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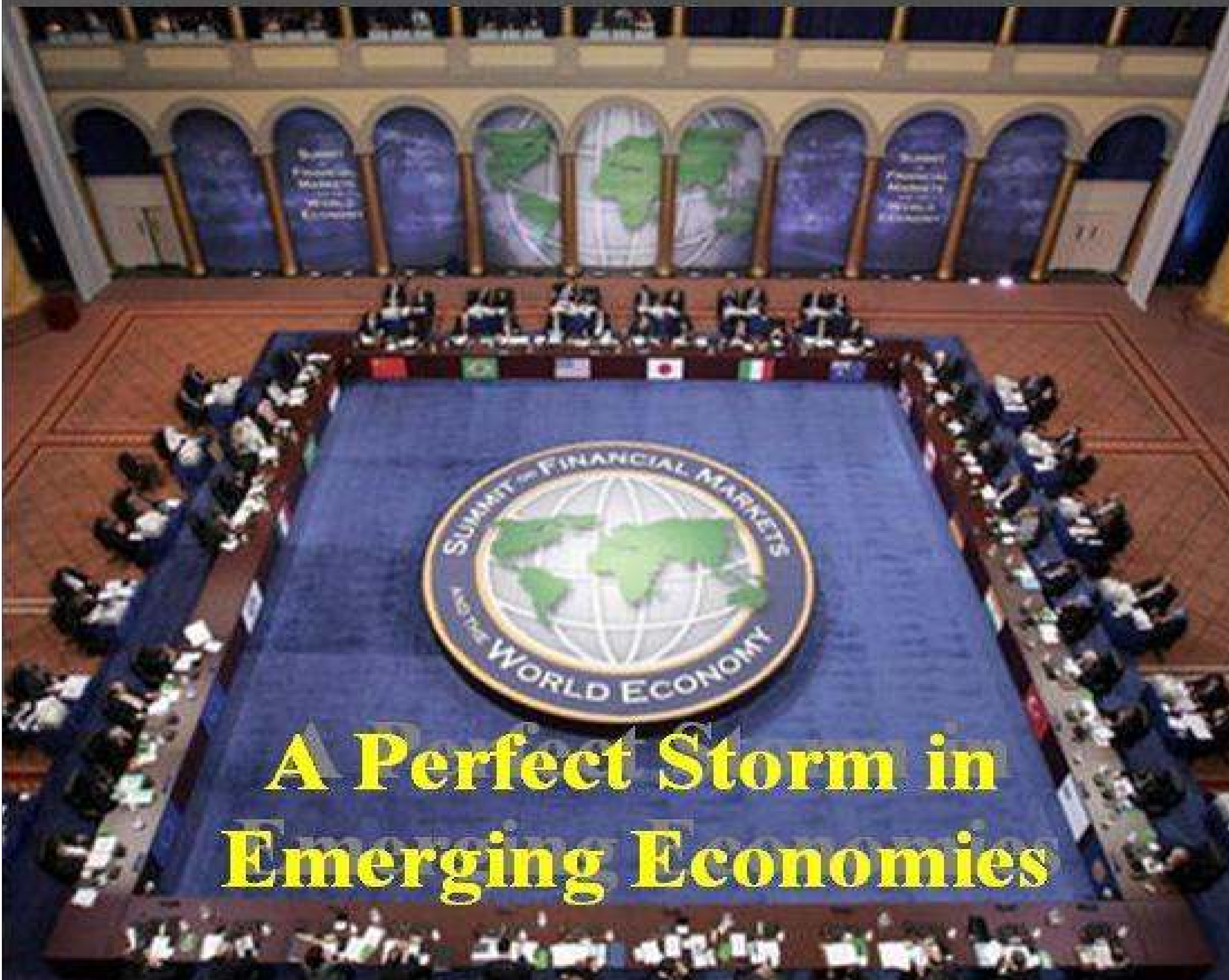

A Perfect Storm in Emerging Economies

SAFE UPDATES-KEEP INFORMED

The security Academy and Faculty of e-Education

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Editorial Preamble: A Perfect Storm in Emerging Economies

1.1 THE LIQUIDITY MIRAGE

End of an Era

By playwright Arthur Miller's yardstick: "An era can be said to end when its basic illusion are exhausted". With much of the blockbuster economic growth of the past few years now appearing like a liquidity mirage, the curtains have indeed come down on an era.

This is particularly painful realisation for the developing world. While the problems with the US economy have been well-telegraphed for long, the widely held view till as recently as mid-September was that the emerging market growth story was largely intact and that most these countries had to fear was some contagion from a housing-led US recession. But now it's becoming increasingly apparent that the liquidity mirage (read: global credit bubble) has also fuelled the exceptional growth rates in emerging markets for much of this decade.

Since 2003, there was a marked increase in the trend growth of developing economies, with the average rate jumping to 7% from 4% between 1980 and 2002. India's growth trajectory too shifted higher by similar magnitude during the same period from 6% to 9%.

Much of the increase was attributed to structural factors such as benefits of globalisation, the demographic dividend and better macroeconomic policy management. While there is more than an element of truth in such arguments, it's hard to escape the conclusion that much of the growth leap was due to easy access to *cheap money*.

Whenever money is cheap and easily available in the global system, it spills over into emerging markets. But in a tighter liquidity environment – as is the case now – such funding dries up.

It was no coincidence that the rise of emerging markets began in earnest from mid-2003, once the US economy started to recover strongly on the back of a booming housing sector.

Following the tech bust in the preceding year, the US Federal Reserve cut interest rates aggressively to engineer a new growth cycle. This resulted in US households accumulating more debt, largely in the property sector. But the Fed was not just setting US interest rates – it was also determining the global price of money. Capital gushed into many developing countries that did not want to run an interest rate policy too different from the US given the currency linkages.

The fundamental flaw with the emerging market growth model is that foreign capital typically nearly half the finances needed for expansion in any year.

Given the easy availability of credit over the past few years, corporates in the developing world raised huge amounts of debt/equity to fund ambitious growth plans, largely from western financial institutions. Last year was a bumper year, with \$ 435 billion in new overseas syndicate loans, \$ 150 billion in external corporate bonds issuances and \$ 210 billion of foreign IPO money heading to emerging markets. Such a global *liquidity tap* suddenly turned off, leaving many emerging market companies high and dry.

Ironically, some of the economies most affected by the credit crisis are those that were perceived to have relatively strong macroeconomic fundamentals and viewed as reasonably safe bets with their large forex, robust fiscal accounts and healthy current account balances. Lenders/investors took comfort in the strong balance sheets of various countries.

And in turn, corporates in these countries used the halo from the sound macroeconomic fundamentals to accumulate foreign debt and jacked up their profit growth. So, this time the emerging market vulnerabilities are focused in the corporate sector instead of the sovereigns. The astounding development is that the credit market is now pricing in a sizeable probability of a default by some large emerging market countries despite their still strong macroeconomic positions.

The market is assigning a 40% probability for Russia defaulting on its sovereign debt over the next five years and more than a 20% chance for Brazil going down the same tube. Even though Russia virtually has very little government debt, the default probability arises from the expectation that the state will be forced to bail out a heavily indebted corporate sector.

From $ 600 billion in July, Russia's effective forex have declined by a massive $ 250 billion with the Kremlin announcing various packages to rescue the corporate sector, where many companies face the pressure of rolling over large sums of short-term foreign debt.

Now, investors seeing death spiral in almost every region. The West Asian countries were thought to have a massive cushion as their accounts were budged on oil at $ 80 a barrel – a level that till recently seemed to be floor price. But, the bottom having been breached with fall in commodity prices, yesterday's stars have suddenly become susceptible to panic as well.

If the global deleveraging cycle continues at the dizzying pace of September and October 2008, the various outcomes being priced in currently are all possible. However, the more likely scenario is that policymakers across the world will succeed in stabilising the credit market as they are throwing the entire kitchen sink, and more, at the problem.

What seems inevitable is that the net capital flows into emerging markets will remain very weak for the foreseeable future and well below the frenetic pace of the past few years. The broader implication of the radically changed environment for capital flows is that the golden era of high economic growth that spanned five years from 2003-07 is over. Capital flows played a very important role in lifting overall growth during that period. After hitting a peak of 7.5% in 2007, the average growth rate in the developing world is likely to fall to 4% in 2009.

India too is likely to slip back to its old growth trend of 6% for the next couple of years.

Beyond that, the growth trajectory will depend a lot on what sort of reforms countries such as India undertake to better channel domestic savings into avenues for broader growth. Many emerging markets have high domestic savings rates but inadequate local credit systems in place to effectively use those savings. Hopefully, the reduced availability of foreign capital in the coming years will set the stage for changing the growth model to relying more on domestic rather than foreign savings.

The question then is what are the implications of this new lower-growth era for equity investors in emerging markets? With the sharp slowdown in growth likely to last well into 2009, it is hard to make the case for a new bull market as such phases thrive on high growth and low inflation.

However, equity investors have broadly done the job of re-pricing emerging markets for a pre-2003 growth environment. Now it's over to the real economy to carry out the painful adjustment process of resetting growth expectations back to those old levels.

Value Investing

Benjamin Graham suggested that during the worst days like 1930, investors should look at 'value investing' rather than attempt to time the market. One has to look at the company's assets, liabilities and its ability to produce cash. If the company is so cheap that its value would scarcely be less if it were to go out of business, there is a margin of safety.

The similarities with what Benjamin Graham said in 1930 and current market conditions are striking visible. We should not try to work out how long the market will take to recover or when it will hit the bottom – that task is impossible. We should use basic balance sheet method to work out how much a stock is worth and how much it would be worth in the worst case scenario. If that calculation leads us with a margin of safety, we should buy it.

With market valuations having fallen drastically, many investors seem to be rummaging for value picks. But they must remember: *all that glitters is not gold*.

An investor must have the skill to spot the good stocks from the bad ones. It is a good idea to lay down the basic framework so that investors can zero in on the right stocks. Investors can consider certain financial indicators to gauge the underlying health of a company, which may not be adequately represented by its stock price.

1. **Business Model:** One of the basic features of a stock is the business model of the company, which makes it a defensive or aggressive bet. A growth stock is likely to perform well in a bull run, while a defensive bet may pay off in a bearish market. When buying stocks of commodity-based businesses, one should be aware of the specific commodity cycle; and the consequent cyclicity in the company's earnings.

2. **Positive operating cash flow:** The net cash that a business generates through its operations, as reflected in the company's cash flow statement, is also a critical feature. Another parameter to be considered is free cash flow, i.e. the cash left with the company after capital expenditure (capex).

It is important for a company to have a positive cash flow from its operations. A company can report net profit in its profit & loss account without generating a positive cash flow from the so-called 'profitable' growth. Any company may have negative operating cash flow (OCF) for one or two years, but a good company with a sustainable business model cannot have a history of negative OCFs.

3. **Debt-Equity ratio:** This is a critical tool to measure a company's leverage. A low debt-equity ratio is generally preferred, but is not always necessary. The phase of a company's growth is also an important factor to be considered. A company in a growth phase may, at times, choose to leverage itself more than ideally required, against a company that has an established business.

4. **Dividends:** A company which consistently pays dividends implies it's rewarding its shareholders. Preference should always be given to a company with higher dividend yield. It also signals the management/promoter's willingness to share the growth with the company's shareholders.

5. **Management or promoters' credibility:** Last, but not the least, while fishing for good stock, investors must also scrutinise the promoter's credibility. A corrupt and fly-by-night management can inflict greater damage on the company than any other factor. This explains why companies owned by reputed and well-regarded business houses are widely sought-after on the bourses.

How long will the pains last?

Jamie Dimon, chairman $ CEO, JP Morgan Chase said: "You cannot run any business thinking that it's going to be sunny every day. You just have to be prepared for the monsoon". He added: "I have never seen anyone ever pick up the true inflection point of an economic cycle. That's because the answers to these questions – like, how long will the pains last? – are beyond the understanding of mankind. They are just too complex. However, Asia will not steer clear of the problems created by this financial crisis and it'll be worse hit than some people think.

1st week of November '08 – Sensex up by 2%

Daily review	31/10/08	03/11/08	04/11/08	05/11/08	06/11/08	07/11/08
Sensex	9,788.06	549.62	293.44	(511.11)	(385.79)	230.07
Nifty	2,885.60	158.25	98.25	(147.15)	(102.30)	80.35

Weekly review	31/10/08	07/11/08	Points	Percentage
Sensex	9,788.06	9,964.29	176.23	1.79%
Nifty	2,885.60	2,973.00	87.40	3.03%

2nd week of November '08 – Sensex down 6%

Daily review	07/11/08	10/11/08	11/11/08	12/11/08	13/11/08	14/11/08
Sensex	9,964.29	230.07	(696.47)	(303.36)		(150.91)
Nifty	2,973.00	80.35	(209.60)	(90.20)	Holiday	(38.10)

Weekly review	07/11/08	14/11/08	Points	Percentage
Sensex	9,964.29	9,385.42	(578.87)	(5.80%)
Nifty	2,973.00	2,810.35	(162.65)	(5.47%)

Wealth destruction

Though the stock indices have for now managed to avoid falling to their October lows, many blue-chip stocks have already breached the levels reached then. The over 55% drop in front-line indices from their peak has also masked the much larger wealth destruction in the wider market. India's total stock market capitalisation has dropped a massive near 70% from its peak, suggesting a much sharper fall in prices of stocks that are outside the leading indices.

This astounding wealth destruction is sure to dampen consumption but it has more serious implications for corporate investment in the near to medium term. Because of the low share prices, promoters would be loath to use shares as currency, as equity dilution would be large for even raising modest amounts.

And debts, even if available, would turn out to be costly, in particular for sectors such as retail, telecom and power as most of them are heavily leveraged with average debt equity ratios going up to near 2.5. Even as interest rates go down, lenders are not likely to extend more loans to such companies. Such corporates would want to consolidate before they think of growth. This means many of them would be looking to sell assets – real estate ones are already doing so – to improve their balance sheets.

3rd week of November '08 – Sensex down 5%

Daily review	14/11/08	17/11/08	18/11/08	19/11/08	20/11/08	21/11/08
Sensex	9,385.42	(94.41)	(353.81)	(163.42)	(322.77)	464.20
Nifty	2,810.35	(10.80)	(116.40)	(48.15)	(81.85)	140.30

Weekly review	14/11/08	21/11/08	Points	Percentage
Sensex	9,385.42	8,915.21	(470.21)	(5.01%)
Nifty	2,810.35	2,693.45	(116.90)	(4.16%)

The fate of Citigroup

In the past week alone, US markets erased more than a decade gains as banks, led by Citigroup touched new lows and worries mounted about the likelihood of a bailout for automakers. Stocks also reeled from a slew of negative data that put US new jobless claim at a 16-year high. But market-watchers will hone in on Citigroup over the weekend for any development as to the future of the bank, the second-largest in the United States by assets. Hopefully it'll be a positive news story, whether it be a sale of the company, a restructuring, a new management – the market will take anything at this point.

4th week of November '08 – Sensex up 2%

Daily review	21/11/08	24/11/08	25/11/08	26/11/08	27/11/08	28/11/08
Sensex	8,915.21	(12.09)	(207.59)	331.19	Terror strike	66.00
Nifty	2,693.45	14.80	(54.25)	98.25	In Mumbai	2.85

Terrorist attacks on Mumbai

The terrorist attacks on India's financial capital have resonated far beyond Mumbai. There will hardly be a Fortune 500 chief executive who has not lately stayed in the Oberoi or the Taj Mahal, and the impact of this attack will be felt in board-rooms around the world. Incidents like this have short-term psychological impact on the financial markets but ultimately the long term dynamics of an economy prevail. Confidence in Indian economic growth potential would not be dented by these senseless killings.

Weekly review	21/11/08	28/11/08	Points	Percentage
Sensex	8,915.21	9,092.72	177.51	1.99%
Nifty	2,693.45	2,755.10	61.65	2.29%

Start value investing

The US government's rescue of Citigroup is the latest bold intervention in the financial markets. The Fed is supporting a massive $ 326 billion package of Citibank which included a $ 20 billion cash infusion and Guarantees of another $ 306 billion over and above $ 25 billion recapitalisation assistance it had earlier received. This was followed by another $ 800 billion stimulus package for US economy by US Fed, which included funding to the tune of $ 600 billion for purchasing mortgage backed securities and around $ 200 billion for supporting consumer and small business loans taken by borrowers for education, automobiles and credit cards. Both the Fed moves perked up all Asian markets.

In India, on the positive side both, inflation numbers and crude prices continued to soften further. Significant drop in inflation for last three week makes a strong case for interest rates cuts from RBI.

Also 'oversold' status of the market makes a strong case for 'recovery' and with FII selling showing down; this appears to be more likely. Capital markets look very attractive for a short to medium term as many large cap blue chip stocks are available at significant discount to even their book values. No one can predict the exact market bottom, but time seems to be ripe for investors to start value purchases.

Monthly review

Month	March '08	April '08	May '08	June '08	July '08	August '08	Sept. '08	Oct. '08	Nov. '08
Date	31.03.08	30.04.08	30.05.08	30.06.08	31/07//08	29/08//08	30/09//08	31/10//08	28/11//08
Sensex	15,644.44	17,287.31	16,415.57	13,461.60	14,355.75	14,564.53	12,860.43	9,788.06	9,092.72
Points	Base	1,642.87	(871.74)	(2,953.97)	894.15	208.78	(1704.10)	(3,072.37)	(695.34)
%	Base	10.50%	**(5.04%)**	(**18.00**%)	6.23%	1.45%	**(11.70%)**	**(23.89%)**	**(7.10%)**

On Monday (27/10/2008), the sensex plunged to a 3-year low 7,697.39, intraday.

Demand's key for picking stocks

Investors picking market winners and losers during tough economic times will find *the ability to win orders during a global downturn* more critical than how much companies *profit from falling input costs*.

Analysts say food and cement shares will outperform, while oil-intensive sectors like chemicals slide despite crude falling to $ 50 a barrel. When demand falls, lower oil is cold comfort: sectors like chemicals are losers as companies struggling to sell products draw little succour from lower costs.

But demand for food will stay stable and grain prices have fallen in recent months, underpinning food and beverage stocks, for which cheaper crude offers additional bonus of lower packaging and transport costs.

Analyst added, smart investors are looking at cement stocks, which were set to gain from lower fuel costs and attractive demand from a focus on infrastructure. Utility stocks can gain with stable demand and cheaper inputs. There's a link between commodity prices and demand for goods: a fall in fuel costs gives consumers more money to spend.

The stickiness of demand is an important factor, as it's going to drive earnings. This is backed by performance of companies that have kept their heads above water during the current downturn.

Another factor is rise in the dollar. Since mid-July, the dollar has appreciated 23% against the British pound and 19% against the euro, boosting companies with a big part of their turnover from the US.

2.1 INDIAN ECONOMY

India will be Affected More in Asia Pacific Region

Over the years, India's potential growth has been steadily rising, driven by what we call DRG factors –

D: Improving **D**emographics (rising share of working age population),
R: **R**eforms (create a platform for working age population to operate productively), and
G: **G**lobalisation (creates job opportunities).

However, the most important driver for this acceleration in growth was the sharp rise in capital flows.

Capital inflows have risen dramatically over the past five years. There are several key components to this capital inflow: *portfolio equity inflows, debt borrowing, FDI and other inflows*.

Capital inflows

Over the last few months, with the reversal in global risk appetite, we are seeing a sharp fall in capital inflows into emerging markets (EMs) including India.

The question arises here whether the capital inflows dependent only on fundamental story of EMs?

Unfortunately, the direction and magnitude of capital inflows have been highly influenced by global macro environment rather than EM's long-term fundamentals.

Trend for capital inflows into EMs has been dependent on global risk appetite, which has been driven by liquidity and growth environment in the developed world.

Debt inflows

Debt inflows into India have also slowed and will likely drop further.

Global debt market deterioration will make it extremely difficult for the companies in India to raise the same magnitude of foreign debt at a reasonable rate.

It is possible that many small and medium-sized companies in India may not be able to raise debt at all from the international markets.

The environment for the debt market is reflected in the sharp rise in the credit default swap rate (CDS), which measures perceived credit risk.

Indian paper's CDS rate has risen to 218-792 bps from the lows of 60-100 bps in July 2007.

Now question arises, why would India be more affected in the Asia Pacific region?

In the current global financial market environment, a country with the twin macro-problems of *high current account deficit* and *tight banking sector liquidity* is likely to suffer a major deceleration in growth.

In Asia pacific region, Australia, Korea, India and Indonesia are part of this twin-macro-problem group.

It is believed that the India will be the most affected after Australia –

1. A large current account deficit

India runs *a large current account deficit*; most other countries in the region have large current account surpluses. Indeed the burden of higher oil prices, wage hike for its employees, and write-off of farm loans have pushed government's (Centre plus States) deficit, including off-budget items to 10.2% of GDP in FY2009 (YE March 2009).

2. Risk aversion in the domestic banking sector

Risk aversion in the domestic banking sector is increasing; and banks are also suffering higher credit costs. India has already seen a rise in credit spreads in the domestic banking sector.

3. Increase in corporate sector borrowing costs

Corporate sector borrowing costs are rising in the domestic market, with the spread for one year AAA-rated companies over the corresponding government bond yield increasing to near 260 basis points from the bottom of 100-130 basis points in early January 2008.

4. Inflation above the RBI comfort level

There is not much hope for a quick monetary policy response. RBI will hesitate to cut policy rate until the central bank will see deceleration in WPI inflation closer to its comfort levels of 5%.

5. Deceleration in domestic demand growth

Further domestic demand growth deceleration is inevitable; and

6. Slow investment growth

Increased tightening in the global and domestic financial markets will slow investment growth sharply.

Just as strong global risk appetite environment pushed India's GDP growth above potential growth of 6% for three years, an increasingly risk averse global financial market could now pull India's growth below potential in the next 18-24 months.

2.2 INDIA INC

The Fall Season

The slowdown in India Inc's profit growth, which had become visible after first quarter, continues unabated as we near the end of calendar year 2008. And there's little hope that the tide will change in the near future. The globe's worst financial crisis has pushed the world's largest economies into recession with countries like the US and UK witnessing contraction of their economies. The India Inc is also not likely to escape the mayhem unscathed.

Expansion Binge

Encouraged by the strong economic growth of the past five years, cheap and abundant credit, coupled with prevailing bullish sentiment, India Inc embarked upon perhaps the biggest-ever spend on capital expenditure (capex) in the country's history. Companies across sectors either went for aggressive capex or acquired companies, especially outside India, to achieve a global scale and footprint.

The expansion binge was initially financed by strong internal accruals, but as their ambition rose, most companies resorted to debt financing, including external commercial borrowings (ECBs).

The chicken has now come home to roost and India's profitability is now being hit by debt servicing and other recurring costs related to capex.

Besides, companies with high level of outstanding ECBs are being haunted by mark-to-market losses on their dollar-or-euro-denominated debt. The difficulties have been further compounded by the economic slowdown and falling demand for goods and services across sectors. If two years ago, demand was ahead of supply, now companies are facing over-capacity across-the-board.

Even as their internal cash generation is on a downward spiral, companies are being forced to increase cash outlays in the form of interest payments and purchase of capital goods.

During the past two years, leading companies had higher cash outflows on account of investment activity, compared to the cash they generated from operations. In the current scenario, where interest rates have risen and access to credit is restricted, a high dependency on financial institutions adds to the risk. Again, the economic downturn may affect the existing cash flow of such companies, further adding to the woes.

Hurting Interest

A spurt in global interest rates was one of the major outcomes of the unprecedented global credit crisis. At the same time, the rupee lost heavily due to an exodus of foreign investments.

Both these factors increased the interest burden for domestic companies, which rose a whopping 86% y-o-y. The interest costs alone took away over 16% of India Inc's operating profits in Q2 FY09, which was substantially higher than 10% in FY08.

Besides a rise in interest costs, an increase in the proportion of depreciation in operating profits indicate that various projects, launched earlier, have commenced operations in the quarter.

The resultant pre-tax profit grew just 1.4%. However, a fall in the effective rate of tax propped up the net profit growth to 3% y-o-y. The effective rate of tax dipped to a two-year low of 22.8%.

2.3 FOREIGN INSTITUTIONS

The Mother of Bailouts Is On

Citigroup shares fell to their lowest level in 13 years, raising pressure on chief executive Vikram Pandit and the bank's board to improve performance even as the global economy deteriorates. Like other major US banks, Citigroup has recorded billions of dollars of writedowns on securities linked to mortgages, and is expected to face significant losses from areas such as domestic credit card loans and auto loans. While people once thought Citigroup was somewhat insulated from US shocks because of its global exposure, it now has vulnerability because of that same global exposure. What was once viewed a positive is now a negative – as other major economies show signs of slowing.

Meredith Whitney, the Oppenheimer & Co analyst, who a year ago anticipated Citigroup's need for new capital and a dividend cut, said: "I don't see Citi making any money over the course of the next couple of years." She continued: "They will have capital pressures from losing money. They will have capital pressures from resizing the businesses. What Citi and others are going to continue to do is sell assets to raise capital. And we are in a material asset deflationary environment. So that's equally dilutive."

The Wall Street Journal said, Citigroup is cutting at least 10,000 jobs in its investment bank and other divisions throughout the world. Citigroup chief executive Vikram Pandit and his deputies have instructed managers to slash their budgets for employee compensation by at least 25%. Citigroup aims to shrink its workforce to about 290,000 employees by next year from 352,000 as of September 30 2008. The paper also reported that Citigroup is notifying some credit card customers that their interest rates are being raised by an average of three percentage points. A person familiar with the strategy estimated that the rate increases would apply to less than 20% of Citigroup's card portfolio according to the paper.

Citigroup director Richard D Parsons said in a Bloomberg Television interview, he backs chief executive officer Vikram Pandit. "I have got great confidence in him, who replaced Charles O. Prince as CEO last December amid record mortgage-related losses. He came in under the most extreme circumstances. He inherited the biggest bank in the world that's got exposure in virtually every country and every asset, so any time anything goes down; Citi has to deal with it."

Citigroup has lost almost 70% of its market value this year, the worst performance in the 24-company KBW Bank Index. The New York-based firm reported net losses of more than $10 billion in the first nine months of 2008, and analysts estimate the fourth-biggest US bank by market valuation will post a $187 million deficit in the fourth quarter.

Citigroup talking to US government: Faced with a deepening crisis and with no solutions in sight, banking giant Citigroup Inc has started talks with the US government to discuss bailout plans. The plummeting share price raises doubts about the bank's ability to survive – its shares reaching the lowest level since December 1992. So, it is not clear if anything short of capital from the government will soothe markets that are increasingly questioning whether Citigroup has enough capital to withstand the recession. Investors have seen similar movies this year, and the endings are very unpleasant.

US bails out Citi with $22-b cash injection: Citigroup, once perceived as the world's smartest financial service house, has got a US government support of $326 billion – an amount which is roughly equivalent to one-third of the Indian economy. Citi has received US government guarantee of $306 billion – a cover that will help it sell the sticky assets and irrevocable mortgages in its books – and $20 billion cash infusion from the US treasury, which is over and above the $25 billion it had earlier received. However, the US government will get $27 billion of preferred stock, paying 8% dividend.

2.4 WARNING SIGNALS

Search of an Economic Iceberg in Asia

Recently, Iceland became the first developed economy to seek aid from the IMF since 1976. It needed a bailout after investors realised it wasn't running an economy, but a hedge fund. While Ukraine, Belarus, Hungary and Pakistan are also lined up at IMF's door, Iceland's woes are getting special attention. The thought that even a western European economy that once had an AA rating could implode, are bringing back uncomfortable memories about Asia's crisis a decade ago.

The question zooming around markets is this: If the worst-case scenario plays out and the crisis continues, can Asia experience another 1977? Equally important, will investors know it when they see it?

Watch the banks, say analysts: "Bank shares are the canary in the coal mines". In 1977, bank shares underperformed in Indonesia, South Korea and Thailand before all three nations sought IMF bailout.

More recently, drops in bank stocks also preceded a broader realisation of trouble in economies such as Iceland and Hungary. So, if an Asian economy is on the cusp of an Iceland-like emergency, bank shares are the place to look. And here's the good news: The industry is holding its own. In the past 12 months, they have outperformed the broader markets by 23%. Banks in Asia had only small amounts of the toxic debt now hurting US and European peers. Generally, Asia's banks are reasonably liquid and well-capitalised. Non-performing loans may rise as global growth slows, yet the most likely scenario isn't for 1997-style crisis. In relative terms, Asian banks are seen as less risky than peers in other countries.

Korea may be an exception. Korean "banks' outperformance on a 12-month basis has been thin, and more recently they have begun underperforming". Investors are more negative on Korea than conditions in Asia's fourth biggest economy warrant.

Analysts say Asia is anything but immune to this crisis. The cost of insuring emerging market debt has risen 2-1/2 times in less than a month. A deep US recession will weigh on export-dependent economies. Slowing growth in Europe, Japan and China mean Asia may soon run out of engines to expand. However, if the region is harbouring an Iceland, bank stocks will provide an advance warning.

There also are problems today that didn't exist 10 years ago. The Asian crisis was an emerging market phenomenon, leaving larger, developed nations less affected. While, the current one is moving in the opposite direction and knows no borders. As turmoil spreads, all economies and markets will feel the pain.

The Federal Reserve's move to provide $30 billion each to the central banks of Brazil, Korea, Mexico and Singapore showed just how universal this crisis is. Analysts say that Fed's decision to expand efforts to unfreeze markets to emerging nations for the first time was even more significant than its official interest rate cut. The trouble is the US still may be entering into a Japan-like period of stagnation. In cutting short-term rates to 1%, Fed chairman Bernanke nudged the US closer to the experience of Asia's biggest economy. Like the Bank of Japan, the Fed is running out of monetary ammunition.

Developing Asia has its own vulnerabilities. Growth rates aren't the problem, with 7.9% in India, 6.4% in Indonesia, 6.3% in Malaysia, 5.3% in Thailand, 4.6% in the Philippines, 4.3% in Taiwan and 3.9% in Korea. Yet, economies do hit icebergs, and things will cool, if US companies' fire employees. However, the odds still don't favour the next hedge fund economy turning up in Asia. With the exception of Japan, central banks generally have ample room to cut rates; debt-to-gross-domestic-product ratios leave fiscal latitude; and currency reserves offer a cushion. Asia is a very different place than it was in 1997. If the global turmoil worsens, though, Asia won't get off easily.

3.1 MUTUAL FUND INDUSTRY

Old wine in a new bottle

Some may call it innovation, while others may term it as desperation. Faced with shrinking appetite for equity offerings, domestic mutual fund houses have taken to repackaging their old products. They are hoping that investors will perceive these as alternatives to equity funds, which could revive the fund houses' sagging fortunes. Funds which invest partly in stocks and partly in gold, exclusive commodity funds and schemes that are sweetened with insurance are just some of the products vying for equity-fatigued investors' attention. We tried to explore whether these schemes are just baits to attract investors' money or genuine alternatives to equity in the current scenario.

Spice of commodities

A host of commodity funds, especially those that invest in international markets, has hit the market. UTI went a step further in trying to woo investors by offering gold bundled with equity – i.e. a fund that invests over 65% in stocks and a large part of the rest in gold. While most financial advisors say that commodities should account for the 10-15% of an investor's portfolio, they add that it's essential to have a long-term view on these funds. These funds are very volatile in the short run. Ideally, you should stay invested for at least five years.

Insurance-laced SIPs

Many fund houses like Reliance and Birla Sun Life have come out with systematic investment plans (SIPs), where investors also get insurance corresponding to the investments made. Actually, these fund houses buy cover from established insurance houses and provide the facility as a part of MF scheme. Most experts dismiss these products as gimmicks to attract gullible investors. They say that the coverage provided is far from comprehensive and the promised package is very small compared to what similar money could have generated for an investor in a wholesale insurance plan.

Equity-linked FMPs

This product may qualify as a real innovation, but due to the ongoing turmoil in the international markets, experts are advising caution about investing in fixed maturity plans (FMPs). As the name suggests, these schemes entail a debt and equity component. While the debt portion is assigned the task of protecting capital, the equity part provides the upside. However, financial planners disapprove these products and say that the element of risk – that of default by the companies whose bonds these FMPs will invest in – involved is high. Forget the returns; even your capital may not be safe.

Combo funds

IDFC recently introduced a fund that plans to invest 50% of its assets in one sector (say auto, real estate, metals, energy, capital goods or telecom), while the balance will be invested in a diversified set of companies that attempts to generate returns in line with the market. Hence, it is an attempt to give investors a flavour of both sectoral and vanilla diversified equity funds. However, most financial planners say that these funds only lead to unnecessary confusion while creating an investment portfolio.

3.2 CURRENCY MARKET

Paradoxical Strength of the US Dollar

The current financial crisis and economic turmoil has engulfed the entire world. India, too, is significantly affected. Due to a globalised economy, it is natural that the ripples of such turbulences in one country are also felt by other countries. But the speed and magnitude of the global impact of the ongoing US financial crisis have been astonishing. This is primarily due to the strength of the US dollar vis-à-vis other currencies in terms of its perception as a safe and reserved currency.

The paradoxical strength of the dollar is manifested further by the fact that the dollar has appreciated significantly against almost all other currencies except the Japanese yen even though the US itself is at the epicenter of the current crisis. Normally, when the economy of a country suffers a crisis, then its currency also gets a beating vis-à-vis other currencies. But, this has not happened in the case of the dollar.

The dollar's recent appreciation is largely due to the following factors:

- The financial assets of some of the US-based bankers suffered defaults and the asset bubble went bust. This led to a sudden surge in demand for the dollar in the US to honour the financial obligations on banks. So, foreign investors and US bankers started liquidating their non-US dollar denominated assets in India and other countries and remitted the net dollar discounted amounts back home to the US. This led to a surge in demand for the dollar, resulting in an over-supply of the rupee in the domestic market. This is why the dollar is appreciating despite the US economy not doing well.

- The other factor which has led to the dollar's appreciation is that after the onset of the current financial market crisis, almost all other countries have been resorting to liberal monetary stances to increase liquidity in domestic markets. Central banks across the world are trying to sustain the credit flow by reducing cash reserve ratios, slashing repo rates etc. There have been relatively greater cuts in the bank rates in India than the corresponding Fed rates in the US. Hence, there is a relatively greater cut in the interest rates for the Indian rupee than the rate for the US dollar, triggering a foreign exchange rate movement in favour of the dollar

- **America is still a safest place to put one's money**

The world is sinking into major global slowdown, likely to be the worst in a quarter-century, perhaps since the Great Depression. This crisis was "made in America," in more than one sense. America exported its toxic mortgages around the world, in the form of asset-backed securities. America exported its deregulatory free market philosophy. America exported its culture of corporate irresponsibility – non-transparent stock options. And finally, America has exported its economic downturn. Now the crisis has spread, predictably, to emerging markets and less developed countries.

Remarkable as it may seem, America, for all its problems, is still seen as the safest place to put one's money. No surprise, because despite everything, a US government guarantee has more credibility than a guarantee from a third-world country. As America sops up the world's savings to address its problems, as risk premiums soar, as global income, trade and commodity prices fall, developing countries will face hard times. Some – those with large trade deficits before the crisis hit, those with large national debts that must be rolled over, and those with close trade links with the US – are likely to suffer more than others.

4. FINANCIAL SECTOR: TRANSFORMING TOMORROW

The Financial Crisis

The financial crisis has indeed shaken the world never before. The old international institutions look incapable of coping with it. Yet that is hardly new: they could not cope even with the Asian financial crisis. Everybody agreed then that the world needed a new financial architecture. Several international meetings took place to discuss a new architecture. But before these could come to grips with the problem, it disappeared! Asia recovered smartly in 1999-2000. Russia and Latin America recovered as the prices of their commodity exports rose. So, interest in a new financial architecture fizzled out.

Asian countries recovered faster from the 1997-99 crisis than anybody thought possible because – out of the blues – the US emerged as consumer of last resort. Americans discovered the joy of living beyond their means, and their spending excesses were reflected in enormous US trade deficits. These enabled developing countries to run surpluses, and build up their vanished reserves.

The US continued over consuming, enabling third world countries to build up stupendous forex reserves of $4 trillion, half of which belonged to China alone. The American consumer emerged as the new financial architect, unappointed by anybody. This was not a consequence of international agreements or US government action. Even President Clinton and Bush did not urge US consumers to suddenly consume beyond their incomes to save Asia and Latin America.

Rather, it was the unplanned consequence of two phenomena:

First, US financial deregulation facilitated a consumption spree aided by low interest rates and low prices of Asian manufacturers;

Second, Asian government reinforced this trend by keeping their currencies undervalued and exports cheap; and by investing their forex reserves in US gilts, keeping US interest rates low.

Today, that arrangement has collapsed. US over consumption and over borrowing have proved unsustainable. US home and stock prices have crashed, over-leveraged borrowers are deleveraging savagely, and consumption is falling off a cliff.

This has hit other countries that had come to depend on US imports and leveraged global capital flows.

The process will have to run its course. Leverage and consumption will fall, inflicting much pain. Countries across the globe are loosening monetary and fiscal policy to cushion the downswing. Banks and financial institutions are being rescued wherever required.

What next? A recession is inevitable, but that is part of the standard business cycle. Many countries will get tougher regulation and stronger regulators. Maybe, most derivatives will have to be traded through exchanges, eliminating the counter-party risk. Credit rating agencies may be asked to issue multiple ratings for different scenarios. Securitisation will surely be more regulated. The G-20 talks about many things, but these will not constitute a new international financial architecture. Rather, unilateral financial reforms by individual countries will be the main outcome. This will certainly change the financial landscape, but there may be many similarities in reforms across countries. Most experts agree that the financial turmoil has pushed the US economy into deep recession. The scary question is how long will it be? Another scary questions are will this change the world economic order? What would be the effect of a long recession in the US and Europe on emerging economies like India?

4.1 FINANCIAL ADVISORS:
Weigh impact on investors

The Liquidity Trap

The US economy shank at a 0.3% annual rate in the third quarter, its sharpest contraction in 7-years as consumers cut spending and businesses reduced investment. The 3rd quarter contraction was a striking turnaround from the 2nd quarter's relatively brisk 2.8% rate of growth. It occurred during financial market turmoil that has heightened worry about a potentially lengthy US recession.

Consumer spending, which fuels two-thirds of US economic growth, fell at a 3.1% rate in the third quarter – the first cut in quarterly spending since the closing quarter of 1991 and the biggest since the second quarter of 1980. Spending on non-durable goods – items like food and paper products – dropped at the sharpest rate since late 1950.

The United States and several European economies are trapped in a situation that most students of economics get to study only in a classroom setting. It is called **the liquidity trap** – a situation in which the nominal interest rate is zero, or close to zero, and cannot be lowered further to stimulate the economy. In a liquidity trap, the monetary policy becomes completely ineffective.

For instance, the US Federal Reserve lowered its benchmark rate to 1%. Cost of credit, however, to investors and home owners has remained high. In the coming months, Fed chairman Bernanke may further lower the interest rate down to zero, and then there will be no further down to go.

The economic problems in the US are largely because Americans have been living beyond their means for a very long time. And, the only way to stop the current recession from worsening is by ensuring that Americans keep consuming. But, recent signals that American consumers may be tightening their belts have raised fears that the US economy may soon be facing deflation – a situation in which demand declines, inventories pile up, prices decline lowering future investments, resulting in unemployment and lower incomes – a situation that creates a deflationary spiral from which it is not easy to escape.

A text book solution to escape liquidity trap is to use the fiscal policy to prop up demand – by increasing spending in infrastructure, schools, hospitals, power plants etc. Increase in demand will improve investment climate, encourage firms to increase production, in turn creating jobs and increasing incomes.

So the US needs is a new 'New Deal" similar to one that President Franklin Roosevelt employed 75 years ago to bring the economy from the ruins of the 1929 Depression that caused massive declines in incomes in most western economies. In the midst of the Great Depression, in 1933, President Roosevelt launched a series of programme to provide jobs to the unemployed and to reform and regulate financial sector. The Work Progress Administration, the largest agency created under the New Deal provided jobs to eight million persons and operated literacy projects, and constructed buildings and roads.

From the past experience, it seems that a fiscal initiative drawn on the lines of the New Deal has a better chance of rescuing the economy from a long recession than Troubled Asset Relief Program (TARP) under the $700 billion rescue effort. It is almost certain that a second New Deal is implemented in near future, and its blueprint will be out before the end of the year.

Meanwhile the US Federal Reserve announced plans on 25th November 2008 to pump up to $800 billion into the financial system in purchases of mortgage- and asset-backed securities. The new efforts come as part of a move to restart consumer credit markets that froze in October and to get more liquidity and bring down borrowing costs for the housing market, which is at the centre of the economic storm.

1. The US central bank said it would launch purchases of up to **$100 billion** of obligations of housing-related government-sponsored enterprises, including Fannie Mae and Freddie Mac in the next week, and

2. The US central bank would buy another **$500 billion** in a process started by the end of this year. These mortgage securities will be purchases by asset managers selected via a competitive process, which are expected to take place over several quarters.

The Fed said the action on mortgage securities is being taken to reduce the cost and increase the availability of credit for the purchase of houses, which in turn should support housing markets and foster improved conditions in financial markets more generally.

3. Separately, the Fed said it would launch a programme to buy up to **$200 billion** in asset-backed securities – backed by student loans, auto loans, credit card loans, and other loans. The Fed will lend up to $200 billion to holders of AAA-rated asset-backed securities for a term of at least one year, with holders of securities expected to accept “a haircut” reflecting the reduced market value.

The statement noted that these securities amounted to $240 billion in 2007 but had dropped sharply in the third quarter of 2008 before essentially coming to a halt in October,” making it harder for consumers to get credit and threatening a seizing up of economic activity.

According to the Fed statement, “Continued disruption of these markets could significantly limit the availability of credit to households and small businesses and thereby contribute to further weakening of US economic activity.” The asset-backed securities market provides liquidity to financial institutions that provide small business loans and consumer lending such as auto loans, student loans and credit cards.

The US Treasury said it was allocation $20 billion to the asset-backed securities fund as “credit protection.” But, the global financial crisis has been constantly spreading and worsening creating a severe shock to global economic growth.

Britain teetering on the edge of its first recession:

Britain’s economy shrunk 0.5% in the third quarter, the first contraction in 16 years, after registering no growth in the second. The economy is now teetering on the edge of its first recession in nearly 16 years.

Euro zone in recession:

Euro zone data showed that recession has hit much of Europe, confirming a widespread economic downturn. Analysts said, the euro zone is in recession, using the common definition of two consecutive quarters of contraction. The worst financial crisis in 80 years has weakened the world’s major economies and the euro zone said growth fell 0.2% for the second quarter in a row. It was the first time the 15-nation bloc has suffered recession since the common European currency was formed.

Analysts said the European Central Bank would probably cut interest rates further to try to spur growth. Analysts added, now that the recession has been confirmed, the debate will concentrate on its length and severity. A further contraction in euro zone GDP in the current Q4 seems virtually assured.

Japan in recession:

Japan slid into its first recession in 7-yr in the Q3 as exports crumbled, and analysts said an escalation in the global financial crisis may have put the economy on course for its longest ever contraction.

The Japanese yen climbed to a 13-year high against the dollar, as investors continued to pare their carry trades – a process of borrowing in yen and deploying the money in high yielding securities.

The 0.1% contraction in July-September gross domestic product barely captured the impact of the financial firestorm that began in mid-September, wrecking Wall Street banks, triggering a stock market crash in Tokyo and a yen rally that may hit exporters even harder.

Some economists said Japan; the world's second-largest economy could be headed for a record four quarters of shrinking output. Japan cut interest rates for the first time in 7-years, expecting severe stress in the global economy to persist. The Bank of Japan cut its benchmark overnight call rate to 0.30% from 0.50%. The global downturn has come hard on the heels of the credit crunch, the worst financial crisis since the Great Depression, with investors facing what Japanese Prime Minister Tara Aso called "a harsh storm seen only once in 100 years".

World Bank said Chinese growth next year would be at slowest rate since 1990:

China's economic growth slowed to 9% in the third quarter, the lowest level in five years and a sharp decline from last year's 11.9%. That is considered dangerously slow for a government that needs to create jobs for millions of new workers who enter the economy every year and to satisfy public that has come to expect steadily rising incomes.

Exports have been growing at an annual rate of more than 20% but analysts expect that may fall as low as zero in coming months as global demand weakens.

China on 9th November 2008 announced a $586 billion stimulus package, in the biggest move to stop the global financial crisis from hitting the world's fourth-largest economy.

A statement on the government's Web site said China's Cabinet had approved a plan to invest 4 trillion Yuan ($586 billion) in infrastructure and social welfare by the end of 2010. The spending would focus on 10 areas picking up the pace of spending on low-cost housing – an urgent need in many parts of the country – as well as increased spending on rural infrastructure. Money will also be poured into new railways, roads and airports, health and education, on environmental protection, and high technology.

Further to spur growth China announced its biggest rate cut in 11 years. China's cut in bank's benchmark lending and deposit rates by 108 basis points came a day after the World Bank said Chinese growth next year would be around **7.5%,** the slowest rate since 1990. The People's Bank of China also reduced reserve requirements by 1% for big banks and by 2% for smaller banks.

4.2 INCLUSIVE CEOs

Innovative responses to problems

A new danger zone

Developing countries are entering "a new danger zone" as the financial crisis spreads to their economies. A World Bank paper warns that: **Developing countries** face increased risks from falling exports, investment and worsening credit conditions.

Developing countries like China and India once appeared sheltered from the crisis that began in the United States and spread quickly to Europe. But almost every country in the developing world including Russia, Brazil and Mexico has slashed their growth projections.

This could reverse progress made in reducing poverty in many of these countries.

Meanwhile, investment in developing countries, the backbone of their economic growth, has dropped as a result of problems in the global credit market. There is a risk that investment in developing countries may be headed for a "perfect storm." Unless credit markets thaw quickly, the consequences for developing countries could be severe, even for sound domestic financial sectors which find it difficult to borrow or may be unwilling to lend.

Countries that depend on exports, remittances sent home by migrant workers or foreign investment were most vulnerable to the economic downturn.

It identified 20 developing nations whose economies have been hardest hit. Without naming them, it said seven were in Europe and Central Asia and eight in Latin America.

Commodities exporting countries that gained from higher prices now face lower incomes as those prices plummet. Even poorer countries, which are not well integrated in the global financial system, will be affected by the drop in export demand, remittances and lower commodity prices.

The weakening global demand has pushed food and fuel prices sharply down, but the World Bank said prices were still high when compared to a few years ago, forcing governments to pay more to feed their people. The World Bank said it will be hard for some governments to recoup losses from almost a year of very high prices. "Recent decline in food and fuel prices do not imply that pressure and problems have disappeared". For the very poor, reducing consumption from already very low levels, even for a short period, can have important long-term consequences. In addition, the poor will now have to contend with the repercussions of slowing economic growth.

UN secretary general Ban Ki-moon said, the world needs 'to think big' to solve the global financial crisis while helping reduce poverty. It was important to avoid focusing only on financial problems.

"We need to thing big. The financial crisis is not the only crisis we face; we also confront a development emergency and accelerating climate change. We need a fully global stimulus plan that meets the needs of emerging economies and developing countries. Rescue packages must be closely coordinated and we must protect the poor and most vulnerable, not only the rich and powerful."

4.3 WEALTH MANAGERS

Map out the details to translate into benefits

Hedge funds too take hit in global turmoil

The aura of invincibility around hedge funds, the investment pools for the super-wealthy, has been eroded by the global financial crisis. Analysts say the industry – often maligned for its secrecy and short-selling tactics, but lauded for its lucrative returns – has struggled in the economic meltdown despite its aim to thrive in both bull and bear markets.

The hedge funds are investment pools that are typically run on behalf of a limited group of wealthy investors. According to data from EurekaHedge, a Singapore-based company that monitor the industry, the global industry, which is worth around $ 1.7 trillion, and had become notorious for the huge fees the fund charges on the basis of its returns, had lost an average of 7.7% in the first nine months of the year.

The global hedge industry lost $100 billion of assets in October, as firms including Sparx Group and Man Group were hammered by investor redemptions. The biggest market losses since the Great Depression and investor withdrawals hurt the hedge fund industry that manages largely unregulated pools of capital. The index of global funds has lost 11% this year, set for the worst performance since 2000 when EurekaHedge began tracking the data.

The worst hit funds were those in Asia. Excluding Japan, the Asia funds have lost more than 20% in the first nine months of 2008, and more than six percent in September alone.

The dire performance has taken the luster off the industry. Some funds have already collapsed, and more are under pressure. This wave of redemption in the hedge fund industry is going to last for at least another six months. There are some funds that halted withdrawals, but those funds would eventually have to defreeze, and that means another wave of redemptions.

Analysts think there is going to be a lot of pain within the industry. The industry's aggressive attempts to recoup losses and the flight of capital from investors has helped fuel the swings on the world's stock markets. The tough times for the hedge funds come on top of a deleveraging process that was already under way, under which they have been forced by troubled banks to quickly pay down the huge borrowings they took on to maximise their bets. Analysts at EurekaHedge believe: "Deleveraging is one of the biggest factors responsible, for such a bad month on world stock markets".

Top hedge fund managers face US Congress probe: Five of the world's richest and most powerful hedge fund managers will face a US Congressional panel that wants to know if the secretive industry poses risks to the financial system. **John Paulson**, **George Soros, Philip Falcone, James Simons** and **Kenneth Griffin** were scheduled to testify at the House of Representatives Committee on Oversight and Government Reform about the role of hedge funds in financial markets. Committee chairman Henry Waxman asked the men to testify because each earned more than $1billion each last year.

The hearing is the latest in a series Waxman is holding to investigate the causes and effects of the financial crisis. The hearing comes at a time when several lawmakers have suggested the loosely regulated $1.7 trillion industry will face new regulations. Hedge funds, which are delivering their worst-ever returns, are widely blamed for helping bring down two US investment banks.

4.4 CREDIT COUNSELORS

Resolve convertibility and recompensation issue

Mystery of missing liquidity in India

The Indian banking system is facing a whole set of new demands for credit due to the following:

- For importers, suppliers' credit has dried up; they have turned to Indian banks;
- Oil and fertiliser companies have been given bonds instead of cash subsidies. They too have turned to banks for finance;
- ECBs that have matured are not being rolled over. Companies want Indian banks to help out;
- Indian companies that made overseas acquisitions find that finance tied up abroad is not forthcoming. Indian banks have had to go to their rescue;
- Indian banks with overseas operations find that their overseas branches or subsidies are unable to raise finance locally. These banks have to remit dollars from India.

In other words, sources of finance outside the Indian banking system are no longer available and Indian banks have to fill the gap. The banking system faces additional demands for credit at the time when availability if funds in the system has fallen, thanks to FII outflows and the RBI's intervention to contain rupee depreciation. This has been characterised as a 'liquidity church'.

But is this the whole story? Two facts about credit growth this year are striking:

- Fact 1: most of the increase in demand for credit appears to be dollar-related. Forex reserves dipped by $ 56.8 billion in April-October end. Non-food credit during the period has grown by Rs 249,272 crore or $ 49 billion. In the same period last year, credit grew by Rs 106,173 crore or $ 21 billion. Thus, the increase in credit is $ 28 billion more than it was last year;
- Fact 2: Most of the decline in forex reserves in the current year, $ 53.4 billion, has taken place in the period August 1 to October end. This is also the period in which most of the credit expansion during the year has taken place – Rs 183,543 crore or $ 37 billion.

It appears that the Indian banking system has financed a huge amount of credit that is dollar-related. Some of it could be related to imports. But what about the rest? There is an element of mystery here.

Could it be that a big chunk of the increase in credit growth represents the crystallisation of contingent obligations? These could be off-balance sheet *forex and other derivative transactions* of corporates and they could even be *letters of comfort* given to corporates who went in for foreign acquisitions.

It is important to know because growth in credit on account of crystallisation of contingent liabilities must be clearly distinguished from credit growth that takes place to support economic activity. The former crowds out the latter and renders credit costlier. Some of it may turn non-performing assets over time.

4.5 RISK MANAGEMENT CONSULTANTS
Educate – Engineer and Enforce

Liquidity crunch in finance firms

The head of a finance firm in Mumbai met up with Reserve Bank of India to tell the regulator how badly the sector was in need of money, with banks having snapped loan lines.

After a patient hearing, the central banker shot a question, “Why did you have to grow so fast**”.** After CRB Capital, one of the biggest non-banking finance companies (NBFCs) collapsed in 1996, RBI came out with long list of dos and don’ts that forced hundreds of NBFCs to shut shop. NBFCs were asked to chip in with more capital, while raising deposits from the public – up until then the main source of NBFC finance – became almost impossible and within a few months, a large number of NBFCs surrendered their licences. Those were the days when long queues of depositors outside bankrupt NBFC offices were a familiar sight. The few that survived were big enough to take care of themselves.

Everyone thought NBFCs were history. Now, more than a decade later, NBFCs have returned to haunt the regulator. How did they get into this mess? Before that, why did they flourish?

A cleaner or a truck mechanic, who graduates to become a driver and 5-years later decides to buy a used truck to build his own dream fleet, will not get bank finance. But an NBFC knows exactly what he wants – how much loan he can sustain, how he will repay it and, most importantly, how best to recover the money if borrowers fail to pay. An NBFC did what a high-street bank couldn’t. It was also smarter than a bank in regular businesses like consumer loans for auto, two-wheeler, washing machines and televisions.

The NBFC model was also a window for big banks, many of which floated finance companies, to enter into businesses the parent couldn’t due to stringent RBI rules. So, if a bank couldn’t generously lend against shares beyond a point, the NBFC did; if the bank had reached its exposure cap to a particular business house, the NBFC gave the additional loans; or if a promoter was looking for money to raise his holding through a creeping acquisition, he turned to NBFCs for money.

Bankers have a word for this: regulatory arbitrage.

Hardly any NBFC today relies on public fixed deposits. Instead, they borrow from banks and most importantly, place debentures with mutual funds (MFs). Raising money from MFs was even more attractive, as most MFs didn’t care whether the NBFCs were in a position to service the loan. Instead, they left the job to credit rating agencies. So, as long as an NBFC debenture had a good rating, there were takers. The problem arose when the money market went into a tailspin.

Almost overnight, it exposed the touch-and-go business model of NBFCs, which was giving five-year loans with two-year or one-year or even six-month money. So what has deepened the crunch is the duration mismatch between the money raised and money lent. So, at the end of six months or one year, the NBFC had to raise new money to repay the previous loan. This is fine when the things are hunky dory; but not when the credit market has frozen and banks choose to hoard cash and not lent. The market, however, today cannot afford defaults by NBFCs – it just not a few thousands of depositors losing money; it can impair the financial system.

4.6 FINANCIAL PLANNERS

Value unlocking for all stakeholders

Huge losses to commodity traders

Countless Indian traders have been trapped by a brutal commodity market. A small-time importer in Coimbatore is fighting bankruptcy after placing an order for two shiploads of iron scrap. By the time the cargo reached India, prices had crashed 70% in little over a month. His buyers have backed out and the man is facing an Rs 100-crose loss. The scrap trader is picking holes in the shipping and letter of credit documents to wriggle out of the contracts. In another case, iron ore exporters have revealed that their Chinese buyers have disappeared with price dropping to $55 a tonne from the last year's high of $135.

In Mumbai's chemical mart, a sulphur importer is refusing to lift the cargo from the port. In less than two months, prices have crashed from $700 a tonne to $65. The drop in price was sudden. Sulphur importer who had booked consignment in advance is finding no takers. And Across the state border, cashew kernels from the Ivory Coast are piling up. The Kernels have to be processed for re-exports. But there's a problem; many overseas buyers are no longer interested since prices have dipped.

These aren't isolated instances. Across commodities – scrap, iron ore, sulphur, solvents, dyes, soda ash and even edible oil – local traders have been caught on the wrong foot. There are instances where cargoes are lying at the docks and importers prefer to pay the penalty rather than buy at a price which they can't recover. A few are willing to surrender the collaterals to banks they have opened the LC with.

4.7 MICRO-FINANCE PROFESSIONALS

Developing alternative credit delivery models

Job cuts to save bottom line

In a meeting with captains of industry, Prime Minister Manmohan Singh said: "The government will take all necessary monetary and fiscal policy measures on domestic front to protect our growth rates". He also urged industries not to resort to large-scale job cuts before the steps already taken and those being planned delivered results. He asked the industry to be mindful of its social obligations in coping with the effects of this global crisis.

But lay-offs, fringes and salary cuts are increasingly becoming all too common across India Inc, highlighting a deepening slowdown in the economy. From banking and finance to aviation, from manufacturing to information technology, no sector appears immune, mirroring a trend across much of the developed world that has seen tens of thousands of people out of employment. The financial sector continued to see more blood-letting, as the blows from the axe wielded in New York and London was felt in India. The Indian arms of Goldman Sachs and Credit Suisse started retrenchment employees, while Merrill Lynch's operation in the country has seen the second wave of firings.

There were grim warnings from the country's textile sector, where industry body (CITI) said some 700,000 people had lost their jobs so far this year and 500,000 more were likely to go in the next two to three months. A majority of lay-offs have affected daily wagers who constitute about 25-30% of a company's workforce. The Indian Textile industry employs some 35 million people. Mills are running hardly 3-4 days a week, or operating just 75% of their capacities or have reduced shifts from three to one.

4.8 TECH SAVVY PROFESSIONALS

Take first step to ensure efficient and reliable system

India Inc chieftains sound caution

The Aditya Birla Group is exploring options of temporarily shutting down a pulp unit in Canada due to declining demand for rayon. Tata Group chairman Ratan Tata has asked his business heads to go slow on future plans. Auto major Mahindra & Mahindra is rethinking its business plans for the current fiscal year. Wipro, the software leader, has instructed its business heads to brace for tough times and some hard decisions. JWS Steel has deferred its multi-million dollar expansion plans.

India Inc seems to be in an exceeding cautious frame of mind. The ongoing credit crunch and slowing demand is forcing large companies to cut down on expenses, roll back acquisition plans and generally scale back hitherto exuberant corporate activity. According to a study by the Centre for Monitoring Indian Economy, projects worth Rs 76,538 crore were shelved in the first two quarters of the current financial year. The first quarter – April-June 2008 – saw 52 projects worth Rs 42,740 crore being put off, and in the July-September quarter, 45 projects with an outlay of Rs 33,798 crore were postponed.

Citigroup India in a recent report said that it is expecting the capex cycle to see a break. Given uncertainty both on the global/domestic front, the report expect this trend to continue for the next few quarters. While the government could undertake infrastructure spending in a bid to provide stimulus, there appears to be limited space for pump priming, given India's 8.8% fiscal deficit.

4.9 CONTINUING LEARNING CENTRES

Take informed decisions

Recession impacts export

In one of the first definite indications of the debilitating impact of the global financial crunch on India's trade and employment prospects, merchandise exports dipped by 15% and slipped into negative territory during October 2008 compared to the same month in 2007. The government expects the situation to persist or even deteriorate in the coming months. India's exports have witnessed a decline for the first time in five years. According to preliminary estimates by the commerce department, the decline in exports in October is sharper at 20% if petroleum – the only major sector registering an increase – is excluded from the calculation. Labour intensive sectors like textiles, garments, handicrafts, certain segments of leather and gem & jewellery are the ones which have been hit the most by the slowdown in the West.

Recession impacts tax receipts

This could well be the sign of times to come. Indirect tax collection figure for October is sure to worry policymakers. Growth in indirect tax collections in October, 2008 has slipped into negative territory.

Total indirect tax collections sans service tax in the month under review stood at Rs 18,664 crore against Rs 19,646 crore in October 2007, a decline of 5%. In an early indication that India's manufacturing sector could well have begun to feel the pangs of the global slowdown. Excise duty collections were down to Rs 9,399 crore in October 2008 compared to Rs 10,293 crore in October 2007, an 8.7% fall. Custom collections also followed excise collections' footprint. Customs collections witnessed a negative growth of 0.9% at Rs 9,265 crore as compared Rs 9,353 crore in October 2007.

4.10 ONE-STOP-SHOPS

Dedicated to offer related services under a roof

How to prevent future catastrophes?

Mr Alan Greenspan, the former US Federal Reserve chairman, confessed that he had failed to anticipate the financial crisis. He had faith that banks were prudent enough to make sure they were not lending money cheaply to people who could not pay it back. Yet that is what happened.

Blaming the current crisis on securitisation is absurd.

It is just a technique to create securities by reshuffling the cash flows produced by a diversified pool of assets with some common characteristics. By doing so, one can design several securities with different risk-reward profiles which appeal to different investors.

However, an erroneous assessment of the risk characteristics of the underlying assets, the use of faulty models to examine the merits of each security, or an imprudent reliance on leverage can lead to calamity. This is what explains the debacle behind the subprime transactions.

Interesting lessons emerge from a look back.

Earlier traders knew they could only sell their big deal to investors who trusted them.

In recent years, confidence has been replaced by confidence in credit ratings. The unquestioning faith in the bullet-proof status of AAA credit rating led to buying of billions, not just millions, of structured bonds that are now worth little or nothing.

Ever since debt papers began to be appraised by these credit rating agencies, the ratings determined the risk and, hence, the price and cost of investing in such instruments.

Today, most of us will agree that these fiduciaries have abjectly failed in discharging their trust to the global investing community.

Wall Street and the rating agencies were inextricably linked. More than $1.5 trillion of high-risk sub prime mortgages originated in the US between 2004 and end-2007; if you add to this marginally lower risk below prime mortgage, the amount will total over $3 trillion.

These mortgages were aggregated, sliced, window-dressed in every conceivable manner to create myriad portfolio of collateralised debt obligations which, after a few iterations and re-slicing, had no clear relationship to the real underlying assets.

Each agency assigned fairly attractive ratings to most of these securities based on arcane mathematical models. Armed with good ratings, these pieces of paper were sold everywhere – pension funds, private equity firms, municipal treasuries, sovereign funds, mutual funds and the rest.

No buyer knew the quality of what they were purchasing. Probably, it is high time regulators across the globe try to simplify things without stifling innovations.

4.11 GLOBAL OUTLOOK

Global pathways

Globalisation of finance

In his recently released book 'The World is Curved – Hidden Dangers to Global Economy' David M Smick, the editor and founder of International Economy Magazine, focuses on international capital flows and says, "Forget decoupling; the world is intimately connected."

The title is a reference to Tomas Friedman's 2005 bestseller 'The World is Flat'. Friedman's book focused on the 'real' economy, where globalisation has reduced distances and countries have become less important; all is footloose and border-free.

Smick sees his book, as its counterpart, dealing with the globalisation of finance.

He thinks this has been a good thing; world growth has never been stronger.

But it also means that failures in one place can trigger avalanches on the other side of the globe.

This is what the 'curve' of the title refers to; whereas Friedman's world is a level-playing field,

Smick's has a horizon beyond which we cannot see.

Smick's veers towards Naseem Taleb's 'Black Swan' theory of the unprecedented and the unpredictable happening and changing the world forever.

A Perfect Storm

A poll of economists showed: The leading economies will likely be in recession for around a year. The survey of around 250 economists across the G-7 nations showed economies facing a recession for as much as in five-quarters.

Marco Annunziata, economists at UniCredit said: "All developed economies will contract in 2009. It's the worst we have had in a century. But to say it's going to look like 1929 again for all these economies is a bit excessive. It's too pessimistic.

Meanwhile, The International Monetary Fund (IMF) steeped in to bail out troubled Iceland leading a $10.2 billion help package, and was set to make as much as $40 billion available to Turkey.

12. ISSUES OF THE PRESENT

Freedom to get & fail in the system of free enterprise

Beyond doom and gloom

The global financial system is possibly in its worst ever interlude and the received wisdom is that it has possibly not hit the nadir as yet. Several governments and regulators have been working overtime to device innovative solutions to get the markets to function normally. With the stupendous amount of liquidity – in excess of a trillion dollar – that has been pumped into the global credit markets, the element of trust between market participants, that is essential for a well functioning market, has started showing signs of some recovery. The massive recapitalisation requirement of the big banks is beginning to be addressed by way of increased government ownership of these banks

The global equity and commodity markets have, however, been on a free fall with October being one of the worst months in history. This scale of wealth destruction in just one month has rarely been seen in recent history. Still, the news flow has been quite depressing with auto companies halving capacity utilisation levels, petroleum refining margins collapsing, the rising NPAs in the banking system and indefinite postponement of the corporate capex plans. Though the Sensex has halved in the last 10 months and is currently trading at the valuation of around 10 times FY 2009 earnings, it would possibly take quite some time for the anaemic earnings growth to catch up and make the Indian market a compelling buy.

This is more so for foreign investors who have suffered a 20% depreciation of the rupee vis-à-vis the dollar thus far in 2008. Inflation is still hovering around the 9% mark and money market liquidity requiring repeated cuts in the CRR to maintain a semblance of normalcy. The Indian equity market is, therefore, delicately poised at exactly the wrong end of the dynamics that sustained the three year bull run till 2007 – robust economic growth, low inflation and burgeoning foreign portfolio inflows.

An analysis of the institutional funds flow into the Indian equity market over the last three years highlights the current tenuous state of the market. Net foreign portfolio inflows of $8 billion, coupled with domestic institutional flows of around $3 billion in 2006 took the sensex up by 47% during the year. In 2007, the sensex appreciated by another 47% on the back of FII net inflows of around $17 billion and domestic institutional flows of another $2 billion. Till the end of October in 2008, the sensex has corrected by 52% aided by an FII outflow of around $13 billion, despite the domestic institutions pumping in more than $3 billion into the market.

With the assets of the domestic mutual fund industry contracting by about a fifth in October on account of unprecedented redemption pressure and the insurance industry finding increased customer resistance to the hitherto successful Ulips, the prospects of domestic institutions being able to stand up to any large-scale sell from foreign portfolio investors are not very bright. The potential impact of further sizeable disinvestment by foreign portfolio investors can therefore be very difficult. However, the pool of foreign portfolio investments in India that was worth around $200 billion at one time has been significantly eroded by recent sales, a falling market and the depreciating rupee and is now estimated to be worth less than $50 billion. Pressing further concentrated sales can only accelerate value erosion.

While inexpensive valuation itself is not sufficient for a change in market direction, if history is any guide, markets do not wait for the signals of improving earnings and liquidity or softening interest rates for a rally to begin. Given that the bear market has already covered quite some distance, it is prudent not to be unduly bearish at these levels.

5. BANKING SECTOR

Join the Gang

When in doubt, join the gang as there is safety in numbers, seems to be the RBI's philosophy. After striking a pragmatic note with it's *'no change, let's wait and watch'* mid-term review of annual policy statement a week ago on 24th October 2008, the RBI chose to open the liquidity tap again on 1st November 2008. The central bank also found additional comfort in taking the 'lead' provided by the US Federal Reserve and the People's Bank of China, both of which cut key rates on 29th October 2008. The RBI's intent is clear. It means to flood the system with liquidity.

Day one November 2008, citing evident signs of a global recession the RBI has opened sluice gates further to banks for lending. This time the central bank has used most of the conventional tools as its disposal and taken some unconventional measures as well. The RBI not only cut its repo rate 50 basis points from 8% to 7.5%, but went further. It reduced the cash reserve ratio (CRR) 100 basis point to 5.5%, and reduced the statutory liquidity ratio (SLR) by 1% to 24%. It also announced a special refinance facility of up to 1% of their net demand and time liability (NDTL) to banks for 90 days. And to top of all, the RBI declared its intent to buy back securities issued to banks under its market stabilisation scheme, proving another source to longer-term liquidity.

New working capital borrowing norms: Credit limit of companies would now be fixed based on their average utilisation of funds in the last three years. For instance, if the working capital limit (also called the credit limit) of a company is Rs 100 crore but its average fund utilisation was only Rs 60 crore, the new working capital limit would be Rs 60 crore.

Bankers say the move was necessary to free up cash which was otherwise locked up in credit lines to current borrowers. There is no need to unnecessarily block the money by allowing the borrowers to have such credit limit which they cannot use. The same money can be lent to many other borrowers who may really need it. Liquidity is not something which can be expanded beyond a certain limit but the number of borrowers and their requirement keeps increasing. In such a scenario, it is advisable that bankers take prudent measures for the optimum utilisation of the available cash with them.

Forex swap lifeline for dollar-hungry banks: The RBI on 7th November 2008 announced that it would provide foreign exchange liquidity to overseas branches and subsidiaries of local banks through forex swaps. Under this, the bank in need of dollar will do a buy/sell swap with RBI – i.e. buy dollar in the spot and sell it in the forward. Till now, banks have been doing this in the regular currency market with other banks. The transaction with RBI through the special window will be off-market and lend comfort to the foreign exchange as well as money-market.

Some of the foreign branches of the Indian banks have run into severe liquidity crunch since they have been typically borrowing short-term money to fund long-term assets. As rolling over short-term borrowings was impossible in frozen credit markets, banks struck swap deals to take dollar available with other banks in India. It was an expensive operation, but Indian banks had little choice. Indian banks faced further problems since their established dollar lines with banks like Wachovia dried up.

RBI stimulus for strapped credit market: A day after the G20 global leaders' meet on tackling the financial crisis, the RBI took the lead among central banks in moving to boost credit markets on 15th November 2008. The measures come less than 24 hours after Federal Reserve chairman Ben Bernanke said that global policy makers would remain in close contact, monitor developments closely and stand ready to take additional steps.

- The RBI removed the additional capital requirement placed on lending to real estate.

The RBI said the higher risk weightage on real estate was introduced as a counter cyclical measure and was being rolled back keeping in mind the global macro economic situation.

- The RBI provided an additional Rs 22,500 crore for cheap export refinance.

Given the likelihood of an export slowdown the RBI decided to raise the eligible limit of export credit refinance for banks to 50% of the outstanding export credit eligible for refinance.

- To boost dollar inflows, the RBI has allowed housing finance companies to borrow abroad.

According to measures announced, banks can now offer Libor/swap rates plus 100-basis points on FCNR (B) rates as against the current ceiling of 25 basis points over Libor.

- To boost inflows, RBI raised the ceiling on interest rates that banks could offer on *NR(E)RA* deposits.

Banks can now offer on non-resident deposits Libor/swap rates plus 175 basis points as against the current ceiling of 100 basis points over Libor.

- The RBI allowed corporates to buy back FCCBs which are now quoting at dirt cheap rates.

To buy back foreign currency convertible bonds (FCCBs), the RBI said it would consider proposals to prematurely buy back their FCCBs. The buy back should be financed by the company's foreign resources held in India or abroad and/or out of fresh ECB raised in conformity with the current norms of ECBs. Proposals in this regard would be considered under the approval route. Extension of FCCBs would also be permitted at the current all-in cost for the relative maturity.

- The refinance facility aimed at encouraging banks to lend to mutual funds and finance companies has been extended to end March 31, 2008.

NPA fears may put bank on the defensive

According to a Goldman Sachs report, Indian banks are expected to come under further stress in coming months. We expect Indian banks to continue to face significant headwinds, given the origin of the current crisis lies in the financial sector. Access to short-term funds through inter-bank lending, the original cause of the liquidity squeeze, remains difficult.

We believe their ability to raise more long-term capital will be impaired, considering the state of financial market. More importantly, our banks' research team estimates that non-performing loans (NPLs) will double. The higher bad loans will make banks more risk-averse and less willing to lend.

6. SECURITY LAWS UPDATES

1. Rights issues

Indian companies are now banking on their existing shareholders to provide for future expansion as credit crunch shrinks avenues to raise capital. The first half of the current financial year, which has witnessed a sharp drop in volume and quantum of funds raised through initial public offer (IPO), follow-on-public offer (FPO), qualified institutional placements (QIP) and overseas issues, has actually seen higher number of rights issues compared to the first half of the last fiscal.

According to data complied by Prime Database, the number of IPO & FPOs have dropped 63% while QIPs have plunged 91% in April-September period this year. In contrast, the number of rights issues has moved up from 11 issues in the first half of the last financial year to 13 this year. The amount of funds raised through rights has also shot up. Firms that came up with rights issues this year include United Breweries, JK Tyre, Hindalco and Tata Motors.

The financial crisis in the West has made institutional investors cautious as they expect further downside to valuations. In this scenario, companies can look either at preferential allotments to promoters or rights issues as there is not much investment interest from outsiders. As debt has become expensive, thanks to the rising interest rates, equity is the obvious alternative to raise funds. Even, rights issues perked up this year is not a guaranteed way to raise cheap money. The consistent bearish market sentiments threatens to take the sheen away from rights issues as investor can purchase to the shares from the stock market at the same or even lower prices.

Analysts pointed out: "Some promoters also use rights issues to raise their equity holding by pricing the issue close to the market price. In such a scenario, promoters buy shares which are not subscribed by shareholders, thereby increasing their stake."

So, despite rights issues failing to woo investors, India Inc is looking at raising money via this route. Companies such as Religare Enterprises, Disc TV, Tayo Rolls and Jaiprakash Associates are all set to come out with rights offerings this calendar year. For Indian promoters, subscribing to the unsubscribed portion of a right issue is a relatively unrestrained route to increase stake. However, this clearly is the flavour of the season among promoters who want to raise stake in a company dramatically.

Recently, promoters of companies such as Tata Motors and Hindalco Industries took advantage of investors shunning their rights issue to raise stake in their respective companies. Post-issue, while promoter's stake in Tata Motors went up to 42% from 33%, Hindalco promoter's stake went up 35.1% from 31.9%. Both the rights offering (Tata: Rs 4,145 crore & Hindalco: Rs 5,000 crore, respectively) received tepid response from retail and institutional investors. Interestingly, two other major Tata Group companies – Tata Investment Corporation and Indian Hotels – also received a lukewarm response for their rights issue from retail and institutional investors recently, and eventually the promoters had to intervene to save the blushes. Despite the indifferent response, promoters are planning another rights issue for its group company. The merchant banking community doesn't rule out the possibility of these companies intentionally timing their rights issue during the current volatile times.

Analysts unanimously agree that for a right issue to be fully subscribed, it should be offered at a discount of at least 25% given the current market conditions.

2. Manipulators stock

We have been hearing about it for a while but it seems to be official now. An Intelligent Bureau (IB) report analysing India's financial and commodity market has said: "A number of brokers have colluded with promoters of small companies to manoeuvre their stock prices".

The report tracked manipulations included placement of shares in benami and front entity company names; granting contracts to brokers to play with their shares and entering into agreement to indulge in circular trading thereby leading to price manipulation. The IB analysed market manipulations by companies across sectors and sizes, which highlighted the fact the manoeuvring of stock prices is no longer limited to just insider trading. The report in its sub-head "market activity in specific stocks" has mentioned the detailed plans of manoeuvring stock prices of a number of companies.

According to the IB report, **Sterlite Industries**, part of the Vedanta group, has indulged in alleged insider trading during September, 2008. The report found strong evidence of insider trading in SIL.

It highlighted how the company, which announced its decision to restructure into three commodity-focused vertical companies on September 8, revoked its decision quite dramatically after 16 days.

After the restructuring announcements, SIL's share price declined by as much as 33% on the bourses to hit an intra-day low of Rs 405 on September 17, before it again started its northward journey. Thereafter, the SIL stock began to rise despite negative views expressed by analysts.

By September 24 (the date on which company announced revocation of its plan), the stock rose by almost 25% to touch an intra-day high of Rs 517."

Moving on **Uttam Galva**, the IB report stated that an associate cartel of brokers in league with the company's promoters bought five million shares from the stock market at a price of Rs 40. The promoters are now planning to buyback those shares in early 2009 at Rs 62.

In case of **Cerebra Integrated Technologies**, IB report said that a Chennai-based stockbroker has shown keen interest in the company's stock since January 2007 in collusion with other market manipulating entities. The broker who trades through multiple accounts has been actively indulging in circular trading, thereby creating artificial stock price. On the Bombay Stock Exchange, the company's market capitalisation has soared from Rs 5 crore (January 2, 2007) to almost Rs 29 crore (September 30, 2008).

The same broker has now been granted a 'contract' to 'play with' Rs 100 crore worth of shares of Ahmedabad-based entity, **Bell Corporation**, which plans to list on the bourses in near future.

Similarly, in collusion with the promoters of Kolkata-based **Microsec Financial Services**, a broker along with another Ahmedabad-based operator is planning to manipulate their upcoming public offering. The operators are in constant touch with each other with regard to "placement of shares in benami and front entity company names." Earlier this year, Microsec has filed a draft red-herring prospectus with the market regulator. It is planning to raise Rs 160 crore from the public issue.

We feel that Sebi should come down heavily on market manipulators who artificially raise expectations of unsuspecting investors. It's a public menace.

7. IS INFLATION THE RIGHT BATTLES?

The Spectre of Deflation

Inflation was the threat. Led by rising oil and food prices, it was increasing in most countries. But, recently, deflation has suddenly become conceivable and, though still a *long shot*, it's much more threatening than most people realise. The most urgent economic task for the US new president and other world leaders is to prevent the *long shot* from happening. A mild deflation – like a mild inflation – would be barely noticeable, and even pleasurable.

Who doesn't like lower prices? But beyond a few % points, deflation can create economic disorder by forcing debtors to repay loans in more expensive money and causing consumers to postpone purchases. In the Great Depression, deflation reigned. Consumer price fell about a quarter from 1929 to 1933. Spending collapsed. Supply swamped demand, driving prices down. By 1933, manufacturing output had dropped 39% and joblessness had reached 25%. It's this history that makes deflation terrifying.

In US since mid-September, economic conditions have deteriorated badly. Signs of distress also abounded. Stock markets in developing countries have declined about a third. By all odds, this signals a recession that, though severe, fits within the post-World II experience.

It will suppress inflation, not trigger deflation.

Remember: US consumer prices in September were about 5% higher than a year earlier; in developing countries, inflation now averages about 9%. Remember, too, the economy has changed fundamentally since the 1930s. Then, factories and farms dominated. Gluts quickly depressed prices of wheat, steel and meat. Now, our service economy features health care, entertainment and education. Their prices are less volatile. Still, this crisis has repeatedly confounded "experts."

A few months ago, it was widely believed that many developing countries had largely escaped the financial turmoil of rich countries. Their growth would cushion the downturns in the advanced world.

No more. In 2007, China grew 11.9% and India 9.3%. The latest forecast from the IMF cuts their growth in 2009 to 8.5% and 6.3%. It predicts harsher recessions for rich country and slower growth for poor countries. So, there's a possibility that we're on the doorstep of a more dangerous global downturn.

Something significant happened in mid-September, either caused by the bankruptcy of Lehman Brothers or coincident with it. Trust among financial institutions evaporated. Credit spreads – the gap between commercial interest rates and rates of safe Treasury securities – exploded. Stock markets plunged. Economies everywhere lurched downward. Prices for basic commodities, the feedstock of modern economies, attest to a major break. They'd drifted down from historical highs that were usually attributed to strong demand from China and India. Suddenly, prices nose-dived. Oil, now below $60 a barrel, down from almost $150. We have never seen markets turn this quickly or violently.

In theory, lower commodity prices could be a boon. If the propensity to spend among consuming nations is greater than among producing nations, lower prices would promote a global recovery. But in practice, lower commodity prices might herald a broader deflation. We don't know. But we do know that a severe deflation could abort any recovery. Its harm would operate through two channels: First, debt: As prices fell and old debts stayed fixed, companies would have a harder time repaying; bankruptcies and unemployment would increase; banks would suffer more loan losses; the same process would happen to household debts if wages fell. Second, deferred spending: If people believe prices will be lower next month, they may wait to buy; if too many shoppers wait, the economy spirals downward.

Inflation creeps up to 10.72%

After declining for five weeks, inflation inched up marginally to 10.72% for the week ended October 25, from 10.68% in the week before that. The marginal increase in the wholesale price index (WPI)-based inflation was due to an upward movement in the prices of primary articles, which together have a weight of 22% in the index. Despite the marginal increase, economists expect the downward movement in inflation to continue.

Inflation in single digits after sharp drop

Inflation rate fell sharply to a near 6-month low of **8.98%** for the week to November 1, a drop of almost 4 points from its August peak, surprising financial markets and providing the RBI plenty of room to take the knife to interest rates to prop up a slowing economy. The fall in the inflation rate, helped by a steep drop in prices of some petroleum products and metals, will give a welcome relief to the government reeling under a raft of bad news on the economic front from falling exports and a drop in tax collections. The drop could also help the government politically ahead of key state elections later this month.

FM seeks price cuts in return for lower duty

With the global economic crisis looming large, India has readied its war chest to help the economy grow faster. Finance Minister P Chidambaram promised to India Inc that the government was all ready to do its bit even as he asked industry to pitch in by cutting prices to spur demand. He said: "I am open to examining suggestions to cut excise duty further … The classic response to a demand slowdown is to reduce prices in the short term. Carmaker, two-wheeler companies, hotels, airlines and real state developers have to reduce prices. Rather than letting inventory build up and taking a hit on the profit and loss statement, companies should reduce prices. This will also help them retain their market share."

Inflation falls further, touches 8.9%

Continuing its southward movement, inflation dropped to 8.9% for the week ended November 8 from 8.98% the week before that. However, the decline was meager against the sharp 1.74% drop in inflation the week ended November 1. The 0.4% increase in prices of primary products, which include food articles such as pulses, fruits and vegetables, during the course of the week, was one of the main reasons, which made drop in inflation marginal. Despite the drop in inflation to single digit levels, both in absolute terms and relative terms, it is still higher than the central bank's target of 5% for the year. Economists, however, are of view that it has ceased to be a concern. The central bank can cut rates to stimulate growth without worrying about inflation, they argued, as they expect inflation to drop sharply in the next few weeks.

Inflation eases further; down to 8.84%

Continuing its southward movement, inflation dropped to 8.84% for the week ended November 15 from 8.9% the week before that. Again the drop was meager similar to week ended November 8. Economist say while overall inflation has ceased to be a concern, the relentless rise in food prices is a worry. The arrival of new kharif or summer crop was expected to soften prices, but that has not happened so far. Cereals, pulses and vegetables have become dearer week-on-week. The price of rice has moved up 6% during the space of a month to November 15.

8. MISCELLANEOUS UPDATES

1. New US president

Barack Obama rode a wave of voter discontent to a historic White House victory, promising change as the first black US president but facing enormous challenges from a deep economic crisis and two lingering wars. Obama led Democrats to a sweeping victory that expanded their majorities in both houses of Congress as Americans emphatically rejected President George W Bush's eight years of leadership.

His triumph over Republican rival John McCain on Tuesday is a milestone that could help the United States buries its long and often brutal history of racism. Raucous street celebration erupted across the country, but Obama will have little or no time off to enjoy the victory. He was expected to start work on Wednesday (5/11/08) on planning a course for his formal takeover on January 20 and putting together a team to tackle the huge challenges at home and abroad.

The new US president will face intense pressure to deliver on his campaign promises. He has vowed to restore US leadership in the world by working closely with foreign allies, to withdraw US troops from Iraq in the first 16 months of his term and to bolster US troop levels in Afghanistan. But his immediate task will be tackling the US financial crisis, the worst since the Great Depression.

The president-elect has proposed a stimulus package that could cost about $175 billion. For conservatives, Barack Obama's spectacular win is the victory of a Super Santa Claus. Obama's promise to convert the exchequer into a candy dispenser that provide funds for medical bills, fuel charges and mortgage payments swayed the US electorate into voting the most far Left president candidate in American history.

Will all these kill the notion of the US as a centre-right nation?

Not many agree. In the long run, the 'change' that Obama promises cannot be a reversal of the US policies. For, the challenges are similar –

- **Iran will continue to pursue its nuclear ambitions;**
- **Russia may not observe good neighbourly relations;**
- **Murderous jihadis will attempt to take over Pakistan;**
- **Tinpot dictator Hugo Chavez will run riot;**
- **And above all economy may not stabilise that soon.**

The prescriptions of Democrats can only make matters worse – Imposition of new taxes could lead to more pink slips, amnesty for illegal fence-jumpers could pose security problems and cut in defence spending could lead to serious troubles for industry, jobs and security.

And America is known to reject things that are not compatible with its idea of freedom and prosperity.

9. KNOWLEDGE RESOURCE

G-20 Washington Summit

When Prime Minister Manmohan Singh travels to the US for the G-20 meeting on the financial crisis, his main aim was to ensure that India continues to be actively involved in any future remedies for reforming the international financial system. The Indian team, which includes Planning Commission deputy chairman Montek Singh Ahluwalia and department of economic affairs secretary Ashok Chawla, will try to ensure that India is not pushed to the margins and continues to be relevant to the dialogue.

New Delhi's perception is that the solution to the crisis lies in more, not less, globalisation. However, the globalisation process has to be inclusive, meaning it can no longer be led by the clutch of rich nations as in the pre-crisis days, but include major emerging nations in a strengthened oversight mechanism.

India's concerns at the group of 20 developed and emerging nations would be threefold. One, the global financial system must become more inclusive; two, growth of the developing economies must be protected and, three, the leading economies of the world must guard against protectionist economies.

The inaugural banquet

The first leg of the financial summit got to a good start, with the assembled heads of the leading 20 nations attending the inaugural banquet held by the US President Bush. Despite underlying tensions over the summit's objectives, Bush was all smiles as he welcomed arriving leaders, including Britain's Brown, French President Nicolas Sarkozy, Russian President Drnitry Medvedev, UN secretary-general Ban Ki-moon, Italian Prime Minister Silvio Berlusconi and Japanese Prime Minister Taro Aso.

US President George W Bush tried to counter criticism that US-style capitalism is to blame for the crisis. He said that free market principles offer the surest path to lasting prosperity. He has urged leaders to work to fix the system, not dismantle it. Despite the lame duck presidency of Mr Bush and President-elect Barack Obama absent, progress is being achieved on four vital fronts.

- One, there is growing consensus on the need for a coordinated fiscal stimulus in all the major economies. Coordinated expansionary programme are more likely to work than uncoordinated ones as much for the combined larger effect as for the guarantee that countries would actually carry out announced expansion without the fear that the actual beneficiaries of the domestic expansion would be external suppliers of goods and services.

- Two, the leaders are expected to send out a strong signal against protectionism that would curtail the growth momentum of the developing countries that drive growth in the global economy today.

- Three, some progress is expected to be made in gaining representation or greater say in global institutions of finance such as the IMF and the Forum of Financial Stability, a rich nation grouping that came up in the wake of the Asian crisis of 1997.

- Four, some additional sources of multilateral financial flows have already been identified and the summit would consolidate such moves.

Declaration
Summit on financial markets and the world economy
November 15, 2008

1. We, the Leaders of the Group of Twenty, held an initial meeting in Washington on November 15, 2008, amid serious challenges to the world economy and financial markets. We are determined to enhance our cooperation and work together to restore global growth and achieve needed reforms in the world's financial systems.

2. Over the past months our countries have taken urgent and exceptional measures to support the global economy and stabilize financial markets. These efforts must continue. At the same time, we must lay the foundation for reform to help to ensure that a global crisis, such as this one, does not happen again. Our work will be guided by a shared belief that market principles, open trade and investment regimes, and effectively regulated financial markets foster the dynamism, innovation, and entrepreneurship that are essential for economic growth, employment, and poverty reduction.

Root Causes of the Current Crisis

3. During a period of strong global growth, growing capital flows, and prolonged stability earlier this decade, market participants sought higher yields without an adequate appreciation of the risks and failed to exercise proper due diligence. At the same time, weak underwriting standards, unsound risk management practices, increasingly complex and opaque financial products, and consequent excessive leverage combined to create vulnerabilities in the system. Policy-makers, regulators and supervisors, in some advanced countries, did not adequately appreciate and address the risks building up in financial markets, keep pace with financial innovation, or take into account the systemic ramifications of domestic regulatory actions.

4. Major underlying factors to the current situation were, among others, inconsistent and insufficiently coordinated macroeconomic policies, inadequate structural reforms, which led to unsustainable global macroeconomic outcomes. These developments, together, contributed to excesses and ultimately resulted in severe market disruption.

Actions Taken and to Be Taken

5. We have taken strong and significant actions to date to stimulate our economies, provide liquidity, strengthen the capital of financial institutions, protect savings and deposits, address regulatory deficiencies, unfreeze credit markets, and are working to ensure that international financial institutions (IFIs) can provide critical support for the global economy.

6. But more needs to be done to stabilize financial markets and support economic growth. Economic momentum is slowing substantially in major economies and the global outlook has weakened. Many emerging market economies, which helped sustain the world economy this decade, are still experiencing good growth but increasingly are being adversely impacted by the worldwide slowdown.

7. Against this background of deteriorating economic conditions worldwide, we agreed that a broader policy response is needed; based on closer macroeconomic cooperation, to restore growth, avoid negative spillovers and support emerging market economies and developing countries. As immediate steps to achieve these objectives, as well as to address longer-term challenges, we will:

• Continue our vigorous efforts and take whatever further actions are necessary to stabilize the financial system.

• Recognize the importance of monetary policy support, as deemed appropriate to domestic conditions.

• Use fiscal measures to stimulate domestic demand to rapid effect, as appropriate, while maintaining a policy framework conducive to fiscal sustainability.

• Help emerging and developing economies gain access to finance in current difficult financial conditions, including through liquidity facilities and program support. We stress the International Monetary Fund's (IMF) important role in crisis response, welcome its new short-term liquidity facility, and urge the ongoing review of its instruments and facilities to ensure flexibility.

• Encourage the World Bank and other multilateral development banks (MDBs) to use their full capacity in support of their development agenda, and we welcome the recent introduction of new facilities by the World Bank in the areas of infrastructure and trade finance.

• Ensure that the IMF, World Bank and other MDBs have sufficient resources to continue playing their role in overcoming the crisis.

Common Principles for Reform of Financial Markets

8. In addition to the actions taken above, we will implement reforms that will strengthen financial markets and regulatory regimes so as to avoid future crises. Regulation is first and foremost the responsibility of national regulators who constitute the first line of defense against market instability. However, our financial markets are global in scope, therefore, intensified international cooperation among regulators and strengthening of international standards, where necessary, and their consistent implementation is necessary to protect against adverse cross-border, regional and global developments affecting international financial stability. Regulators must ensure that their actions support market discipline, avoid potentially adverse impacts on other countries, including regulatory arbitrage, and support competition, dynamism and innovation in the marketplace. Financial institutions must also bear their responsibility for the turmoil and should do their part to overcome it including by recognizing losses, improving disclosure and strengthening their governance and risk management practices.

9. We commit to implementing policies consistent with the following common principles for reform.

• **Strengthening Transparency and Accountability:** We will strengthen financial market transparency, including by enhancing required disclosure on complex financial products and ensuring complete and accurate disclosure by firms of their financial conditions. Incentives should be aligned to avoid excessive risk-taking.

• **Enhancing Sound Regulation:** We pledge to strengthen our regulatory regimes, prudential oversight, and risk management, and ensure that all financial markets, products and participants are regulated or subject to oversight, as appropriate to their circumstances. We will exercise strong oversight over credit rating agencies, consistent with the agreed and strengthened international code of conduct. We will also make regulatory regimes more effective over the economic cycle, while ensuring that regulation is efficient, does not stifle innovation, and encourages expanded trade in financial products and services. We commit to transparent assessments of our national regulatory systems.

• **Promoting Integrity in Financial Markets:** We commit to protect the integrity of the world's financial markets by bolstering investor and consumer protection, avoiding conflicts of interest, preventing illegal market manipulation, fraudulent activities and abuse, and protecting against illicit finance risks arising from noncooperative jurisdictions. We will also promote information sharing, including with respect to jurisdictions that have yet to commit to international standards with respect to bank secrecy and transparency.

• **Reinforcing International Cooperation:** We call upon our national and regional regulators to formulate their regulations and other measures in a consistent manner. Regulators should enhance their coordination and cooperation across all segments of financial markets, including with respect to cross-border capital flows. Regulators and other relevant authorities as a matter of priority should strengthen cooperation on crisis prevention, management, and resolution.

• **Reforming International Financial Institutions:** We are committed to advancing the reform of the Bretton Woods Institutions so that they can more adequately reflect changing economic weights in the world economy in order to increase their legitimacy and effectiveness. In this respect, emerging and developing economies, including the poorest countries, should have greater voice and representation. The Financial Stability Forum (FSF) must expand urgently to a broader membership of emerging economies, and other major standard setting bodies should promptly review their membership. The IMF, in collaboration with the expanded FSF and other bodies, should work to better identify vulnerabilities, anticipate potential stresses, and act swiftly to play a key role in crisis response.

Tasking of Ministers and Experts

10. We are committed to taking rapid action to implement these principles. We instruct our Finance Ministers, as coordinated by their 2009 G-20 leadership (Brazil, UK, Republic of Korea), to initiate processes and a timeline to do so. An initial list of specific measures is set forth in the attached Action Plan, including high priority actions to be completed prior to March 31, 2009.

In consultation with other economies and existing bodies, drawing upon the recommendations of such eminent independent experts as they may appoint, we request our Finance Ministers to formulate additional recommendations, including in the following specific areas:

• Mitigating against pro-cyclicality in regulatory policy;

• Reviewing and aligning global accounting standards, particularly for complex securities in times of stress;

• Strengthening the resilience and transparency of credit derivatives markets and reducing their systemic risks, including by improving the infrastructure of over-the counter markets;

• Reviewing compensation practices as they relate to incentives for risk taking and innovation;

• Reviewing the mandates, governance, and resource requirements of the IFIs; and

• Defining the scope of systemically important institutions and determining their appropriate regulation or oversight.

11. In view of the role of the G-20 in financial systems reform, we will meet again by April 30, 2009, to review the implementation of the principles and decisions agreed today.

Commitment to an Open Global Economy

12. We recognize that these reforms will only be successful if grounded in a commitment to free market principles, including the rule of law, respect for private property, open trade and investment, competitive markets, and efficient, effectively regulated financial systems. These principles are essential to economic growth and prosperity and have lifted millions out of poverty, and have significantly raised the global standard of living. Recognizing the necessity to improve financial sector regulation, we must avoid overregulation that would hamper economic growth and exacerbate the contraction of capital flows, including to developing countries.

13. We underscore the critical importance of rejecting protectionism and not turning inward in times of financial uncertainty. In this regard, within the next 12 months, we will refrain from raising new barriers to investment or to trade in goods and services, imposing new export restrictions, or implementing World Trade Organization (WTO) inconsistent measures to stimulate exports. Further, we shall strive to reach agreement this year on modalities that leads to a successful conclusion to the WTO's Doha Development Agenda with an ambitious and balanced outcome. We instruct our Trade Ministers to achieve this objective and stand ready to assist directly, as necessary. We also agree that our countries have the largest stake in the global trading system and therefore each must make the positive contributions necessary to achieve such an outcome.

14. We are mindful of the impact of the current crisis on developing countries, particularly the most vulnerable. We reaffirm the importance of the Millennium Development Goals, the development assistance commitments we have made, and urge both developed and emerging economies to undertake commitments consistent with their capacities and roles in the global economy. In this regard, we reaffirm the development principles agreed at the 2002 United Nations Conference on Financing for Development in Monterrey, Mexico, which emphasized country ownership and mobilizing all sources of financing for development.

15. We remain committed to addressing other critical challenges such as energy security and climate change, food security, the rule of law, and the fight against terrorism, poverty and disease.

16. As we move forward, we are confident that through continued partnership, cooperation, and multilateralism, we will overcome the challenges before us and restore stability and prosperity to the world economy.

Action Plan to Implement Principles for Reform

This Action Plan sets forth a comprehensive work plan to implement the five agreed principles for reform. Our finance ministers will work to ensure that the taskings set forth in this Action Plan are fully and vigorously implemented. They are responsible for the development and implementation of these recommendations drawing on the ongoing work of relevant bodies, including the International Monetary Fund (IMF), an expanded Financial Stability Forum (FSF), and standard setting bodies.

1. Strengthening Transparency and Accountability

Immediate Actions by March 31, 2009

• The key global accounting standards bodies should work to enhance guidance for valuation of securities, also taking into account the valuation of complex, illiquid products, especially during times of stress.

• Accounting standard setters should significantly advance their work to address weaknesses in accounting and disclosure standards for off-balance sheet vehicles.

• Regulators and accounting standard setters should enhance the required disclosure of complex financial instruments by firms to market participants.

• With a view toward promoting financial stability, the governance of the international accounting standard setting body should be further enhanced, including by undertaking a review of its membership, in particular in order to ensure transparency, accountability, and an appropriate relationship between this independent body and the relevant authorities.

• Private sector bodies that have already developed best practices for private pools of capital and/or hedge funds should bring forward proposals for a set of unified best practices. Finance Ministers should assess the adequacy of these proposals, drawing upon the analysis of regulators, the expanded FSF, and other relevant bodies.

Medium-term actions

• The key global accounting standards bodies should work intensively toward the objective of creating a single high-quality global standard.

• Regulators, supervisors, and accounting standard setters, as appropriate, should work with each other and the private sector on an ongoing basis to ensure consistent application and enforcement of high-quality accounting standards.

• Financial institutions should provide enhanced risk disclosures in their reporting and disclose all losses on an ongoing basis, consistent with international best practice, as appropriate. Regulators should work to ensure that a financial institution' financial statements include a complete, accurate, and timely picture of the firm's activities (including off-balance sheet activities) and are reported on a consistent and regular basis.

2. Enhancing Sound Regulation

Regulatory Regimes

Immediate Actions by March 31, 2009

• The IMF, expanded FSF, and other regulators and bodies should develop recommendations to mitigate pro-cyclicality, including the review of how valuation and leverage, bank capital, executive compensation, and provisioning practices may exacerbate cyclical trends.

Medium-term actions

• To the extent countries or regions have not already done so, each country or region pledges to review and report on the structure and principles of its regulatory system to ensure it is compatible with a modern and increasingly globalized financial system. To this end, all G-20 members commit to undertake a Financial Sector Assessment Program (FSAP) report and support the transparent assessments of countries' national regulatory systems.

• The appropriate bodies should review the differentiated nature of regulation in the banking, securities, and insurance sectors and provide a report outlining the issue and making recommendations on needed improvements. A review of the scope of financial regulation, with a special emphasis on institutions, instruments, and markets that are currently unregulated, along with ensuring that all systemically-important institutions are appropriately regulated, should also be undertaken.

• National and regional authorities should review resolution regimes and bankruptcy laws in light of recent experience to ensure that they permit an orderly wind-down of large complex cross-border financial institutions.

• Definitions of capital should be harmonized in order to achieve consistent measures of capital and capital adequacy.

Prudential Oversight

Immediate Actions by March 31, 2009

• Regulators should take steps to ensure that credit rating agencies meet the highest standards of the international organization of securities regulators and that they avoid conflicts of interest, provide greater disclosure to investors and to issuers, and differentiate ratings for complex products. This will help ensure that credit rating agencies have the right incentives and appropriate oversight to enable them to perform their important role in providing unbiased information and assessments to markets.

• The international organization of securities regulators should review credit rating agencies' adoption of the standards and mechanisms for monitoring compliance.

• Authorities should ensure that financial institutions maintain adequate capital in amounts necessary to sustain confidence. International standard setters should set out strengthened capital requirements for banks' structured credit and securitization activities.

• Supervisors and regulators, building on the imminent launch of central counterparty services for credit default swaps (CDS) in some countries, should: speed efforts to reduce the systemic risks of CDS and over-the-counter (OTC) derivatives transactions; insist that market participants support exchange traded or electronic trading platforms for CDS contracts; expand OTC derivatives market transparency; and ensure that the infrastructure for OTC derivatives can support growing volumes.

Medium-term actions

• Credit Ratings Agencies that provide public ratings should be registered.

• Supervisors and central banks should develop robust and internationally consistent approaches for liquidity supervision of, and central bank liquidity operations for, cross-border banks.

Risk Management

Immediate Actions by March 31, 2009

• Regulators should develop enhanced guidance to strengthen banks' risk management practices, in line with international best practices, and should encourage financial firms to reexamine their internal controls and implement strengthened policies for sound risk management.

• Regulators should develop and implement procedures to ensure that financial firms implement policies to better manage liquidity risk, including by creating strong liquidity cushions.

• Supervisors should ensure that financial firms develop processes that provide for timely and comprehensive measurement of risk concentrations and large counterparty risk positions across products and geographies.

• Firms should reassess their risk management models to guard against stress and report to supervisors on their efforts.

• The Basel Committee should study the need for and help develop firms' new stress testing models, as appropriate.

• Financial institutions should have clear internal incentives to promote stability, and action needs to be taken, through voluntary effort or regulatory action, to avoid compensation schemes which reward excessive short-term returns or risk taking.

• Banks should exercise effective risk management and due diligence over structured products and securitization.

Medium -term actions

• International standard setting bodies, working with a broad range of economies and other appropriate bodies, should ensure that regulatory policy makers are aware and able to respond rapidly to evolution and innovation in financial markets and products.

• Authorities should monitor substantial changes in asset prices and their implications for the macroeconomy and the financial system.

3. Promoting Integrity in Financial Markets

Immediate Actions by March 31, 2009

• Our national and regional authorities should work together to enhance regulatory cooperation between jurisdictions on a regional and international level.

• National and regional authorities should work to promote information sharing about domestic and cross-border threats to market stability and ensure that national (or regional, where applicable) legal provisions are adequate to address these threats.

• National and regional authorities should also review business conduct rules to protect markets and investors, especially against market manipulation and fraud and strengthen their cross-border cooperation to protect the international financial system from illicit actors. In case of misconduct, there should be an appropriate sanctions regime.

Medium -term actions

• National and regional authorities should implement national and international measures that protect the global financial system from uncooperative and nontransparent jurisdictions that pose risks of illicit financial activity.

• The Financial Action Task Force should continue its important work against money laundering and terrorist financing, and we support the efforts of the World Bank – UN Stolen Asset Recovery (StAR) Initiative.

• Tax authorities, drawing upon the work of relevant bodies such as the Organization for Economic Cooperation and Development (OECD), should continue efforts to promote tax information exchange. Lack of transparency and a failure to exchange tax information should be vigorously addressed.

4. Reinforcing International Cooperation

Immediate Actions by March 31, 2009

• Supervisors should collaborate to establish supervisory colleges for all major crossborder financial institutions, as part of efforts to strengthen the surveillance of crossborder firms. Major global banks should meet regularly with their supervisory college for comprehensive discussions of the firm's activities and assessment of the risks it faces.

• Regulators should take all steps necessary to strengthen cross-border crisis management arrangements, including on cooperation and communication with each other and with appropriate authorities, and develop comprehensive contact lists and conduct simulation exercises, as appropriate.

Medium -term actions

• Authorities, drawing especially on the work of regulators, should collect information on areas where convergence in regulatory practices such as accounting standards, auditing, and deposit insurance is making progress, is in need of accelerated progress, or where there may be potential for progress.

• Authorities should ensure that temporary measures to restore stability and confidence have minimal distortions and are unwound in a timely, well-sequenced and coordinated manner.

5. Reforming International Financial Institutions

Immediate Actions by March 31, 2009

• The FSF should expand to a broader membership of emerging economies.

• The IMF, with its focus on surveillance, and the expanded FSF, with its focus on standard setting, should strengthen their collaboration, enhancing efforts to better integrate regulatory and supervisory responses into the macro-prudential policy framework and conduct early warning exercises.

• The IMF, given its universal membership and core macro-financial expertise, should, in close coordination with the FSF and others, take a leading role in drawing lessons from the current crisis, consistent with its mandate.

• We should review the adequacy of the resources of the IMF, the World Bank Group and other multilateral development banks and stand ready to increase them where necessary. The IFIs should also continue to review and adapt their lending instruments to adequately meet their members' needs and revise their lending role in the light of the ongoing financial crisis.

• We should explore ways to restore emerging and developing countries' access to credit and resume private capital flows which are critical for sustainable growth and development, including ongoing infrastructure investment.

• In cases where severe market disruptions have limited access to the necessary financing for counter-cyclical fiscal policies, multilateral development banks must ensure arrangements are in place to support, as needed, those countries with a good track record and sound policies.

Medium -term actions

• We underscored that the Bretton Woods Institutions must be comprehensively reformed so that they can more adequately reflect changing economic weights in the world economy and be more responsive to future challenges. Emerging and developing economies should have greater voice and representation in these institutions.

• The IMF should conduct vigorous and even-handed surveillance reviews of all countries, as well as giving greater attention to their financial sectors and better integrating the reviews with the joint IMF/World Bank financial sector assessment programs. On this basis, the role of the IMF in providing macro-financial policy advice would be strengthened.

• Advanced economies, the IMF, and other international organizations should provide capacity-building programs for emerging market economies and developing countries on the formulation and the implementation of new major regulations, consistent with international standards.

Deep Connections

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