of the banking sector. So, are we about to see a brave new world of banking?

Any celebration would be premature. There are at least three reasons why progress on the ground may not match the rhetoric of the G-20 meet. The first is a sense of complacency as the global crisis shows signs of bottoming out. The second is the difficulty in reaching a common understanding among regulators on precisely what new rules should be put in place. The third is that banks that are too big to fail are likely to be with us even after the crisis blows over.

It is hard to miss the signs of complacency as the world economy shows signs of recovery. Several banks have seen their stock prices recover smartly and are poised to post obscene profits this year.

Why ‘obscene’? Because profits in the present environment have flowed from a combination of unusually favourable factors. Monetary policy aimed at stimulating economies has lowered bank’s cost of funds. Banks have benefitted from infusions of capital from government. Government guarantees have allowed banks to raise funds at lower cost than otherwise. Large banks that have survived and gobbled up those failed are reaping the advantage of market dominance.

Banks in the US are taking every opportunity to repay public funds so that they are freed from restrictions, especially restrictions on compensation. Goldman Sachs is set to declare its highest bonuses ever – the betting is that average bonus could touch a million dollars this year. There are also reports that Goldman is planning to surrender its banking licence.

Governments need unusual resolve to overcome any sense of business as usual and push ahead with measures to prevent the next big crisis. The one solid assurance we have is that capital requirements for banks will go up. But how much more capital banks will have to hold is yet to be spelt out. Most regulators will wary of taking unilateral steps for fear of putting their domestic banks at a disadvantage. So we need regulators to reach agreement quickly on what is an appropriate level of capital. Higher capital is an indirect way to rein in excessive risk-taking. The direct way is regulating managerial pay. The G-20 mentions a number of measures. But it may not be enough to get the design of compensation right. Some caps on compensation may be inevitable. The G-20 communiqué waffles on this point.

Lastly, there is the issue of ‘systemically important’ institutions that are too big to fail. Higher capital cannot address this to fail. Plans for orderly resolution of these institutions in the event of failure may be of little avail in times of crisis. This problem needs to be tackled head-on either by limiting the scope of banks, or it may require limits on the size of banks. But such measures are considered too radical even in today’s context. We need an even bigger crisis before such solutions find acceptance.

Whether it is capital requirements or executive pay or the problem of large banks, solutions will be slow in coming and will be in the nature of compromises worked out by politicians, regulators and powerful banking lobbies. Moreover, by its very nature, financial innovation is likely to find its way around many regulations – witness the huge ‘shadow banking system’ where the present crisis originated.

4.12 ISSUES OF THE PRESENT

Freedom to get & fail in the system of free enterprise

G20 Leaders' Statement

Through the looking glass: When, we use a word, Humpty Dumpty said in a rather scornful tone, It means just what we choose it to mean – neither more nor less.

The question is, said Alice, “whether you can make words mean so many different things.”

The question is, said Humpty Dumpty, “which is to be master – that’s all.

If reading the Leaders’ Statement released at the end of the two-day meeting of the leaders of the G20 group of nations in Pittsburgh reminded us of this wonderful conversation between Alice and Humpty Dumpty in Lewis Carrol’s *Through the Looking Glass*, the reasons will become clear by and by.

‘We will fight protectionism’ says the Statement in a ringing endorsement of free trade. Good show! Yet less than a month ago the US slapped a 35% duty on imports of Chinese types. It’s not the only one. China has its ‘Buy Chinese’ clause on the lines of the ‘Buy American’ clause while India holds the record for initiating the highest number of anti-dumping probes.

There’s more in the same vein. ‘Excessive compensation in the financial sector has both reflected and encouraged excessive risk taking,’ says the Statement, calling for reforming compensation, policies to align compensation with ‘long-term value creation, not excessive risk-taking.’ Does it mean extravagant payouts seen in the boom years and even after the crisis have becoming history? Unfortunately, no! What is excessive? \$10 million? \$ 20 million? What is long term value creation? What is a sound capital base? Eight per cent? Ten per cent? The statement leaves these tricky questions to the Financial Service Board. But the latter’s standards are much too vague and allow as much scope for gaming as before.

That’s not all, the call to develop ‘cooperative and coordinated exit strategies recognise that that the scale, timing and sequencing of this process will vary across countries or regions and across the type of policy measures. ‘If the scale, timing and sequencing of exits is going to vary across countries, can the G20 compel the give-and-take inherent in ‘co-ordinated exit strategies? Unlikely! The fact is, for all the tom-tomming about the success of coordinated responses to the crisis, there was no prior co-ordination. Each country responded as it saw fit from its own prospective.

So make no mistake about it. As long as nation states exist, each nation will be driven by national interests. Co-ordination might be possible in the good times (when there is usually less need for it or the downside of un-coordinated policies is not obvious, as during the pre-crisis years). But in bad times, when push come to shove, each nation looks to its own.

So does that mean Pittsburgh is an empty victory for the G20? No! The Statement marks a significant break with the past in that for the first time the presence of the emerging economies at the high table has been formalised. This is no mean achievement even if the new grouping like the G8 it seeks to replace is no more than a talk shop. But to the extent the G20 is to be the ‘premier forum for international economic cooperation’, developing countries will now have a forum where they can voice their concerns. Whether their voices will carry any weight remains to be seen. But if they are determined they can make a difference, however small, to the course that is finally charted.

Most studies to date on the on-going crisis have focused on the factors responsible for the crisis. Few have looked at the consequences. A recent Bank of International Settlements (BIS) paper does just that. Paper writers look at length, depth and output costs relating to 40 systemic banking crises in 35 countries since 1980 to assess the likely real impact of the on-going crisis. Not surprisingly they find past crises are of little use in analysing current events since the events engulfing the world are truly quite unique.

This despite the fact that financial crises are more frequent than most people think and lead to much larger losses than one would hope. On average, there have been between three and four systemic crises per year for the past quarter century. The problems in banking crises are also quite diverse. Hence, a study of past banking crises, they find, is of limited utility when it comes to drawing broad-brush conclusions.

Having said that, they argue the **length** of the contraction following systemic banking crises is strongly related to a number of variables:

- ◆ Growth of GDP in the year before the crisis (*higher* growth implies shorter contraction);
- ◆ Presence of a currency crisis (*longer* by 5 quarters, on average);
- ◆ Presence of a sovereign debt crisis (*shorter* by nearly six quarters, on average);
- ◆ Fiscal position at the beginning of the crisis (a 1 percentage point *higher* deficit-to-GDP lengthens the downturn by about one month); and
- ◆ Whether an asset management company has been set up

Turning to the **depth** of contraction, they believe this seems strongly related to whether it was accompanied by a currency crisis or a sovereign debt crisis and to the GDP growth in the year preceding the crisis (lower growth implying a deeper contraction). When a banking crisis is accompanied by a currency crisis, it lasts longer and the trough in output is also lower. Regulatory forbearance also seems associated with higher cumulative losses.

By altering attitudes towards risk, as well as increasing the level of government debt and the size of central bank's balance sheets, systemic crises have the potential to raise real and nominal interest rates and consequently depress investment and lower the productive capacity of the economy in the long run.

A number of crises had lasting, negative impacts on GDP. In some countries this was a result of an immediate, crisis-induced drop in the level of real output combined with a permanent decline in trend growth. In others the growth trend increased following the crisis but the immediate drop was so severe that it took years for the economy to make up for the crisis related output loss.

Rather surprisingly, the length, depth and cumulative output losses of the contractions associated with financial crises appear to be unaffected by whether a country is rich or poor or whether it has a small or large financial sector. But a country that also faces a currency crisis has, on average, a longer and deeper contraction. Countries exhibiting traditional vulnerabilities such as a high fiscal deficit have a tendency to have longer – but not necessarily deeper – contractions following financial crises. Further, high growth immediately prior to the onset of a crisis is associated with shorter and shallow contraction.

Clearly the consequences will vary from country to country and are far from crystal clear at the moment. But the silver lining is the paper's prognosis that the main crisis-affected economies will return to their pre-crisis level of GDP by the second half of 2010.

1. Tax department brings gifts in kind under net

The tax department has willy-nilly become a party-pooper bang in the middle of India's month-long festive season, characterised by indulgences in food, festivity and gifting. The apex body of direct taxes in the country, the Central Board of Direct Taxes (CBDT), has given effects to finance minister Pranab Mukherjee's Budget declaration to tax all gifts in kind from October 1, 2009.

Budget 2009-10, presented in July, brought all gifts in kind under the tax net. Cash gifts above Rs 25,000 have been taxed in the country since April 1, 2004. Through an amendment in the IT Act, the floor was raised to Rs 50,000 effective April 1, 2006.

Any gift in kind such as real estate, cars, diamond jewellery or any other item worth over Rs 50,000 will attract income tax. Any person who receives a gift of any such property on or after October 1, 2009 must pay the income tax due on the value of the gift and disclose the taxable value on such property in the return of income for assessment year 2010-11 and subsequent years. However, gifts from a relative, on occasion of marriage, under will or by way of inheritance, in contemplation of death of donor, from any local authority, or from any fund or trust would be exempt from tax. Spouse, siblings, spouse/parents' siblings and any linear ascendant or descendant are defined as relatives under the Income Tax Act.

2. All property deals to be scanned by fin watchdog

Financial Intelligence Unit (FIU), India's anti-money laundering agency wants to scan real estate deals. It has asked states to submit **monthly data** on registration of properties. FIU is a central agency responsible for receiving, processing and analysing information relating to suspect financial transactions.

Often the real estate deals in the country involve unaccounted cash transactions leading to money laundering. Money laundering involves disguising financial assets in a way that they can be used without detection of the illegal activity that produced them. Through money laundering the launderer transforms the monetary proceeds driven from illegal activities into funds with an apparently legal source. At present, all property registrars have to send data to income tax authorities on property transactions above Rs 30 lakh as part of the Annual Information Return. Now, the FIU demands monthly data for **all property** transactions. If timely data are available, any intelligence generated by it could be acted upon promptly.

The complete data is required for the agency also for co-ordinating efforts of international intelligence in checking money laundering and related crimes. Since India is on the verge of becoming a member of the elite international body 'the Financial Action Task Force', which has been founded by the G-7 group to develop policies to combat money laundering and terrorist financing. It is obliged to keep a tab on any such transactions that could be used as a means to launder money. The body recommends placing real estate agents and brokers, besides a host of other entities, under reporting obligations. However, India, which recently amended its anti-money laundering law – Prevention of Money Laundering Act – skipped them even as it brought overseas payment gateways such as Visa and Master, money changers and money transfer service providers and casinos under reporting obligation. Banks, stock brokers, foreign financial investors are among the entities that already submit data to FIU on a regular basis.

At a broad political and philosophical level, the draft direct taxes code has many interesting dimensions. Just imagine the political capital the UPA government will reap among India's growing middle classes once the direct taxes code replaces the present Income Tax Act in 2011. Of India's individual taxpayers, 97% will be charged income tax at only 10%. The new code levies only 10% income tax for a taxable income of up to Rs 10 lakh. Only, the remaining 3% of taxpayers fall in the higher taxable income slabs of beyond Rs 10 lakh. The rates for these are prescribed at 20% for up to Rs 25 lakh income and 30% beyond it. We have been told these slabs may even be indexed to inflation so that not many changes to income tax rate be made for a long time.

In a sense, one may only see expenditure budgets in the future as there will be no tax rate or exemptions to tinker with! The proposed direct tax code seeks to lower the rates while doing away with exemptions at both the individual and corporate levels. At a broad philosophical level, the new income tax code is also an invitation to the rapidly rising class of individual traders, shopkeepers and small businessmen to come clean and declare their income at effective tax rates of 10% to 15%. This is what is expected to widen the tax net hugely and increase compliance. The incentive to small businessmen to come into the income-tax net will be further strengthened by a transparent goods and service tax (GST) regime which will seek to capture all businesses along the value chain with a clean one-time indirect tax to be shared by the state and the Centre. In a sense, the direct taxes code to work in tandem with a GST regime will ensure a large number of small businesses come into the income tax net.

So the GST should actually result in a major widening of the income-tax net. For instance, a small contractor in the construction space, with an annual taxable income of Rs 15 lakh, may be avoiding paying income tax because he buys most of his materials without official billing to avoid cascading local taxes. But with a simple and transparent one-time levy of GST the contractor may bring his activity into the official channel and also pay the new effective tax of around 12.5% of his income. This is precisely what the direct taxes code and the GST are betting on.

At a political and philosophical level, both these frameworks actually attempt to correct the historical tax bias in favour of the capital-intensive big businesses. In the last few decades of the exemptions raj, most big businesses hardly paid any tax as they kept availing of accelerated depreciation and other tax holidays provided to drive investments. This can be established by just looking the number of companies that pay just the minimum alternate tax (MAT). On the other hand, largely labour-intensive small manufacturers, who obviously did not enjoy these exemptions, paid much higher income tax.

The new direct taxes code seeks to correct this imbalance with two clear strategies: One, it intends to phase out all tax holiday regimes, mostly used by capital-intensive big industries, by grandfathering them till they phase out. Second, these businesses will have to pay a MAT of 2% of the gross assets as shown in their balance sheets, if they do not have taxable profits. There is maximum protest over this provision coming from reputed law firms who mostly represent the interests of big business. They are describing this as a sort of wealth tax being introduced through the backdoor.

The authors of the new code argue that this is a sort of efficiency tax which ensures that businesses flog their assets optimally. For instance, in the real estate space, companies are known to accumulate land banks and wait for these to appreciate before building on them. A 2% tax on vacant land will force the real estate company to build faster. So goes the logic for levying the 2% tax on gross assets in lieu of MAT. Overall, the new tax code and GST recognise that India's business landscape today is very different from what it was twenty years ago. Small businesses will increasingly become the backbone of the growth process and tax policy must remove the bias against them.

1. Wealth Tax

Wealth Tax Act, introduced in 1957, was a complicated piece of legislation focusing on entire wealth of an assessee with many exemptions and was supported by rules of valuation. It was based on the counsel of Mr Nicholas Kaldor, a Cambridge economist. It was a part of a series of recommendations, including the one to tax capital gains, and a reference was made to tax wealth in excess of 15 lakh at the rate of 1.5%. It could easily be argued that the circumstances then demanded the levy of such a tax, since it was like a “self-checking” mechanism and was meant to compensate for the taxes that may not have been paid by several people who had amassed large fortunes.

Later in 1993, the approach was modified by recognising only unproductive wealth as subject matter of levy. The category of assets encompassed were residential houses not let out at least for 10 months in a year; urban land; jewellery; motor cars; yachts, boats and aircraft and cash in excess of specified limit. Even among these assets, exemptions were provided for assets held as stock in trade or held in business etc. The objective has been not to earn any revenue but to discourage holding unproductive assets for a long duration. In fact, the amount of tax gathered by way of wealth tax was a paltry sum.

Under the direct tax code Bill, chapter-VIII deals with charge of wealth-tax and the approach is reversed to pre 1993 position. The discussion paper goes on to narrate four reasons for the proposed levy.

Firstly, the charge is justified as being imposed on those who hold substantial economic resources and thereby having capacity to pay more. Secondly, it is a progressive levy on a year to year basis that supplements income-tax levy. Thirdly, it helps to monitor the accretion of wealth so that tax avoidance or evasion can be captured. Finally, wealth tax constitutes an independent base for levy besides the income base. All the reasons sound logical and acceptable. Since the entire wealth as reduced by relatable debt as on the last day of the financial year shall be liable to wealth tax, it is expected to bring about social equity in collecting more tax from those who are richer than others.

The existing law imposes wealth-tax on individual, HUF and companies whereas the proposed code focuses levy on net wealth only in the case of individuals, HUF and private discretionary trusts. While the existing wealth tax law provides a threshold limit of Rs 15 lakh (enhanced to Rs 30 lakh by the Finance Act, 2009) and imposes tax at 1% rate, the code exempts net wealth up to Rs 50 crore and prescribes a rate of 0.25% on the value of net wealth in excess thereof. No such basic exemption is provided to private discretionary trusts so as to discourage formation of more number of trusts to hold assets.

As on the last date of each financial year, the value of all assets including financial assets and deemed assets, as reduced by exempt assets and debt owed in respect of taxable assets shall be computed for calculating this levy. The valuation of financial assets shall be at cost or market price, whichever is lower.

The reason for exclusion of companies from levy of wealth-tax is because the code provides for MAT on companies calculated with reference to the “value of the gross assets”. The rate of MAT will be 0.25% of the value of gross assets in the case of banking companies and 2% in the case of all other companies. No tax credit will be allowed in respect of MAT in the subsequent years. While individuals, HUFs and private discretionary trusts would suffer wealth tax levy each year, in the case of companies the MAT applicability would depend on whether it exceeds the tax liability on the total income of the company.

2. Capital gains taxation

The government's proposed direct taxes code has been widely welcomed. Experts are analysing most proposed changes threadbare. We hereby elaborate one area where the proposed code goes seriously wrong – capital gains tax. Indeed, the underlying issues are fundamentally misunderstood globally.

Any financial expert will tell you that it is prudent to diversify your savings, putting them in different asset classes (shares, bonds, real state). It is also prudent to diversify within each asset class like shares – you should distribute your holdings of shares between different sectors such as finance, auto, healthcare, and IT. The sums you allocate to different assets should change with time – if textile constitutes a sunset sector and IT a sunrise sector, you should reshuffle your portfolio accordingly. A fund manager who never reshuffles his portfolio will be sacked on the ground of incompetence. He will be guilty of having harmed the savings of the clients whose interest he is supposed to serve.

Yet the proposed capital gains tax will exempt people who never sell any assets, and penalise those who do. Assets rise in value whether they are sold or not. Reshuffling a portfolio of assets means selling some assets and buying others. The proposed tax will be levied only on gains from sales, not on gains in the value of unsold assets. So although reshuffling is economically efficient and financially prudent, the proposed code will tax this good practice and exempt the bad alternative. It makes better sense to levy capital gains tax only on assets that are liquidated – converted to money. Portfolio reshuffling should be encouraged, and so the new tax code should exempt reshuffling.

Three considerations should govern any tax proposal: *equity, efficiency and simplicity*. However, the proposed change in capital gains tax fails on all three counts.

Equity: International studies show that revenue from capital gains tax is typically less than 1% of total revenue. It is nevertheless widely used to check the conversion of income into capital gains to avoid tax (zero coupon bonds are one example). It also improves vertical equity to the extent it gathers revenues from rich folk. Despite some improvement in tax administration in the last decade, taxes are widely evaded and many transactions (and associated capital gains) are not officially reported. So, *taxing capital gains, which looks theoretically good in terms of vertical equity, can in practice be bad for equity – it taxes honest folk while leaving out very rich evaders.*

Efficiency: Besides, with the opening up of foreign portfolio investment in India through Mauritius and other tax havens, foreigners (as well as crooked Indians laundering their black money) are investing in stock markets via tax havens, escaping capital gains tax. Horizontal equity is offended when foreign investors get preferred tax treatment over Indians, and when Indian black money laundered through tax havens gets preferential treatment over white money. So, *how does the proposed capital gains tax score on efficiency?* It will be inefficient to the extent it strengthens laundering through the Mauritius loophole. And it will reward inefficiency and imprudence in portfolio management.

Simplicity: What about simplicity of administration? Because of widespread tax evasion, former minister Chidambaram abolished long-term capital gains tax on shares transacted on stock exchanges, and instead levied a securities transaction tax. The STT has a huge advantage over capital gains tax in simplicity of administration. STT is collected automatically from all stock markets, and is a rare tax that is not evaded at all. So STT is most effective and simple to administer. Stock market turnover has risen sharply after the imposition of STT, suggesting that its adverse effect on transaction volume have been limited. .

3. Individual savings

The draft DTC signals an end to aggressive tax planning for individual, particularly for the salaried class. To begin with, employees may have to shift to a system where consolidated amount is offered as compensation package or salary with very few perks, from the existing structure where salaries normally comprise basic, house rent allowance, conveyance, medical allowance, and leave travel assistance.

Secondly, the nature of savings of individuals for lowering tax liability too have to undergo a drastic change, as tax incentives under the proposed EET regime may be restricted to retirement benefit plans such as provident funds, life insurance and pension plans rather than encouraging investment-led savings.

The draft DTC has proposed comprehensive taxation of incomes at moderate rates and that objective has proposed to bring all perquisite that form part of salary packages into taxable net. As a consequence, companies may generally not find it worthwhile to push large part of the compensation package into components such as LTC and house rent allowance. Other than HRA/free accommodation and LTC, perquisites such as car and telephone are also proposed to be taxed.

Clearly, the tax department wants to push for greater transparency in compensation structures of companies. The general feeling in the tax department has been that there is no clarity on compensation package paid by companies, rather there is flagrant abuse of perks. It may be recalled that the introduction of fringe benefit tax (FBT) in 2005-06 was also an exercise to comprehensively tax benefits extended by companies to their employees but usually escape the tax net.

Yet it does not mean that there will be no scope at all for some amount of planning. Much of that will depend on the rules for valuation of perquisites. The DTC proposes to treat government employees as well as private sector employees equally. Therefore, it is very unlikely that the rules would be very harsh. Tax experts feel that the government would have politically backlash on the valuations of perks. That is because a significant portion of the compensation of the government employees is in the form of perks and if these perks are monetised and taxed at full value, the tax burden will rise sharply.

Further, the proposal in the draft code on tax deductions for savings would drive a rethink on long-term investment. The code requires individuals to save with four specified saving intermediaries to defer tax liability during working life. The four permitted intermediaries are approved provident funds, approved superannuation funds, life insurer and new pension system trust. But, it is felt that the tax code may be a little too harsh on the senior citizens when the EET regime comes in, particularly if the existing threshold limit of Rs 2.4 lakh is maintained.

The general consensus among the tax experts is that this is meant to encourage people to focus on saving during their working life to secure their retirement. Thus, receipts on account of gratuity, superannuation funds and voluntary retirement become eligible for deduction only if they are deposited in retirement benefits account maintained by permitted savings intermediaries. And several savings instruments that are currently available such as National Saving Certificates, National Saving Schemes, Ulips, Equity Linked Saving Schemes, and Five-Year Term Deposits of Banks would come ineligible. However, the code gives the Centre enough discretion to bring other saving instruments eligible for deduction. The present Section 80C had too many schemes and limited amount of deduction. As the result, Rs 1 lakh was spread thinly. Now even with the increased limit of Rs 3 lakh, there are enough avenues to save.

In a bid to improve disclosures and accounting norms, a committee of the Sebi made a few proposals. The discussion paper *on recommended changes in the way companies disclose earnings* sought placing greater responsibilities on internal audit committees and firms to ensure compliance with accounting norms.

The Sebi committee indicated that the chief financial officer of a listed entity need not be a chartered accountant, but proposed that the appointment should be approved by its audit committee. It said the audit committee which comprises two third of an entity's independent directors, will be responsible to ensure the top financial officer's professional credentials.

The Committee, however, recommended the Sebi's proposal to make it mandatory that an external audit firm would carry out the internal auditor's role, would not be prudent.

Further, the Sebi committee proposed making disclosure of audited figures on the balance sheet every six months. Currently, companies disclose their statements of assets and liabilities at the end of every financial year. The step will enable investors gain a better perspective about a company's asset-liability position more frequently. Auditors and lawyers said, "The implementation of these proposals would require companies to make more efforts to stay listed on the stock exchanges". The Sebi's committee has recommended streamlining the submission of financial results by companies and reducing the period for their submission to the stock exchanges. V.Venkataramanan, Director, accounting advisory services, KPMG said, "There is still a need to try and standardise the extent and quality of reporting by various companies. Introducing a more consistent and comparable format for quarterly reporting should be the medium term aim for listed companies in India.

Recast IPO documents

Sebi's guidelines forbid a company coming out with a public issue from making any financial projections about the company. The regulator now has stipulated that all research reports on public issues should be based only on information made available in the offer document. This is to create a level playing field between brokerages, associated with intermediaries selling the issue that may have access to internal financial projections, and other independent brokerages and retail investors.

Small IPOs turn playground for riche rich

Small-sized initial public offerings are susceptible to manipulation, if the institution portion of many of the issues below Rs 150 crore has been subscribed by less than half-a-dozen qualified institutional buyers (QIBs). Market watchers allege that in some cases these QIBs are newly-formed entities with non-existent transaction records and may have been set-up to invest in small-sized issues.

A public issue cannot go through unless the QIB portion of the book is fully subscribed. Most genuine QIBs are uninterested in small-sized issues, partly due to the minuscule quantity of shares on offer. However, there are cases where the entire institutional book is bought out by one (or more) overseas entity, and the criteria (fully-subscribed QIB book) met.

Market watchers say wild swings in stock prices are common if 60% (the institutional portion of the book) of the issue is held by a few investors. Most of the small-sized IPOs see huge price swings, causing small investors to sell out in panic. They also say the poor performance of many IPOs in the last couple of years can be attributed to this factor.

Inflation worries in India have emerged sooner than expected, largely owing to the effect of poor monsoon on food inflation. Rising inflation, or strengthening expectation of higher inflation, is never good news for any central bank, least of all for one, like the RBI, that has injected massive quantum of liquidity into the financial system to successfully stabilise it following the Lehman bust a year ago.

But all inflation demons are not the same, and there is no one cookie-approach of dealing with all of them. This is especially true in an emerging economy such as India where supply constraints and policy-driven non-market based prices only complicate the interpretation of signals from various price indices.

For example, the government must have known that hiking minimum support prices for some food items will push up food inflation. Or initiatives such as the one guaranteeing employment will improve demand for food items at the subsistence level of the population, which in turn will worsen the demand-supply imbalances in case of a shortfall in supply. Surely, the solution for these byproducts of fiscal initiatives is not with the RBI going overboard with imminent tightening.

Tracking India's inflation dynamics has never been easy owing partly to the differences in the signals given by WPI & CPI. But, interestingly, investors and the media only focus on the differences selectively. Recall that few questioned the aggressive policy easing last year, despite CPI inflation being high.

Further, creative analysts and some columnists conveniently decide on their preference for WPI or CPI depending on whether they wanted to emphasise that real interest rates (i.e., interest rates adjusted for inflation) from a policy perspective are high or low. Thus, we heard about the misguided deflation fears as WPI turned negative, despite CPI inflation being high, or about real interest rates being too high. Both views were wrong, to put it politely.

India announces a weekly WPI and four monthly CPIs. While the RBI tracks all inflation indices and also has its own surveys, the WPI has an edge over the CPI as the RBI announces a forecast for it. Consequently, the local bond market investors pay more attention to the WPI than the CPI in order to map the central bank's likely response function as reported inflation deviates from the RBI's guidelines.

Also, change in WPI input prices give some lead time as these changes eventually do affect final goods prices, which in turn affect CPI, though there have been phases when the gap between the two temporarily widens. Until the government improves CPI and WPI indices, the RBI has little choice but to work with the existing indices.

But bear in mind that the RBI is not a formal inflation targeter but instead uses a multiple indicators approach. Consequently, factors other than inflation also influence its monetary policy decisions.

The emerging inflation threat now is significantly different from the one that was being tackled just a couple of years ago when the economy was bursting at its seams with record-high capital inflows coupled with a torrid pace of credit expansion. Then, the increase in aggregate demand outpaced supply in a large supply-constrained economy, and the demand-driven inflationary pressures were worsened by the dramatic surge in commodity prices.

This time around, the poor monsoon season rainfall has worsened the already elevated pace of increase in food prices. This in turn has pushed up YoY CPI inflation, even as WPI inflation is running close to zero on a YoY basis. CPI inflation is much higher (in the low teens) than WPI inflation, owing mainly to a higher weight for food in CPI relative to WPI, and higher weight of fuel-related items in WPI.

Also, the jump in food inflation is concentrated in a handful of items and was high even prior to monsoon effect taking hold. This suggests that there are other sector-specific factors at play that may not have their solution in monetary policy.

WPI inflation is widely expected to pick up following the reversal of the favourable impact of last year's high base, and the anticipated impact of higher food inflation. The upward momentum in commodity prices will also play a role in local inflation dynamics down the line.

But even here there is little to justify an imminent tightening.

Rising food inflation complicates monetary management for the RBI. However, the solution is not premature hiking of policy rates or an early withdrawal of liquidity. The effect of the drought on food inflation will be temporary at worst, and in case tightening policy will not affect food prices, but will surely hurt the ongoing recovery.

The RBI's reported conclusion that the current stance of monetary policy is unsustainable and that India might have to adopt an exit strategy sooner than the other countries is a correct message. To be fair, there is no new guidance or signal here, as these have been the central bank's views for sometime; only the media and some analysts are waking up to these now, and giving it a far more hawkish spin than is warranted. In contrast, RBI governor and the FM continue to sound pro-growth in their media comments.

In the near term, the RBI's talk is likely to be worse than its bite. Economic recovery is broadening and will probably push up GDP growth to around 6.5% and 8.0% for FY10 and FY11, respectively. However, it is still early days, and the RBI should prefer to be more confident about the sustainability of the recovery before tightening. Note that GDP growth will be decelerating until the December quarter.

The first policy rate is likely only early next year, possibly in April rather than January, unless growth, the pace of credit expansion and/or inflation surprises significantly on the upside. Prior to the rate hikes, the RBI will begin to reverse the liquidity injections, but not before the government's borrowing is substantially over and/or loan growth picks up meaningfully. The RBI is unlikely to tighten while it is still intervening to favourably affect bond yields.

What about the pesky issue about the cash reverse ratio (CRR)? The RBI pumped in excess liquidity partly to compensate for weak monetary transmission. This is why the pace of credit expansion remains unimpressive, despite the mother-of-all liquidity injections. Before pressing the CRR button, the RBI is likely to reverse some of the other measures that do not have a monetary policy signal.

The biggest mistake the RBI can commit is to trip on food inflation and hike CRR even before loan growth picks up appreciably. Such an action will compromise the growth work it has done so far, and also probably cripple the evolving recovery.

Excess liquidity has so far not contributed to demand-driven inflation. Further, the RBI should look through the statistical illusion of rising WPI inflation created by the base effect (essentially, the reverse of the recent "deflation" phantom), and reiterate this in its communication.

Also, the excess liquidity injection has to be viewed in the context of the massive borrowing by central and state governments. Indian policymakers will have to be doubly sure that growth upturn is sustainable, as the Union budget next year will have to withdraw the stimulus, and monetary policy will also have to reverse course. That hints it is safer to continue with the easy monetary policy.

It is a foregone conclusion that policy has to normalise after last year's aggressive easing. The key issue is of timing, and here, there appears to be little need for rushing towards tightening.

Unfortunately, most analysts are still using conventional analysis to map the exit strategy. The RBI has so far outwitted analysts with its unconventional response to the combination of unconventional local and foreign circumstances. The sequencing and timing of the exit strategy in India will be anything but conventional, in our humble opinion.

Hyper food inflation coming to an end: Economists

A late revival of monsoon rains and steps taken by the government to contain prices may have tamed the galloping food price inflation, which is ruling at 11-year high of 15.64%. Economists expect above average monsoon rains in September to dispel fears of a summer (kharif) crop failure and end speculative activity. However, deficient rains in July and August have resulted in a 7% fall in area under the kharif crop. This, along with government's limited ability to effectively intervene in the market to manage the prices of perishable items, will keep prices of vegetable, dairy products and pulses high in short term.

Inflation turns positive at 0.12%

The annual rate of inflation came in at 0.12% for the **week ended September 5**, ending the 13-week decline in the wholesale price index (WPI) as prices of food articles showed no signs of abating. Inflationary pressures are beginning to build up with retail inflation already in double digits. With the comfort of negative inflation for the most widely-watched WPI also gone, economists expect the RBI to take steps to suck out excess liquidity from the system and even resort to selective credit control.

However, indications are that RBI is not likely to take any steps till there is more conviction about the economic recovery. At the conference in the Capital earlier this week, central bank governor Duvvuri Subbarao had said, "We will not exit from the expansionary monetary policy unless we are sure that recovery is secured...But soon after the recovery is secured, we have to unwind the accommodative monetary policy". RBI has already factored in inflation touching 5% by the year-end.

The central bank has cut interest rates six times between October 2008 and April 2009 and pumped in liquidity to boost the economy reeling under the worst global recession since the Great Depression. Reverse repo – the rate at which RBI sucks out liquidity – and repo – the rate at which RBI injects liquidity – are currently at 3.25% and 4.75%, respectively. These rates were at 6% and 9% when RBI started easing policy in response to the global financial crisis. Internal calculations by treasury benches at various banks show that there is close to Rs 1.5 lakh crore in the system,

The government too does not seem unduly worried about the overall inflation though it is worked up about the sharp rally in prices of food articles. Finance minister Pranab Mukherjee said that inflationary pressures in the economy are expected, and the inflation figures released for the week ended September 5 are in line with expectations. The Union Cabinet on 17th September 2009 extended the control imposed under the Essential Commodities Act, which makes de-hoarding operations more effective, by another year to October 2010 to address food price inflation.

According to economists, the spike in food price inflation is triggered by inflationary expectations rather than supply-demand concern.

Inflation rises to 0.37%

Annual inflation for food articles soared to 15.64% in the **week ended September 12**, the highest in more than a decade, fueled largely by a 75% rise in potato prices and a 45% increase in the prices of vegetables and sugar. Current surge in inflation in food prices has more to do with the market expectations rather than the supply-demand gap. Economists feel that a better mechanism to manage the inflationary expectations will cool the pace of rise in food prices.

Selective credit control on the avail to tame inflation

The Reserve Bank of India (RBI) is likely to resort to sector-specific measures to tame food price inflation and to ensure credit flow to some key sectors, including housing below Rs 30 lakh and small and medium enterprises. Under Section 21 of the Banking Regulation Act, RBI is empowered to issue directions to control advances by banking companies, when it feels that it is necessary to give directions in public interest, in the interest of depositors and in the interest of banking policy. Cabinet secretary KM Chandrasekhar, who is closely monitoring the growth and inflationary scenario in the country, said that a selective credit control mechanism needs to be adopted to address the inflationary pressure building up in certain segments of the market. “Unlike last year, when RBI had to adopt an overall credit squeeze policy, the idea is to go in for selective credit control so that growth prospects and investments are not hurt”.

Inflation goes up to 0.83%

The wholesale price-based inflation for the **week ended September 19** went up sharply to 0.89% from 0.37% in the previous week on costlier food items.

Inflation in food articles for the week under consideration was at an eleven-high of 16.32%, causing some concern in the government. With more than 40% of India's districts declared drought hit, the high inflationary expectations have pushed up prices of food articles. But economists and agri-commodity analysts pointed out that the prices of food items should start moving down as the kharif produce (summer crops) comes to the market in coming weeks.

The prices of food articles did not go up sharply in the last two severe droughts faced by the country, in 1987-88 and 2002-03. During these years, food price inflation was less than 3-4% and even overall consumer price inflation remained low, insulating the poor from the impact of drought.

Capitalism and the role of private enterprise are currently being questioned across the world, particularly after the last year's economic meltdown and the current economic recession, which has gripped the world. Criticism, which appears largely valid, focuses on the factors that led to the current crisis. There is now widespread acceptance that lack of effective regulation of private sector activity combined with unethical decisions at the leadership level in the corporate sector have been the main cause of the current impasse.

In the coming years, there would be a vigorous debate on how the strengths of capitalism could be used for the benefit of society, avoiding some of the evils that have become manifest in recent times. The leadership of private enterprise would, therefore, do well to reflect on a whole range of issues connected with overall corporate behaviour and measures by which they can regain the trust of the public at large.

If one examines recent trends in corporate philosophy and decision-making, it is felt that business leaders have been exhibiting an increasing preoccupation with myopic goals and narrow targets. Mahatma Gandhi defined the nature of ownership of private capital akin to trusteeship of social enterprise. In some sense, the growing acceptance of corporate social responsibility as an important part of business activity is an acknowledgement of Gandhian philosophy.

However, it is also true that much of what is projected by corporate organisations as their dedication to objectives of social responsibility are generally devoid of real substance. The time has come for corporate organisations to realise the importance of in-depth scrutiny of all their actions by civil society and their own interests in articulating and implementing a genuine programme of corporate social responsibility.

In an age when deviant corporate behaviour is highlighted instantly and information about it disseminated through the internet and other instant communication channels, misbehaviour by corporate entities cannot be forgiven. Though the civil society in India has become increasingly active in whistle blowing, redressal of irresponsible actions on the part of corporate organisations seldom takes place on a timely or adequate basis. However, the day is not far when the public, supported ably by an increasing active media, would ensure that irresponsible corporate behaviour will not remain hidden or neglected.

Corporate organisations need to realise that upholding the interests of society is clearly in the interest of these organisations themselves. India today is at a stage when it can make a range of choices, including those that would ensure sustainability. The corporate sector must not only lead in this effort as its duty to Indian society, but also as a measure of enlightened self-interest, since future markets worldwide would favour products and services that subserve the objectives of sustainability.

In a major project undertaken by TERI on the eve of celebration of fifty years of India's independence in 1997, a detailed assessment was carried out of the country's record of managing our natural resources. The results of this extensive analysis showed progressive damage and degradation of the country's natural resources including forests, biodiversity, water resources, clean air and healthy soils.

On the basis of the economic estimation of this damage, it was concluded that India was losing over 10% of its GDP annually in the form of depletion of natural resources. Such a trend at some stage start imposing major costs on business and industry, and therefore there is a clear conformity of interest between shareholders in business enterprises and stakeholders in society. Therefore corporate organisations should make critical choices that support the welfare of society, while at the same time safeguarding the interests of shareholders.

Are Insurers ready?

Insurance regulator Irda's recently announced guidelines lay stress on institutionalising effective anti-money laundering (AML) policies, systems. Accordingly, Insurance Companies need to train their advisors. They need to watch out the following:

- ◆ The early termination of an insurance product, especially at a cost to the customer, or where cash was tendered and/or the refund check is directed to an apparently unrelated third party.
- ◆ The transfer of the benefit of an insurance product to an apparently unrelated third party.
- ◆ The reluctance by a customer to provide identifying information when purchasing an insurance product, or the provision of minimum or seemingly fictitious information.
- ◆ The borrowing of the maximum amount available soon after purchasing the product.
- ◆ A transaction is sought that is not appropriate to standard market activities.
- ◆ A transaction request is made by, or payment is received from, a third party or one whose identity is not disclosed or whose relationship to the owner is unclear.
- ◆ The customer makes payments under the policy with:
 - Multiple cashier's checks,
 - Third-party payments,
 - Money orders,
 - Third-party checks of under Rs 50,000.

Striving to revive the world economy while simultaneously responding to the global climate crisis has raised a knotty question: are statistics giving us the right “signals” about what to do?

In our performance-oriented world, measurement issues have taken on increased importance: what we measure affects what to do. If we have poor measure, what we strive to do (say, increase GDP) may actually contribute to a worsening of living standards.

We may also be confronted with false choices, seeing trade-offs between output and environmental protection that don’t exist. By contrast, a better measure of economic performance might show that steps taken to improve the environment are good for the economy.

Eighteen months ago, French President Nicolas Sarkozy established an international Commission on *the Measurement of Economic Performance and Social Progress*, owing to his dissatisfaction – and that of many others – with the current state of statistical information about the economy and society. The big question concerns whether GDP provides a good measure of living standards.

1. Citizens’ own perception: In many cases, GDP statistics seem to suggest that the economy is doing far better than most citizens’ own perceptions. Moreover, the focus on GDP creates conflicts: political leaders are told to maximise it, but citizens also demand that attention be paid to enhancing security, reducing air, water, and noise pollution, and so forth – all of which might lower GDP growth.

The fact that GDP may be a poor measure of well-being, or even of market activity, has, of course, long been recognised. But changes in society and the economy may have heightened the problems, at the same time that advances in economics and statistical techniques may have provided opportunities to improve our metrics.

2. Measurement of output: For example, while GDP is supposed to measure the value of output of goods and services, in one key sector – government – we typically have no way of doing it, so we often measure the output simply by the inputs. If government spends more – even if inefficiently – output goes up. In the last 60 years, the share of government output in GDP has increased from 21.4% to 38.6% in the United States, from 27.6% to 52.7% in France, from 34.2% to 47.6% in the United Kingdom, and from 30.4% to 44.0% in Germany.

So what was a relatively minor problem has now become a major one.

3. Quality improvement: Likewise, quality improvements – say, better cars rather than just more cars – account for much of the increase in GDP nowadays. But assessing quality improvements is difficult. Health care exemplifies this problem: much of medicine is publicly provided, and much of the advances are in quality.

4. Health care spending: The same problems in making comparisons over time apply to comparison across countries. The United States spends more on health care than any other country (both per capita and as a percentage of Income), but gets poorer outcomes. Part of the difference between GDP per capita in the US and some European countries may thus be a result of the way we measure things.

5. **Disparity of incomes:** Another marked change in most societies is an increase in inequality. This means that there is increasing disparity between average (Mean) income and the median income (that of the “typical” person, whose income lies in the middle of the distribution of all incomes). If a few bankers get much richer, average income can go up, even as most individuals’ incomes are declining. So GDP per capita statistics may not reflect what is happening to most citizens.

6. **Market prices:** We use market prices to value goods and services. But now, even those with the most faith in markets question reliance on market prices, as they argue against mark-to-market valuations. The pre-crisis profits of banks – one third of all corporate profits – appear to have been a mirage.

This realisation casts a new light not only on our measures of performance, but also on the inferences we make. Before the crisis, when US growth (using standard GDP measures) seemed so much stronger than that of Europe, many European argued that Europe should adopt US-style capitalism. Of course, anyone who wanted to could have seen American households’ growing indebtedness, which would have gone a long way toward correcting the false impression of success given by the GDP statistics.

7. **Citizens’ sense of well-being:** Recent methodological advances have enabled us to assess better what contributes to citizens’ sense of well-being, and to gather the data needed to make such assessments on a regular basis. These studies, for instance, verify and quantify what should be obvious: the loss of a job has a greater impact than can be accounted for just by the loss of income. They also demonstrate the importance of social connectedness.

8. **Depletion of nation resources:** Any good measure of how well we are doing must also take account of sustainability. Just as a firm needs to measure the depreciation of its capital, so too, our national accounts need to reflect the depletion of natural resources and the degradation of our environment.

9. **Uses and abuses of the statistical measure:** Statistical frameworks are intended to summarise what is going on in our complex society in a few easily interpretable numbers. It should have been obvious that one couldn’t reduce everything to a single number, GDP. The report by *the Commission on the Measurement of Economic Performance and Social Progress* will one hope to a better understanding of the uses, and abuses, of the statistic.

The report should also provide guidance for creating a broader set of indicators that more accurately capture both well-being and sustainability; and it should provide impetus for improving the ability of GDP and related statistics to assess the performance of the economy and society. Such reforms will help us direct our efforts (and resources) in ways that lead to improvement in both.

Who knows where it will take you tomorrow

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Alka Agarwal
Managing Trustee Mi7

Financial Literacy Mission
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Missions Seven Charitable Trust
120/714, Lajpat Nagar, Kanpur - 208005
Phone 0512-2295545, 9450156303, 9336114780

E-mail at: safe@mi7safe.org