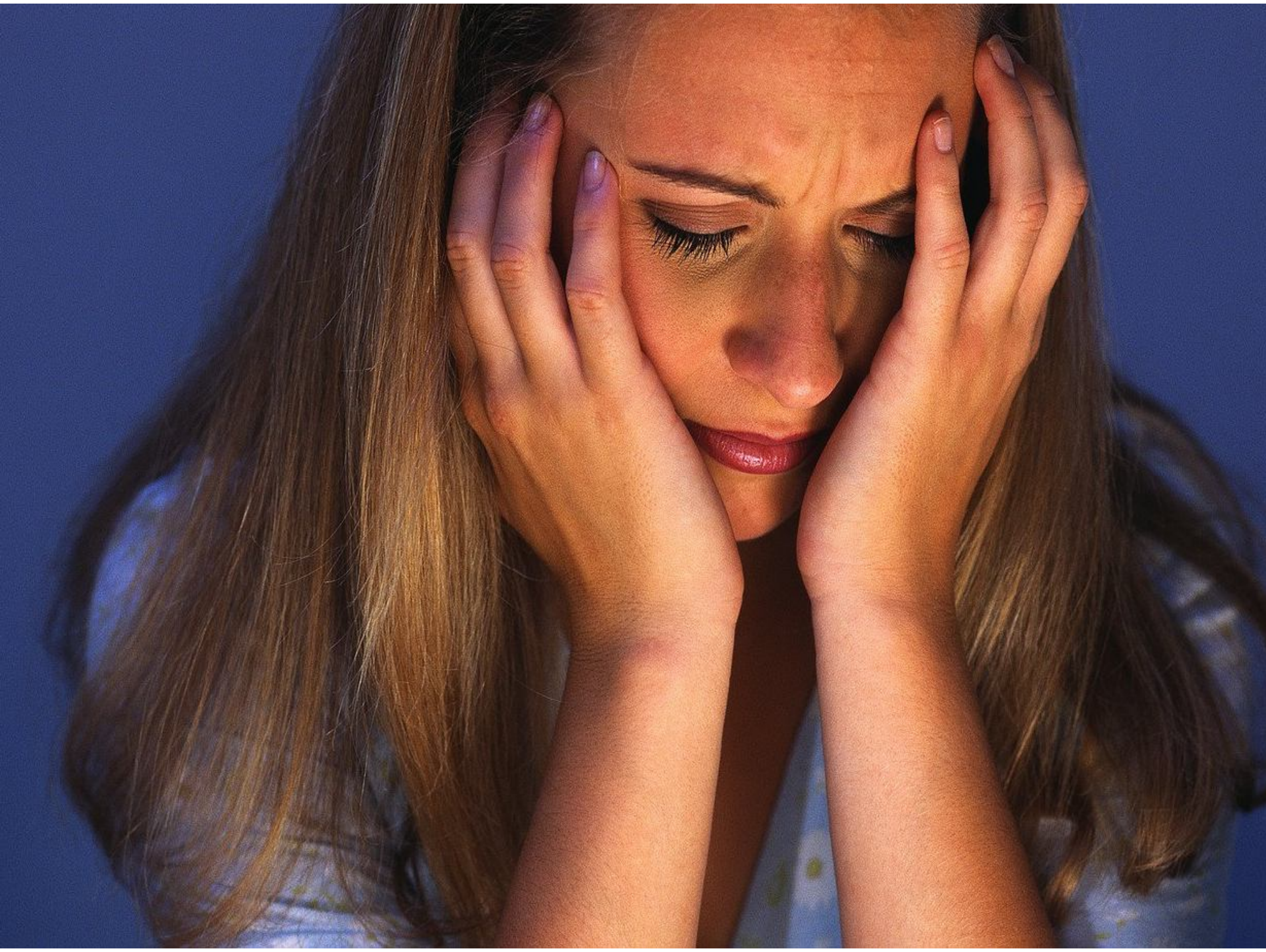
Volume 27 / March 2009

FINANCIAL ADVISOR PRACTICE JOURNAL

JOURNAL OF THE SECURITY ACEDEMY AND FACULTY OF e-EDUCATION



BROKEN ARROW

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Editorial Preamble: Broken Arrow

1.1 EXCESSIVE PESSIMISM

How Long Will Meltdown Last?

Typically the leaders gathered at the “World Economic Forum in Davos” from the last fifteen years share their optimism about how globalisation, technology and markets are transforming the world for the better. Even during the recession of 2001, those assembled in Davos believed that the downturn would be short lived. But this time, as business leaders shared their experience, one could almost feel the clouds darkening. The sprit was captured by one speaker who suggested that we had gone from “boom and bust” to “boom and Armageddon.” The only upbeat not was struck by someone who remarked that Davos consensus forecasts are almost always wrong, so perhaps this time it would prove excessively pessimistic.

Equally striking was the loss of faith in markets. In a widely attended brainstorming session at which participants were asked what single failure accounted for the crisis. There was a resounding answer:

The belief, “That markets were self correcting”. The so-called “efficient markets” model, which holds that prices fully and efficiently reflect all available information, also came in for a trashing.

So did inflation targeting: the excessive focus on inflation had diverted attention from the more fundamental questions of financial stability.

Central bankers’ belief that controlling inflation was necessary and almost sufficient for growth and prosperity had never been based on sound economic theory; now the crisis provided further skepticism.

While no one from either the Bush or Obama administrations attempted to defend American-style free-wheeling capitalism. Perhaps their absence made it easier for those who did attend to vent their anger.

The few labour leaders who work hard at Davos each year to advance a better understanding of the concerns of working man and women among the business community were particularly angry at the *financial community’s lack of remorse:*

Some American financiers were harshly criticised for seeming to take the position that they, too, were victims. The reality is that they were the perpetrators, not the victims.

And it seemed particularly galling that they were continuing to hold a gun to the heads of governments, demanding massive bailouts and threatening economic collapse otherwise. Money was flowing to those who had caused the problem, rather than to the victims. Worse still, much of the money flowing into the banks to recapitalise them – so that they could resume lending – has been flowing out in the form of bonus payments and dividends. The fact that businesses around the world were not getting the credit they need compounded the grievances expressed at Davos.

This crisis raises fundamental questions about globalisation, which was supposed to help diffuse risk. Instead, it has enabled America’s failure to spread around the world, like a contagious disease.

Obama seems to be offering a needed boost to US leadership after the dark days of George W Bush; but the mood in Davos suggests optimism and confidence may be short-lived. America led the world in globalisation. With American-style capitalism and America’s financial markets is disrepute, will America now lead the world into a new era of protectionism, as it did once before, during the Great Depression?

1.2 TIME LINE OF REVIVAL

When Will The World Demand Revive Again?

Analysis of the depth and duration of 14 ‘severe’ meltdowns by Kenneth Rogoff and Carmen Reinhart provide some insights into the possible time-line for demand regeneration.

1. Generally, financial crises are long-drawn out affairs:

- On an average, GDP per person falls by more than 9% and takes almost two years to bottom out;
- Unemployment down-phase lasts for nearly five years;
- Housing market collapse stretches out to over five years;
- Equity prices reach their nadir after about three-and-a-half years; and
- Public debt increases by an average of 86% to make-up for the shortfall in tax collections and to implement policies to mitigate the effects of the meltdown.

2. If past crises offer a reliable guide this bust is going to be long and deep:

- Output is expected to decline for at least two years.
- Low consumer spending, little housing construction, poor business investment, and reduced exports have left demand regeneration to governments.
- Finally, government interventions restore production, employment, consumer spending, and business confidence.
- Only after households, businesses, and exports regain their position as drivers of economic growth will global demand be resorted.

3. In the long run, the present global crisis is likely to change the post WW-II economic structure established at Bretton Woods:

- Up to now increased consumer spending in the west was partly financed by the poorest countries – in the recent past China, West Asia, and India have accumulated dollar surpluses, which were reinvested in US treasury bonds permitting people in the west to create a global demand based on borrowings.
- This is collapsing and the challenge is to create sustained world demand.

2.1 SECURITY MARKETS

Eventually Turn Into Sustained Upturn

Old timers and experts in the securities market are of the view that the stock market would be range-bound, and 2009 would most likely end 8,000 – 8,500 for the Sensex.

The only silver lining is the near consensus that India would be among the first to come out of the slump and that the stock market would took up much before the real economy turned a corner.

There was, however, no consensus on when turnaround could happen. Some expected the outlook to improve in early 2010 but warned things might get worse before they get better.

Clearly, equity investors face difficult choices.

Though, equities offer a promise of decent gains over a three-to-five-year horizon, in the short term, there are significant risks. There would be many 20 – 30% bear market rallies, one of which, hopefully, would eventually turn into sustained stock market upturn.

If investors choose to wait for a definite revival, they are sure to miss out on the initial part of the rally. On the other hand, if they invest in this volatile market, the returns could be flat or, in the worst-case scenario, suffer erosion that could be as deep as 20% from the current levels.

Also, mid- and small-cap stocks tend to join the rally when the front-line companies and the large caps have already run up sharply. Therefore, a prudent mix of large and small/mid cap stocks can deliver a good return if the investor joins the rally when the blue chips have already travelled some distance.

1st week of February '09 – Sensex down 1.31%

Daily review	30/01/09	02/02/09	03/02/09	04/02/09	05/02/09	06/02/09
Sensex	9,424.24	(357.54)	(82.60)	52.55	(110.97)	209.98
Nifty	2,874.80	(108.15)	(17.25)	19.15	(23.00)	63.05

Weekly review	30/01/09	06/02/09	Points	%
Sensex	9,424.24	9300.86	(123.38)	(1.31%)
Nifty	2,874.80	2,843.10	(31.70)	(1.10%)

Markets continued to display range bound movement all throughout the week. There were increased sell off by the FIIs and domestic institutional investors. The signal emanating from the US economy which saw the ever biggest job loss in January 2009 is clearly a huge concern. The European banking system scenario also continues to look extremely uncomfortable with large banks are not in a very comfortable position. The governments across Europe, US and the respective central banks are grappling with unprecedented economic crisis and trying desperately to contain the same.

The Indian markets, in the absence of volume support from foreign financial institutions and local funds are likely to witness a ranged movement in the coming week. Globally US president Obama may finally be announcing the mega fiscal package which may even boost the local market sentiments. The expectations are also building around further fiscal measures from the government, which if announced, should have positive impact on the markets.

2nd week of February '09 – Sensex bounces back by 3.59%

Daily review	06/02/09	09/02/09	10/02/09	11/02/09	12/02/09	13/02/09
Sensex	9300.86	283.03	63.58	(28.93)	(152.71)	168.91
Nifty	2,843.10	76.80	14.60	(8.80)	(32.65)	55.30

Weekly review	06/02/09	13/02/09	Points	%
Sensex	9300.86	9,634.74	333.88	3.59%
Nifty	2,843.10	2,948.35	105.25	3.70%

Indian capital markets witnessed the ranged movement because of expectations from interim budget next week. On the domestic economy front, the minus 2% growth in IIP for December 2008 was the lowest on record since 1993, when the index was first compiled. The market next week will eagerly await the expected relief in both direct and indirect taxes from the interim budget on Monday. Market would welcome removal of irritants like securities transaction tax. Appropriate budgetary measures aimed at providing boost to growth will definitely be appreciated.

3rd week of February '09 – sensex plunges over 8%

Daily review	13/02/09	16/02/09	17/02/09	18/02/09	19/02/09	20/02/09
Sensex	9,634.74	(329.29)	(270.45)	(19.82)	27.45	(199.42)
Nifty	2,948.35	(99.85)	(78.00)	5.65	13.20	(52.90)

Weekly review	13/02/09	20/02/09	Points	%
Sensex	9,634.74	8,843.21	(791.53)	(8.22%)
Nifty	2,948.35	2,736.45	(211.90)	(7.19%)

Indian capital market corrected sharply. Indian Interim Budget for FY 2009-10 turned out to be a non event for the markets. The efforts of the Central and State Governments at this stage is rightly centered around ensuring that the two fiscal stimulus packages announced during the last couple of months. The markets next week are likely to see some actions, being 'expiry' week in F&O. In absence of any triggers, global news-flow is likely to drive the markets in this truncated week.

4th week of February '09 – Sensex bounces back by 0.55%

Daily review	20/02/09	23/02/09	24/02/09	25/02/09	26/02/09	27/02/09
Sensex	8,843.21		(21.15)	80.50	52.30	(63.25)
Nifty	2,736.45	Holiday	(2.55)	28.60	23.15	(22.00)

Weekly review	20/02/09	27/02/09	Points	%
Sensex	8,843.21	8,891.61	48.40	0.55%
Nifty	2,736.45	2,763.65	27.20	0.99%

Domestic capital market continued to trade indecisively with both Nifty and Sensex displayed flat trend. During the week positive news flows in the form of third stimulus package, benefiting sectors like Steel, Cement and Autos supported the otherwise weak market sentiments. GDP data released for Q3 FY09 shows that Indian economy grew at 5.3% as against 7.6% in Q2, much lower than the consensus expectation of 6.1%. The Real GDP growth for the period of Apr-Dec stood at 6.9%.

Monthly review

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

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

Markets are exhibiting indecisive trend with dismal volumes, indicating lack of participation of institutional players. FIIs remained net sellers in equity markets and outflow of dollar continued pushing rupee to a new low. Downgrading the country's long-term sovereign credit rating outlook on February 24 by international rating agency Standard & Poor's partly compelled operators to look profits at higher levels. According to analysts, the market would remain still under pressure on worsening global recession despite a host of stimulus packages and weaknesses on Wall Street as the Dow Jones Industrial Average tumbled to nearly 12-year-lows in the week on fears of the effectiveness of Washington's rescue plan.

Markets were jittery after economic growth contracted to 5.3% for the December quarter. Investors' are still concern about the global economic downturn impacting Indian economy, expecting lower than anticipated growth. Continued selling by the FIIs also was the cause of concern. They pulled out nearly USD 1.6 billion in the 2009 so far. With the elections likely to be announced soon, markets will be pushed into election uncertainty till political certainty emerges. Markets are likely to remain in a range with domestic and global economic news flow driving the sentiments.

2.2 INDIAN ECONOMY

Whistling In the Dark

It is said that Indian economy is still on 'fast track', but this is now more a wishful thinking than the hard fact. In fact, India did have a sliver of a chance of staying on a relatively fast track despite the deepening global recession, but seems to have blown it.

Now it may be too late to rely on interest rates alone to kick start a recovery.

According to the advance estimates of the Central Statistical Office, GDP growth had slowed down to 7.6% in the first quarter of 2008-09 and further to 7% in the second quarter.

This was before the global financial meltdown occurred.

What was worse, manufacturing, the main driver of growth, had already declined from 11% in 2006-07 to 4.7% in the Q2 of 2008-09. Since then industrial production has actually contracted in October for the first time in 18 years and any recovery in the remaining 5-months of the year is likely to be paltry at best.

Thus the Q3 growth will probably fall to 6% or less. The Q4 could be even lower.

If India's GDP growth still looks reasonable at the end of the year it will be partly because the really bad news covers only half of it, and because of the continuing surge in the services sector. But any good satisfaction with a long enough memory knows that our service sector figures are extremely shaky.

The truth is that India did have a sliver of chance of staying on a relatively fast track despite the deepening global recession, but seems to have blown it.

- Its farmers are reaping their second bumper harvest in a row, so there should normally have been a sharp rise in consumer spending.

- The pay commission awards should have boosted the sale on consumer durables, as they did in 1998 and 1999.

- But instead the additional income is going into bank deposits which are rising rapidly, but not being lent out. Today the increase in credit is less than a third of the increase in deposits.

It's all due to government policies to cool the economy

If the economy continues to slide into a recession in spite of stimuli, the government will have only its past policies to blame. In December 2006, just weeks after industrial growth had gone into double digits for the first time in almost 11 years, and before the industrial boom really set in, the government began to scent a future inflation and decided to 'cool' the economy down by pushing up interest rates and tightening the supply of credit.

- The Reserve Bank of India did this by raising the Cash Reserve Ratio and a variety of interbank lending rates.

- But the removal of thousands of crores of rupees from circulation pushed up long-term interest rates by 2-4% for prime and non-prime borrowers.

It's all due to easing external commercial borrowings

In order to minimise the rise in the resulting cost of investment the government simultaneously eased restrictions on external commercial borrowing by the private sector.

- As a result private borrowing abroad skyrocketed to more than $ 20 billion in 2007 and rose still faster in the first half of 2008.

This inflow of foreign exchange began to push up the value of the rupee against the dollar. Coming on top of a bounding stock market, this unexpected bonanza helped to pull billions of dollars of foreign portfolio investment – essentially 'hot' money bent upon quick profits – into the Indian stock market.

- This self-reinforcing but immensely dangerous cycle continued till the US subprime loan market crash in December 2007. From the very next month this money began to withdraw from the Indian market.

For six months the outflow remained moderate but the financial meltdown in September 2008 turned it into a flood. In late September and October 2008 as bankrupt or nearly bankrupt foreign banks scrambled to pull back resources from all over the globe, India's foreign exchange reserves fell by a billion dollars a day and the exchange rate plummeted.

It's all due to slower policy action by the RBI

In October '08, when it became apparent that the world was headed for a major recession, the government found itself caught on the horns of a dilemma.

By reducing the cash reserve ratio dramatically it could, conceivably, both force down lending rates and inject sufficient confidence into investors to make them take up their stalled and postponed projects once again. But the sharp fall in lending interest rates that it hoped to trigger could accelerate the outflow of foreign money from India and send the rupee into a free fall.

So the RBI tried to steer a middle course and instead brought down the CRR and inter-bank interest rates in a series of steps spread over two months.

This defeated its purpose, for as the global recession deepened and exports plunged, investor confidence declined faster than the CRR and associated interest rates.

By December 2008, when the prime minister took over the finance portfolio, it was apparent that everything the government had done was a shade too little and a shade too late. That policy has still not changed, and by now it may be too late to rely on interest rates alone to kickstart a recovery.

2.3 INDIA IN 2009

Unwinding of Excesses

The year 2009 will see the real economy's excesses being unwound. There will be pain, but the question is for how long. With capital, liquidity and confidence – the three main pillars of the financial system – all badly battered during 2008, the global financial landscape has changed not only irrevocably but also at breakneck speed.

The ***negative feedback loop*** of tightening financial conditions, weakening economic activity and further tightening in credit has hurt non-financial companies. Emerging markets (EMs), including India have felt the pressure not only due to a rise in borrowing costs but also due to the rise in risk aversion coupled with the need to sell assets to meet margin calls.

Although India is largely a domestic-oriented economy with domestic savings playing a key role in financing its growth story, the dramatic change in the **macro-environment** has taken its toll on the economy. The recessionary global environment has impacted investments, as well as consumption due to the knock-on-effects on sectors such as IT and real estate.

Moving on to the other **macro variables**, while concerns on inflation dominated most of 2008, excess capacities in both labour and product markets have made deflation the buzzword on the global front. It would increase problems in the real economy as expectations of falling prices could likely trigger a further reduction in consumption demand. In addition, deflation would be negative for earnings growth.

On the **rupee,** trends are unlikely to be unidirectional in 2009. Given the prevailing uncertainty in the global front and its impact on external financing, we expect the rupee to trade at Rs 48.50/USD with a range of + / - Rs 2. The trends in the rupee in the first half are likely to be in the upper end of the range. The impact of lower oil prices on trade deficit, as well as the possibility of global flows due to the likelihood of an easing in the dollar rally, could result in the rupee gaining in the latter half of the year.

Parliamentary elections likely to hold by April-May '09 – will be a keenly watched event this year. While the recent state elections in November '08 provided little indication of how the scenario will pan out, what is clear is that the Indian voter has clearly become more discerning, favouring performance and leadership and rejecting the 'anti-incumbency' factor. Key issues that could dominate are border and security issues, and the economic downturn.

Other factors to watch out for in 2009 are geo-politics, remittances, non-performing loans and measures towards climate change.

Starting with **geo-politics,** with globalisation economic relationship between countries continue to assume increasing dominance. An example is the nuclear deal which, apart from enhancing energy security, has geo-strategic implications. However, while foreign alliances do assume importance, all through its history, India's biggest geo-political/security risks have in fact arisen from its immediate neighbours. Fallout of mounting tension in the sub-continent is a likely rise in defence budget.

Moving on to **remittances**, which play an integral role in the balance of payments and have emerged as a stable counter-cyclical source of revenues for developing countries; However, the global recession could result in the deceleration in flows as unlike in previous downturns that have been concentrated in specific regions (e.g., dotcom bubble burst in the US), the current slowdown has resulted in the intensification of recessionary conditions across all the source countries.

Yet another impact of the current crisis is a rise in *non-performing loans* (NPLs). Higher rates, FX assumptions going wrong, slowing industrial output and corporate profits are likely to result in a rise in NPLs and weakness in asset quality. This escalates the negative feedback loop of tightening financial conditions, weakening economy activity, and further tightening in credit standards which could result in growth remaining weaker for longer.

Finally, with US President Obama placing considerable emphasis on clean energy and aiming to pass legislation to double alternative energy production within the next three years, *climate change and energy initiatives* constitute to remain major issues to watch out for in the year ahead.

To conclude, the synchronised global recession coupled with the dramatic change in the financial landscape is likely to result FY 10 growth coming in at 5.5% levels. However, while much has been debated on the impact of the global headwinds on growth, it's worth keeping in mind the growing impact of the tailwinds in play. These include the co-ordinated response to the crisis including monetary and fiscal stimulus as well as collapse in commodity price. Both these factors should help enable some recovery in FY 11.

Deficit eats up household financial savings

For the first time in a decade the combined fiscal deficit of the Centre and states has exceeded the total household financial savings. This is serious because household financial savings is what is readily available for both the government and the private sector to borrow through the market.

Therefore, if the fiscal deficit (gross borrowings) of the Centre and states appropriates the entire kitty of household financial savings, there will be virtually nothing left for the private sector.

The fiscal deficit of the Centre and states together is now close to 13% of GDP, if all off-balance sheet items of government borrowings are included. The household financial savings were at 11.3% of GDP in 2006-07. This may have increased a little during 2007-08, when the economy had over 9% growth rate.

Even if one takes the total household financial savings at close to 12% by end 2007-08, the total borrowings by the Centre and states this fiscal would easily exceed 12% of GDP.

Indeed, the bond markets have recognised this and we are already seeing a hardening of yields.

The debate on another massive fiscal stimulus must be seen in this context. If the next government which comes to power administers another big dose of fiscal stimulus, the overall situation will only worsen from here. Pranab Mukherjee in his interim budget declared that a bigger fiscal package will have to be delivered in a full budget which will be presented after three months.

We have no quarrel with the fact that in these troubled times running a higher deficit is par for the course.

The US is also running a very high deficit in its bid to revive the economy. But India is not the US, which still remains the leading economy with leading currency. If India crosses the *lakshman Rekha* in its fiscal profligacy, it would soon start reflecting in the deterioration of other critical parameters like the external sector and the stability of the rupee. Beyond a point, even the markets don't believe that an excessive dose of monetary and fiscal stimulus is a panacea. We need to guard against committing policy excess.

India and United State

Our budget deficit is more worrisome

The US and India have much in common – home to the two largest democracies in the world, both are multi-cultural, multi-ethnic plural societies. And now both have something else in common: huge budget deficits, estimated at close to 12% of GDP in both cases.

But there the similarity ends. The US, unlike India, can get the world to finance its deficits, courtesy the hunger for US government treasury bills due to the dollar's pole position as international reserve currency. This gives the US economy the luxury of elbow room, the kind of which we do not have in India. That is not all. Unlike India, the US seems alive to the costs (and dangers) of the huge fiscal stimulus. US President Barack Obama is on record that his administration would do all it can to "get exploding deficit under control as soon as the economy begins to recover."

Indeed, just days before budget day on Thursday (26/02/09) the President convened a Fiscal Responsibility Summit attended by officials, academics and politicians from both parties to discuss how to deal with deterioration in finances. So even as the budget showed US finances in appalling shape with the deficit at $1,750 billion, well above the $1,300 billion inherited from President Bush.

Part of the reason is that the budget also outlines plans to get the fisc into shape. Thus the government plans to end President Bush's tax cuts for the wealthiest by 2011 and introduce new tax increases on families earnings $250,000 or more to pay for healthcare expansion.

This is in sharp contrast to our interim budget that is completely silent on how we plan to restore our public finances to health. Sure, the acting finance minister, Pranab Mukherjee did express a need to return to the path of fiscal correction. Sure, the fact that elections are due in just over two months constraints the government. Nevertheless the absence of a medium term strategy is a cause for concern. This is not to dispute the need for a stimulus. In the short-run, it is more than apparent that almost all economies in the world will need both fiscal as well as monetary props. But what is equally indisputable is that we need a coherent, well-thought out programme to tackle the hangover.

India's Export: Searching For a Silver Lining

Riding on the back of brisk growth in the global economy since 2002, India's exports have witnessed a phenomenal three-fold rise during the period 2202-03 and 2007-08. This powerful dynamo for employment generation is now threatened by the liquidity crunch and declining global demand. India needs to properly manage the fallout from the current slowdown on its export sector in order to limit adverse consequences for the employment situation.

A quick analysis shows that a 10% decline in overall exports of goods from 2006-07 level would result in a direct and indirect loss in employment of 2.2 million man-years. Sectors which are likely to witness job losses include traditional export sectors such as textiles and clothing, metal and metal products and miscellaneous manufacturing.

Two additional noteworthy points emerge from this analysis: *First, the agricultural sector would not remain unaffected.* In particular, the food crops sector is likely to see sharp loss in employment as it has a high employment multiplier and provides crucial inputs to exports of the processed food industry, which has emerged as a dynamic sector.

Second, employment in certain sectors such as minerals may take a severe hit – although these sectors may not contribute directly to India's export share. The lesson is clear – sectors which provide inputs to the exporting sectors and have high employment multipliers would also be adversely affected.

In order to sustain the export momentum and contain job losses, the central government has finalised an economic stimulus package comprising measures aimed at easing the liquidity crunch and providing enhanced incentives to exporters. While these measures may provide some relief to the exporters, the present crisis should be used as an opportunity to address more deep-seated problems by adopting suitable mitigation strategies for sustaining the export growth in the long term.

A more focused effort is required for diversifying India's export basket to new employment-intensive sectors. As a preliminary exercise, industry could identify products and seek markets in which India is globally competitive. Indian industry needs to formulate and implement appropriate strategies for becoming part of global supply chains. While the auto part sector provides success stories, there is a need to have a hard look at sectors such as electronic components so that India can gain from the increasingly fragmented nature of global supply chains. With profit margins shrinking globally, competitiveness would be the most important determinant for acquiring a share in export markets abroad.

India should take advantage of its strength in IT and use it extensively to upgrade manufacturing and thereby increase the competitiveness of India's export. While some of the industries are actively engaged in this effort on a regular basis, innovative solutions are required in sectors such as handicrafts for improving product designs and enhancing exportability of the products. In order to sustain India's export growth the need to preserve the existing market access in big economies becomes extremely important. The European Union (EU) and United States of America (UK) account for nearly one third of India's export, although the share of the US in India's exports has reduced gradually over the years. China, Japan, West Asia and Asean provide viable and sustainable alternative markets.

India's economic stimulus package might offer an immediate succour to the exporters. However, there is a need to develop and implement long-term measures that would ensure sustained export growth, which is not impeded by adverse developments in big foreign markets. The current global slowdown will have a silver lining if the opportunity offered to diversify exportable products and markets as also enhance competitiveness is fully utilised by the Indian industry.

2.5 INTERNATIONAL

To Play By the Rules That Everybody Plays By

The perceived absence of a level playing field for US industries in the Chinese markets, on account of the grossly undervalued renminbi – the Chinese currency – is seen as highly unfair by the Americans. Vice President Biden has followed this up with the remark that the current US administration will ask China "to play by the rules that everybody plays by". The Chinese leaders, who are extremely sensitive to any criticism, have protested quite vehemently, with its prime minister declaring that Beijing's policy for the renminbi was oriented towards market needs and flexible.

Almost all analysts will agree with the Americans that there is very little doubt that the renminbi is tightly controlled and is allowed to fluctuate only within a very narrow band against the dollar. Of course, to acknowledge that the Chinese government regulates its currency is one thing; to accuse them of not playing by the rules of the game is quite another matter. The fact of the matter is that there are no rules of the game in this context because there are no international agreements stipulating that individual countries cannot regulate the external value of their currency. Indeed, China is not the only country – it is an open secret that all countries pursue policies with the aim of furthering their own welfare.

So, there is very little point in one country preaching to another about the need to be a good citizen of the world. Instead, it is perhaps more sensible to examine the consequences for the rest of the world when a country as big as China regulates its currency. And to explore the possibilities of adopting measures which will defer or perhaps induce China to let its currency adjust to international market forces.

For a long time, the Chinese have been intervening quite heavily in the foreign currency market. The government buys up dollars in order to keep the external value of the renminbi appreciably lower that it would be in the absence of intervention. There are varying estimates of the extent of the undervaluation, but even the most conservative suggests that it is at least as 20%. In effect, this undervaluation makes foreign goods more expensive in China while it promotes Chinese exports to the rest of the world by making their products cheaper in foreign markets.

Since the American economy has sunk into deep coma, it has become increasingly difficult for American companies to sell their products in the US domestic markets. This makes foreign markets – particularly one as large as the Chinese market – very attractive. So, what is perceived to be the absence of a level playing field for the US industries in the Chinese domestic markets is perceived to be grossly unfair.

One consequence of the undervaluation of the renminbi is that the Chinese have accumulated huge current account surpluses and hence very large foreign exchange reserves. A sizeable fraction of these reserves is held in the form of US government securities. The Chinese can always threaten to offload these holdings and move to some other country, perhaps in the euro zone. This can have grave consequences for the US economy as well as international financial stability.

First, any move away from US debt will mean that the US government will have to find new lenders. Given the large volume of debt held by the Chinese, this will be possible only if they raise interest rates in order to make these securities more attractive to hold. But, this will put an upward pressure on interest rates precisely at a time when the US government is trying to keep interest rates low in order to prop up the recession-hit economy. Second, this will also result in a vastly lower demand for dollars and hence lead to a significant devaluation of the dollar. Given the importance of the dollar in international financial transactions, this too would have quite disastrous effects for the world economy.

Inaction may also be the best course of action for the US simply because the current situation is not sustainable. The Chinese economy cannot continue to run up huge current account surpluses year after year. This is causing a big imbalance in world demand and supply with the rest of the world supplying much less to China than it is demanding from them. The global economy cannot revive unless there is a significant increase in demand from China. A long period of recession in the rest of the world will ultimately rebound on the Chinese economy since its export sector will be starved of demand. So, the only sensible option is for the Chinese to increase their domestic demand. Fortunately, the Chinese seem to be aware of this. The gigantic two year stimulus package is certainly an important step in the right direction.

Japan's economy slumps as crisis widens

Strangled by the collapse in global export demand, Japan's economy shrank at its fastest rate in 35 years in the fourth quarter of 2008 and shows no signs of reversing course anytime soon.

Japan's gross domestic product contracted 3.3% from the previous quarter, or an annual pace of 12.7%, in the October-December period. This was worse than expected and the steeper slide for Japan since the oil shock in 1974. It is more than triple the 3.8% annualised contraction in the US in the same quarter.

Economy minister Kaoru Yosano said, "There is no question that this is the worst economic crisis since the end of World War II. The outcome clearly shows that Japan's export-dependent economy has been severely hit. Chief cabinet secretary Takeo Kawamura went further, calling the economic downturn a once-in-a-century calamity. Rattled officials hinted they may soon call for more government steps to stem the widening damage but urged lawmakers to first give final approval to a $52.2 billion extra budget, which includes cash payouts to taxpayers.

Already, Toyota Motor, Sony and a slew of other companies have announced deep job cuts and projected net losses for the fiscal year through March. The yen's appreciation, which erodes income from abroad, has only intensified the pain. The fallout has begun to penetrate families, which are spending less amid rising unemployment and withering confidence.

Japan's economy – the world's second largest – has now contracted for three straight quarters and is almost certainly headed for a fourth. The first three months of the year will likely be "another horrifying quarter", said Kyohei Morita, chief economist at Barclays Capital in Tokyo, who predicts GDP to contract an annualised 10% during the period. The latest data underscore the vulnerability of Asia's export-driven economies during global downturns and point toward more cuts in jobs, production and profits in the coming months. Even demand from emerging markets, which earlier had partly offset declines in North America and Europe, began falling sharply in the fourth quarter.

Martin Schulz, an economist at Fujitsu Research Institute in Tokyo said, "The three main pillars that lifted Japan out of so-called "lost decade" of the 1990 had crumbled – favourable exchange rates, overseas investment and demand, and old industry such as steel, cars and chemicals. The recovery was unsustainable. It was built on a major global bubble, and now basically the economy is paying the price."

Indeed, Japan's exports plummeted a record 13.9% in the fourth quarter from the previous three months. Capital expenditure – business investment in factories and equipment – fell 5.3% from the previous quarter, while consumer spending slipped 0.4%. In the latest forecast, the International Monetary Fund predicts Japan's economy will shrink 2.6% this year, outpacing the 2% overall decline it expects for advanced economies.

3.1 MUTUAL FUND

Deal of convenience

Abrupt resignation of senior investment officials at a couple of asset management companies recently could shift the spotlight on some of the "deal of convenience" struck between promoters and fund managers during the boom years. Such transactions, mostly involving mid-sized companies, helped the promoters boost the valuation of their firms while the fund houses gained by way of inflows into their equity schemes. However, at least half-a-dozen such "lemons" are now left in the portfolio of such schemes. In some cases, promoters had verbally committed to buy back the shares later at a pre-decided price, but are now unable to do so because of liquidity problems. The fund houses are stuck with these shares because there are no takers for these high fliers-turned fallen angles. The holdings in such companies are not huge, compared to the size of the portfolio. But looking at the fundamentals, or rather the lack of them, it is intriguing how these stocks made it to the portfolios of mutual funds. When the market was booming, nobody objected because the returns were too good to resist. But if the downturn persists, some uncomfortable questions are bound to be asked.

Inter-scheme transfer

The internal compliance teams of some mutual fund houses have asked their fund managers to curb inter-scheme asset transfer, which are often adopted as recourse to meet short-term liquidity constraints. The fund house has been asked to meet shortfall only by borrowing from the market. The move comes in the wake of several fund houses cutting questionable asset transfer deals during October and November '08, when debt schemes – particularly FMPs – witnessed unprecedented redemption pressures. While there is nothing illegal for mutual fund houses to transfer assets – or to put it plainly, sell papers to other schemes – to schemes of longer maturity terms or higher liquidity, the transfers have to be done at fair market yields. And industry sources claim that there have been instances where the schemes which received the assets were short-changed or saddled with dud paper.

Norms set for NPS fund managers

The pension fund regulator announced the norms for six asset managers it has hired to invest the pension contributions of corers of individuals outside government service, who would be allowed to join New Pension Scheme (NPS). While the NPS will be available to all individuals from April 1, 2009, it is mandatory for all government employees who have joined service after January 1, 2004. According to the investment norms, private individuals will be allowed to choose a fund manager as well as investment options including equity that meets their risk appetite.

A panel chaired by HDFC chairman Deepak Parekh appointed by Pension Fund Regulatory Development Authority (PFRDA) recommended three investment options classified as 'conservative', 'moderate' and 'growth' depending on the risk-reward profile of underlying instruments. Members of the scheme can decide how much of their contribution should go to which of these asset classes. Depending on their choice, their contribution will go into government securities, corporate bonds or the shares of companies represented in the National Stock Exchange's benchmark 50-share Nifty Index. The idea is to invest only in companies with strong fundamentals while giving the members an option to participate in the benefits of investing in the stock market. For those who-do not want to declare on how much of their contribution should go into which scheme, the regulator has an 'auto choice'. Depending on the age of a member at the time of joining the scheme, the investments in each of these schemes will vary. At the lowest age entry, 65% of the investment will go into high-risk, high-return equity market instruments, 10% in low-return, low-risk securities like government bonds and 25% in medium return for credit risk instruments such as corporate bonds. The proportion of investments in these categories will change according to the age, with equity instrument investments being limited at 10% at the age of retirement.

3.2 GOLD

In A Structural Bull Market

The increase in the price of gold to over Rs 16,000 per 10 gram in less than a month is a reflection of heightened uncertainty. Gold has always been seen in most societies, more so in traditional ones like ours, as a hedge against economic distress. At a time when other asset classes like shares and real estate look week, gold becomes attractive even though it is not the wisest or the most productive of investments in normal times. In the Indian context gold is vested with an added aura. Cultural values have elevated gold to a special status. As a result we have the incongruous situation of one of the poorest countries in the world being the largest consumers of gold, importing close to 1,000 tonnes a year.

Sporadic efforts by the government to wean people away from physical holding of gold have not met with much success. Despite the availability of gold ETF (exchange traded funds), the bulk of demand continues to be for physical holding mostly in the form of jewellery. And almost all the gold we consume is imported so any weakness of the rupee vis-à-vis the dollar pushes up the domestic prices even further. Gold is also benefiting from long-term worries about inflation. As countries boost money supply to stimulate sluggish economies, many fear the world will see a repeat of the high inflation days of the 1970s. At the moment with deflation a real prospect, that might seem unlikely.

In the international trading space, gold is exhibiting all the classic signs of being in a structural bull market. On fear of inflation in early 2008 it rallied. Then, on fears of deflation in late 2008, it rallied again. So does gold perform batter during inflation or deflation?

That question may be the wrong starting point. On the contrary, the rationale for owing gold, as it once again approaches the $1000 an ounce level is the prospect of mounting monetary disorder. The US Federal Reserve, having flooded the market with liquidity by more than doubling its balance sheet in less than six months, may be unable or unwilling to withdraw in time for fear of precipitating a secondary relapse in economic activity. Other central bankers will also face intense pressures to support their domestic economy by weakening the currency, leading to competitive currency devaluations.

Gold is a prime candidate to become a "mania asset" once it demand becomes chiefly financially driven as opposed to jewellery and/or industrial demand driven where its upside could be capped by "sticker shock." The fall in Indian rupee has meant Indian gold prices have reached record levels. This is causing a slowdown in jewellery purchases & even though rupee expenditure levels are holding up, the tonnage of gold imports is suffering.

Gold may be booming as other investment avenues lose their luster, but getting too close to the hot metal now comes with a serious health warning for investors: you may end up burning your finger. As seasoned punters, HNIs and increasingly retail investors flock to grab the yellow metal whose prices have jumped 50% since October 2008. As an investment option, analysts caution that there may be a big bubble building in the commodity renowned for its reputation as a safe-haven asset.

Waking up to gold today is like waking up to stocks or real estate in 2007. Investors are chasing short-term performance. The domestic retail market for gold, which usually hits a peak during the October-March Indian wedding season, is already showing signs of weakening demand because of sky-rocketing prices. Analysts say investors in gold cannot take the long-term prospects of the metal for granted. The graph of the yellow metal almost mirrors the recent surge in crude oil and stocks. Both saw hot money flowing in, but the bubble eventually burst taking down investors with it. It is very difficult to time such rallies. It is advisable that the common man should stay away from gold. With all the investment options drying up in recession, it is the hot money which is flowing to gold now.

3.3 RUPEE

Rupee drops to record low past 51 per dollar

Rupee plunged to a record low of 51.17 per dollar on Friday (27/02/09), hit by importer demand for dollars and share market losses after data showed growth slowed to its weakest in nearly six years at the end of 2008. The partially convertible rupee closed at 51.10/12 per dollar taking a loss in 2009 to 4.7%. Everyone was a (dollar) buyer, while the state-run banks were selling sporadically to smoothen the fall.

When a life low breaks, everything changes. Lots of people with imports, loans etc. who are unhedged are forced to take decisions. Exporters simply disappear from the market temporarily.

Asian currencies tumbled across the board on concerns over the region's grim economic outlook, with South Korean won tumbling to an 11-year trough. There was underlying (dollar) demand from corporates and oil companies weighing on the rupee. Adding to the rupee's woes, Indian shares fell 0.7 percent, with the market posting its second monthly drop of 2009, as grim growth data indicated the global financial crisis was damaging the domestic economy more than expected. The economy grew an annual 5.3 percent in the December quarter, its slowest pace in almost six years.

Rupee free fall triggers record dollar sales

With the rupee falling to record low past 51 per dollar, money changers are seeing record sales from Indians who are ferreting out dollar bills left from foreign travel or gifted by relatives and encashing them. According to forex dealers, money changers are seeing a record number of sellers approaching them with dollar notes of various denominations.

Many households have been holding on to the greenback ever since it firmed up to the 40 level a little over a year back. The rupee, which has been sliding in recent days dropped to a record low of 51.17 on Friday, before recovering to close at 51.10.

Some bankers speculate that the spate of sales could also from businesses bringing in illegal dollar reserves into the banking system. They add that dollar inflows could also have something to do with elections being around the corner. They pointed out that sales of dollar notes by large traders in Gujarat and Rajasthan has been mind-boggling. These players are using the falling rupee as an opportunity to convert all illegal monies (a part of which is usually dollar denominated) into white money.

Paradoxical strength of the US dollar

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

Broken Arrow

Financial reforms: They say the time to clean up and build afresh is when the flood waters have receded. The massive de-leveraging by global financial players through the second half of 2008 was a bit like flood waters receding the emerging markets. Earlier, fresh financial reforms got delayed because the Central Bank feared more asset bubbles would get created in a regime of excessive capital flows.

The Greenspan idea that monetary and regulatory policy cannot prick asset price bubbles but should deal with the consequences when the bubble has burst – now looks dangerously quaint. The intellectual justification for the idea – was that identifying equilibrium levels of asset prices is difficult; and policy tools to prick or limit bubbles are limited.

The unmentioned but perhaps real rationale is a kind of implicit doctrine of *market fundamentalism*: market value assets best, and even if markets makes mistakes, policymakers can never be sure in advance whether and to what extent mistakes have been made.

The fear should wane in the years to come as greater sanity will prevail among global financial market players. Now, for the RBI, it no longer has the challenging task of managing capital flows. This presents a very good opportunity to once again build and bridge the weaker links in the financial integration process.

Remember that we did not suffer so much because our financial sector and product markets were relatively closed and underdeveloped cannot become reason for us to not take up future reforms.

1. FINANCIAL ADVISORS:
Weigh impact on investors

Feel good factor

The current global crises have dominant Keynesian features. The crucial issue is not just the fact that there is a demand contraction but that this has been brought about by a market failure which fuels *adverse expectations* on the part of both producers and consumers. These *adverse expectations* lead to reduced production by producers anticipating lack of demand and increased savings by consumers anticipating lack of jobs. Over time, actions of both producers and consumers further justify their expectations which then become self-fulfilling. In the 1930's, it took a whole decade to reverse such expectations and even then only because of government intervention.

Today, governments have already started coordinating actions and it is unlikely that these crises would last as long. However, it is still foolhardy to guess when exactly the current crises would come to an end. We have various guesstimates ranging from end 2009 to middle 2010 but it must be clearly realised that there is no scientific basis for such estimates.

After all, how can one estimate when the "*feel good*" factor returns to reverse *adverse expectations*? The crucial role of expectations is also clear from the fact that monetary policy has successfully driven interest rates to near zero levels in most OECD countries and yet there is still no sign of recovery. In India too the RBI has tried valiantly to drive interest rates down. Yet the impact seems limited. During last four months of 2008, RBI pumped in almost all the liquidity it had sucked out of the system in the preceding 12 months. But the new funds have only found their way into the government T-Bills. A strange situation where the government pumps money into the system only to see it finding its way back to them via funding of government debt! Expectations are adverse indeed.

2. FINANCIAL PLANNERS
Value unlocking for all stakeholders

Cash-22 Situation

There is a lot of misunderstanding about the prevailing state of growth (recession vis-à-vis slowdown) in the Indian economy. People think that the global recession has affected India in the same way as it has in the West, and that the reasons are similar. If it is not so, what are the real situation and the reasons for this economic slowdown in India?

Companies are not able to increase their production because there are lessor orders. But orders will come only when there is buying capacity with people. Globally, buying capacity has declined because there has been shortage of funds. This has had a cascading effect on the ability of businesses to not only produce and supply but also retain their workforce.

The problems get further compounded for SMEs as, besides the credit crunch they are unable to realise payments from their foreign and Indian buyers. Money supply got further tightened and credit from banks fully dried up with interest rates going sky high. Over the last six months, every productive sector – real estate, consumer finance, automobiles, infrastructure and retail – was affected. Corrective action was promptly initiated the damage was already done.

Now, whatever has happened the question is – is this good or bad for economies like India?

Developed economies were rising on speculative and unrealistic prices of oil; minerals, real estate and commodities; and they were generous for unrestrained greed of their financial institutions. Although, reasonable levels of speculation can be considered useful for promoting growth, the excessive speculation can never build a sustainable economy.

On the other hand, India has been growing steadily at 9% + annually, and this has been backed by real growth in production and services with assets formation. It has already built capacities for processing and value addition. What it needs is the raw material at reasonable prices and once it’s available, production will increase, which can be absorbed by the huge domestic market.

Now, with reduction in prices of oil, metals and commodities India stands to gain. Domestic demand will continue except the postponement of some consumer items or luxury goods. What is needed is the restoration of money and credit supply from the banking system. The RBI has taken certain steps by way of correction in the monetary and credit policy but the impact is not yet visible. Banks are still wary of lending. Without restoration of credit supply, the productive sector can not come up once again.

Besides, the confidence of people in stock markets also needs to be restored because majority of investors are still not educated enough to evaluate and understand the financials and growth prospects of companies in which they are lured to invest by merchant bankers. Here SEBI has to play a greater role. If resources have to be generated by way of saving through stock exchanges and investment in mutual funds, better regulation has to be enforced on companies soliciting investments from the public.

Investors have lost thousands of crores not through speculation but by going in for IPOs with highly inflated premiums without any checks and controls. This is another issue that needs to be tackled urgently if the growth story of India is to be resorted.

Free market system

The free market system till recently was celebrated as the only credible solution to the ills of the world. Critics ask, "What happened to the received wisdom of the last several decades that free market system holds the key to a fair, stable and efficient society leading to economic prosperity for all."

The fault clearly is not with the free market mechanism but with the belief in the hype that the ***new*** *financial capitalism* that occupied centre stage over the last decade had fundamentally changed the laws of economics. While the blame rests partly on the shoulders of the market participants who 'innovated' their way to the current catastrophe – creating complex derivative structure – the case for better regulation of the markets covering almost all market participants has never been more compelling as it is today.

If truth be told, the free market tenets are alive because a better alternative that allows citizens to exercise their judgment leading to rising living standards across continents has not yet been discovered.

Free market is still a better way to allocate resources, distribute risk and price goods and services.

The real benefits that have occurred to the economies of the world through a competitive financial system that has quite efficiently intermediated between savers and investors over time cannot be wished away just because some admittedly serious cracks have developed in the system over the last year and a half.

But two successive mega crises in this decade – the *dotcom bust* at the beginning of the decade and the current *financial sector bust* – are quite simply two crises too many for *capitalism* to rescue itself from infamy. Suddenly, the markets do not seem to work, nor do they seem to have all the answers.

Given the sheer scale of the problems in the global financial systems, it would not be long before most of the big global banks become largely government owned if not completely nationalised.

While this is not an endearing prospect from the view-point of free market system, "black swan" events like the present crisis require unconventional interventions because the alternative of allowing these Banks to fail is far worse.

However governments need to return their shareholding in the recapitalised banks to private hands at a profit to taxpayers through a transparent process as soon as the financial system returns to normalcy.

Needless to say, an urgent overhaul of the regulatory system is imperative by incorporating the right lessons from the global meltdown. While so doing, it needs to be recognised that economics after all is much more than a zero sum game. The forces of economic nationalism are held on a leash to keep markets open in order to realise the larger benefits of global trade, commerce and capital flows.

Therefore, it is useless to erect new tariff walls around countries when it is obvious that any real solution to the current problem lies in increased cooperation and coordination policy action among the countries of the world. Meanwhile it is, indeed, worth keeping the faith in the efficacy of free markets that have served us well, except for a brief interlude.

4. CREDIT COUNSELORS
Resolve convertibility and recompensation issue

Good Governance

Even as the world brakes into a recession, the questions reverberating in India are:

Has the Indian boom ended even before it quite took off?
Will India emerge as an economic power?

The more pertinent questions are:

What role does India have to play in the revival of the global economy?
In fact, does it have a role in the recovery at all?

The Indian market holds attractive promise in the long term. Whether it will continue to do so in the short and mid-term depends on how attractive Indian policymakers make it to invest here. Indeed, as the world's 12th largest economy, India offers the promise of a substantial consumer market and presents an attractive investment destination – both are key components of what global investors and industry need.

The country's consumer market is projected to become the fifth largest by 2025, worth more than $1,500 billion. A McKinsey Global Institute study released in 2008 projected that the urban market in India is expected to grow by more than 60% and the rural by about 32%. Many other studies make equally optimistic forecasts.

Questions are being raised today about these projections as the Indian economy has begun to show signs of a slowdown. But if recent years are an indication, India is capable of growth that can address issues of development for all. There is obviously room for more growth within national borders and beyond. Indian businesses have grown globally and have become companies to watch for on bourses across the world.

We believe that the current financial and economic crisis actually presents an opportunity to take stock of the situation on the ground and take strategic steps for long-term development on every front – social, industrial, in employment generation – keeping sustainable and inclusive development as a benchmark.

But while India's potential and its capabilities are clear, what it needs is to focus as much on developing social infrastructure – primarily focusing on education, health and good governance. Private-public partnership would become a byword in the service sector, especially in providing civic services; what is needed now is to extend this partnership to the social and governance sectors.

Constructive dialogue is the best tool for strategic planning; and the government needs to demonstrate its leadership by initiating wide-ranging dialogue with all stakeholders in the country's future on all development issues.

Good governance is the lynchpin on which India's future rests – as much in the short term as in the longer term. It is through this alone that India will rise to meet the challenges of the current financial and economic crisis, and realise its promise as a dynamic market for investments and goods. It is only thus that India would live up to its anticipated dynamic role in the process of global economic recovery, providing an attractive destination for investors. And on that rests the future of India's two hundred million-plus households.

Process complexity

Downturns reveal a company's weaknesses. An organisation that seemed nimble and focused during the period of expansion may be sluggish and ineffectual when demand drops off. Survival can depend on quickly determining which products are making money, what customers really value, and where organisational bottlenecks are getting in the way of effective action. One major cause for this sluggishness is complexity – product complexity, organisational complexity, and process complexity.

The cost of complexity are usually hidden, so executives often don't grasp the magnitude of the problem until a downturn hits and businesses start feeling strong pressure on margins and profits.

The challenge is that some complexity is actually advantageous, even in a downturn. For example, country or regional business units are closer to the ground and are more likely to know what customers want. It takes a complex organisation to provide enough local autonomy so products or services can be tailored to those customers while still taking advantage of global scale. That kind of complexity can be vital to sustain sales through a recession. A similar challenge arises when companies struggle to balance complexity and innovation. Adding new products, services, features and options creates complexity of all sorts. But companies become leaders by offering customers new choices, and in a downturn innovation may be a company's salvation.

A usual way of analysing the level of complexity in your company – and separating complexity that's beneficial from complexity that hurts the business – is to begin from a base of zero.

Imagine, for example, that your company produced just one product or service with no variation, sort of like Henry Ford's classical Model T. A manufacturer with only one product would still need a supply chain, a factory, a distribution network, and a sales-and-marketing function. But it could greatly simplify its IT systems, its distribution and sales efforts, and its forecasting. The point of the exercise, of course, isn't to return to the days of the Model T, but to determine your zero-complexity costs, and then assess the costs of adding variety back in. The key task is to balance its benefits with its costs. And in a downturn – is to manage these balance points.

For example, you might decide to eliminate individual options and instead offer customers a small number of configurations that include the most popular features. Thus Honda's CRV comes in just eight configurations and 13 interior/exterior colour combinations, for a total of 104 possible build combinations. This is far fewer choices than most cars offer, yet the CRV is the hottest-selling vehicle in its class in the US. In India, the CRV has also made a strong sales growth over the past few years.

Similar kinds of analysis can diagnose organisational and *process complexity*. It is found that companies get the best results by attacking *product complexity* first and *organisational complexity* next and only then focusing on *process complexity*. The reason is this: *complex processes* often reflect *unnecessary product variety* or *poor organisational design*. If you attempt to *simplify a process* without changing *product* or *organisational complexity*, you find even more complexity cropping up in some *other process area* – like pushing on one side of a balloon only to find it bulging out on the other side.

All these complexity-management efforts help a company become lean and flexible enough to adjust to the changing market conditions in a downturn. It pays off again when the economy improves and a company has stripped out enough complexity to accelerate quickly out of downturn.

6. WEALTH MANAGERS
Map out the details to translate into benefits

Evolve and adapt

In a changing environment, organisms that do not evolve and adapt may not survive. This is as true of social structure as it is of biological entities: organisation and countries that do not adapt to the new environment of rapid technological changes are likely to be endangered. The superstructure, to stretch the metaphor, depends not only on the foundation, but also on the soil or the ambience within which it is embedded. What is required is not just a coping mechanism to weather on-going change, but proactive measures that enable one to take advantage of the situation.

In an era of fast – and, often, revolutionary – technological change, to be a leader requires that one has to think differently, to go beyond imitation or incremental change.

Economic and strategic power will increasingly go to those who innovate, who create the breakthrough technologies. The days of seeking economic advantage by efficiently productising technology development by others, are numbered because of the speed with which technologies become obsolete, as also the increasingly restrictive regimes, which often deny access to new technologies.

Radical breakthroughs, on a sustainable and on-going basis, happen mainly when the socio-cultural milieu encourages divergent – even subversive – thinking.

A quick solution to India's colossal problems of poverty, illiteracy, healthcare, social justice and economic equity, depends on its ability to device and use new and innovative tools. Some of these will be technological, while others will be societal, organisational and fiscal. Such solutions – with the speed and scale warranted by the magnitude of the problems – will necessarily be radical deviations from the present, requiring many alternatives to be tried and an even larger number thought about.

We need, therefore, to catalyse an explosion of radically new ideas. Such a flowering of creativity, in a number of different areas, can take place only in an ambience where divergent thinking is encouraged.

The future of India depends upon this. India, with its immense diversity in every sphere, and a vibrant democracy, is well placed to foster such creativity. Yet in recent times, we have seen attempts to stifle such openness. Recent incidents in Mumbai, Mangalore and elsewhere, have brought to the fore groups that seem determined to stamp out diversity. The issue is not just about "outsiders" or of women's rights. The larger issue is that of diversity, of tolerance and a respect for the rights and freedom of others.

While fringe groups have a right to their view, they must not be allowed to impose this on others through force or even threat, coercion and fear. It is the duty of the state to permit all citizens to live a life style of their choice and certainty to have and propagate any ideas, however radical these may be, as long as they are within the bounds of the existing laws. Permitting lumpen groups, of whatever persuasion, to enforce their own version of laws and morality is a dereliction of duty by the State.

In an evolving society, many ideas and behaviours are manifest. We need, in our own collective interest, to permit all streams of ideas, however diverse or deviant, and not seek to stifle them or impose pre-determined ones. Such diversity, and the freedom of espouse it, is necessary for organisations, and also for a technologically and economically resurgent India; it also embodies the very idea of India.

Information gap

Pranab Mukherjee's focus on rural development and inclusive growth in the interim budget for 2009-10 appears to have brought cheer to those involved in the *business of removing poverty*.

The stated intent of reducing the BPL population by 50% by 2014, increasing job opportunities for the poorer sections, improving housing facilities and better rural infrastructure has been read to mean a greater opportunity to put money into the hands of the have-nots.

Understandably, micro finance institutions (MFIs) are now gung-ho about what lies ahead. Their excitement has been further bolstered by the decision to set up the Unique Identification Authority of India, which may help them easily fulfil the know-your-customer (KYC) norms stipulated by the RBI.

The stand-in finance minister also added to the cheer when he put the number of women's self help groups in the country at 29 lakh, implying that at least 23 million women (at an average of eight members per group) are now experiencing economic well-being. If you add up this 50 million households that private MFIs reportedly service, the picture that emerges is one of a country which is well on its way to achieving financial inclusion sooner than later.

But somewhere the lines are getting blurred. For one, financial inclusion and micro credit are being used interchangeably; disregarding the fact that other kinds of interventions, especially plugging information gaps, are needed to put the poor on the road of economic self-sufficiency. Secondly, the numbers of the loan-taking poor are being misread to mean mission accomplishment.

The current volume-driven approach of most MFIs – especially the well established ones, who have been doubling or quadrupling client numbers in magical spans of time – has thrown up some worrisome trends. The growth appears to be getting concentrated in certain geographies and not covering newer or unlinked areas. The net result is that in some localities, a large number of poor people now owe money to more than one agency, making repayment a burden and increasing the chances of default. And this race for numbers might end in a larger number of perpetually debt-ridden people. Also, what happens to the poorest of the poor?

It is also taking away from the quality of involvement with micro borrowers where little is being done to help them move up the value chain.

As Shankar Datta, Dean of The Livelihood School, an arm of Basix, said at a conference on micro finance in Gurgaon, "there is a need to explore ways and means to generate sustainable livelihood… there is a need for information to be disseminated among the masses." In other words, it is not enough to give the poor money. They must know how best to use it and what they can do to make it grow. When and how much loan to take, if at all, and what use to put that to must be an informed choice.

A recent study shows that the micro borrowers have an unfulfilled need for a variety of livelihood-related informations. The micro borrowers want information on alternative markets and potential customers, sources of cheap raw materials, other employment possibilities, credit availability at low interest rates, skill building programmes, so on and so forth. For them lack of information was a bigger hindrance than lack of resources or skills. So, a lot of ground still remains to be covered before the poor lead lives that are economically robust, scaleable and crash-proof.

US Jobs

An amendment seeking to bar US companies which receive federal bailout money hiring H-1B visa holder has been introduced in the Senate. Indian IT professionals, who have been the major beneficiaries of the H-1B visa programme, will be adversely impacted by this amendment passed by the Senate.

Introducing the amendment in the Senate, Vermont Senator Bernie Sanders said that there would be a suspension of H-1B programme of any institution which would be receiving TARP (Troubled Assets Relief Programme) funds for just one year… I firmly believe that companies going through layoffs that employ H-1B vises (holding workers) have a moral obligation to protect American workers by putting them first during these difficult times.

Republican Senator from Iowa Chuck Grassley said: “Hiring American workers for limited available jobs should be a top priority for businesses taking taxpayer money through the TARP,” adding if banks are going to be getting American taxpayer money than they should be hiring American workers. Grassley underlined the need for US companies to hire qualified Americans who were looking for jobs as the global economic crisis had put large number of workers out of employment. With the unemployment rate at 7.2% there is no need for companies to hire foreign workers through the H-1B programme when there are plenty of qualified Americans looking for job. Grassley said he supports the H-1B programme, but it should be used in the way it was intended as a temporary measure to supplement a company’s need for hi-tech or specialised workers when none are available in the US. Observing that H-1B and other work visa programmes were never intended to replace qualified American workers,

The measure forms part of the American Recovery and Reinvestment Act, popularly known as the *stimulus bill*. The Act finally passed by the Congress – both the House of Representative and the Senate – makes a provision of USD 787 billion for reviving the battered US economy. It has prohibited banks and firms receiving federal bailout money from hiring people on H-1B visas in place of Americans laid off by them due to the economic meltdown. The measure, as finally approved by the Congress, would require the bailed out banks to hire only Americans for two years unless they could prove they were not replacing laid-off Americans with guest workers.

Senator Bernie Sanders, who along with another Senator Charles Grassley had moved the proposal for such restrictions said, “As the banks have announced mass layoffs, the measure would effectively place a moratorium on the H-1B visa programme. About a dozen banks which are getting over USD 150 billion as the bailout money have sought visas for over 21,800 foreign workers in past six years to replace sacked Americans. These banks have announced at least one lakh job cuts in the recent months. With thousands of financial services workers unemployed, it is absurd for banks to claim they can’t find qualified American workers. While we are suffering through the worst economic crisis since the Great Depression, the very least we can do is to make sure that banks receiving a taxpayer bailout are not allowed to import cheaper labour from overseas while they are throwing American workers out on the street”.

In addition to banks, the Sanders-Glassley provision also restricts hiring of guest workers at any other firm that receives funds under the Troubled Asset Relief Programme or from emergency loans made by the Federal Reserve.

Fiscal stimulus packages

Almost all the economies in the developed world have been experiencing economic contraction over the last few quarters. The current crisis is the worst since that of 1930s and so, a recovery could take more time than the usual recession. Some expects a turnaround by early 2010, but others bet that the crisis would last a couple of years more at least. For sure, 2009 is going to be worse than the previous year.

China and India would continue to grow, though at reduced rates, through these bad times. However, the demand slump in export markets has started hitting these economies hard. Global trade volume could come down for the first time since 1982. The impact of this will be harder on China.

The crash in commodity prices, however, is helping both China and India as net importers of commodities. Commodity-exporting countries namely Russia, West Asian, African and South American countries, are the worst fit, besides, of course, the USA and UK.

Central banks across the globe have been trying to infuse liquidity into the markets. But banks are not lending to those who need money as they are deemed not credit-worthy. The triple-A-rated ones are not demanding credit as they don't see investment opportunities.

Indeed, credit-rating itself got discredited, of late, after some of the biggest banks and financial institutions in the world have disappeared from the scene.

The long-forgotten Keynesian solution of 'pump priming' appears relevant again. Almost all the major nations have come out with 'fiscal stimulus' packages of varying dimension.

The two tranches of stimulus packages announced by the Indian government do not add up to even $20 billion, as compared to about $600-billion fiscal stimulus announced by China. Indeed, China is in a much better position to fight the crisis as compared to India.

The important point, however, is not the quantum of money available for stimulating the economy but how, and how fast, it is being used.

When the export demand is down, the best way to stimulate the economy is to create domestic demand. This is the time to step up public investment in agriculture and in sectors supportive of agricultural and rural development. Also needed is to fill the gap in physical and social infrastructure – schools, hospitals, low-income housing, sanitation, energy security and environmental protection. In all these areas, India has huge deficits. Filling these gaps will imply true broad-based inclusive development. So link these investments to the ongoing NREGS. As far as possible, we have to ensure that the labour component of all infrastructural investments is met by the NREGS.

The big question, however, is about our ability to execute the stimulus packages in time. Indeed our bureaucracy and technology have perfected the art of making it appear that a lot of things are done without anything much happening on the ground. This is the real danger. Our public sector development programmes suffer more from sloth than from resource-constraints.

Depression

When an economy falls into a depression, governments can try four things to return employment to its normal level and production to its "potential" level. Call them fiscal policy, credit policy, monetary policy, and inflation.

Inflation: Inflation is the most straightforward to explain: the government prints up lots of banknotes, and spends them. The extra cash in the economy raises prices. As prices rise, people don't want to hold cash in their pockets or their bank account – its value is melting away every day – so they step up the pace at which they spend, trying to get their wealth out of depreciating cash and into real assets that are worth something. This spending pulls people out of unemployment and into jobs, and pushes capacity utilisation up to normal and production to "potential" level. But sane people would rather avoid inflation.

It is a very dangerous expedient, one that undermines standard of value, renders economic calculation virtually impossible, and redistributes wealth at random.

Monetary policy: The standard way to fight **incipient depressions** is through monetary policy. When employment and output threaten to decline, the central bank buys up government bonds for immediate cash, thus shortening the duration of the safe assets that investors hold. With fewer safe, money-yielding assets in the financial market, the price of safe wealth rises. This makes it more worthwhile for businesses to invest in expanding their capacity today for a better market position that will allow them to reward their shareholders in the future. This boost in future-oriented spending today pulls people out of unemployment and pushes up capacity utilisation.

The problem with monetary policy is that in responding to today's crisis, the world's central banks have bought so many safe government bonds for so much cash that the price of safe wealth in the near future is absolutely flat – the nominal interest rate on government securities is zero. Monetary policy cannot make safe wealth in the future any more valuable.

Credit policy: The third tool is credit policy. We would like to boost spending immediately by getting businesses to invest not only in projects that trade safe cash now for safe profits in the future, but also in those that are risky or uncertain. But few businesses are currently able to raise money to do so.

Risky projects are at a steep discount today, because the private-sector financial market's risk tolerance has collapsed. No one is willing to buy assets and take on additional uncertainty.

Fiscal policy: This brings us to the fourth tool: fiscal policy. Have the governments borrow and spend, thereby pulling people out of unemployment and pushing up capacity utilisation to normal levels.

There are drawbacks: The subsequent deadweight loss of financing all the extra government debt, and the fear that too rapid a run-up in debt may discourage private investors from building physical assets, which from the tax base for future governments that will have to amortise the extra debt.

But when you have only two tools left, neither of which is perfect for the job, the rational thing is to try both – credit policy and fiscal policy – at the same time. That is what the Obama administration is attempting to do right now.

11. GLOBAL OUTLOOK
Global pathways

Reverse migration

The global economic crisis is slowly turning into a migration crisis with thousands of expat Indians likely to return home from developed and emerging geographies in the West, Southeast Asia and West Asia where governments are coming under increasing pressure to salvage jobs of the native labour force.

A serious downturn in these markets, which has already taken its toll on million of jobs across the globe, now threatens to give rise to artificial barriers that restricts mobility across borders. And increasing pressure to employ the local workforce is gaining ground across world markets.

There are instances galore of a downturn and protectionism going hand in hand. The UK government is under pressure from striking British workers against employing foreign workers, mainly from continental Europe. The US lawmakers too are finding themselves confronted with the pressure to trim expat workforce levels at Microsoft and Saudi government has asked companies to retrench imported labour.

Market observers viewed that labour mobility may be determined by the political economy. It's natural that every country will try to safeguard their own workers' interests. For instance, US senators Dick Durbin and Chuck Glassley are planning to introduce legislation that makes it mandatory for Indian outsourcing firms such as Tata Consultancy Services, Infosys and Wipro to hire American employees before they file for HIB visas for their Indian employees.

Commerce and industry minister Kamal Nath said at the World Economic Forum in Davos recently that History is witness that whenever countries try to prop up protectionism, it intensifies depression. Many other government and business leaders, who gathered at Davos, echoed Mr Nath's point of view, warning against the rising tide of protectionism.

Domestic concerns over job losses could lead to the erection of new barriers of trade and further job cuts. India's export sector is already reeling under the massive demand destruction in the developed world and industry lobbies claim that attrition levels have climbed close to a million as a result of this.

The International Monetary Fund pegged global economic growth to just 0.5% this year, the slowest pace of growth since World War II while International Labour Organisation has warned that as many as 50 million people could be rendered jobless in 2009. While it is hard to predict the outcome of a recession of this magnitude, fears are rife that the number of US visas being issued will be curtailed.

Migration to the Gulf, which employs the largest number of Indians outside the country, has helped several families tide over poverty in the past few decades. There is no centralised data of the number of Indians working abroad, but the ministry of labour web site suggests that at least 30 lakh Indians, mainly construction workers and nurses, are currently employed in the Gulf. Meanwhile, the flight to advanced countries has also helped thousands of technically-qualified Indian professionals find their dream jobs.

As the number of migrant Indian workers swelled over the years, overseas remittances added to the country's forex kitty and afforded the government comfort in framing economic policy. An unceremonious home-coming of thousands of white and blue-collared non-resident Indians would reduce overseas remittances and impact foreign exchange reserves.

12. ISSUES OF THE PRESENT

Freedom to get & fail in the system of free enterprise

Globalisation

Globalisation entails rapid intensification of cross-border trade, services, and capital flows; greater to and fro movement of people and ideas; enhanced welfare through efficient gains, greater equity and higher growth. However, globalisation, may have increased income inequality and undermined nation states. It has also been linked to colonialism, under-development and to external shock, with a crisis in the US housing market threatening to bring down the global economy.

So, how far, and in what directions, will the process go in future?

Historical trends are rarely linear either in space or time. Predicting the future is consequently full with hazards. Nevertheless, just as a study of the past is a meaningful way of understanding the present, the present in turn is a creaky window opening into the future. For instance, one of the immediate consequences of the 9/11 attacks on the United States was to reverse the growing ease of cross-border labour mobility. However, global integration through trade in goods and services and capital flows, and at the level of ideas and interpersonal exchange continued to expand geometrically.

In recent months, however, following the unprecedented global financial crisis, a number of economists expressed scepticism regarding the globalisation process, a number of renowned developed country economists such as Joseph Stiglitz, Lawrence Summers, Paul Krugman, Martin Wolf and Dani Rodrick, have expressed scepticism regarding the globalisation process. Its institutional basis is seen to be weak, and perceived losses seem to outweigh gains:-

For the first time in modern history per capita incomes in developed and developing countries are converging. (Coming close together)

Understandably, protectionist sentiment is currently stronger in developed countries, just as it was in developing countries when the divide was widening. Workers in developed countries seem to be losing out. The greater gains seem to accrue to non-democratic countries like China, Russia and Venezuela bent on pursuing geopolitical ends rather than enhancing welfare.

The recent surge in commodity prices reawakened nationalistic fervour and temporarily reversed the long-term trend in transportation costs that made globalisation possible.

There is also widespread fear that globalisation may unravel in the wake of the ongoing turmoil in financial markets and global recession.

Are these rising whispers of a retreat from globalisation a turning point in history, or yet another interlude in the relentless movement forward? Nevertheless, a global recession, and possible depression, appears imminent and with it a contraction in world trade and capital flows.

5. BANKING SECTOR

Lend More & Charge Less

India's central bank and its commercial banks are being faulted for not doing enough to make credit available in the present trying conditions. There are complaints about both the price and volume of credit.

On the price of credit, the latest policy statement the RBI lists many limitations that banks face. Banks have to compete for funds against national savings schemes that have a relatively inflexible administered rate structure. They are stuck with deposits raised at higher rates earlier. Risk aversion in times of uncertainty implies a higher spread over the prime lending rate than in normal times.

Above all, government and industry cannot ask banks to both lend more and charge less. When demand for bank funds goes up, banks have to mobilise costly bulk deposits in order to meet higher demand. Reliance on bulk deposits limits the potential of lowering lending rates.

Today, we have the seeming paradox of acceleration in bank credit at a time of deceleration in economic growth because non-bank sources of credit have dried up. Banks have to substitute for funds from a variety of other sources, such as the capital market, overseas debt borrowings, NBFCs, etc. The aggregate flow of financial resources to the commercial sector from all sources was only marginally lower than in the same period last year. So, it's not clear what all the howling about a 'credit squeeze' is about.

Everybody wants banks to lend more. But banks can and will accommodate the demands made on them only up to a point. There are structural limitations to credit expansion. And there are also disincentives against credit expansion. Take up the structural limitations first. Whom should banks lend to?

- Infrastructure is a growth area but over-exposure to infrastructure can create serious asset-liability mismatches for banks.

- Large corporates are hungry for bank funds in order to complete their acquisitions abroad or because foreign debt is not being rolled over. But lending more to them increases concentration risk for banks.

- As for retail credit, private banks which have been the most aggressive players in this area are revisiting their business model which focused on using agents for sale and recovery of loans. This model delivered high growth but it is now posing issues of loan quality and recovery that conforms to RBI norms. Banks want to go back to the branch model for retail banking. This adjustment will take a while. Until then, retail credit growth will be lower than in the past.

There are also clear disincentives to lending more at a time when policy rates are declining. Indeed, cuts in policy rates can have the perverse effect of discouraging loan growth. These cuts are quickly transmitted to the government securities (G-secs) market. Banks, especially public sector banks are sitting on huge hoards of G-secs. They stand to make big gains from declines in rates on G-secs. The interest rate on government securities plus capital gains on securities yield a risk-free return of over 8%. Why would banks be so foolish as to make loans at below 10%? It pays to practice 'lazy' banking in these conditions.

Meanwhile, how does government take care of sectors in dire need of credits? Well, alternative channels must be found. The move to create a special purpose vehicle (SPV) for routing finance to NBFCs is the right idea. Similarly, let there be an SPV for acquisition finance. If subsidies are required, let these be borne by the exchequer. Under no circumstances must we fall into the trap of loading this burden onto banks. To do so would be to negate the hard-won gains of a decade-and-a-half of banking sector reforms.

Challenging time for Money Changers

Money changers just form the most visible component of the close to $7-billion industry that includes many other commercial banks. These firms provide foreign currency to Indians when they travel abroad and also rupees to foreigners. The money changers need to have discipline, niche knowledge and ability to weather through cyclical movements of a currency. And a proper infrastructure is also essential.

The money changers community, comprising 400-odd professionals, is facing challenging times. The slowdown in the global economy has impacted the flow of foreigners travelling to India. Corporates too are in a cost-cutting mode with a good number of Indians cutting down on their holidays abroad. Add the unprecedented volatility in the rupee-dollar exchange rate and it truly a heady mix.

Little wonder that many small money changers are shutting shop or selling out to large players. The latter in turn expanding aggressively in the hope of making it good when the good times return. Thomas Cook, Wall Street Finance, VKC Forex, Wiseman are some of the prominent players among professional money changers.

What does this consolidation mean for the average Indian traveller? Fewer, more efficient money changers perhaps, and as many officials in the industry put it, one-stop-shops where you can buy everything you need for travelling abroad – air tickets, international currency, pre-paid cards, traveller's cheques and dollars in cash all at one place.

When the going gets tough… While most of these firms operate at margins of close to1%, the risks involved are manifold. For instance, most money changers routinely give credit to people setting out on business trips. If the money is repaid in time, there are exchange risks that the changer has to incur. When corporate clients deal on credit, only the final amount to be paid in rupee is fixed. With the rupee as its volatile best, one needs proper risk-management systems to stay solvent.

Also, there is the cost of borrowed money that the money changer has to incur. In fact, the recent Satyam scam is said to have impacted the businesses of three money changers who have lost a handful of crores, with the tainted company not allegedly being able to honour its commitment.

The start & the evolution… It was only in the mid 80s – with the entry of American Express Bank (popularly called AmEx) – that money changers were allowed to sell traveller's cheques. But business grew by leaps and bounds in the 90s, after RBI allowed them to assist in corporate travel. The next big push came earlier in the decade when RBI enhanced the currency limit that an individual could draw while travelling abroad. The prospects of roaring business attracted many new players. At one point, there were close to 800 money changers who were operating on wafer-thin margins.

From 800, the number of money changers has halved in the past few years. Over the past few months, Thomas Cook, Reliance Money and FCH Centrum each have acquired a firm and said that they are open to more such acquisitions. This trend of consolidation is only expected to accelerate in the coming months and drive efficiency. What is also comforting is that despite the possibility of money laundering through the route, money changing industry has remained largely free of any scandal.

The industry, which helped usher in democratisation of travel in India, is still evolving. But the process will not complete until the evolution takes it to maturity.

6.1 TAX UPDATES

Third Stimulus Package

Excise duty, service tax cut by 2%

The government on Tuesday (24/02/09) unveiled Rs 30,000-crore stimulus package, the third in a row to boost demand in an economy that has been feeling the heat of the global meltdown. Finance minister Pranab Mukherjee, who had refrained from tweaking tax rates while tabling the interim budget, said the UPA government had taken these measures as "the full impact of the recession in other parts of the world, especially Europe and Asia, is yet to unfold. Due to strong export linkages with these economies, it is likely that the Indian economy may feel further impact in coming months.

The package, which comes a week after the government presented its interim budget, includes a cut in the median excise duty and service tax rates by 2%. All products that attracted an excise rate of 10% will now be subject to only 8% while service tax on all products is down to 10%.

Colour television sets, washing machines, refrigerators, soaps, detergents, colas, hybrid cars, commercial vehicles and 90% of manufactured items that attract an excise duty of 10% at present are expected to become cheaper as a result of the duty cut. Today's stimulus package comes on the back of two similar packages that were announced in December 2008 and January 2009. In December, the government had slashed median excise rates by 4%. Finance minister made it clear that 4% across-the-board cut in excise duty, which was announced as a part of the first stimulus package, will be valid beyond March 31, 2009.

Utility services set to cost less

Consumers, battered by steep increase in prices in the past one year, can breathe a sigh of relief with a 2% reduction in service tax. This will direct touch the lives of over 500 million consumers in the country and help reduce their monthly spend and put more money into their pockets.

From lower telephone and credit card bills, reduction in international airline tickets and tour packages to paying less for services offered by health clubs, banqueting services and beauty parlours, the impact, though marginal, will be felt across service accessed on a daily basis. The significance of this is best explained if we consider the larger picture. This comes at a time when fuel prices have come down significantly, food prices have softened, inflation is at record lows and banks have cut interest rates for home and automobile loans.

Tax refunds for BPOs, marketing agents

Call centres, investment advisory and medical transcription services providers, marketing agents and money transfer companies, among others, can breathe easy. The government has spelt out that the services rendered by these entities can be considered as 'exports' and can therefore be eligible for refund of tax paid on inputs to vendors. Activities of ongoing concerns such as call centres were being denied the benefit of export of services and refund of service tax as departmental offices raised questions as to how their services could be deemed as exports when these were being performed within the country. The operative part in this case was that these activities did not satisfy the condition "used outside India."

Service tax cut a big boost for FIIs

Foreign institutional investors will be one of the biggest gainers in the financial sector from the reduction in service tax. FIIs will see their brokerage costs come down because of the lower service tax.

Unlike corporates, FIIs do not have any output service tax liability in India against which service tax payments can be offset. So, the two-percentage-point reduction will result in an equivalent cost saving.

IT SEZs get tax breather, to enjoy full benefits

India's largest information technology companies received a morale-boosting assurance from finance minister when he accepted that the income tax law that prevented their subsidiaries in special economic zones from getting full tax benefits was discriminatory and needed to be removed. However, the companies will have to wait for the new government that comes to power after the general elections to bring about the change through an amendment to the Income Tax Act.

Indirect Tax cuts would benefit all

Pranab Mukherjee, the minister in charge for finance, has finally delivered his share of fiscal boost. By cutting excise duty and service tax by 2% each, he can claim to have somewhat mitigated the criticism that he did nothing during the interim budget presentation. The current economic downturn as an exceptional situation requires policy response on a regular and consistent basis. The tax cuts would certainly help improve sentiments for both industry and consumers alike. The finance ministry will sacrifice revenues of about Rs 30,000 crore with these tax give-aways. With this, the total indirect tax give-aways in the past few months would amount to Rs 70,000 crore this fiscal. This is about 15% of GDP. The only worry that remains is on account of the ballooning fiscal deficit.

In any case, the government cannot do much in the next three months as the nation prepares for the general election. The next government takes over sometime after mid-May. Once a new government is in place, more comprehensive tax cuts could be undertaken to boost the economy. Pranab Mukherjee did the right thing by not touching direct taxes which would have required an endorsement by Parliament. That could prove tricky as many allies of the Congress are politically in a hard bargaining mode. Their behaviour can become unpredictable in the event of a money Bill being brought to Parliament. Therefore, cutting indirect tax is politically safe.

Special package for exporters

Quick on the heels of acting finance minister Pranab Mukherjee's give-aways, on Thursday (26^{th} February 2009) commerce and industry minister Kamal Nath announced a set of his own. The minister's hands are obviously tied by the limited fiscal space available – give-aways announced to date, including off-budget items, have already seen fiscal deficit grow to more than 10% for the Centre alone.

Hence most measures, apart from the 2% reduction in custom duty under the export promotion capital goods (EPCG) scheme and special incentive of Rs 325 crore for sectors like handmade carpets, leather and technical textiles from April 1 are non-fiscal.

The benefits under Duty Entitlement Pass Book (DEPB) scheme can now be extended without waiting for realisation of export proceeds; Authorised persons from gems and jewellery units can personally carry imported gold of up to 10 kg; The deadlines for fulfilling obligations under the EPCG scheme for sops availed during 2008-09 has been extended till 2009-10.

Hunt for bear cartel

The SEBI is examining the alleged role of a group of strong bear operators in the sharp fall in a few shares. According to market participants, the bear cartel targets shares that are relatively vulnerable to swift declines. Their targets are mostly companies where valuations are perceived to be high or firms whose promoters are believed to have pledged shares with financiers.

The bear cartel has used the most relevant topics such as balance sheet irregularities and triggering of margin calls, which have created huge panic in other stocks, as weapons to trigger panic in the targeted stock. This group of operators has successfully targeted companies such as Educomp, Rolta and Ruchi Soya. In the latest case, shares of Educomp were hammered on market talk that the company's accounting practices were questionable.

Inspection of financial statements

Corporate Affairs Minister Prem Chand Gupta has asked the Registrar of Companies (RoC) to comb through the financial statements of 150 private sector companies, including a large number of listed ones, to unearth suspected financial misdeeds and bring the guilty to book. Mr Gupta had ordered a similar inspection of the books of six-state-run companies on February 2 '09. His idea is to clean the system.

The companies were chosen for inspection based on several distinct criteria – such as adverse remarks by auditors, serious investor complaints, non-disclosure of material facts, improper related party transactions, and references from other regulators like I-T department, SEBI and RBI are the main ones.

The inspection entails RoC officials visiting company premises, scrutinising the books and taking procession of documents if required. It, however, does not include the harsher steps of an investigation.

Empowering ordinary shareholders

The government is set to empower the ordinary shareholders of the eight lakh domestic companies by encouraging them to critically examine the decisions of the companies, and if unhappy about them, complain to the government. The ministry of corporate affairs will investigate the matter if such complaints have merit. If the probe reveals wrong-doing, the ministry may even move the Company Law Board to rescue the company and book the erring executive the way it did in the case of scam-hit Satyam.

As the beginning the ministry is launching an awareness blitzkrieg across financial and regional newspaper targeting the first gatekeeper in any company – the ordinary investor – impressing upon her the rights as well as the need to question the decisions of the companies at annual general meetings.

The ministry wants to strengthen all levels of oversight in the company, beginning with shareholders. The other gatekeepers include lenders, internal and external auditors, independent directors and regulators. The systematic fraud in Satyam that went on for years has highlightened the imperfections in the system. Minister of corporate affairs Prem Chand Gupta said, "Our idea is to clean the system.

7.1 INFLATION RETREATS: NOW ADDRESS GROWTH

Consumers Back In Bazaar

Robust consumer spends on durables in urban and rural markets since early January 2009 seem to defy conventional logic about recessionary trends impacting discretionary purchases. Leading industry majors and retailers are reporting an upbeat 20%-plus growth in volumes for LCDs, laptops, ACs, refrigerators, washing machines and audio systems, after cutting down production in the last three months in 2008. Ajit Joshi, CEO of Tata Group-led Croma said, “Given the projected GDP growth of 6-7%, it is hardly surprising that demand for aspirational consumer products remain upbeat. I think there was a lot of hype about recession and job layoffs, which depressed consumer sentiments. After sitting on the fence for a while, consumers are back in showrooms.”

Industry players say the trend indicates that the purchasing power of the average middle-class Indian consumer is still strong. They pointed out that rural markets are more upbeat and insulated from the impact of the global meltdown and even rural markets are throwing up good volumes. There are demand drivers such as investment in rural economy, good agricultural growth and higher disposable incomes in the hands of consumers after the implementation of the recent sixth Pay Commission.

A survey conducted by Futures Company and TNS Global as part of its ‘Feeling the Pinch’ series, conclude – anyhow, urban Indians continue to be reasonable optimistic about the state of the economy and as high a proportion as 75% of them expect their family’s financial situation to remain stable or improve over the next 12 months. Expectations of this kind determine spending behaviour. The mood in India is positively uplifting. The Futures Company’s Mr Rama Gupta says, the confidence emanates from the level of savings respondents have accumulated over the years. After all, with the economic boom of the past few years, more than 50% feel they were better off than they were 3-years ago.

Inflation declines to 5.07% for the week ended January 24 from 5.64% in the previous week, as price of metal products, fruits and vegetables fell considerably. The wholesale price index-based annual rate of inflation was 4.78% in the corresponding week last year. Inflation had raced into double digits in June ’08 after the government raised fuel prices, and peaked just below 13% in August ’08.

Inflation at 4.39% for the week ended January 31: The annual rate of inflation dropped to a 12-month low of 4.39% following the cut in retail fuel prices getting reflected in the WPI. The WPI-based annual rate of inflation was 4.74% in the corresponding week last year. Crisil principal economist DK Joshi said, “With the industrial output contracting and the demand slump, I am expecting fall in inflation to gather further momentum from here on. If the current scenario continues, the economy might enter deflationary phase by March-end for a brief period.

Inflation drops to 3.92% for the week ended February 7: A sharp fall in prices of edible oil and many manufactured products causing the headline inflation to fall to a 13-month low of 3.92% for the week.

Inflation drops to 3.36% for the week ended February 14: Inflation dropped to a 14-month low of 3.36% in the week ended February 14 on the back of easing prices of food items, metals and machinery.

Inflation falls to 3.03% for the week ended February 21: Inflation dropped to a six-and-a-half year low of 3.03% for the week ended February 21 as prices of many food items and select manufactured products such as metal and transport equipment fell sharply during the week. The other trigger for a sharper drop in inflation in the coming weeks is the 2% cut in excise duty (from 10% to 8%), announced as part of the third stimulus package, which should cause prices of manufactured products to decline in general.

The Economic Base Theory owing its origins to the debate between Charles Tiebout and Douglass North provides a useful framework to understand the Indian growth story and predict future growth prospects. Douglass North argued that an exogenous *world demand* creates *direct, indirect, and induced effects* and leads to local political, economic, and social growth. Moreover, government decisions, *investment decisions at least in the short-run, and export decisions may lead to the outside demand*.

- *The direct effect* is the initial/immediate effect of the demand on output, employment, or income. For instance, output in the manufacturing sector will increase by, say, $5 million.

- To meet this additional output the manufacturing sector has to buy additional inputs from other industries, pay additional salaries to households, or import additional goods and these changes in output, employment, and income that occur as a result of the *direct effect* are called the *indirect effect.*

- Another round is the *induced effect* that measures the increase in household incomes and spending caused by the *direct* and *indirect effects*.

- Moreover, the *direct effect* stimulates the economic base, or export sector; in contrast, the *indirect* and *induced effects* exist only to serve the basic factor.

Positive, high correlation between *foreign direct investment inflows* and *India's GDP growth* provide some evidence for the operation of **the Economic base theory (EBT).**

During the last five years the aggregate FDI inflows have increased nearly seven times from Rs 95,639 crore in 2003 to Rs 654,949 crore in 2007. The service sector has the largest share (22%) followed by the software industry accounting for 15.6%. GDP growth rates show a corresponding increase – an average of 9.3% during the three years ending March 2008, compared with an average of 6.6% and 6% respectively, in the preceding three and five years.

India's rise as a dominant actor in the service outsourcing sector is partly explained by the Theory of the New International Division of Labour, associated with Frobel.

Technological advances permitted splitting of production processes and China became a manufacturing centre, followed by the spread of information technology, during the 1990s, and the main beneficiaries was India. Additionally, India was well placed to derive the full benefits of globalisation due to an unintended convergence of events.

- First, India was fortuitously placed *twelve hours away* – while the west slept. India worked.

- Second, the *Y2K scare* focused research attention on IT and led to the creation of tools that accelerated services outsourcing.

- Third, *privatisation of higher technical education* during the 1990s fulfilled the desire of Indian parents to make their children engineers, ensuring that sufficient numbers of willing technical personnel were available to work in the IT sector.

8.1 MISCELLANEOUS UPDATES

Dividend Cheque

What is it about dividends that Indian investors don't get? The times are bad. Prospects for economic growth are dim. Credit is hard to come by. Investors are shunning equity risk. Yet, company managers are reluctant to distribute that one thing that every one of their shareholders wants: cash.

This may not be a repeat of the Great Depression. But it does look like that the anthem of the early 1930s – Bing Crosby's classic, "Brother, can you spare a dime?" – is an apt description of what present-day investors might want to say to the chairmen of Indian companies.

Corporate India is worse than Uncle Scrooge McDuck.

On the CLSA list of 122 Indian stocks, only 10 are expected to offer a dividend payout in this calendar year that exceeds the current 10-year government bond yield of about 6%.

Consider a stock that has a future dividend yield of 5%. If there was no secondary market in this stock, one would need to hold the shares for 20 years just to get back one's investment. A 20-year 'payback' period is no big deal in a bull market.

In a report last year, Citigroup Inc equity strategist Markus Rosgen calculated the payback period for someone investing in the MSCI India index in January 2008 as 113 years. No one back then bothered to stop and think what they'll do – if their bet on price appreciation soured – with securities that would take four or five generations just to recoup the original investment.

In a bear market, such as the one we now have, investors are fearful of losing their capital. So they demand a higher dividend yield to cover the risk of price erosion. In the absence of a culture of shareholder activism, there's unlikely to be much pressure on management to return more cash to investors. Equity analysts can go on issuing strongly worded reports that "If the dividend return improves, our market may actually become more robust and less prone to frequent booms and busts".

British economist John Maynard Keynes made the point succinctly in his *General Theory of Employment, Interest and Money* by taking a swipe at Americans.

Keynes wrote, "It is rare for an American to invest, as many Englishmen still do, 'for income'; and he will not readily purchase an investment except in the hope of capital appreciation." When he purchases an investment, the American is attaching his hopes, not so much to its prospective yield, as to a favourable change in the conventional basis of valuation, i.e., he is in the above sense a speculator.

The next couple of sentences are as relevant today as they were in 1936, when the *General Theory* was first published: "Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes a bubble on a whirlpool of speculation".

Keynes went on to confess that his exasperation with "Spectacle of modern investment markets," had often pushed him to the conclusion that making the purchase of any investment 'permanent and indissoluble, like marriage, except by reason of death or other grave cause might be a useful remedy for our contemporary evils." We don't want to go that far. Such drastic steps aren't even necessary.

Corporate India can – and must – do better. Brother, you had better spare that dividend cheque.

8.2 LIFE INSURANCE SECTOR

Back to Basics

In the past decade, no other sector has been able to attract so much capital without any hint of profits as the life insurance industry. Nor has any other sector accumulated as much losses as the life sector.

Until last year, the red ink did not matter. Insurers have been able to convince shareholders that the losses are only notional and hidden behind the deficits in the profit and loss statement are future profits which will flow effortlessly in due course.

The bull-run in the equity markets in the past three years helped companies, raise capital without worrying about breaking even. But even after a decade, profits continue to be elusive for private life insurance companies. Now, the game is changing. Some new joint ventures have run aground following Indian partners' inability to bring in the requisite capital. With capital becoming scarce, promoters of life insurance companies have started asking questions on profits and efficiency of capital.

Industry leaders expect that new business will see a dip during the current fiscal and will remain subdued for the next fiscal. For the industry, this means a move back to basics. In other words, companies will have to reassess their growth plans and product structures, and work towards increasing persistency.

The past three years has largely been that of expanding branches, getting as many agents on the street as possible and pushing products that will grow toplines. The half-a-dozen fledgling companies could do well to look at how strategies of existing players have panned out and decide their own plans accordingly. But, now the review of overall strategy appears imminent

ICICI Prudential, whose capital infusion of over Rs 4,500 crore is the highest in the industry has focused on *value creation*. In any other business this is relatively easier to measure. In the case of insurance it is based on number of assumption including persistency and return on investments. So it is difficult to ascertain and compare due to limited disclosure by life insurance companies.

If ICICI Prudential's focus has been on valuation, the second largest SBI Life Insurance appears to be focused on *value for money*. Thanks to the support from parent SBI in terms of branding, distribution and infrastructure. SBI Life has been able to do business at fraction of the cost of its rivals. But riding piggy back on its parent bank's infrastructure has resulted in a very low renewal ratio. The company's dependence on group insurance has also resulted in death claims being among the highest.

Bajaj Allianz General Insurance was earlier called the *insurer with the lowest expenses*. The charges were not visible under the capital unit gain product, which was subsequently banned by the regulator. As per IRDA figures, pertaining to 2006-07, New York Life and HDFC Standard Life have had the *highest conversion ratio*, which means that their lapsation are the lowest. However, lapsations could have gone up as companies embarked on an aggressive push for new business. The LIC – the country's largest financial institution – has for many years been following a strategy of bringing *a new attractive product* and maximising sales just before the scheme is about to close.

Until now 100% growth in new business has diverted attention from existing customers. Given the slowdown in premium collections, the best route for life insurers is to ensure the existing policyholders continue to pay their renewal premiums. Simple calculations show that everything else being equal, a company growing at 8% annually, with 85% of the previous years' policies being renewed will in 10 years have highest assets under management than a company growing at 10% but with renewals of 75%.

9.1 **KNOWLEDGE RESOURCE**

What Falling Prices Are Telling Us?

Consumer prices in the US fell at a breathtaking annual rate of nearly 13% in the last three months of 2008. Prices plummeted for all sorts of goods, ranging from clothing to TVs to furniture, as retailers, advertised sale after sale. But deflation missed big chunks of the economy. For all of 2008, college fees increased by 5.8%, followed closely by price increases for hospitals and legal services. Even fees for preparing tax returns were going up.

This inconsistency in prices casts doubt on the usual explanation for the recession, which is that it's mainly due to the credit crunch and resulting squeeze on demand. It also hints as why government efforts to fight the downturn have been ineffective so far. If the lack of demand that the Obama Administration is fighting were the only problem, you'd expect prices to fall across the board.

Instead, it appears that supply – that is, oversupply – is an important factor.

The sectors in which prices are falling are those plagued by an excess of factories and ways to get goods to consumers, often because of huge investment in plants in China and other developing nations. Most services, in contrast, are not in severe oversupply and have domestic labour as their main ingredient. Consider this: Prices of goods fell 4.1% last year; prices of services rose 3%.

The government's deflation-fighting weapons – low interest rates, financial bailouts, and spending packages – can boost demand but do little to deal with oversupply. As CEOs of Microsoft and General Electric have observed, and long-term demand growth has been "reset" downward. The world's productive capacity is simply too big. That means prices need to fall further, or more factories need to close in the US and abroad, or some combination of the two.

The stimulus can ameliorate the downturn, but not prevent continued contractions in the sectors of the economy where global overcapacity is the most extreme. Examples: The world is able to make 90 million vehicles a year, but at the current rate of production, it's making only about 66 million. Similarly, global production of semiconductor wafers is running at only about 62% of capacity.

Such overhang hurt not only manufacturers, but retailers who sell goods and the truckers who distribute them, not to mention the financial wizards around the globe who abetted the buildup of overcapacity through foolish lending and financial inventions. For the US, global overcapacity will mean bargain prices for consumers in 2009 but tougher-than-ever competition for US producers that compete with imports, such as carmakers and steel producers. Pricing power is now deteriorating.

Economists describe it as a vicious circle of declining output, prices, and profits. In the North American steel industry, 16 of 29 blast furnaces are temporarily shut down. It's going to get worse. Because inventories of manufactured goods piled up before producers realised how badly demand had fallen. But the picture is dramatically better in education and heath care. Enrollment is rising at many community colleges. Hospitals are still adding workers.

For economists, overcapacity is a tricky concept. Human wants are unlimited, so how could the world ever produce too much of a good thing? The key is what people can pay: In many goods sectors, prices still aren't low enough to bring forth enough buyers. There will have to be some combination of falling prices and destruction of productive capacity before supply and demand come back into balance. The question is how that balance will be achieved. Deflation is a signal that all is not right. For businesses and policymakers, the key is to diagnose the malady correctly.

9.2 KNOWLEDGE RESOURCE

Asia to Emerge Stronger Despite Global Turmoil

Exit the year of the unpredictable Rat; enter the year of earthy Ox, hopefully bringing with it its characteristic stability, conservatism and harmony. The changeover in the lunar almanac aptly reflects the mood in the world economy. For the first time since World War II, the US, Europe and Japan are simultaneously in recession. After the turmoil of 2008, the world is yearning for a period of relative calm.

Yet, amidst the gloom, the dourest estimates for China and India indicate that the two fastest growing economies of the 21st century expanded by more than 7% last year and may grow by 5-7% in 2009. While investors have focused on the sharp global downturn in the West, they have largely overlooked the relative resilience of the East. Without doubt developing markets are slowing. Exports have been impacted as consumers in the West borrow less and start saving again. Tighten dollar liquidity, the freezing of trade finance and heightened risk aversion among local banks have caused severe distress among many small and medium-sized enterprises.

Still, the reversal in fortunes is a cyclical downturn as opposed to the West's deeper structural slowdown. The region is well prepared to withstand a deceleration in growth. The ever-growing middle class of emerging Asia – which has saved prodigiously during boom time – can pick up some of the slack left by the withdrawal of western consumers. Asia's middle class, excluding Japan, comprises more than 250 million people who are increasingly saving less and borrowing to pay for overseas holidays, home or cars. Add to that some one billion Chinese and Indians who are increasingly getting wealthy and they are an emerging consumer base that could soon surpass in the US, EU and Japan put together.

Asian governments are in better shape to provide incentives because of their strong fiscal position, low debt levels, large foreign exchange reserves, resilient financial systems and falling inflation. The region's record reserves and inter-governmental foreign currency swap lines have helped it counter an acute shortage of dollar liquidity, while multiple free-trade agreements make the region a lot less susceptible to developed economies than a decade ago.

In India, for instance, building infrastructure from power plants to sewage treatment facilities will require trillions of dollars over the next decade. Strengthening capital markets infrastructure will help harness such large-scale, long-term capital.

Many people wonder whether Asia will turn back the clock on financial reforms in the wake of the current turmoil. In fact, Asia has brought in greater sophistication, transparency and depth to its financial markets since the 1997/98 financial crisis. Asian regulators are likely to be enablers of change, coming together to facilitate measures that promote prudence at financial institutions and make them more consistent and transparent for stakeholders.

A lot of work still remains. For example, for setting up of credit bureaus and establishing proper supervision over lending practices at consumer finance companies will help prevent a repeat of the West's subprime crisis and benefit millions of borrowers in Asia's smaller towns and rural societies which have no transparent access to finance today. Indeed, authorities in emerging financial centres such as Mumbai and Shanghai, along with more established centres such as Hong Kong and Singapore, should grasp the emerging opportunity to be at the forefront of change in the global financial architecture. With some deft handling and a little bit of luck on the socio-political front, these Asian centres can join the ranks of New York, London and Tokyo as equals in a new world order once the dust settles from the ongoing financial turmoil. 2009 might just mark that turning point in history.

The sooner the authorities clean up the financial system;
The faster the economy will be on road to recovery.

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