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LET ALONE CHECK THE BOOM

SAFE UPDATE– KEEP INFORMED

The Securities Academy and Faculty of e-Education

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Editorial preamble: Let Alone Check The Boom

1.1 LET ALONE CHECK THE BOOM

Booms and busts

Ever since Queen Elizabeth II asked in July why nobody had predicted the Great Recession, sundry economists have given an avalanche of weak explanations.

Phooey. Actually, Queen Elizabeth herself exemplifies the problem. Contrary to her complaint, dozens of economists and journalists warned repeatedly that the world suffered from unsustainable asset bubbles, global imbalances and high debt. But most people, including the Queen, were not interested in listening.

The Queen's financial portfolio shot up in the boom, yet she never asked whether this was justified or sustainable. Only after her portfolio lost $135 million did she ask why nobody had predicted the downturn. She typifies the millions of suckers who asked no questions when blinded by euphoria in the boom, and then indignantly demanded explanations in the subsequent bust.

A group of British economists led by Tim Besley told the Queen it was "a failure of the collective imagination of many bright people." This failure, they explained, arose from "a psychology of denial." While many experts were indeed in denial, others shouted the truth but were ignored.

For instance, it was repeatedly said that 9% GDP growth in India was an unsustainable by-product of the biggest global boom, and that the global tide would one day fail and lower all boats, including India's.

Queen Elizabeth may not read business papers. But she must have heard of two chairmen of the US Federal Reserve Board, Alan Greenspan and Ben Bernanke.

Both were fully aware of the housing bubble in the US. Indeed, Greenspan warned the US Congress that the dominance of Finnie Mae and Freddie Mac (government supported institutions) in the mortgage market posed a huge systemic risk, a warning all Congressman ignored. Besides Alan Greenspan and Ben Bernanke both opposed imposing high interest rates to check asset bubbles, since this might plunge the whole economy into recession. They said it was better to let bubbles burst and then clean up the mess.

The Queen might disagree with their timing, but can hardly say they didn't foresee the bursting of the bubble. Many economists wrote about asset bubbles in housing, real estate and commodities.

Many columns pointed out that market-indices suggested that asset prices were too high. So, don't accuse economists. Rather, it so often that they were dismissed as boys crying wolf.

Nouri EI-Roubini and Stephen Roach repeatedly predicted the bursting of the asset bubble, but since the bubble kept inflating nevertheless, they were dubbed failed prophets.

Nissim Nicholas Taleb's book *The Black Swan* lampooned fund managers for ignoring the improbable, thus exposing themselves to massive bankruptcy of the sort that actually happened. The book was a best seller, yet few readers acted on Taleb's advice.

Former IMF chief economist Raghuram Rajan said, in lectures and articles from 2005 onwards, that financial institutions were taking on excessive risk. Newspapers pointed out that the debt of individuals, corporations and the US government had reached historic highs. Savings as a proportion of disposable household income become negative in 2005, and the media pointed out that the last time this happened was in 1933, during the Great Depression. Very few drew the appropriate conclusion.

Yale economist Robert Shiller's celebrated book *Irrational Exuberance* in 2000 highlighted the unsustainability of the bubble and predicted correctly, that it would burst. Shiller's second edition of the book in 2005 warned that US housing was another bubble ripe for bursting. His Case-Shiller index of housing prices showed how far housing prices were out of line with household incomes and rents. His book sold millions of copies, and many reviewers declared that Shiller was obviously right. Yet, so entrenched was irrational exuberance that the housing bubble kept inflating, and burst only in 2007.

All economic theory and history held that rich countries had plentiful savings while poor ones had littler, and so capital flowed from rich to the poor. But in the last decade poor China ran up enormous trade surpluses – reflecting enormous savings – which financed enormous over consumption – reflected in trade deficits – in the richest economy in the world, the US. Obviously this inversion of economic logic and history could not last forever. Yet as the imbalances rose year after year, markets bubbled with delight instead of freezing with apprehension.

Martin Wolf of the *Financial Times* wrote of the unsustainability of global imbalances. Wolf pointed out that US consumers simply had to stop living beyond their means at some point.

- One scenario could be a gradual adjustment by consumers year by year, providing a soft landing to the US economy.
- The second scenario could be a sharp fall in US consumption, causing a deep recession.

We all know today which scenario came true. This should not have come as a surprise; the most cursory look at business cycle history shows that soft landings are rare and hard landing common.

Why then did so few anticipate a hard landing?

Sadly, human euphoria during a boom is hard to shake.

All humans – householders, businessmen, politicians, financiers – love bubbles. They love to see their wealth skyrocketing, they love to see the proliferation of jobs and income.

Barring a few naysayers, nobody wishes to focus on the inevitable downturn.

So, let alone check the boon.

This is why booms and busts are inevitable.

They reflect the human condition.

Most of us are so much like Queen Elizabeth.

STOCK MARKETS

It's better to Earn 1% A Year than to Lose 1% A Year

Legendary investor Jim Rogers said the stock markets could head for a pullback following a strong rally. It's overdue for a correction. But he was not selling the market short, and the equities market could keep rising for a long period of time. Jim Rogers warned against chasing hot markets and venturing into unfamiliar assets. Investors should only invest in a thing that they know a lot about and that's how you are going to get through all of these and survive; even though that means just putting your money in the bank. It's better to earn 1% a year than to lose 1% a year.

A new stock investor has only one complain as far investments are concerned that once he buys stock, prices start falling and in most of the cases he ends up with a loss. The main cause of this is the inability to buy a stock at right price. While it is impossible to be 100% sure on movement of stock prices, one can make money by buying undervalued stocks and selling those which have peaked.

However, sometimes despite a particular stock being undervalued, due to the fall in the broader index price of the stock comes down. This is a cause of concern for many short-term investors. Similarly, it is also seen that a stock might have become overvalued but continues to move northward for a long period of time. So under or over valuation cannot always explain short-term price movement.

- So, it should always be seen in the context of future earnings potential of the company. For instance, some of the commodity or metal socks might trade at extremely attractive PE level relative to the market. But if the commodity prices are expected to fall in the foreseeable future, the stock prices of such companies will not rise as the markets always prices in the future earnings.

The hardest decision in investing is when to sell. The selling decision is the most important and painful, as greed takes over. Once a stock becomes P/E or P/B, which is way ahead of the peer group, one should be cautious. Actually an investor should enter with a return in mind.

Exit ROUTE... With over 90% appreciation in the Sensex since March this year, a large segment of the investor community is in a fix on whether to sell or hold. While the views are divided as far as the direction of the market concerned, investors should follow certain parameters before exiting from any stock:

- If an investor has a return estimation before buying any stock, the best time to exit is when your target is achieved. However, if one expects further upside due to any development. It makes sense to go for partial profit booking.
- Valuation of the company is another parameter to look at for deciding whether to hold or sell the stock. Although, it may be possible that a stock goes up further even after reaching the fair valuation, experts suggest that investors should sell once the stock price goes beyond fair value.
- Also, one has to look at the options available, if you find any other investment option more attractive compared to your current investment in a particular stock, you may consider switching.
- The market trend, which is mostly driven by sentiments, is crucial. The moment the sentiment in the market changes or uncertainty starts creeping in, it is better to exit all mid-cap and high beta stocks regardless of whether the target one his in mind while investing has been achieved or not. Also, one should exit from companies which do not react positively to good news coming in or do not fetch higher valuation even after showing impressive quarterly results.

1st week of October 2009 – Market undergoing healthy correction

Daily review	02/10/09	05/10/09	06/10/09	07/10/09	08/10/09	09/10/09
Sensex	17,134.55	(268.14)	92.13	(151.88)	36.88	(200.88)
Nifty	5,083.40	(80.20)	24.20	(41.65)	18.50	(57.05)

Weekly review	02/10/09	09/10/09	Points	%
Sensex	17,134.55	16,642.66	(491.89)	(2.87%)
Nifty	5,083.40	4,945.20	(138.20)	(2.72%)

The market showed a healthy correction of nearly 3% during the week despite a string of good news, including liberal bonus by India's largest private sector corporate entity Reliance Industries. The market virtually failed to respond to RIL's surprised 1:1 bonus issue and higher than expected Q2 results announced by IT bellwether Infosys Technologies. Analysts said the major trigger would be Q2 results during the next week but liquidity situation seems to be causing concerns among investors as several companies are expected to raise large chunk of funds by way of IPOs and QIPs in the calendar year.

2nd week of October 2009 – Sensex up 4%

Daily review	09/10/09	12/10/09	13/10/09	14/10/09	15/10/09	16/10/09
Sensex	16,642.66	384.01		204.44	(35.91)	127.62
Nifty	4,945.20	109.05		63.95	(9.35)	33.30

Weekly review	09/10/09	16/10/09	Points	%
Sensex	16,642.66	17,322.82	680.16	4.09%
Nifty	4,945.20	5,142.15	196.95	3,98%

3rd week of October 2009 – Sensex down 3%

Daily review	16/10/09	19/10/09	20/10/09	21/10/09	22/10/09	23/10/09
Sensex	17,322.82		(103.00)	(213.84)	(219.43)	21.07
Nifty	5,142.15		(27.35)	(50.85)	(75.00)	8.45

Weekly review	16/10/09	23/10/09	Points	%
Sensex	17,322.82	16, 810.81	(512.01)	(2.96%)
Nifty	5,142.15	4,997.05	(145.10)	(2.82%)

4th week of October 2009 – Sensex dips below 16K

Daily review	23/10/09	26/10/09	27/10/09	28/10/09	29/10/09	30/10/09
Sensex	16, 810.81	(70.31)	(387.10)	(69.91)	(230.77)	(156.44)
Nifty	4,997.05	(26.15)	(124.20)	(20.55)	(75.60)	(38.85)

Weekly review	23/10/09	30/10/09	Points	%
Sensex	16, 810.81	15,896.28	(914.53)	(5.44%)
Nifty	4,997.05	4,771.70	(225.35)	(4.51%)

Review your portfolio and decide on the course ahead

Within a period of some seven months, the Sensex has doubled from levels of 8,200 to about 16,400, taking a lot of investors by surprise. Many investors have missed the rally, waiting for an opportunity to invest and a correction that never came. Those who are invested are wondering whether it makes sense to take some profits off the table. These are some questions in the minds of investors.

Clearly, there is no single answer to these questions, since the needs and wants of every individual are different, but it make sense to review portfolio and decide on the course ahead. Equity markets have entered a consolidation phase and corrections should be used to invest in equities, since they will provide superior returns over the next two years. However, investors should tone down return expectations to a moderate 15-20%. The present correction should be used to accumulate and build a solid portfolio.

Which stocks will power the next round of uptrend in the Sensex once the current bout of correction runs its course? That is the question facing investors as key indices have retreated 7% in October 2009. When we look at the latest quarterly numbers, it is clear that companies are not exactly galloping out of the slowdown. The correction could continue for some more time, though it is unlikely to be a steep one because of the global liquidity on the sidelines.

6-Monthly Review

Monthly Review

Month	Dec '07	June '08	Dec '09	June '09	Sep '09	Oct '09
Date	28/12/07	30.06.08	31/12/08	30/06/09	30/09/09	31/10/09
Sensex	20,206.95	13,461.60	9,647.31	14,493.84	17,134.55	15,896.28
Points	Base	(6,745.35)	(3,914.29)	4,864.53	2,640.71	(1,238.27)
%	Base	(33.38%)	(28.33%)	50.24%	18.22%	(7.23%)

$ Carry Trade

Yen carry trade was the rage during the bull-run in 2006-07, and now it appears to be the dollar carry trade that is fuelling stock prices across emerging markets, including India. A carry trade basically means borrowing in a currency with very low interest rates and deploying the funds in assets offering higher yields. In this case, the currency is the dollar and high yielding assets are emerging market equities.

According to people at foreign brokerages and international fund houses, "What we have witnessed is a dollar carry trade, where risk-seeking assets gone after the most attractive assets, which is the emerging markets." The dollar borrow is lower to the yen borrow, LIBOR rates are at 3% and emerging market bond spreads – the differential between government bond yields and corporate bond yields – are down from 800 bps at the peak, to 300 bps. So, in essence, the emerging market risk is coming down, which is a comfort zone for foreign fund managers to increase exposure to emerging markets.

According to fund managers, the overall MSCI (World) universe is $23.7 trillion. Nearly 90% of that - $20.8 trillion – is the MSCI developed world, while the rest - $2.9 trillion – is the MSCI emerging world.

An asset de-allocation of even 1% here would mean a 10-15% jump for the emerging world, which is what has happened. The global perception is that emerging markets are the best equity asset class out there. So, there is a lot of money chasing growth.

Stretched valuation or not, FIIs' enthusiasm can be gauged by the net weekly inflow of dollars. However, strategists at foreign brokerages maintain that unlike the first leg, when it took just $4.5 billion for the Sensex to move from a low of 8,000 (March 9) to 14,000 levels in May, the overall incremental flow for the next leg was higher i.e., $ 6.8 billion for the June-September quarter. In other words, the market now needs a higher level of capital to keep rising. FIIs have been net buyers to the tune of almost $13 billion so far in 2009 compared with net sales of $8.4 billion for the corresponding period last year.

India has been a key beneficiary of the improvement in sentiment towards emerging markets and this is reflected in the large FII flows this year and the strong performance of the market. We are still at the beginning of a long-term rerating of the Indian stock market and are positive on the market on a 12-18 month view, although clearly in the short run, the market may suffer a small correction, given the run-up.

Prepare For Dollar Deluge

The world's largest economy has turned in a positive rate of growth, after four straight quarters of decline. The US economy's 3.5% growth in the third quarter (July-September) is a big positive for global recovery, never mind that it rode on state-sponsored car and home sales that would not continue in the coming months. However, an offsetting feature is the 21% jump in US exports in Q3, driven both by recovery elsewhere and the dollar's weakening, which makes American goods cheaper in the importers' currencies. But will the dollar now remain weak?

Perversely enough, rising economic confidence in the US is likely to result in further depreciation of the dollar. Resorted confidence would reverse the flight to safety in the wake of the Lehman collapse in September 2009. The funds that had fled emerging and other markets to take refuge back home in the US in a bid to minimise uncertainty are now likely to retrace their steps back to markets where the returns are higher. Just as the influx to safety had driven up the dollar, the funds' redeployment across the globe would drive down the dollar.

While restoration of economic health in the US would boost growth around the world and enlarge the market for India's exports globally, oil prices would go up, too. India must free up fuel prices. Since the dollar is likely to depreciate against most currencies, India's export competitiveness is not the main problem. Export volumes would go up, export revenues at a more sedate pace. The biggest challenge, however, would be the resumption of capital inflows in excess of what the Indian economy can absorb. As one of the fastest growing economies, India would get more than its fair share of investments, direct and portfolio and that would drive up the rupee and boost valuations on the stock market. An appreciating rupee improves dollar returns on investment and induces further capital inflows.

To moderate the rupee's rise, the RBI would buy up dollars and then sell government bonds to mop up the rupees created to purchase the dollars, so as to avoid inflation. The cost of holding down the rupee would, thus, be rising yields, as bond prices dip. The government has to start thinking now, whether it should follow Brazil's example and impose restrictions on excessive capital inflows.

Is it different this time?

Just twenty months since the peak of the last stock market boom, it seems like the next one is already in the making. The market has risen over 50% since February this year. The spectre of drought held things up a little, with a flat market in August. But with plenty of rain in the latter half of the month, September has seen a resumption of the optimism that has characterised stock trading in recent months.

So, how sustainable is the developing boom? Is it real or will it dissolves as suddenly as it precipitated resulting in another crisis leaving red-faced investors to rue their optimism and their losses?

One of the most fascinating characteristics of stock market booms is the euphoria that accompanies the phenomenon. Each time, we are told that something fundamental has changed in the market. Indeed, there is a myth attached to each bout of madness that accompanies a boom.

Carmen Reinhart and former IMF chief economist Kenneth Rogoff have argued in their aptly titled book, *This Time is Different: Eight centuries of financial folly*, contemporary finance can rarely deny the influence of precedent. So for assessing the current situation it is interesting to look at the three stock market booms in the Indian markets since the launch of economic reforms in 19991.

First, the boom that started in late 1991.

This is also commonly known as the Harshad Mehta boom as the "big bull" took investor gullibility to the extreme and used bank funds to shore up stocks before selling them at high prices. P/E ratios on the BSE increased to over 50 the highest levels ever, as investors bought the story of unbelievable riches forthcoming as a result of economic reforms.

The discovery of the Harshad Mehta scam had a short-lived sobering effect on the markets as reforms euphoria took hold again and P/E ratios zoomed past 50 again in mid-1994.

This was a continuation of the 1992 boom as the sensex never fell below 2,000, roughly twice the level it had been before the launch of reforms. This was the real reforms euphoria boom; policy liberalisation had changed things so much for the better that it was thought that unbelievable riches were indeed on the way. When it become apparent that things had overheated beyond tolerance in mid-1994, the market subsided to more sober levels and P/E ratios declined gradually below 20.

There was certainly some difference this time; reforms did bring a fundamental change to the strength of the economy and the sensex never again declined significantly below 3,000. However, the political instability of the late 1990s and the Asian financial crisis both contributed to a flattening of investor sentiments and a long period of lacklustre trading followed even though earnings were rising steadily. Not surprisingly, at times during this period, P/E ratios declined to as low as 10.

Second, the boom that started in early 2000.

Along came the Y2K phenomenon and things became "different" again. First, Indian software companies cashed in on the Y2K scare and made huge profits. Second, the internet economy took off internationally resulting in a worldwide boom.

Once the experts got into the act we were told that things really were different this time, the internet had changed the rules of economics and internet companies would never lose value! So long as the customer base of such companies kept expanding, current losses were of little significance in the matter of company valuations.

As a result, the Nasdaq (in the US) doubled its value to over 5,000 by March 2000 and the sensex also shot past 5,000 with 60% one year growth. P/E ratios in India rose to around 30.

When internet company after internet company started to report huge losses in the international reporting season of 2000, doubts about the impact of the internet on the rules of economics began to surface and the dotcom bubble (as it had become known) quickly burst. The sensex fell below 4,000 by October 2000 and P/E ratios declined below 20.

Third, the boom that started in 2006.

If the theory of the internet and the laws of economics were unbelievable, the latest "difference" was equally breathtaking. In the growing bubble of international prosperity in 2006, we were told by the experts that things were different again; house prices were rising and would never come down! The rest, as we know is history; subprime lending led to massive default in the US housing loan market and the international financial system needed massive government intervention to rescue it from collapse.

Interestingly, while the sensex rose to dizzying heights, P/E ratios on the BSE never attained the astronomical levels of the 1990s boom. The ratios remained around 20 for many months in 2006 and 2007 before peaking at 27. In December 2007 just before the disastrous collapse began.

So consider the current situation. The earlier perception that India was one of the emerging economies that had decoupled from the international market was proved to be wrong as the sensex was dragged down by the great worldwide meltdown of 2008. That India has nevertheless emerged as having one of the most resilient economies in the world demonstrates the complexity of economic relationship and that neither coupling nor decoupling is absolute.

However, with P/E ratios moving past 20 again as the stock market climbs, it is a time for investor caution. Over the past two decades at no time has the market seen a sustained rise in the P/E ratio above 20 without a precipitous fall?

Perhaps the revival of the developed economies will result in the cooling of foreign institutional investors' ardour for emerging market economies, hot money will be quickly withdrawn and the euphoria in the Indian stock markets will subside.

But perhaps our salvation lies in the fact that no one has yet tried to justify the developing boom with the argument that there is a significant difference this time. If they do, look out!

1. **India August factory output up 10.4 %**

The 10.4% growth in industrial production in August is the strongest proof that economic recovery is robustly underway. The 10% plus growth for each of the manufacturing, mining and electricity has taken index of industrial production (IIP) growth to a 22-month high. This strong performance by manufacturing hinges on a stellar 22.3% growth in consumer durables. Intermediate goods also grew at 14.3% suggesting strong production going forward.

Finance minister Pranab Mukherjee said, “We are hoping that when the final GDP figure for the second quarter will be available, there will be some higher growth.” The government has projected a growth of over 6% in 2009-10. It is expected that most economy watchers would revise their GDP estimates upwards in a few days, as they expect the increased government spending to continue to drive growth and compensate for the poor monsoon that ended with a 23% deficit.

Finance secretary Ashok Chawla was also confident about the continued momentum in factory output as measured by the index of industrial production (IIP) seeing better figures in September. The strong stimulus by way of the Sixth Pay Commission arrears that are being released should keep the momentum going, particularly in the case of consumer durable, which grew at 22.3% in August. The purchasing manager’s index for September corroborates this expectation with a reading of 55.0 against 53.2 in August, suggesting industry thinks demand is likely to improve in the future.

Mr Harsh Pati Singhania president of industrial body Ficci said, “The latest IIP figures show that the industrial sector is surely on a roll, responding the stimulus measures which have been introduced earlier this year and late last year. The sharp turnaround in the fortunes of consumer durables (22.3% growth) indicates that demand is growing in the economy which had been a major concern late last year.”

Chetan Ahya an economist at Morgan Stanley said, “The capital goods sector, which has also rebounded with 8.3% growth in August against low single digit growth in earlier months, is expected to pick up as demand picks up and funds crunch ease further. The rebound in global capital markets implies that investment proposals are likely to start rising from November-December. Growth recovery over the next 12 months is likely to be more sustainable, though lower than that seen in the period prior to credit crisis”.

Despite the strong industrial growth, emerging asset price concerns and inflation worries, the RBI is widely expected to keep interest rates unchanged in its upcoming monetary policy review on October 27. The country’s chief-statistician Dr Pranab Sen pointed out that “it is better-off to tolerate a little-bit of high inflation and make sure that the growth impetus is not jeopardised.

The industrial production growth could be over-stated marginally because of the base-effect – low IIP numbers in the corresponding month last year – but it is more broad-based than in recent months with only three out of the seventeen sub-sectors in manufacturing showing a contraction in growth.

Though industrial production accounts for only about 20% of the Indian economy, due to its interlinkage with the services sector that constitutes about 60% of the GDP, this uptick would cause other sectors to also move up to higher growth and may help in making up for the possible contraction in agricultural output because of the poor monsoon.

2. **China, India, S'pore to lead Asia growth in 2010:** Poll

A Reuters' poll shows that Asia's economic recovery is on a firmer footing than three months ago with China set to easily reach in 8% growth target this year and expand 9% in 2010, while trade-reliant Singapore and Taiwan will see a sharp turnaround next year.

Economies in the region are also being supported by surging asset prices, which are boosting consumer confidence. There's a feel-good factor from rising stock and property prices.

Rob Subbaraman, Asia economist at Nomura in Hong Kong said, "**If we don't have a major relapse in the big advanced economies,** I think this is the start of a durable economic recovery". Domestic demand is an important part of it, but also exports are no longer collapsing as they were earlier in the year. At the very least they are stabilising. The poll included GDP estimates from more than 100 analysts in 12 economies in Asia including Australia and New Zealand but excluding Japan.

Asia's fastest-than-expected rebound from the global recession in recent months looks set to continue, in sharp contrast to a far murkier outlook for many Western economies. China will remain Asia's best performing economy, helped by its massive $585 billion fiscal stimulus programme, and forecasts for 9% economic growth in 2010 were up from 8.8% in the previous Reuters poll in July 2009.

Stronger-than-expected recoveries likely **point to interest rate rises** in much of the region next year to curb potential inflationary pressures, though policy-makers will be cautious about unwinding emergency stimulus measures until they are sure the global economy is on solid footing. Australia's central bank raised rates recently and heralded more to come; saying the worst danger for the economy had passed.

Strengthening consumption and improving exports will herald **an uptick in inflation** next year, most seriously in India, where wholesale price inflation is expected to jump to 6% in fiscal 2010/11 from an estimated 2.8% in the current fiscal year.

Asia's head start in rebounding from the global recession, and the prospect of tighter monetary policy, will also keep **upward pressure on Asian currencies**. Several central banks in the region have intervened in recent weeks to curb appreciation of their currencies, fearing it could make their exports less competitive and impede economic recovery.

Economic growth forecasts for India for the FY 2009 were cut to 6% from 6.3% in the July poll, after the weakest monsoon in nearly 40 years ravaged rice and sugarcane fields.

Singapore's economy is on course to rebound 5.7% next year, making it Asia's best performer after China and India, the poll showed. Growth prospects have also notably improved for the Philippines, which analysts now expect to expand by 4.2% in 2010, up from 3.3% in the July poll.

3. **Q2 scorecard:** Profits hop, sales limp

A study of the financial performance of 400 non-financial firms shows that profits of Indian companies grew at their fastest pace in a year during the three months ended September 2009 but sales growth continued to decelerate for the fifth quarter in a row.

Slower rise in raw material and wage costs as well as interest payments helped the 22% increase in corporate profits between July and September compared to the year ago period. The second consecutive quarter of profit growth for Indian companies comes after three straight quarters of shrinking profits and amidst increasing hope an economic recovery is underway. Companies whose profits more than doubled during the quarter include Apollo Tyres, Welspun India, TVS Motors, Pidilite, Birla Corp, Century Textiles, Prism Cement, Sakthi Sugar, Srerlite Technologies and JK Papers.

The lower revenue growth is partly because of lower prices of commodities such as metals and slow revenue growth of software exporters hit by the economic slowdown in developed economies. Since sales realisations for many industrial product makers, metal traders and mining firms declined compared to last year, it has subdued overall revenue growth. But the results of consumer goods and services firms show domestic demand are robust. Many large consumer goods and services companies such as ITC, Asian Paints, Pantaloon Retail and top automakers Maruti Suzuki, Hero Honda and Bajaj Auto have reported double-digit growth in revenues and a sharp rise in profits.

4. **Core sector grows 4% in September**

Growth in industrial output as measured by the Index of Industrial Production may see some drop in September from the previous month's 10.4% as the index of core sector industries that has a weightage of 26.7% in the index clocked a 4% growth in September sharply lower than the 7.8% clocked in the month before. None of the six core industries captured by the index – crude oil, petroleum refinery products, coal, electricity, cement and finished steel (carbon) – showed a month on month uptick in the production.

Crude oil and petroleum refinery products were the only two segments which showed a higher annual growth rate over the previous month. Analysts are expecting the growth rate in these two segments to gather further momentum as the out put from Reliance's KG basin and Cairn's oil field in Rajasthan stabilise. Policymakers pointed that this would have an impact on electricity generation as well.

On a cumulative basis, the core sector index was up 4.8% during first six months of the year was at 5%, outpacing the 3.4% growth seen during the same period last year. Growth in coal and cement in the first six months of the current fiscal starting March strongly outperformed growth in the same period last year.

5. **Export falls 13.8% in September**

India's exports dropped by 13.8% in September, but the decline was the lowest this fiscal, giving hope of a rebound of a year-old negative trend from the third-fourth quarter of the current fiscal.

Exports during the month were $13.6 billion, compared to $15.8 billion a year ago. Commerce Secretary Rahul Khular said, "It is difficult to predict a precise timeline for exports to transit to a positive phase. But it is expected that it (trend reversal) will be towards the end of 3rd or beginning of the 4th quarter of the current year". Under the impact of the global slump in demand, exports started contracting since October 2008, with May 2009 seeing the sharpest decline of 39.2%.

Rahul Gandhi said, "The opposition wants to have one India for the rich and another for the poor." He blamed opposition for trying to divide India between the rich and the poor.

In an election rally ahead of October 13 Haryana assembly elections; Gandhi said the people had rejected the ideology of those who gave "India Shining" slogan. People rejected the NDA in 2004 when they gave India shining slogan. India was shining only for a selected few in which the farmers, poor and the Dalit were not included. They gave a slogan which was not in Hindi and only a few could understand. On the other hand Congress said 'Aam Aadmi Ki Sarkar' (government of common people). We believe that every person has to be part of the country's progress including the Dalit tribals, poor and women.

In 2009 again when they raked up issues like terrorism and Pakistan, again you sent them home (defeated the opposition). "The opposition talks about terrorism, Pakistan, M A Jinnah, but don't utter a word about poverty and Dalit…and when they don't talk about you, you send them home". He said, "People voted for the ideology of Prime Minister Manmohan Singh and Congress President Sonia Gandhi, and rejecting those who were only talking of welfare of a selected few".

Gandhi criticised the opposition for not visiting Dalit homes and not going to meet the poor in villages and said when he does that the opposition makes fun of him.

Slamming those who scoff at him and criticise him for visiting Dalit households, having food there and even sleeping in their homes, he said, "Those who never visited Dalit homes, the homes of poor and rural people and farmers, only took the slogans from television." Our slogans don't come from TV. Our slogans come from villages, from the houses of poor living in slums. His party was committed to work for the betterment of every section of the society, particularly the poor and the downtrodden.

Without taking any name, Gandhi said a leader once said India does not need farmers, but IT and computers. They eat the food produced by our farmers and then speak like that…I visit homes of the Dalit in villages, and then they ask why I am doing that.

Referring to the visit of British Foreign Secretary David Milliband, who along with Gandhi spent a night at a Dalit home in the Congress leader's constituency Amethi in Uttar Pradesh in January this year, he targeted the opposition for trying to hide India's poverty.

I took him (Milliband) to see the rural India. He had asked me how the country was progressing so fast and I told him that you will need to go outside Delhi and Mumbai and meet farmers and rural people. He came with me and had food with farmers and the poor, interacted with rural women and the next morning he told me that India's strength comes from its farmers. Gandhi said the opposition wants to hide India's poverty 'even as we want to recognise the fact and eradicate it."

About induction of youths in the party, Gandhi said he was creating a force of youngsters who will work for the cause of Dalits, labourers, the downtrodden and the other weaker sections. Gandhi also referred to various Central schemes and talked about the centre's farm loan waiver scheme under which lakhs of farmers had benefitted. He said, "Congress government thinks and works for the uplift of farmers, Dalits, labourers, tribals, the downtrodden and other sections".

Having retained Maharashtra and Arunachal Pradesh and managed to also keep Haryana, Congress will be in much stronger position within UPA. Certainly, there are gains at the centre level. There will be no takers for tantrums of Trinamool Congress or even DMK. The less elbow room for allies could translate into more out-of-the-box ideas on the policy front. The upcoming Parliament session could testify to the Congress' near dominance on the national political stage.

Most importantly, the wins in Maharashtra and Arunachal Pradesh will help keep Congress' revival script in place for the imminent take over of the party by general secretary Rahul Gandhi.

Maharashtra assembly election 2009 outcome can be summed up in one line. *Thackerays caught and bowled Raj Thackeray.* A family feud that dominated the state's political space for last three years ended bleeding the Sena yet again. The three-year old Maharashtra Navnirman Sena (MNS) led by Raj Thackeray may have managed just about dozen-and-half seats in its maiden assembly election. But it spoiled the Shiv Sena-BJP chances in well over 33 seats. In other words, the saffron siblings lost some 50 seats because of MNS. The fact that the Sena has been pushed down to Number four position in its hometurf of Mumbai could explain the gravity of the damage MNS has inflicted on the party founded by his uncle Bal Thackeray. Political observers feel that MNS' spectacular performance in the election will put a big question mark over Uddhav Thackeray's leadership and Shiv Sena's future. It's Raj, and not Uddhav, who would be seen as filling the void left open by ailing Bal Thackeray.

Arunachal Pradesh voted on expected lines. The BJP, which had emerged as an important force in the border state, has been displaying a penchant for self-destruction. The decisive victory for the Congress party in Arunachal Pradesh will also help Congress at the Centre as it gears up to tackle China's aggressive posture on the boundary issue.

The party, which is on the rebound after its successful Lok Sabha bid, was expecting a clean 3.0 victory in this round of polls to continue the winning streak. But, this psychological boost has suffered setback, following the less than expected performance in **Haryana,** as it heads for Jharkhand elections in December. The Lok Sabha verdict, in Haryana at least, now appears to be vote against BJP and its prime minister face L K Advani, rather than a backing for Congress chief minister Bhupinder Singh Hooda. The Congress had won nine out of 10 Lok Sabha constituencies in the state.

The Haryana verdict also holds important lessons for Congress state units. Congress' shortcomings at local-level management seem to have played a big role in the party's fall from 59 seats in the 2005 to 40.

In this election held barely six months later: the Jat vote split, with a large section which backed the Congress in the Lok Sabha polls shifting loyalties to Om Prakash Chautala's INLD. The INLD, which could not win a single Lok Sabha seat, improved its performance from 7 in 2005 to 32.

INLD has silenced political pundits and those in the corridors of power by winning 32 seats in Haryana. The unstuck alliances between INLD and BJP, BSP and HJC were expected to work in favour of the ruling Congress, but it did not happen so.

Political observers also attribute INLD's success to its strong cadre in rural areas and turning away of religious cults like Dera Sacha Sauda from Congress. These sects have a reputation of voting in a group.

Surge in Rs 1-crore-plus earners

Earning Rs 1 crore a year may have been a dream for top executives till a couple of years ago, but no longer. The new aspiration level for the country's professionals is $1 million, or Rs 5 crore, with hundreds of new faces joining the Rs 1-crore-salary club last fiscal.

As many as 640 directors of public listed companies went home with Rs 1 crore-plus in total remuneration for the year ended March 2009, compared to 570 in the previous year. More than 2,000 others – including senior executives who are not part of board of directors or directors of privately held firms whose compensation details are not in public domain – took home more than Rs 1 crore last year. HR experts say, "If we include professionals from financial services, the number could easily be 3,000.

This despite 2008-09 being one of the toughest for Indian businesses with stock markets crumbling, consumer demand falling and economy slowing as the world plunged into its worst recession since the Great Depression. Now that there are clear signs of an economic revival such as higher growth forecast, rising demand for cars and houses and increasing activity in the job market, thousands will storm the Rs 1-crore club in the coming years.

At present, Bharti Airtel has the highest number of Rs 1-crore-plus earners among companies that disclose details of their highly paid executives in their annual returns. The country's largest telecom operator has 27 executives including enterprise services president David Nishball and mobility services president Atul Bindal who earned more than Rs 1 crore last year.

If headhunters are to be believed, Citibank has anywhere between 50 and 75 people earning more than Rs 1 crore in India. ICICI Bank, the country's largest private sector bank, had around 15 executives including the CEO taking home more than Rs 1 crore last year, according to its annual report.

Hindustan Unilever, the country's largest consumer products company, is estimated to have 20-25 such executives, while cola major Pepsi and Coca-Cola are believed to have around 15 such high earning executives each and LG Electronics is said to have two or three such executives. In general, headhunters say, a company with revenues of Rs 5,000 crore has 5-8 people earning more than Rs 1 crore.

Indian CEO packet pales globally, but 'ethics' debate on

Each of the top five highest paid global executives took home more than Rs 500 crore by way of compensation last year, which was what the top 30 Indian bulge-bracket executives together managed to net, but the debate over pay packets is heating up with corporate affairs minister Salman Khurshid's comment that stratospheric CEO pay packages need to be trimmed. His comments echo PM Manmohan Singh's remark in 2007 when he told a leading industry body to avoid "excessive remuneration" and to "discourage conspicuous consumption," warning widening inequalities could lead to social unrest.

A day after the minister's remarks, India Inc seemed to broadly agree that pay packets should be made accountable but the consensus was that it was an issue best left to shareholders to decide. Sanjiv Goenka, of RPG Enterprises, said that executive remuneration should not be viewed in absolute terms, but in terms of the profits that a company makes. A company has to incentivise its managers to get their best performance. Not only do many Indians work with MNCs across the globe and earn fat salaries, but India Inc too employs expatriate talent. In such cases, the salaries have to be internationally competent.

PM says no checks on paychecks

India Inc can now have a collective sigh of relief. Putting the issue of salaries in corporate sector to rest, Prime Minister Manmohan Singh made amply clear that the government has no plan to curb on remuneration in the private sector. It is best left to boards. Mr Singh's unambiguous statement, however, will clear air on the issue that he still believe that the salaries are best determined by the boards of various companies and the government as such has no intention of imposing restrictions on CEOs' salaries.

Mr Singh's statement comes in the wake of a debate on the pay packets of private sector honchos triggered by corporate affairs minister Salman Khurshid's remark. He said, "When we are working on various austerity measures, we can hardly say that we will shut out eyes on what salary the CEOs are going to take." His statement angered the India Inc with many advising the government not to intervene.

India, China to treble number of HNIs in next decade

India and China are together projected to treble the number of high networth individuals (HNIs) from 4.48 lakh in 2008 in the next one decade as per a report collected by Merrill Lynch Wealth Management and Capgemini which pegged the number of Indian HNI at 84,000 for last year.

India and China are the two countries which are likely to lead growth in the Asia-Pacific region, underpinning by robust domestic consumption and growing number of affluent individuals.

As per the report, the combined wealth of Asia Pacific's HNIs is estimated to grow at an annual rate of 8.8% until 2018, faster than the global average of 7.1%.

After seeing 22.7% growth in the population of HNI in 2007 to 1.23 lakh – the highest percentage jump in the world – India saw a 31.6% drop in the number of HNIs last year. India happened to witness the second drop in the population of the rich, as defined by the survey, behind Hong Kong which recorded over 60% drop in HNIs in 2008. The survey defined HNIs as those with investable assets at least $1 million (Rs 5 crore), excluding their primary residence and consumables.

With the Indian economy showing clear signs of the revival and the stock market bouncing back, the number of HNIs in the country is expected to bounce back soon. Notably, HNIs in India allocated the highest proportion of their assets in equities across the region. Although the exposure to equities declined from 37% in 2007, when the stock markets were still in the bull run, to 32% in 2008, it was much higher than the average of 23% for the Asia Pacific region.

Indian HNIs in particular had much lower cash/deposits (13%) compared to the rest of the region where cash/deposits constituted as high as 29% of the assets. The average exposure of the Indian HNI to real estate as an asset was marginally higher at 25% in 2008 compared to 22% for the Asia Pacific region.

In 2008, Asia Pacific's population of HNIs fell 14.2% to 24 lakh amid global economic downturn and market volatility, while its combined wealth dropped 22.3% to $7.4 trillion.

Fight between Brothers, Not Shareholders: SC

Hearing petitions by the group firms of both the Ambani brothers, challenging the Bombay High Court order on June 15 that asked RIL, to reach an agreement with RNRL for gas supply, a bench headed by Chief Justice KG Balakrishnan observed that it is not a fight between shareholders.

The bench said it's like people of two countries don't have any problems, but there is a fight between two persons who are heading these countries. "Thus, there is no fight between the two companies, but just between two individuals that has percolated down to the people."

The case pertains to RNRL's demand that it be supplied 28mmscmd of gas from RIL's KG-D6 gas fields at a price of $2.34 per Btu agreed in a 2005 family MoU. RIL however contends that it cannot do so in view of the government policy.

The court said: "Neither of the kings are party, but they are shadow boxing (through their companies)."

The Supreme Court asked the Ambani brothers' group firms RIL and RNRL why they cannot settle their gas supply dispute through arbitration or mediation. The bench headed by Chief Justice KG Balakrishnan said the two parties could arrive at a "suitable arrangement" through arbitration, as the Bombay High Court that approved the Reliance Empire's demerger cannot spell what is the ideal arrangement.

Finance Minister Pranab Mukherjee also hoped that Mukesh and Anil Ambani would be able to sort out their differences amicably for the Indian market's sake, but said no one can say what would happen. He said on being asked if he saw the dispute being resolved out of court, "I do not know what would happen because they are too big. They have substantial influence over the Indian market, therefore it is better that they sort out among themselves amicably. But, after all it is for them to decide."

The Supreme Court, on the sixth day, said the basis for fixing the government-determined natural gas price of $4.20 per unit required examination. The three-judge bench observed that the sale of gas at $2.34 per unit may not only end the dispute between the Ambani brothers but may also be in public interest.

The bench comprising Chief Justice KG Balakrishnan, Justice RV Raveendran and Justice P Sathasivam said, "If the price (of the gas produced from RIL's KG-D6) will be at $2.34 (per unit), then it will not only end the dispute between two companies (RIL and RNRL) but also be in (the) public interest. Fertiliser and power companies will be getting gas at cheaper rate. Ultimately, the people will be benefited. Justice Raveendran said raising (gas price) from $2.34 to $4.20 per unit would make "only you (RIL) the beneficiary and not the public. RIL is gaining and not the public. Is it in public interest?"

RIL council Harish Salve said the $4.20 per unit price benefited the government as this would make cost recovery quicker and the government would receive a higher share for longer period.

The court, however, said the basis for fixation of price for sale of KG gas at $4.20 per unit also required consideration. "Whether fixation of price at $4.20 (per unit) was done arbitrarily; whether it has some statutory basis or contractual obligation; these are the issues which have to be decided."
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"Isn't it the case that the price of $4.20 per unit will benefit RIL?" The court asked. Mr Salve said the pricing was approved by an EGoM and the contractor (RIL) has to supply KG-D6 gas at $4.20 per unit.

2.5 INTERNATIONAL

US Back On Growth

The US economy grew in the third quarter for the first time in more than a year as government stimulus helped lift consumer spending and home building, fuelling an unexpected strong advance. Signalling the end of the worst recession in 70 years, the commerce department on 29th October 2009 (Thursday) said the economy expended at a 3.5% annual rate in July-September period, snapping four down quarters with its fastest growth pace since the third quarter of 2007. The report, which followed improving third-quarter corporate earnings, lifted stock markets around the world and the broad S&P 500 index of US stocks rose more than half a percentage point at the open. Prices for US government debt and the dollar fell as traders switched out of safe havens and into riskier assets.

Consumer spending, which normally accounts for more than two-thirds of US economic activity, surged at a 3.4% rate in the third quarter, the fastest advance since the first quarter of 2007. Spending had fallen to a 0.9 percent pace in the previous quarter.

Growth was generally broad-based, with solid gains in consumer spending, exports and home constructions. But it was also driven by government programmes like the popular 'cash for clunkers' incentive for new auto purchases and an $8,000 tax credit for first-time home buyers.

The auto discount programme ended in August and the home tax credit is due to expire next month, although Congress is working on a plan to extend it. Stripping out auto output, the economy would have expended at only a 1.9% in the third quarter.

Residential investment jumped at a 23.4% rate, contributing to GDP for the first time since 2005, after declining 23.3% in the April-June period. A housing slump had been the main factor behind the economy's downturn.

A sharp moderation in the pace of inventory liquidation by businesses also supported recovery in the third quarter. Business inventories fell $130.8 billion, slowing from the record $160.2 billion plunge in the second quarter. The change added nearly 1 percentage point to the growth in GDP.

Analysts are hoping that the slowdown in the inventory decline by businesses will continue to support the economy in the fourth quarter, even as consumer spending is expected to retreat under the weight of the worst labour market in 26 years. With inventories at a lean level, any advance in consumer spending is more likely to lead to an increase in output. Excluding inventories, GDP rose at 2.5% rate compared to a 0.7% increase in the second quarter.

The weak dollar boosted exports, but a rise in imports subtracted from real GDP during the quarter. Federal government spending contributed to growth, but both state and the local governments were a drag. Business investment fell at a 2.5% pace, with spending on non-residential structure dropping at a 9% rate. A lack of credit has hit the US commercial property market hard.

A separate report from the Labour Department showed the number of US workers filling new claims for jobless benefits dipped by 1,000 last week to 530,000. Analysts polled by Reuters had forecast claims to fall to 521,000 from 531,000. The number of people still on jobless aid after an initial week of benefits slid by 148,000 to 5.8 million in the week ended October 17. It was the lowest reading since March, hinting at some stability in the downtrodden job market.

With GDP shrinking in Q3 too, the UK left out of recovery march. The official figures said that in the third quarter, the UK economy contracted by 0.4%, making it the sixth consecutive quarter of negative GDP, the longest recession in history since records began almost 60 years ago. Chancellor of the Exchequer, Alistair Darling, speaking from Newcastle, one of the regions worst hit by the downturn in Britain, insisted that he remains confident about a turnaround by the end of the year. “I’ve always said the improvement will come at the turn of the year, we are not yet out of the wood.”

Instead of moving out of recession, data raised the dreaded spectre of a depression, shocking economists and analysts and battering the sterling. UK GDP contracted by 5.9% from the first quarter of 2008. Ahead of the official data, forecasts were UK GDP would grow between 0 and 0.7%, with the consensus at 0.2%. Hopes were high given that neighbours France and Germany turned the corner with positive growth last quarter; and Japan and US are also looking to move out of the negative zone, making UK the last of the G7 nations to still remain in the doldrums.

George Buckley, chief UK economist of Deutsche Bank, said the data was far weaker than expected. “This is a sharp decline, and we don’t normally get GDP forecasts so wrong. The surprise came from the services sector mostly distributors and hotels, where we don’t get much details”.

Mr Buckley may see surprises in data, but, we (people living in London) are not at all surprised; we’re still in recession, so unlike the rest of the economists and analysts from those places where they get those hefty bonuses, we are not at all surprised? All they needed to do was take a walk down high streets with closed down shops, drop into usually packed restaurants looking eerily deserted, wander around the City of London and check out the huge On Sale banners in posh shops, and talk to common people.

It’s also been rather funny, with everyone from commentators, media, governments, academics, economists’ et al – who were all set to pop the champagne of green shoot of recovery up to last week, struggling to rationalise what’s happened.

We don’t, unlike the economists and analysts, have to depend on ‘surveys’ or PMI data. Being no expert, we can say what we like. We think that Britain will, like the Chancellor says, turn around in the headline macro figures sooner than later. But what we see happening around us is the kind of feeling you get when people have been holding their breath for too long, and suddenly get a blast of oxygen.

Everyone around us is feeling a lot better, and those famous green shoots?

The wolf pack has been given a hint of blood (profits, and a return of good days). They’re not going to let go of the scent. After all, how much worse can it get than the deprivation we’ve already been through?

It can, but that’s not human nature.

Ditto with businesses and financial services people, it’s been so long since they’ve had any money, or orders, or deals, or customers, it feels like a windfall. The danger, like deep sea divers coming up, is that people who make up economies won’t stop long enough to decompress property. We’ll gat a mad, wild, rush of risk-taking and spending as people come up for air, that will eventually find its way into the PMIs and GDP data, and make them look good. For a while, at least.

Contrary to widespread belief, insider trading is depressingly commonplace. But not surprisingly, given the number of entities – investment banks, commercial banks, consultants, staff, board of directors – that are privy to information that is not publicly available. The temptation to use or rather misuse such information is bound to be high, especially when the stakes are so huge and the chances of being caught and punished so low (as evidenced by the abysmal record of regulators in nabbing the guilty). Hence it is significant that US tycoon of Sri Lankan origin Raj Rajaratnam and five others including two people of Indian origin have been charged with insider trading, based on wiretapped evidence.

According to US prosecutors, Rajaratnam, founder of Galleon Group, a US based hedge fund used insider information from sources inside public companies, Moody's Investor Service and an investor relations firm to trade ahead of earnings announcements, acquisitions and joint ventures. What is new are both the quantum involved - $ 20 million, which makes it the largest to date involving hedge funds – and the use of wiretaps, normally reserved for organised crime and deployed only after court authorisation.

Galleon case opens window on secret hedge funds

The US government's charging of billionaire Galleon Group founder Raj Rajaratnam provides rich insider details of usually secret hedge-fund operations. The case, focusing on a slice of trade that produced $ 20 million in alleged profits, provides a snapshot of an alleged network of informants and traders, led by Rajaratnam, 52.

His co-conspirators, according to prosecutors, included a McKinsey & Co. consultant, an Intel Corp. treasury manager and Danielle Chiesi, 43, a Bear Sterns Cos. veteran who used expletives as she worried about getting caught. With the alleged inside help from these people and others, Rajaratnam built a hedge fund that managed $ 7 billion at its peak before being reduced to $ 2.6 billion in assets as of March 31.

US Securities and Exchange Commission enforcement Chief Robert Khuzami, who sued Rajaratnam and others, said that success was achieved more by guile than genius. He is not the astute student of company fundamentals or marketplace trends that he is widely thought to be. He is not a master of the universe but rather a master of the Rolodex.

Rajaratnam became billionaires driving analysts, demanding edge

Every weekday at 8:35 a.m., Galleon Group's 70 analysts, portfolio managers and traders peck into a conference room on the 34th floor of the IBM Building, a grey-green polished granite skyscraper on New York's Madison Avenue. Tardy arrivals are fined $ 25. At the head of the table, CEO Raj Rajaratnam fires off questions: Which companies' margins are peaking? What's the risk of that company failing to win an expected contract? The 52-year-old billionaire expects his analysts to have an edge: better information than anyone else.

US prosecutors allege that Rajaratnam's own edge was illegal. He was charged with using inside information to trade shares including Google Inc., Polycom Inc., Hilton Hotels Corp. and Advanced Micro Devices Inc., according to complaints. Ron Geffner, a lawyer at New York-based Sadis & Goldberg LLP said, "Every trader wants an edge, and there are many grey areas when it comes to aggressive research. But if you trade on material, non-public information that comes from a company insider who is breeching his fiduciary duty, odds are that it is illegal."

US set to target wave of insider-trading networks

Federal investigators are gearing up to file charges against a wider array of insider-trading networks, some linked to the criminal case against hedge-fund manager Raj Rajaratnam. The pending crackdown, based on at least two years of investigation, targets securities professionals including hedge-fund managers, lawyers and other Wall Street players.

Some probes, like the one that focused on Rajaratnam, rely on wiretaps. Others stem from a secret Securities and Exchange Commission data-mining project set up to pinpoint clusters of people who make similar well-timed stock investments.

Investigators have struggled for years to build case against large institutional investors such as hedge fund managers, who often deflect regulatory quarries about suspiciously timed bets, arguing they're statistical flukes amid their millions of trades. The case against Rajaratnam, built on recorded conversations within a web of alleged conspirators, offers a glimpse of how US investigators are using more aggressive tactics to cut through the blizzard of trading and trace the flow of information.

Data mining

The SEC began using computer software about two years ago to shift hundreds of millions of electronic trading records, known as blue sheets, attached to the stock exchange reports about suspicious incidents. By looking for patterns in the library of data, they identified groups of traders who repeatedly made similar well-timed bets.

Once investigators find a cluster of correlated trades, they tap other sources of information to unravel how its members obtain share tips. For example, if a group profits on trades before a series of corporate takeovers, the SEC may check so-called league tables listing which investment banks or law firms advised the deals. If one firm was involved in all of them, an employee there may be the source of the leak. While the investigation of Rajaratnam didn't stem from data-mining project, it did start with the SEC's Identification of suspicious trades.

No Cloning Of Existing Schemes Please

It is a case of old wine in a new bottle many a time when it comes to new fund offerings (NFOs) by mutual fund houses. But fund houses may no longer have the freedom to launch NFOs that have similar features as some of their existing schemes. Currently there are around 3,000 MF schemes in the market and there are more to come, with fund houses Axis Bank and Union Bank-KBC set to make their debut.

NFO – Measure up to proposed transparency code

Capital market regulator Sebi is considering a proposal to curb this practice, widely prevalent among asset management companies. The regulator wants AMCs to elaborate their fund deployment method and the risk associated with it. Sebi has already set the ball rolling and has closely scrutinising new fund offers so that they measure up to the proposed transparency code.

Offer document – Simple and shorn of jargons

Sebi has communicated to chief executives of fund houses that disclosures standards of offer documents need to be improved. Sebi also wants the offer document to be simple and shorn of technical terms or jargons. Sebi's move is aimed at improving the quality of investor communication from AMCs, whereby every opportunity is used to highlight the investment strategy and risks to enable the investors take better informed decisions.

Trustee –Individually evaluate the scheme

Sebi has also called for greater accountability and responsibility from the trustees of AMCs, as they are custodians of investors' funds. This mean that fund houses will have to details of the proposed scheme well in advance for us to study it as well as justify the reason behind it. Also, trustee members need to individually evaluate the scheme before the board certifies it. This may result in some of the inactive trustees immediately opting out of their fiduciary responsibility. Typically, the AMC board meets in the morning and the trustee board meets in the evening of the same day, thus hurrying up the whole process.

In the past, trustees used to just give their approvals for new schemes. However, the scenario changed two years ago with Sebi making it mandatory for trustees to give a declaration that the new scheme is different.

AMCs – Talk directly to investors

The regulator has also conveyed that AMCs should talk directly to investors rather than completely rely on distributors so that there is no miss-selling of products.

But some feel this could fray relations between fund houses and distributors. Another industry official said, "Presently, distributors own/service the client (read: Investors). If intermediaries are bypassed, it could cause conflict between fund houses and distributors.

With Sebi asking fund houses for a detailed and elaborate offer document, asset management companies could save a few bucks in terms of advertising expenses in the bargain. As, may be now, there would not be a need to have a separate product marketing brochure: the offer document itself will be quite elaborate!

Striking a Mutual Deal

Gone are the days when you would call a mutual fund distributor home and invest in a mutual fund scheme of your choice and hand over your cheque for the investment.

Now, in addition to the cheque you write out for your investment, you will also have to write out a cheque for the distributor. The tricky part here is while you probably know how much you want to invest in a scheme; the payment to the distributor is something that will have to be negotiated.

With the abolition of the entry loads on mutual fund schemes, mutual fund distributors are expected to be remunerated by investors for the service they provide. This change is an outcome of the massive drop in the commissions that the distributors used to get due to the removal of entry loads.

The upfront commissions on the mutual fund products on equity side now range between 0.25% and 1% of the assets mobilised by the distributors, against 2% and 2.5% earlier. The shortfall, of course, will have to come from the investor's end. Though there is a practice of paying trail commissions to distributors as the investors stay invested in a scheme. However, not many distributors have banked much on the trail in the past, and hence, it is absolutely normal if your distributor bills you separately.

To cut a better deal, you have to first understand various fee structures in the market. The first one is 'volume-based no charge' model. Here, the larger players in the mutual fund distribution business come in. Distributors such as Bajaj Capital, Bluechip Investment do not charge the mutual fund transactions, all thanks to the high volumes they place with mutual fund houses.

The second business model is a pure fee-based business model. Here players such as ICICI Direct would charge you a fixed fee 'per transaction'. This fixed fee is expressed either in absolute terms, irrespective of the amount you invest or it may be a percentage of the amount invested subject to a minimum fee. ICICI Direct charges Rs 100 for a lumpsum investment in mutual funds done through their trading platforms. The fee for SIP stands at Rs 30 or 1.5% of the investment amount, whichever is lower. However, here if you are one of the big clients, the transaction fee can be waived altogether. But a word of caution, get a clear definition of the word 'big'. For ICICI Direct, the threshold limit is Rs 8 lakh. In other words, while placing a new lumpsum order if the MF unit holdings' value in an investor's account, as per icicidirect.com records, stands at Rs 8 lakh (as per the value at NAV) the system will levy no transaction charge on the said transaction.

There is a third option also available in the market. Here the distributor tells the investor how much upfront commission she is paid by the fund house and the remaining has to be paid by the investor. In other words, if a distributor is paid 0.25% commission from mutual funds, she may charge the investor around 2% of the amount invested. This is especially popular among private banks and financial planners.

The complexity goes up, when the same distributor comes out with multiple options for a fund investor. Bajaj Capital though charges nothing for transactions in mutual funds; if you need an advice on your mutual fund portfolio you will have to subscribe to their advisory services. Bajaj Capital vice-chairman and managing director Rajiv Deep Bajaj says, "We don't charge our investors for transactions. But where they need our expert assistance to manage their mutual fund holdings, we have 'paid offerings' at their services." If you know where to invest and can monitor your portfolio, you are free to opt for 'transaction only' mode. For those who need some expert support can go for 'premium services' where they get benefits such as scheme recommendations, view on new fund offer, portfolio alerts. "Though we are offering services at no charge, ultimately we will have to move to fee-based model."

3.2 BUYING GOLD

Start a beautiful relationship

Investor Jim Rogers, a prominent commodities bull, said, "Among precious metals palladium and silver looked more attractive due to cheaper prices, but he would buy gold in the long term as a real asset".

There are three main reasons why gold is such a good buy: One, it helps you sleep better.

Instead of global economic recovery, all that everyone can see is governments' raising cash to give to people who are unlikely to put it to any productive use. The US is the scariest example of spending more, making less. All the hectic activity, akin to printing of notes, has made the dollar feeble.

Since dollar is the currency that makes the world go round, when it starts quivering, it is time to return to only store of value that has lasted man 4,000 years. Gold is a hedge against the types of investment Dalal Street sells. If your portfolio implodes, gold will be your only friend.

Two, there is enormous new demand. From ETFs that have stashed 500 t between April to September to small guys like us who squirreled away 166 tonnes in coins and bars, gold is hot. And yet, guess what. Just 0.6% of world's wealth is currently put in gold, says World Gold Council. So there is still a long way before the world's appetite will be satisfied. In short, the demand story has just begun.

Three, and best of all, new supply is barely a trickle. At the end of last year, the world had 165,200 t above ground. Output from gold mines has been flat or falling since 2001 and with just a decade's life likely left. There have been only five-six new finds in the last four years because finding gold ore is expensive and tricky. So while demand is rising, supply won't keep pace.

What experts are really saying is that gold is right now under-owned and under-appreciated. Gold has always been man's best friend. And we could be in sore need of this friendship. However your relationship with gold needs a lot of self-awareness. The best way to make gold work hard for you is think a bit hard why you want it and how you will use it.

If you want jewellery, that's fine. Just remember, jewellery is like a car. You drive it out of the showroom at one price. You trade it back at another. You can immediately write off the making charges you are paying now. On designer pieces, that can be quite steep. Sure, the gold itself in your piece may have appreciated. But it has gold plus other alloys, whose re-sale value is zero. So best be very sure how much gold there is. Buying hallmarked pieces helps.

If you want gold as another way to hold rupees, then you have some more thinking to do. The two big issues are ease of storage and ease of use. If you don't trust bank lockers or have a transferable job, then bars and coins are not for you. The easiest way to store gold is to buy it on paper. That way only you know you have it. Buy paper from exchange traded funds (ETFs) offered by companies such as Benchmark, Reliance, Kotak, and UTI that will buy physical gold on your behalf in the spot market. You can buy and sell this paper quite conveniently. The downside of paper is, well, paper work.

Bars and coins are far easier to buy and sell. Plus, it's only when you hold a softly gleaming piece in your hand and know it is yours that you begin to dimly figure why men go crazy over the yellow metal.

Gold-Linked Debentures

For those investors who have taken a fancy to the yellow metal, here is another opportunity to invest in it. Wealth managers are now wooing investors, and the structured product being offered is on the underlying gold price. This is still a new trend in India and is being targeted at high net worth individuals, who can make a minimum investment of Rs 5 lakh.

Among those in the business are Kotak Commodities, Edelweiss Capital and Citi Financial while the products are being distributed by wealth management firms, brokerages and banks. For a distributor, the earnings come in the form of an upfront entry load of 2.25%, which the client pays. The product is customised and structured, based on what the clients wants.

This kind of a product works well for investors who see gold prices moving upwards and are keen on their capital being protected in the event of a downside in prices. Karvy Wealth CEO Hrishikesh Parandekar said, “We have advised investors who want the twin benefits of capital protection and participation on the upside to invest in such products.” A gold-linked debenture, as the product is called, is a structured product that comes with a pre-packaged investment strategy based on the underlying gold prices. This product offers principal protection if held to maturity.

Effectively, this means, regardless of market conditions, investors will get back the money they invested, subject to the credit risk of the issuer.

Stated otherwise, at maturity, payout on the structure is the original principal, plus any appreciation from the underlying asset, which in the case is gold.

Although, these gold-linked debentures are a debt instrument, unlike the conventional debt product, the coupon rate is variable and linked to gold prices. While the basic version of the investment strategy is to offer 100% of the upside, there are leverage notes available in the market which could offer as much as 150% of the upside. This means that for every 10% rise in gold prices, the note offers 15%.

Take the case of an investor who puts in Rs 100 for a three year gold-linked structure. of this, the issuer invests a portion of the fund – typically any Rs 70 and Rs 80 – in a zero coupon bond that would grow to Rs 100 after three years. While the principal protection is offered, funds that are not used will go into purchasing gold options and swaps or any other combination needed to execute the investment strategy.

Theoretically, an investor can do all of this himself. The time and costs involved in the transactions are often a deterrent for most investors.

The theme of a synchronous global recovery must be well and truly in its mature stage, with green shoots now spotted even in the economic outpost of Zimbabwe. The global tide has once again been so strong over the past few months that it has lifted everything along the way. This is not just a mirror image of what was happening a year ago; it is also the same phenomenon where a single impulse is driving economies and markets across geographies.

4.1 FINANCIAL ADVISORS:

Weigh impact on investors:

A Regime of global macro-mania

The world has never been so unidimensional. All that seems to matter for forecasting the performance of various economies and asset classes is one macro view of the world. Correlations between different economies and various financial asset classes have been growing over time due to increasing trade, rising capital flows and converging economic policies, but the level of synchronisation has never been higher. There was a marked increase in correlations after the credit crisis broke out in late 2007 and peaked at the height of the financial turmoil last autumn. Even though the economic environment has since returned to some sort of normalcy, the extent of synchronicity remains very elevated.

Over the past year, output declined the most in economies with significant exposure to the global industrial and trade cycle, almost regardless of any domestic fundamentals. Now those same economies are enjoying the biggest bounce on a sequential basis. Similarly, in the equity market, all those stocks that got crushed in 2008 have significantly outperformed this year. Sectors and styles that quickly ran out of favour last year (mainly cyclical stocks) have been back in vogue since April 2009. An indiscriminate rerating of low quality stocks has taken place over the past few months.

The aspect of macro factors dwarfing all micro ones is more evident in the behaviour of commodity prices. Commodities and the US dollar shared a very loose relationship from 1990 until 2007, with an inverse correlation of 0.25. Over the past two years, that correlation has averaged a staggeringly high 0.79, suggesting that commodities and the dollar are just two sides of the same trade. The recent rise in the value of many commodities is more due to the dollar's weakness than any underlying demand and supply fundamentals. Oil is a case in point: despite very high spare capacity and a continuing contraction in global demand for the commodity, it is trading well above its historical level of $50 a barrel – the inflation-adjusted price over the past century. Record amounts of money have flown into exchange-traded oil funds as investors increasingly view the commodity as just an anti-dollar bet.

Stocks, bonds, credit, currencies and commodities the world over have all become variants of essentially one trade. A view on the global industrial cycle is the only guiding light in determining the level of risk to take on. Investors are well aware of this phenomenon and spend an inordinate amount of time on analysing global macro factors. Even pure stock pickers who would earlier sneer at the '30,000-feet from above' views peddled by macro thinkers now flock to conference to hear their thoughts about what the future holds. However, the current regime of global macro-mania will not last much longer.

If history is any guide the stock market may rally sharply during a short-lived economic revival in the midst of a difficult structural backdrop. Trading ranges typically follow V-shaped market moves.

A horizontal world

The current rally is the global proxy for stock market behaviour – the US S&P500 index- has two historical precedents in terms of the size and velocity of the move. The S&P500 rallied by over 50% in 1938 and then again in 1974-75. But, after both the spikes it spent next couple of years treading water. Even if the current rally marks the start of a brand new bull market – a la 1982 – or is analogous to the 1908 recovery after the financial panic of 1907, the parallels would still suggest a sideways market at least over the next year. Sharp rallies in the first year of recovery are typically followed by horizontal movement in stocks for at least a year thereafter.

A horizontal rather than a vertical market implies that *the global macro-mania* will subside considerably in the months ahead. Although correlations have always increased in bear markets, this time around they went off the charts and have remained high even during the recovery this year, possibly due to the intensity of the economic shock and the globally coordinated policy response. Research by JP Morgan shows how heavily economic growth rates are synchronised in the current phase; while recessions tend to exhibit this trend, the recent levels are twice the previous high recorded the severe downturn in 1974-75.

With increasing signs of normalisation in economic and financial market activity, the intense correlation exhibited by sectors and stocks within the equity marketplace and between different asset classes should naturally ease. There are indeed some very early signs of more varied behaviour within the US market.

To be sure, the level of synchronisation is unlikely to fall to the norms of two decades ago. Professors Dennis Quinn and Hans Joachim highlight in a recent paper that the correlations between *different equity markets* have increased steadily since the end of World War II with a marked increase from the late 1980s due to policy changes, including unprecedented global financial sector liberalisation. But the relationship between markets, which went into another orbit in the past two years, is unsustainable.

Extremely high correlations are a symptom of a global boom-bust environment. Hopefully, after the tech and credit boom-bust cycles, it will be a while before the same mistakes are repeated and a relatively dull environment should prevail for the next few quarters. In such a scenario, it will be key to focus more on secular themes and less on cyclical movements. Within the emerging market space, more capital will flow to countries that have shown greater resilience on the fundamental basis to the volatility of the past couple of years. In that regard, India and Indonesia are among the very few markets in the world where earnings by end-2009 are likely to be at new all-time highs, suggesting a secular underpinning to their growth story. Countries such as Russia and Taiwan, in contrast, are unlikely to see earnings return to peak levels even beyond 2011, underscoring just how vulnerable these economies are to global disturbances.

Of course, the risk persists of the global economy suffering a major double-dip or conversely of a policy-induced synchronous melt-up in growth rates after the meltdown of last year. Either event will make the world continue to behave as just one market. However, the odds do not favour another extreme outcome and the markets are therefore likely to go horizontal after being vertical and highly correlated in the recent past. The time for taking aggressive one-way directional bets is probably behind us and the case for differentiation based on local influences is strong.

The nature of markets is, in fact, to let new factors take on the reins just when everyone is conceived about the prevalence of a particular regime.

Many–many factors and few answers

- What is one to make of this global downturn – is it a prolonged recession, a mild depression or merely a correction? Is it likely be V shaped, U shaped, a W or even (heaven forbid) an L?
- Is unbridled capitalism dead, consigned to the dustbin of history along with communism?
- Are regulated markets back in vogue, is a social welfare state of the European variety more effective, or is the India semi-protected market better?
- Are emerging markets getting de-coupled, are they going to drive global growth or are they going to suffer under the weight of their export-dependent model?
- Is the dollar going to stay the dominant global currency with reserves surplus countries such as China and Japan continuing to collect US Treasuries, or is the dollar going to fade away eventually under the deluge of spending by the US government?
- Will the US fiscal stimulus be sufficient to bail out the US economy and put it on the path of recovery, or as Krugman and Roubini would argue, will there need to be a second stimulus?
- Will inflation rear its ugly head and will central bankers rush to tighten monetary policy prematurely, thus choking an incipient recovery?
- Will Chinese and Indian consumers compensate for an over-leveraged US economy?
- Will oil prices stay stable after their recent gut wrenching volatility?
- Will commodity prices plateau off at these levels or will we see another run up in prices – something which the Jim Rogers and Marc Fibers of the world keep talking up?
- Will one-off crises such as HINI impact global growth?
- Will global warming result in conclusive changes in the way in which we live our lives and carry out business?
- Will the world be able to come together cooperatively to deal with climate change in time before island nations such as the Maldives get swept away?
- Will the monsoon be impacted by such events to change the Indian economy?
- And what of terrorism and the so called battle of civilizations – how will that play out?
- And will regimes such as North Korea be brought into the global fold before they develop and deploy nuclear weapons?

Many, many questions and few answers: How does a manager plan in this uncertain environment? And how does an individual plan his or her own life? Let's take a look at some of these issues and while we cannot come to definite answers, we shall attempt to arrive at some meaningful markers for the Indian economy as well as for those who hold leadership positions in Indian corporates.

(Almost) unregulated capitalism, of the US variety, has powerful backers in the shape of Wall Street and powerful corporate chieftains. It is doubtful that belief in this model will go away in a hurry.

There are too many vested interests that will ensure nothing fundamental changes in the US way of running its economy. The Wall Street model of banking is making a comeback, and as soon as the financial markets begin to right themselves, we can bet that things will be back to the way they were.

In the words of Raghuram Rajan, capitalism will still need to be saved from the capitalists.

We doubt that anything fundamental will change. However, this convulsion will mark a subtle but important shift. If the US and the developed world can go through this kind of major economic upheaval bordering on total catastrophe, then in fact they are no better than the less sophisticated emerging markets that these countries had been preaching to, often through the multilateral agencies.

The morel authority and the economic lecturing of the western world will be put in doubt and more and more countries will look their independent path.

The shift of the economic gravity of the world to Asia will also get more pronounced. The growth engine of the world will no longer be the US consumer, but in fact, the Asian consumer.

This will not only be a welcome change but also a long lasting one as the Asian consumer starts from a much lower position. In the long run, this will mean a continuing shift of manufacturing to Asia, as well as sustained infrastructural development that concurrently will have to take place.

Without being an economist, it appears to us that this will lead to a long-term decline of the dollar. The euro is made up of too many disparate elements and so cannot inspire confidence as a long-term anchor and most other important currencies are not freely convertible. So in the short term at least it looks like to dollar will continue as the driver of the world's monetary policy.

The countries of the world have so far shown little ability to work together and pull in the same direction. In the years to come, the issue of climate change will severely test this ability.

Changes in the environment we live in and the consequent gut wrenching changes to our economies will all begin to become more scarily real as global warming takes hold. Climate change will not respect borders and therefore no country can really be immune to this phenomenon. Therefore, whether we like it or not, all countries will have to pull together and tackle this problem collectively. Action on climate change is not a 'nice to have' such as, for example, trade talks – it is a "must have". As we go into the COP 15 deliberations in December in Copenhagen, expectations are not high, nevertheless let's hope for humanity's sake that tangible progress is made.

Will inflation rear its ugly head? We doubt it. There is simply too much slack in manufacturing in the world along with softness on the demand side for this to happen in a hurry.

Let alone check the boom

Yes, there may be some inflation in agricultural commodities where either climate change impact or the search for alternative bio-fuels changes cropping patterns and so on, but we doubt we will have significant price rise in the mined or drilled commodities in the near term. As it is, commodity prices have moved up significantly and there may well be an element of financial speculation underlying some of these moves.

So all in all, we foresee a more uncertain economic world where some of the truths of the past have been severely compromised, but have not yet been replaced by other established alternatives. It means an increasingly multipolar world where market strength will be more diffused; cooperation among nations will be crucial but may not happen, thereby imperiling the economic future and livelihood of many of our fellow travelers on this planet. Almost paradoxically, there will also be vast opportunities for those who can capitalise on the eastern swing of economic gravity. But then these are our thoughts only!

4.4 WEALTH MANAGERS

Map out the details to translate into benefits:

Global Imbalances

Global imbalances, although not the triggering factor, were crucial determinant that exacerbated the current global financial crisis. Such imbalances attenuate the macro economy by creating situations of sudden reversal in capital flows and skewed saving-consumption pattern across the glove. One silver lining of the current financial crisis is that it has acted as an automatic stabiliser by helping to reduce global imbalances to some extent through declining oil prices, lowering domestic demand, increasing saving rates in deficit countries and leading to investment decline in some surplus countries. However, this is a temporary adjustment and cannot be depended upon as a long-term solution.

In the present scenario if the world economy has to return to a sustainable growth path, then global imbalances must be reduced. The G-20 countries club, which contributes 73% to the global imbalances and has emerged as the premier forum for global economic co-operation after the recently held Pittsburgh Summit, would be the right platform to address this issue. In fact, the G-20 did propose to address this issue in the Pittsburgh Summit but a proper plan or road map has not been charted out. Therefore, in the forthcoming meetings it is extremely vital for G-20 to initiate concrete steps in this regard.

India is not a major contributor to these global imbalances. However, capital reversals via FIIs as part of deleveraging process had impacted the Indian stock markets. During the period from January 2008 to February 2009, total net FII outflows were around $ 13.3 billion. In the case of FDI not much impact has been seen in India due to the financial crisis. FDI for the year 2008-09 has increased to around US $ 27.3 billion as compared to US $ 24.5 billion seen in the year 2007-08. The latest trends suggests towards reversing of flows with net inflows by FIIs during April-July being around $10.2 billion. India should be cautious regarding quality of the capital flowing in.

It has been well documented in the crisis literature that preceding a crisis there is a huge inflow of capital into the countries. In recent sudden spurt of FIIs in India of around US $ 1.8 billion in such a short period (October 1-9) is a cause for concern as this has led to a sharp appreciation of the Rupee to Rs 46/US$ from around Rs 48/US$. Although, appreciation of the exchange rate can be beneficial for addressing inflation in normal times, but when exports are sharply contracting, then it can be growth retarding. RBI will have to address this issue in the forthcoming monetary policy review.

Let alone check the boom

4.5 RISK MANAGEMENT CONSULTANTS

Asset bubbles

The housing bubble that burst in the US in 2007 has played havoc with the world economy. Elsewhere, stock market busts have been known to derail economies. How to respond to asset bubbles has, therefore, become a central policy issue.

The argument is often made that booms and busts or business cycles are integral to capitalism and it would be foolish to attempt to manage these. This view is most famously associated with the former Fed chief, Alan Greenspan. The former Fed chief argued that it's hard to tell an asset bubble, that is, whether an increase in asset prices is driven by fundamentals or not. In responding to perceived bubbles, policymakers risked cutting off the benefits of high growth. The only sensible thing for policymakers to do, therefore, was to clean up quickly once the bubble burst.

In the period 2003-07, when the world economy boomed, this view prevailed and Greenspan was hailed as a visionary. Now, he is being reviled for not preventing the worst financial crisis of the last century.

Policymakers will hereafter find it difficult to adhere to the *laissez faire* attitude towards asset bubbles and ignore the possibility of large disruptions to the economy. The idea that asset bubbles must be managed is fast gaining ground. Remember, the idea of managing exchange rates was also once unfashionable but "managed float" is no longer sneered at.

The practical questions are three.

- Do we have reliable indicators of future busts?
- Is lax monetary policy the primary culprit in the present bust?
- And does it make sense for central banks to have financial stability as an objective in addition to the traditional objective of price stability?

The IMF's *World Economic Outlook* (October 2009) sheds light on these questions.

Do we have reliable indicators of future busts?

The answer to the first questions is: yes, we do have indicators of the busts but they are not very reliable. The IMF finds three significant predictors:

- The ratios of credit,
- The current account and
- Residential investment to GDP,

But these predictors are not very reliable. In the post – 1985 period, these predictors raised an alarm in advance of a bust only one-third to one-half of the time. Asset bubbles are hard to predict.

Let alone check the boom

Is lax monetary policy the primary culprit in the present bust?

To what extent has monetary policy been responsible for the present crisis, as many have contended? The IMF's answer goes against the current wisdom: monetary policy, its analysis shows, was not the main or systematic source of the recent asset price booms.

If that were the case, it would have showed in the behaviour of inflation and output. It does not. So, monetary authorities seem to have been quite successful in meeting the objective of price stability. However, this has not helped prevent a first-class financial crisis, which gives rise to the third question:

Should central banks, therefore, focus on financial stability and not just on price stability?

Prior to the resent crisis, economists tended not to favour multiple objectives for monetary policy. In India, the Raghuram Rajan committee argued as recently as in 2008 in favour of a focus on price stability.

The IMF's analysis suggests that it makes sense for central banks to respond to signs of macrofinancial risk. But this does not mean simply responding to sharp increases in asset prices, given that asset prices are not very reliable predictors of an impending bust.

The IMF argues that you need to look closely at the drivers of bubbles: lax lending standards and rapid credit growth, overinvestment and deteriorating external balances. This seems like quibbling because you still have to work out what is rapid credit growth, overinvestment etc.

So, the IMF's analysis suggests that it is all very well to have financial stability as a goal in addition to price stability. But this is difficult in practice because we do not have satisfactory indicators of macrofinancial risk.

Still, in the near future, we should expect policymakers to respond to asset bubbles, using some rough indicators.

There are three reasons why this will happen even though the costs and benefits to such intervention are not clear.

One, it has become evident that regulation by itself cannot prevent financial crisis.

Two, disruptions caused by banking failures are widely perceived as unfair and iniquitous and have fuelled popular outrage. In the present crisis, bank managers are perceived to have benefited from their reckless actions while shareholders and tax payers lost out.

Three, less developed countries cannot afford big setbacks to growth given their low per capita incomes.

If India does not achieve a 10% growth rate, it will not been seen as a big disaster. But, if a banking crisis causes growth to fall to 4% that will become an unmitigated disaster for whoever is in power.

Politicians will see clear advantages to responding to asset bubbles. The theory of asset bubbles may take time to develop but practices is likely to lead theory.

Let alone check the boom

4.6 INCLUSIVE CEOs

Innovative responses to problems

Outrageous compensation practices

Should the government be in the business of fixing the salaries and bonuses of private sector bank employees? An intense debate is raging on the issue in Europe and the US. On one side are diehard free marketers who are against any government intervention even in a sector that has received billions in bailout over the past year and due to the bailout, government in Europe and the US own substantial stakes in many banks and financial companies.

On the other side are those who argue that last year's global financial crisis was caused by the outrageous compensation practices that provided executives high incentives for taking unwarranted risks. These compensation packages included high reward for short-term profits, but no punishment for losses. To avoid future financial crises, it is argued that governments should regulate the compensation packages of bankers so that they are not rewarded for taking excessive risks and governments should 'claw back' bonuses in the event of poor performance.

Despite the intense debate and public outrage, executives in banking and investment companies that were bailed out by tax money last year have continued to receive outrageous salaries and bonuses. In July, the New York attorney general Andrew Cuomo's office reported that financial firms that received federal bailout paid more than 5,000 employees over $ 1 million each in bonuses in 2008. The saga of banking excesses is continuing in 2009. The *Wall Street Journal* recently projected that in 2009 the US banks and securities firms will pay $140 billion in bonuses and salaries – an all time high.

Political response to big bonuses has not been uniform on both sides of the Atlantic. Politicians in Europe have been more proactive in taking on big banks and investment companies. While politicians in the US, on the other hand, have been reluctant to intervene. Yet, the Obama administration has taken a number of steps to limit executive compensation at financial institutions that have received bailout money. In July, the US House Financial Services Committee approved a Bill that allowed shareholders to vote on pay packages. Unfortunately, it does not seem that shareholders are using their powers. Take the case of Bank of America. It incurred a loss of $3.2 billion in the most recent quarter, but its employees received a hefty $13.2 billion in compensation and the share holders did nothing about it.

The Obama administration has also appointed Kenneth R Feinberg as the pay czar to oversee the compensation of employees at companies receiving billions in federal assistance. According to news reports, Feinberg has broad discretion to determine the salaries and bonuses of the five most senior executives and 20 most highly paid employees at each of these companies.

The Federal Reserve is also considering imposing rules that require banks to "claw-back" bonuses in the face of losses and link pay to long-term rather than short-term performance. The Fed has argued that it has the authority to impose this rule as part of its general mandate to oversee banks' soundness. It may have the authority, but it is uncertain if it will be able to effectively restrain the salaries and bonuses of bank employees without the enthusiastic backing and support of the White House.

Banking is one of the most globalised industries. International cooperation would, therefore, be needed to regulate this sector. European countries that have proceeded with regulating executive salaries are hopping that the US government will follow similar policies. If it does not, the EU countries would come under considerable pressure from their banks to become lax on these restrictions.

Let alone check the boom

4.7 MICRO-FINANCE PROFESSIONALS

Developing alternative credit delivery models

Government policies

What can government do to crank up America's creaky job machine? The answer, frankly, isn't clear, i.e., die hard Keynesians insist that only more government spending and tax cuts will accelerate job growth. But many other economists fear that exploding federal debt – incurred partly to pay for more spending and tax cuts – could trigger a new crisis that would destroy jobs.

Almost everyone agrees that the outlook is bleak. Since the recession's start in December 2007, about eight million payroll jobs have disappeared. More will go. Employment is lower than a decade ago: the first time that's happened since Great Depression. With the labour force expanding by more than 1 million new workers annually, economists estimate that even the job growth of the 1990s (2.4 million a year) wouldn't reduce today's 9.8% unemployment to 5% until 2017.

The Keynesian solution holds that government activism can generate more jobs. That's the theory behind the $787 billion "economic stimulus" passed in February. The rap on Stimulus 1.0 is that it hasn't yet, as promised, reduced unemployment. However, the Obama administration is more plausible than its critics. In early 2009, consumer and business spending was collapsing. The stimulus has helped stabilise the economy. It's saved jobs that otherwise would have never lost.

Interest rates didn't rise. But just because the earlier stimulus was justified doesn't mean that another would be, because circumstances are changing. Government debt is now rising at unprecedented post-World War II rates. In fiscal 2009 (ending September 30), the federal budget deficit was $1.4 trillion. The Congressional Budget Office predicts a similar amount for 2010.

Economist Kenneth Rogoff, co-author with Carmen Reinhart of "*This Time Is Different: Eight Centuries of Financial Folly"* says, "Right now, the world wants to lend to us, and we can carry a huge debt burden at relatively modest interest costs. But history teaches that confidence is fickle". If rising debt frightens domestic & foreign lenders into fearing high inflation or default, interest rates could soar. A first stimulus was warranted, but now it makes no sense to use stimulus just to postpone the reality of lower economic growth over the coming decade. He favours a gradual reduction of huge deficits. The trouble, of course, is the capriciousness of psychology. No one can know when or whether a future crisis might occur.

Economists Mishel and Rogoff frame the debate: the first impatient, the second prudent. A middle way would be to scour government for policies that discourage job creation.

Consider the Environmental Protection Agency's recent proposal requiring permits for large industrial facilities emitting 25,000 tonnes of greenhouse gases annually. New plans or expansions would need permits demonstrating they're using the best practices and technologies" (whatever they might be) to minimise six greenhouse gases. Permits would be granted on a case-by-case basis; the proposed rule is 416 pages of dense legalese.

How could this promote investment and job creation, except for lawyers and consultants? Government erects many employment obstacles: restrictions on oil and natural gas drilling; unapproved trade agreements; some regulations. But reducing these barriers would require the Obama administration to choose between its professed interest in more jobs and its many other goals.

Let alone check the boom

4.8 ONE-STOP-SHOPS

Dedicated to offer related services under a roof

The fear of deficit

Over the last one year or so we have been arguing about the nature of the current recession. Academic work is still on to ascertain the typology of the current recession. But the nature of recession should be clearly encoded first as it gives some indication of the task ahead for all countries. The consensus however is that the current recession is of Keynesian in nature.

Even the period 2007-2009 shared one common feature with the Depression of 1930s that in both cases outputs and prices fell globally. This made this recession somewhat different from previous episodes as these were restricted to one set of countries (developed countries or East Asian economies) and were set off by known cause like the oil price hike of the 1970s or the crony capitalism of 1990s. But in these previous episodes there was no generalised fall of both prices and output. So these episodes were more problems of structural change as compared to the clearly Keynesian nature of the current episode.

However, it is interesting to note that the strict monetarists have already started bemoaning the increasing fiscal deficits in countries. This needs some consideration. If we accept that the current recession was Keynesian in nature then the fear of deficit is unjustified.

In Keynes, the motivating factor was the breakdown of expectations on the part of both consumers and producers. Because the essential element is a set of events which leads consumers to start 'saving for a rainy day' and producers then use this reduced consumption as an indication that demand is falling and hence cut production. This set off a set of self-fulfilling expectations which can only be negated by the operation of the government which has to come in to 'pump prime' demand.

This pump priming is what we now call government 'stimulus' in each country.

Since in a recession falling incomes imply that government tax revenues will also go through a cyclical downturn, it is common sense that this 'stimulus' must come through higher fiscal deficits. In other words, the stimulus is the fiscal deficit itself.

Stimulus: But how long?

This is not so clear, how long the stimulus should be continued? First, we now know that the US demand was based on excessive consumption financed by excessive savings in the rest of the world. Yet, today it is clear that the 'zero savings' behaviour in the US is clearly not going to return. The US savings rate (out of disposable income) fell to around 1% in 2006 but its now up to around 5%. In other words, someone in the rest of the world has to make up the 3-4% decline in savings if global demand is to return to the 2007 levels. It is not clear that the level of optimism in other countries is near the required levels.

It is often forgotten that the US accounts for about 25% of the world demand so that the level of potential increase in consumption required in emerging economies like India and China is going to be insufficient. This is particularly true given that China has shown no inclination to reduce its huge trade surpluses of over $2 trillion. Till structural changes in world demand work themselves out it is clear that the stimulus must continue. How long? Difficult to say, wait till signs of optimism return.

Dollar carry trade

Over the past year, the dollar has increasingly been at the epicenter of so-called "carry trade". The Fed has been injecting liquidity into the monetary system to stimulate lending. With interest rates effectively at zero in the US, stock and commodity traders are borrowing dollar and investing in higher-yielding currencies and assets, such as stocks, commodities, oil, gold and emerging markets.

Still the policy interest rates will stay "exceptionally low" for an extended period flashes a green light for the dollar-funded carry trade that has suddenly come in fashion and is conceivably behind the all-asset rally that has gained momentum since March 2009. And the 'dollar carry trade' will accentuate because of a wide gap between valuations and the outlook for economic fundamentals in 2010.

Japanese investors are a big engine behind this new carry trade dynamic. When Japanese institutions invest in US dollar denominated assets, they become exposed to forex risk. As a natural hedge, they can make their liabilities also dollar denominated. There is a clear correlation between the lower rates in US and recent yen appreciation. The Japanese yen closely tracks US LIBOR.

However, experts say the carry trade is dangerous: Firstly, when the yen rebounds against the dollar, it often snaps back very fast; so carry trades can go from profit to loss with almost no warning. Secondly, the ensuing monetary easing feeds an asset bubble in the destination-economies. So the perfectly correlated bubble across all global asset classes gets bigger and frothier. Thirdly, when the dollar rises and carry traders bail out of their assets again, we'll probably see another sharp global sell-off in all assets.

World of contradictions confirm carry-trade-financed global asset bubble: Those who believe the worst is over have been merrily buying equities since March. They are also pushing oil and commodity prices higher, expecting global demand to recover to pre-crisis levels reasonably quickly. Simultaneously, for opposite reasons, doom-mongers are piling into bonds.

Oil is on boil just when demand is easing. Buoyant traders wanting risk are loving Australian dollars and Brazilian reals. But safe-haven currencies such as the Japanese yen are rallying as well. Likewise, gold investors are schizophrenic encouraging signs and negative news both seem reasons to buy.

The parallel universe existing in the world today merely reflects the inconsistency of fundamental data. Why are US retail sales improving while unemployment and foreclosures continue to rise, consumer credit is shrinking and consumer confidence still fragile? Export heavy nations such as Germany are recovering just as their currencies are getting more expensive. Dodgy emerging market sovereign debt or US municipal bonds are priced as if riskless. Since early March, a Brazilian 10-year sovereign bond has seen its yield drop 208 basis points even as the US 10-year note's yield has risen 52bp.

Markets can remain irrational for a long time but the reality check will be brutal for some. To the extent that carry trade is supporting money growth; the Fed could be deceived into thinking monetary policy is looser than it really is. That could set up the markets for a nasty shock, in which the Fed signals an end to accommodation, the dollar surges, and the carry trade reverses. Such carry trade reversal could bring the whole pack of global asset cards down with it.

Let alone check the boom

Wall of debt

The idea that the government of a major advanced country would default on its debts – this is, tell lenders it won't repay them all they're owed – was, until recently, a preposterous proposition. Well, it's still a very, very long shot, but it's no longer entirely unimaginable. Governments of rich countries are borrowing so much that it's conceivable that one day the twin assumptions underlying their burgeoning debt (that lenders will continue to lend and that governments will continue to pay) might collapse.

What happens then? The question is so unfamiliar that the past provides few clues to the future. Psychology is crucial. To take a parallel example: the dollar. The fear is that foreigners (and Americans, too) lose confidence in its value and dump it for yen, euros, gold or oil. If too many investors do that, a self-fulfilling stampede could trigger sell-offs in US stocks and bonds. People have predicted such a crisis for decades. It hasn't happened yet. The currency's decline has been orderly, because the dollar retains a bedrock confidence based on America's political stability, openness, wealth and low inflation. But, something could shatter that confidence – tomorrow or 10 years from tomorrow.

The same logic applies to exploding government debt. We have moved into uncharted territory and are prisoners of psychology. Consider Japan. In 2009, its budget deficit – the gap between spending and taxes – amounts to 10% or more of gross domestic product (GDP). The total government debt – the borrowing to cover all its deficits – is approaching 200% of GDP. That's twice the size of its economy. The mountainous debt reflects years of slow economic growth, many "stimulus" plans, an aging society and the impact of the global recession. By 2019, the debt-to-GDP ratio could hit 300%.

No one knows how to interpret these numbers. If someone had predicted 20 years ago that Japan's debt would rise so spectacularly, the forecast would doubtlessly have inspired this alarm: Japan will pay crushing interest rates as fearful lenders demand high returns to compensate for the risk that government might default or inflate away its debt. Instead, the opposite has happened. Japanese investors – households, banks, insurers – have absorbed 94% of the debt. Interest rates on 10-year Japanese government bonds have dropped from 7.1% in 1990 to 1.4% now. Superficially, it's possible to explain this. Japan has ample private savings to buy bonds; modest deflation – falling prices – makes low interest rates acceptable; and investors remain confident that new and maturing debt will be financed.

The American situation is similar. Despite huge deficits, interest rates on 10-year Treasury bonds have hovered around 3.5%. In time of financial crisis, investors have sought the apparent sanctuary of government bonds. But the correct conclusion to draw is not that major governments (such as Japan and the United States). These governments can easily borrow as much as they want. It is that they can easily borrow as much as they want until confidence that they can do so evaporates – and we don't know when, how or whether that may happen.

Wealthy societies everywhere face same dilemma. Debt is ballooning from already high levels. Higher interest rates would aggravate the debt burden. While containing debt by spending cuts or tax increases would involve wrenching and unpopular measures that might, perversely, weaken the economy and worsen deficits. Against choices like that, some advanced countries might decide that a partial or complete default, though dire, would be less damaging economically and politically than the alternatives.

Let alone check the boom

Escaping Depression 2.0

How close did we come to the Great Depression 2.0? That question will spawn a cottage of books, studies and conferences. But Christina Romer, the head of President Obama's Council of Economic Advisers, already has an answer. Her conclusion deserves attention because Romer, in her previous academic career, was a scholar of the Great Depression.

Depression is a term of art. It's more than a serious economic downturn. What distinguishes a depression from a harsh recession is paralysing fear of the unknown – so great that it causes consumers, businesses and investors to retreat and panic. They hoard cash and desperately curtail spending. They sell stocks and other assets. A devastating loss of confidence inspires behaviour that overwhelms the normal self-correcting mechanisms that usually prevent a recession from becoming deep and prolonged: a depression.

Comparing 1929 with 2007-09, Romer finds the initial blow to confidence far greater now than then.

- True, stock prices fell a third from September to December of 1929; but fewer Americans then owned stocks, and prices had risen early in the year.
- Moreover, home prices barely dropped. From December 1928 to December 1929, total household wealth declined only 3%. By contrast, the loss in household wealth between December 2007 and December 2008 was 17% - more than five times as large.

Both stocks and homes, more widely held, suffered larger losses.

The anniversary of Lehman Brothers' bankruptcy in mid-September inspired much commentary that saving the investment bank *wouldn't* have averted the crisis. True. But allowing Lehman to fail almost certainly made the crisis worse. *By creating more unknowns* – which companies would be rescued, how much were 'toxic' securities worth? Lehman's bankruptcy converted normal anxieties into extreme fears that triggered panic. Credit markets froze, stock prices collapsed. Financial panic poisoned popular psychology. Shoppers recoiled from buying cars, appliances and other big-ticket items. With a slight lag, businesses canned investment projects. Though private markets for goods, services, labour and securities do mostly self-correct; but panic, *driven by the acute fear of the unknown*, feeds on itself and disarms these stabilising tendencies. In this situation, only government can protect the economy as a whole, because most individuals and companies are involved in the self-defeating behaviour of self-protection.

However, these huge declines didn't lead to depression mainly reflects, as Romer argues, countervailing government actions. They all aimed to reassure people that the freefall would stop and, thereby, curb the fear perpetuating the freefall.

Confidence had to be resorted so that the economy's normal recovery mechanisms could operate. This seems to have happened. But the improved confidence is not optimism. It is the absence of terror. The consumer sentiment index is still weak. Unemployment (9.8%) is abysmal, the recovery's strength unclear. Government didn't ensure recovery. Some policies helped, some hurt.

The good news today is simply that the bad news is not worse.

Let alone check the boom

Rescue Plans: Jury Is Still Out

What was the market response to bank rescue packages announced after the collapse of Lehman Brothers? A BIS paper *Time to buy or just buying time? The market reaction to bank rescue packages* assesses the impact of rescue packages announced in October 2008 in six countries – US, UK, France, Germany, Netherlands and Switzerland. It measures the market reaction of bank CDS spreads and stock prices for 52 banks 50 trading days before and after the announcement in each country.

It finds that while government interventions protected bank depositors and calmed financial markets, they were less successful in restoring market confidence in the banking sector.

Though average bank CDS spreads for each country narrowed around the time of the announcement in all cases, bank stock prices underperformed in all countries except the US where the generous terms of the government support allowed bank stock to outperform the market.

In fact stock prices of banks receiving direct government support did worse than banks not receiving government capital.

Bank access to private sector capital remained restricted through the end of the year, with little or no access to private borrowing or equity markets. Instead, banks remained dependent on government-guaranteed debt issuance and capital injections, with some banks being taken into government ownership.

While government interventions avoided further bankruptcies and brought policymakers valuable time, continued weakness in bank stocks and the need for more such interventions suggests that bank shareholders did not view rescue packages as a buying opportunity.

Unlike the European experience, US rescue packages were well received by both creditors and shareholders. Non-convertible preferred shares issued under the Capital Purchase Program were favourably priced, offered little dilution of existing shareholders and did not impose material constraints on bank management. In contrast, bank shareholders in the UK saw their equity diluted and their future income stream reduced. So, the response is not unexpected. Rescue packages were not designed to protect shareholders; on the contrary, shareholder capital is designed to bear losses.

The positive response of creditors suggests that government intervention reduced the risk of a default across all banks. Judged from this perspective, the fact that only a few institutions were nationalised suggests government interventions were successful.

In fact, the October rescue packages provided governments with time to assess the situation and formulate their policy responses. At the same time, these policy interventions did not represent a buying opportunity. And it is too early to assess the impact of rescue plans on restoring the flow of credit to businesses and households. Given the weakness in bank stocks through January 2009 and the limited access to bond markets, it is not clear that banks were in a position to extend more loans.

RBI governor Duvvuri Subbarao on 27th October 2009 (Tuesday) ended the soft monetary policy, which began last year to ease the global credit crisis, by withdrawing liquidity boosting measures, becoming the second central banker in the world to do so after Australia. An increase in lending rates is now imminent next quarter if consumer and asset prices remain high. However, he left the benchmark rates unchanged.

The governor withdrew a special facility that made funds available from banks to stimulate mutual funds and finance companies, made loans to commercial real estate more expensive, forced banks to invest more in government bonds, and asked lenders to set aside more capital for bad loans.

RBI maintained the repurchase rate, or repo rate – the rate at which it provides funds to banks – at 4.75%; reverse repo rate – the rate at which it takes funds from banks – at 3.25%; and the cash reserve ratio – the slice of deposits that banks have to mandatorily park with the central bank – at 5%.

But the central bank surprised the market in its choice of instruments to announce the exit of an easy money policy. The statutory liquidity ratio (SLR), which prescribes the percentage of deposits that banks are required to invest in government debt, has been raised from 24% to 25%, which Mr Subbarao said was a reverse of an exceptional measure. Last year, at the height of the global credit crisis, the central bank had lowered the SLR to ease credit flow to industry.

RBI also raised its forecast of inflation as measured by the Wholesale Price Index to 6.5% by March 2010, from 5% earlier, as food prices continue to rise on short supply due to the worst monsoon rains in more than a quarter of a century. The central bank pointed out that inflation has returned to positive territory earlier than expected.

Despite statements from fiscal policy managers saying they want to ensure that there is a solid rebound in growth before interest rates are hiked, the Centre and the RBI governor have chosen a policy that leads rather than follows the market. Mr Subbarao is the second central banker after his Australian counterpart to signal the exit of an accommodative monetary policy, which was eased drastically in concern with other central banks of the world a little over a year ago in response to the global credit crisis.

Last year, when monetary authorities worldwide eased policies, many were concerned that the resultant liquidity would push up asset prices and stoke inflationary pressures. According to Mr Subbarao, the pressure on inflation was being felt earlier than expected. The governor has warned that pressures could increase stating that "the lag with which monetary policy operates suggests that there is a case for tightening sooner than later". While RBI has broken ranks with other central banks in timing its exit, it has moved in tandem with global regulators in acting on other issues. For instance, it has decided to draw guidelines on how much banks can pay their CEOs, introduced curbs on securitising loans, and announced a stress test for all banks next year.

While the governor was alarmed with the secular rise in prices of all asset classes – real estate, equities, gold and commodities – resurgent foreign portfolio inflows of $14 billion in the first seven months appear to have reassured him that recovery will not be hit. The fact that year-on-year bank lending to real estate has grown 43% as on August-end had already sparked speculation that RBI may act on these loans. As Mr Subbarao said, although the amount of credit to real estate is not very high, it has been the fastest growing. By choosing to increase the extent of standard provisions that banks need to make on real estate loans, RBI has discouraged fresh loans while ensuring that capital adequacy ratio is not hit because of existing loans. The central bank also said it expects activity in the service sector to grow with a lag.

"The lady is not for turning," said former British Prime Minister, Margaret Thatcher in her famous speech at the Conservative Party conference back in 1980. Substitute 'gentleman' for 'lady' and there, in the nutshell, you have the essence of the Reserve Bank of India (RBI) second quarter review of the bank's monetary policy for 2009-10.

Sure there are some feeble moves to tighten monetary policy and some pious talk about the need to exit it excessive accommodative stance. But by keeping all policy rates unchanged, RBI governor D Subbarao has signaled, that like Saint Augustine's, 'Lord, give me chastity and continence, but not yet,' he is not yet ready for restraint.

The net result is a policy that is strangely at odds with his own earlier remarks about how the RBI might need to exit its expansionary stance faster than other central banks because of rising inflationary pressures as well as ground realities.

The problem is there is never a 'right' moment to tighten the monetary belt; certainly not from the perspective of the lay public. Worse, the final verdict on whether a moment was opportune or not is always known only in hindsight, never before. The governor knows that as well. He knows he has to change course. Virtually everyone agrees the world and the Indian economy cannot live forever on steroids. He also knows the longer he delays, the more he risks aggravating inflationary pressures.

In the circumstances, are the constituents of what the RBI ambitiously, if rather naively, terms its 'first phase of exit' – a return to 25% statutory liquidity ratio (SLR) and rollback of special refinance facilities to banks – good enough? No! They are too tentative and make no difference in a scenario where banks' holding of SLR securities is well in excess of 25% and, as per the RBI'S own admission, the "banking system has been awash with liquidity since November 2008."

In an economy where even a cut in policy rates takes months to get translated into action on the ground and has, at best, a partial impact because of weaknesses in the transmission mechanism (in the period between October 2008 and October 2009, the RBI cut its repo rate by 4.25 percentage points, yet bank lending rates came down by less than 3%) and tentative, half-hearted signals cut no ice.

The RBI knows as much. But in the tradition of central banks, it is wary of rocking the boat. To be fair to the governor, you can't fault him entirely on that. The mighty Fed under Alan Greenspan and then Ben Bernanke did not have the courage to change course when the going was good, despite clear evidence of asset bubbles, so why point a finger at the RBI?

Moreover, the pressure on the bank to continue its easy stance has been immense. Both the finance minister and the prime minister have made no secret about not wanting a 'premature withdrawal' of stimulus.

The question here is what is 'premature'.

Is it 'premature' when 300 listed companies record an average 17% increase in profits in the second quarter (twice the growth in the comparable period last year?), when companies like Maruti Suzuki post as astounding 93% rise in net profit and even 'lesser' companies like Tata Motors, still grappling with its misguided purchase of Jaguar-Land Rover, report a doubling of profits?

Is it ‘premature’ when industrial growth in August 2009 (the last month for which the data is available) is up 10.4%, the fastest in 22 months, and the stock market has given a return of more than 100% in the year-to-data (samvath to samvath), forex inflows are all set to surge to a new record and global commodity prices are up 30% over the year?

Most important of all, it is ‘premature’ when surplus liquidity has already driven consumer price indices (CPI) up by close to 12% and the wholesale price index (WPI) is also on the uptick? Is it premature when by the bank’s own admission on March 2010 will see the WPI at 6.5%? Assuming the gap between WPI and CPI continues as before, where does that take CPI? A frightening 15-16%; and on a high base!

Yes, there are a few signs to the contrary. But unfortunately, monetary policy is all about timing. Tighten early and you risk killing off a recovery, tighten late and you risk inflation. Also, much like timing the market, it is virtually impossible to get the timing right. So to put it very bluntly, it is really a choice between (possibly) spooking growth and (hopefully) spooking inflation.

In a rich country that’s a no-brainer. Between growth and inflation, policy makers can opt for growth (assuming there is a straight-forward choice) for the reason that even if they do err, inflation is not a catastrophe. It hurts growth, long term, but in the short-term there is no human distress because of people being priced out of the market.

There is not so in a poor country like India. Yes, we’d all like higher growth but if that means higher inflation, should we push for more growth? Yes, growth does create more prosperity, more jobs and more opportunities. But it benefits the rich far more than the poor since they are better placed to benefit from the fruits of higher growth. Who will deny that the rich and the middle-classes in India have benefited far more from the reform than the poor?

The trickle-down effect of higher growth is too slow. In contrast, the impact of rising prices is immediate; not only does it hurt the poor much more than the rich, it hits them where it hurts the most – their stomachs. So in India the trade-off must be viewed very differently from the west; they must always be skewed in favour of fighting inflation even if (and that is a big IF) it means giving up some short-term gains in terms of growth.

Sure, most of the inflationary pressure in India is because of supply-side issues (poor harvest, etc). But inflation is ultimately, and always, a monetary phenomenon. The longer we remain insensitive to the need for price stability and relegate it to second place vis-à-vis growth the more we will have to rue in the future. The danger is by then it might be too late.

CBDT plans new measures to boost tax mop-up

Direct tax mop-up has grown barely 2% this fiscal so far despite telltale signs of a pickup in economic activity, prompting the government to look at new measures to boost collections. As part of the efforts, the Central Board of Direct Taxes (CBDT) – the apex body that administers all direct taxes such as corporate tax and personal income tax – will take a close look at the advance tax collections, scrutinise companies that enjoy tax holidays, carry out searches and even reopen certain cases.

The collections will have to grow by over 18% for the rest of the year to achieve the enhanced target of Rs 400,000 crore for the year 2009-10. Direct tax collections grew 3.6% in the first half of the current financial year. But due to a sharp increase in refunds, the growth has dropped to less than 2% by the third week of October 2009. This has caused alarm in the government as preparations for the budget for the next year have already begun. The authorities are counting on a robust growth in direct tax collections to meet revenue targets. Indirect tax collections are expected to disappoint as the government had cut rates earlier in the year to stimulate the economy. The CBDT wants to ensure that taxpayers do not defer advance tax payments, as sometimes corporates choosing to pay up later with a penal interest.

The CBDT is also exploring the opportunities thrown up by the retrospective changes in the tax provisions in the budget of the year. The criterion for computation of “book profit” for the purpose of minimum alternate tax (MAT) was changed with effect from April 1, 2001. Some tax exemptions to the infrastructure sector, export oriented units and software technology parks and units in special economic zones (SEZs) were also altered from April 1, 2000. For these companies, it would be double trouble as barring SEZs most are under the minimum alternate tax regime. The change that was introduced in respect of MAT would increase companies’ profits and enhance their tax outgo.

The investigation wing of the department has also drawn up a strategy to carry out targeted and focused searches and surveys with a view to nab tax evaders and maximise tax collections.

Nation-wide IT search on former Jharkhand CM’s ‘properties’

The Income Tax department on 31st October 2009 (Saturday) conducted country-wide searches on nearly 60 properties allegedly owned by former Jharkhand chief minister Madhu Koda after the Enforcement Directorate (ED) registered a case against him for money laundering and diversion of state funds. The ED had registered the case on October 9 against Koda and three of his ministerial colleagues on charges of making huge illegal investments abroad, including purchase of mines as far as in Liberia. Koda was chief minister between February 2006 and August 2008.

The searches, which began early morning, were being conducted by at least 400 IT sleuths on the properties located in Jharkhand, Bihar, Mumbai, Kolkata and Delhi.

38-year-old Koda, who may also face arrest, is the first former chief minister and high-profile politician to have been booked under the Prevention of Money Laundering Act. The ED had filed an Enforcement Case Information Report (ECIR), which is equivalent to an FIR, before the Prevention of Money Laundering Act court in Ranchi against Koda and three of his cabinet colleagues – Kamlesh Singh, Bhanu Pratap Shahi and Bhandu Tirkey – besides five other persons. According to the ECIR, Koda is alleged to have purchased mine in Liberia worth USD 17 lakh (Rs 8.5 crore) besides making other ‘benami’ purchases in the name of his close confidant Binod Sinha, once a tractor mechanic. As per the ECIR, the property in the name of Sinha runs into several hundred crores of rupees.

How effective are Sebi orders banning individuals and entities from trading in the stock markets as a penalty for manipulative practices? If Dalal Street veterans are to be believed, such curbs matter little as the debarred players can easily work their way around. As surveillance officials in regulatory bodies admit, enforcing the ban is far more difficult than handing out the punishment.

"Float a private limited company, appoint some relative or close acquaintance as a director, and invest through this firm without drawing attention to yourself," said a market old-timer while talking on the modus operandi of players who have fallen foul of the regulator.

The more sophisticated players transfer their money out of the country, through hawala or some other convenient route, and deposit it with a friendly foreign bank. The bank then routes this money to a tax haven-registered sub-account of a foreign institutional investors (FII), with instructions to invest that money in specific stocks in India.

Back home, there are brokers willing to execute trades on behalf of debarred players, as long as the margin commitments are met and brokerage commissions paid.

Over the years, technological advancements have made it possible for regulators to quickly zero in on suspicious transactions/movements in stocks. At the same time, market operators too have been honing their skills to keep the regulator at bay.

Promoters got to dilute stake in phases

The finance ministry has firmed up the details of its budget announcement that listed companies will have to achieve at least 25% public holding in a phased manner, opening up the possibility of a plethora of equity offerings from listed companies.

Beginning April 2010, those companies falling short of the required 25% minimum would have to divest at least a 5% stake within a year and a similar amount in the following year till they reach the threshold prescribed. Information technologies and infrastructure would be impacted the most as they had been allowed to list with only 10% public float.

According to government estimates, the value of total shares that will come to the market in the next few years as a result of implementing the new requirement is about Rs 150,000 crore at July prices.

Though the ministry will implement the minimum 25% public shareholding requirement from the beginning of the next fiscal year, companies will not be asked any question before the end of the next fiscal year on whether they have started the process or not.

The idea is to let them time their stake dilution at the most opportune time depending on market conditions. A regulatory action on non-compliant companies will be taken only after the five-year transaction period.

The government's disinvestment programme is independent of these norms. State-run companies have to also keep in mind the schedule for compliance with the continued listing norms.

7.0 ISSUES OF INFLATIONARY EXPECTATIONS

Inflation and Rate-Hike Dilemma

After implementing aggressive rate cuts and pumping substantial liquidity into the system in a short span of time, most central banks across the world have put a halt to further monetary easing. Clearly, the days of easy monetary policy are coming to an end, though there is no clarity as yet on the time frame for the exit. The recovery in most advanced economies, although faster than expected, is still fragile, and concerns abound that a premature withdrawal of stimulus could stifle the slow but ongoing recovery.

Policymakers in India too are facing a somewhat similar dilemma. Though overall GDP growth remains weak, inflation is now on the rise. Primary articles inflation registered a sharp rise, while fuel and manufacturing inflation continued to be subdued. Recently, raw material prices have also posted a sharp month-on-month increase compared to a much sharper dip last year. CPI inflation is already in double digits, and WPI inflation is expected to go beyond RBI's tolerance limit of 5% over the next few months.

Should RBI start raising rates in response to these developments? To answer this question, it is imperative to examine the nature and drivers of inflation. If inflationary pressures are accompanied by rising demand, then there is no alternative to a rate hike. Even if the inflation is the result of a supply shock, the monetary policy is generally tightened to curb the transmission of raw material prices to final products (second round effects). However, if the supply shock is from food prices, the monetary policy's effectiveness in curbing inflation would be curtailed further.

We recognise WPI into three different categories – food, raw material and manufactured products. While raw material WPI capture price movements in crude items, energy and non-food primary articles, manufactured products (excluding food products) covers both intermediate and final finished goods.

Our findings suggest the key pressure point on inflation continues to be the supply shock from food articles. Food prices have remained much above their long-term trend since the middle of 2008. With rains playing a spoilsport, food inflation averaging 11 per cent in first five months of this fiscal does not come as surprise. Food price-led inflation cannot be tamed by raising interest rates.

The year-on-year inflation in raw material prices continues to be negative. However, the prices have displayed rapid growth on an m-o-m basis (in the de-seasonalised series) over the last few months. This reflects correction in raw material prices, which had hit rock bottom during the worst phase of the global crisis, due to signs of improvement in global growth prospects, Nevertheless, raw material WPI is yet to touch the long-term trend levels, and remains significantly low as compared to last year's abnormally high levels. Prices of raw material are largely shaped by global conditions. Therefore, the steep upturn in the prices is unlikely to continue, as the recovery in advanced countries will be quite weak.

While the overall m-o-m growth in manufactured product prices is positive, prices in some categories such as metals and machinery have not started rising as yet. The recent price correction notwithstanding, both raw material and manufactured product prices are still below their long-term trend.

Despite the few signs of recovery in the economy and the fastest-than-expected growth in industrial production, overall demand conditions remain subdued. The draught will exert further downward pressure on demand this year. Under such conditions, second round effects of raw material price increases would be weak. The CSO data shows a significant moderation in private consumption demand in the first quarter of this year. The evidence from credit offtake also does not convey that that a decisive recovery is underway. Inflation patterns present a mixed picture, and do not convincingly reflect a pick up in demand.

The key factors that supported India's movement to a higher growth trajectory in the five years beginning 2003-04 were low interest rates, aggressive lending by the banks and buoyant global environment.

While the global environment is gradually improving, recovery will be sluggish and remain a pale shadow of the pre-crisis year buoyancy.

Interest rates have fallen from their peaks in response to the RBI's signal; but given the state of economy they still remain high and are already under pressure due to massive government borrowings.

Monetary tightening at this juncture would have little impact on inflation, and can actually impair the ongoing economic recovery. The trade-off between growth and inflation will become more pronounced as we go ahead. However, it is important to establish that inflationary pressures are being driven by demand before reversing the easy monetary stance.

The nature of inflation, signals of credit expansion and demand pick-up should guide the monetary measures of the RBI. As of now, these signals point towards a neutral stance.

Inflation goes up to 0.83%

The wholesale price-based inflation for the **week ended September 19** went up sharply to 0.89% from 0.37% in the previous week on costlier food items. Inflation in food articles for the week under consideration was at an eleven-high of 16.32%, causing some concern in the government. But economists and agri-commodity analysts pointed out that the prices of food items should start moving down as the kharif produce (summer crops) comes to the market in coming weeks. The prices of food articles did not go up sharply in the last two severe droughts faced by the country, in 1987-88 and 2002-03. During these years, food price inflation was less than 3-4% and even overall consumer price inflation remained low, insulating the poor from the impact of drought.

Balancing stimulus against risks of inflation & threats to fiscal viability, a key short term challenge:

Speaking at the annual meeting of the World Bank and the International Monetary Fund in Istanbul, Finance Minister Pranab Mukherjee said that balancing the stimulus against the risks of inflation and threats to fiscal viability is a key short term challenge.

The possibility of inflation – now in the positive zone – strengthening further, could force the authorities to tighten interest rates. It might attract more foreign funds into the country seeking to take advantage of a tight interest rate regime compared to the rest of the world.

Mr Mukherjee said that continued stimulus to the economy is crucial for recovery as the global economic recovery appears to be unsteady and long-drawn. The effects of the crisis on the poor may continue for many years. The timing and sequencing of exit strategies assume importance. The medium-term goals are returning output to pre-crisis levels, recovering jobs, and to continue the fight against poverty.

Inflation down at 0.7% on cheaper food

Rise in annual inflation as measured by the Wholesale Price Index (WPI) for the **week ended September 26** was at 0.7%, marginally lower than previous week's level of 0.83% as the food items become cheaper.

Annual inflation for the food articles in the week was at 15.45%, a slower rise than the previous week's 16.3%. Various food items including vegetables and fruits became cheaper over the week. Agri-analysts attributed the fall in prices of vegetables to a strong revival in monsoon rains towards in month of July and September.

Inflation marginally up at 0.92%

The annual rate of inflation inched up to 0.92% for the **week ended October 3** from 0.70% in the week before, as the base effect, low inflation at the same time last year, negated the effect of decline in the WPI in the course of week under consideration. There was a general decline in prices in the course of week ended October 3 across the three major product categories, primary articles, manufactured products and fuel. However, economists are expecting prices of these items to gather further pace with the recovery in the economy gathering momentum.

The economists and agri-analysts pointed out that the easing of food price inflation is set to continue as the Kharif produce will be available in the markets in the coming weeks. The revival of monsoon from mid-August has improved the vegetable yields, causing their prices to drop nearly 14% on a week-on-week basis was also visible in fruits, cereals and pulses categories as well. The annual rate of inflation in the case of food articles had touched a high of 16.3% in mid-September. But, prospects of a bumper winter crop have tamed high inflationary expectations for food items.

Inflation rises above 1%, at 20-week high

The annual rate of inflation as measured by the wholesale price index (WPI), touched a 20-week high of **1.21% for the week ended October 10** after a marginal increase in the costs of food and manufactured items.

Inflation rises to 1.51%

Inflation based on wholesale data continued to climb up, hitting 1.51% for the **week ended October 17**. Food inflation for the week ended October 17 was at 12.85%. India's chief statistician Pranab Sen pointed out that since rural economy has got relatively delinked from agricultural income, farm failures don't have a heavy impact on the rural economy as it used to have earlier. Hence, even though the agriculture output is low the demand is still high.

Food items comprise the largest single expense in cost of living among the high-income group in urban areas. For every Rs 100 spent by an Indian per day, more than Rs 26 goes into the food basket, Rs 20 to pay for services including conveyance and telephone bills, Rs 10 for education, Rs 5 for clothing and Rs 7 on rent, according to the 63rd National Sample Survey (NSS). The survey conducted by National Sample Survey Organisation (NSSO) between July 2006 and June 2007, classified well-off urbanities having monthly per capita consumption expenditure (MPCE) of Rs 2,540 and more.

8.1 MISCELLANEOUS UPDATES

RIL offers 1 bonus share for every share owned

Reliance Industries' decision to issue bonus shares after a gap of twelve years indicates the management's confidence in the company's future prospects and its ability to service the enhanced capital. Reliance retail investors customarily seek bonus shares at almost every annual shareholders meet, but the management has been resisting the temptation, probably to avoid an equity overhang. The latest issue of bonus shares, which will double the outstanding shares to 328 crore, caught some investors by surprise. Reliance, listed in 1978, has so far issued bonus shares thrice in its history- the last one in 1997.

RIL, which has highest weightage of 12.8% in the benchmark Sensex, has underperformed the index this year as the fight of gas with RNRL raged with many claims and counter claims. While Sensex has risen 74% this year fuelled by global liquidity as the central banks printed money to get the world out of the worst recession since the 1930s, Reliance fell behind, by advancing only 70%, during the same period. Market analysts feel, "The present RIL stock has discounted the court tussle between the Ambani brothers; so the stock was underperforming in recent months".

Also, the bonus share issue is an attempt to erase a belief in investors' minds that the company's sale of treasury stock recently was an indication that the company thinks the stock price has peaked for the time being. RIL last month raised around Rs 3,188 crore rough sale of 1.50 crore equity shares of the company itself, which was held by its treasury department in Petroleum Trust the shares it got from the merger of the first Reliance Petroleum with itself.

Many brokers are advising their clients to cash in on big moves, if any, as stock is likely to perform in line with the market in the near term. The trend in RIL shares would also depend on the overall sentiment. Till some years ago, the trend in RIL shares would often set the tone for the rest of the market. But with India's stock market now more closely integrated with its global peers, that is no longer the case. But, for many of the old-timers in the market, the latest bonus issue is one more reason to stay invested in the stock. The bonus is good for retail investors. Investors should continue to hold the stock as bonus is an added attraction for medium and long-term investors.

Bonuses, however, in themselves do not guarantee that shareholder wealth would go up. The bonus of one share for every share held (one-for-one) and a Rs 13 per share dividend follow successful completion of two big projects: development of the KG basin gas assets and the refinery at Jamnagar. Dividends are certainly a straightforward reward to shareholders but bonus shares work in a more subtle way. Bonus issues are essentially cash-neutral transactions in which the accumulated general reserves are capitalised or converted into capital by issuing shares.

A company's reserves also belong to shareholders. Capitalisation of reserves merely gives that ownership a more tangible form by converting reserves into equity and issuing shares against that to shareholders. There is no immediate material change because of capitalisation of reserves, as both cash flow and the cost of capital, which determine shareholder returns, remain unchanged.

However, the bonus issue does send out a strong signal, particularly in the case of a company like RIL. The equity heavy balance sheet is desirable for a core sector company as it give comfort to the creditors. Meanwhile, the drop in share price following the issue of bonus shares would allow more investors to invest in the company. The wider ownership and large number of shares would increase liquidity or, put differently, reduce volatility. And in situations where a bonus issue is not a gimmick, this could fetch a liquidity premium for the shareholders. RIL shareholders certainly have a lot to look forward to.

8.2 INSURANCE SECTOR

Life insurers post 13% rise in first-income premium

The life insurance industry has registered a 13% rise in first-premium income during April-to-September 2009. First premium income of life insurance players for the period stood at Rs 39,046 crore against Rs 34,599 crore in the previous corresponding period. The industry sold 2 crore policies in the first half of the current fiscal against 1.8 crore in the previous corresponding period – a 7% rise.

Although, in terms of cumulative first premium income, the industry has registered growth, the private sector has been seeing a decline. However, LIC has been maintaining a positive growth. The private player, 21 in all, registered 14.67% fall in first premium income of Rs 13,232 crore during the first half of 2009-10 against Rs 15,508 crore in the previous corresponding period. Only, a handful of companies including Tata AIG, Sahara Life and IDBI Fortis managed to clock positive growth in first premium income during this period. In terms of number of policies sold, the private companies saw a 4% decline to 60.66 lakh in the same period, against 63.33 lakh in the previous corresponding period.

Life Insurance Corporation however, did well. It achieved a 35% growth in first premium income for the period under review at Rs 25,814 crore against 19,091 crore in the previous corresponding period. Interestingly, it regained about 10% of its market share during the period. The insurance behemoth now commands as much as 66% of the market while the private players have about 34%. On number of policies sold, an aggressive marketing policy saw LIC register a 13% rise in number of policies sold during the period April-September 2009 at 1.4 crore as against 1.24 crore in the previous period.

LIC set to launch new single premium plan ‘Jeevan Nischay’

Life Insurance Corporation of India is set to launch a new guaranteed single premium plan – Jeevan Nischay. The plan will be similar to last year’s Jeevan Aastha which rejuvenated the life insurance market when confidence on financial services was shaken following the global financial crisis.

There are several unique features in the plan which differentiates Jeevan Nischay from last year’s close-ended single premium plan. For starters the policy will be available only to existing policy holders of Life Insurance Corporation. The amount a person can invest will be linked to the extent of protection the individual already has purchased. For instance someone with a term insurance plan of Rs 10 lakh or with Rs 5 lakh policy with double compensation for accidental death can invest a maximum of Rs 1 lakh. This policy will also be available to only those who are not subject to any additional charges for ill health.

According to source, the main objective of the policy is to tap the maturity benefits offered under an older plan – Bima Gold which sold more than 1 crore policies when it was launched. Jeevan Aastha mobilised close to Rs 10,000 crore as it offered a safe haven of guaranteed returns amidst the turmoil in the market. The only difference is that while Jeevan Aastha was launched when interest rates were crashing, Nischay’s launch coincides with the RBI’s exit from the accommodative policy. Just as in the case of Jeevan Aastha, Jeevan Nischay is more like a single premium bond as the protection it offers is only rudimentary. The policy covers only the mandatory five times of the premium amount for the first year of insurance. For subsequent years, the sum insured will be equivalent to the premium paid.

The recent death of Norman Borlaug provides an opportune moment to reflect on basic values and on our economic system. Borlaug received the Nobel Peace Prize for his work in bringing about the "green revolution," which saved hundreds of millions from hunger and changed the global economic landscape.

Borlaug's death at 95 is a reminder of how skewed our system of values has become. When Borlaug received news of the award, at four in the morning, he was already toiling in the Mexican fields, in his never-ending quest to improve agricultural productivity. He did it not for some huge financial compensation, but out of conviction and a passion for his work.

What a contrast between Borlaug and the Wall Street financial wizards that brought the world to the brink of ruin. They argued that they had to be richly compensated in order to be motivated. Without any other compass, the incentive structures they adopted did motivate them – not to introduce new products to improve ordinary people' lives or to help them manage the risks they faced, but to put the global economy at risk by engaging in short-sighted and greedy behaviour. Their innovations focused on circumventing accounting and financial regulations designed to prevent the exploitation of the less informed.

Neoclassical economic theory that has dominated the west for a century holds that each individual's compensation reflects his marginal social contribution – what he adds to society. But Borlaug and our bankers refute that theory. If neoclassical theory were correct, Borlaug would have been among the wealthiest men, while our bankers would have been lining up at soup kitchens. However the neoclassical theory has survived as long as it has (as bad ideas often survive in economics remarkably well).

Nevertheless, the simplistic economics of the 18th and 19th centuries, when neoclassical theories arose, are wholly unsuited to 21st-century economics. In large corporations, it is often difficult to ascertain the contribution of any individual. Such corporations are rife with "agency" problems: while decision-makers (CEOs) are supposed to act on behalf of their shareholders, they have enormous discretion to advance their own interests – and they often do. Bank officers may have walked away with hundreds of millions of dollars, but everyone else in our society – shareholders, bondholders, taxpayers, homeowners, and workers – suffered. Their investors are too often pension funds, which also face an agency problem, because their executives make decisions on behalf of others. In such a world, private and social interests often diverge, as we have seen so dramatically in this crisis.

Does anyone really believe that America's bank officers suddenly became so much more productive, relative to everyone else in society, that they deserve the huge compensation increases they have received in recent years? Worse, in America stock options became a preferred form of compensation – often worth more than an executive's base pay. Stock options reward executives generously when shares rise because of a price bubble. Not surprisingly, stock options create strong incentives for short-sighted and excessively risky behaviour as well as for "creative accounting," which executives throughout the economy perfected with off-balance-sheet shenanigans. The skewed incentives distorted our economy and our society. We confused means with ends. Our bloated financial sector grew to the point that in the US it accounted for more than 40% of corporate profits.

But the worst effects were on our human capital, our most precious resource. Absurdly generous compensation in the financial sector induced some of our best minds to go into banking. Who knows how many Borlaugs there might have been among those enticed by riches of Wall Street and the City of London? If we lost even one, our world was made immeasurably poorer.

India's top B-schools are doing some soul searching after the world's colossal financial folly. They are asking some fundamental questions:

- Are a curriculum recast and tectonic shift in the science of management in order as a response to the worst crisis in recent times?
- Should students be taught differently now that it's all too well-known that greedy alumni from prestigious schools were as much responsible as any other factor in the collapse of firms like Lehman Brothers? Or should institutions effect changes just for the sake of it?

One of them found the answer in the apostle of peace. Sometime in June, many months into the global financial crisis and the trudge back to recovery, when Marx and Keynes returned to global economic discourse, their teachings dusted off the shelves, the Indian Institute of Management (IIM) chose to listen to the Dalai Lama. Inviting His Holiness was part of its many efforts to address a dilemma that B-schools across the world have been grappling with.

Corporate ethics has become a highly contentious issue for B-schools with many media reports laying the blame for the financial crisis squarely at the doors of business schools. We disagree with these media report, but in any case, managers need to have strong ethical convictions not to get swayed by greed.

Prof Radhakrishna Pillai of IIM Kozhikode said, "In economics, a problem of 'moral hazard' is said to exist when different actors have differential access to information, giving an opportunity to informed actors to act in ways that hurt uninformed actors, and in turn leading to a breakdown of potentially beneficial economic relationships. In the case of financial crisis, moral hazards occurred at different levels – between regulators and financial institutions as well as between financial institutions that originated mortgage-backed securities and institutions which bought them. After the crisis, the issues of corporate governance, right strategy, corporate value system, preparedness to adjust to macro environmental changes etc are reemphasised or understood better, he added.

However, despite some teaching against the backdrop of the meltdown, B-schools are loath of making drastic changes in the curriculum. Indeed, institutions are clearly demarcating a change in attitude from "Creating Hype" to "Working on Ground realities". A major change in the mindset is the growing realisation that the need of the hour is to have value-driven business model addressing the latent needs of consumers as well as the citizens.

Incidentally, this drift in moral values at IIMs comes after demands from students themselves. Students are not only conscious of the developments, but also cautious. They are asking professors to talk about real-life experiences and bring to light the developments in case studies. The Dalai Lama's visit ended in four-fold path: to learn from the modesty of an extraordinary monk like this; to learn from the manner in which Tibetans have preserved their culture despite all adversities; that the purpose of life is more important than the final outcome; and the only way to lead life is to be fully in line with one's inner self and to exercise compassion and non-violence.

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