Road Runner
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SAFE UPDATES – KEEP INFORMED

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Editorial preamble:

1.1 ROAD RUNNER

Commodity-Intensive, Hyper Growth Cannot Continue Forever

If something cannot go on forever, it will stop. Investors, for many months, have been wondering just how long the strong cyclical momentum in the global economy can continue in the face of all sorts of structural problems, ranging from excessive sovereign debt to China's overinvestment boom.

Well, the panic over the state of government finances in the euro zone and a premature outbreak of inflation in emerging markets has finally ended the *Great Reflation trade*. The focus is again turning to all the structural issues. The reflation regime that led to a synchronous surge in every asset class across the world starting early 2009 began to show the first signs of cracking late last year with the Chinese equity market losing steam. Chinese stocks over the past few years have behaved as the proverbial canary in the coal mine regarding the country's growth prospects and yet most analysts under-appreciate their signalling power.

The pretext of never-ending Chinese demand sustained the rally in commodity prices and other so-called China plays – from currencies of major commodity exporting nations to global industrial stocks – until March 2010. But the Chinese market had already started to drift lower several months ago in response to various policy-tightening measures aimed at controlling inflation and calming down rampant speculation in the property market where home prices have risen more than 30% nationwide over the past year.

The disconnect between Chinese equities and China plays was also apparent in the first half of 2008 when commodity prices carried on surging despite the slump in Chinese stocks. The global financial crisis later in that year abruptly closed the gap and, this time around, the sovereign debt troubles in southern Europe are bringing about a return to rationality. The probability that China plays are now well past their period of best relative performance is a reasonable one.

China's capital spending spree undoubtedly fuelled the commodity super-cycle and defined the investment performance of various asset classes over the past decade. And the China's economic size magnified the demand for commodities. No country in the history of economic development ran an investment-to-GDP ratio north of 40% for as long China did over the last 10 years. Its capital spending is now larger than that of US or Europe, and China accounts for 25-50 % of world demand for most industrial metals even though its share of the global economy is less than 10%.

This equation is way out of line and is set to correct in future. China's investment boom is indeed showing signs of finally slowing down. After all, the country cannot build roads, rail networks and airports at the frenetic pace of the past few years. Moreover, following the global recession in 2008, Chinese authorities injected a massive infrastructure-oriented stimulus that led to even greater excesses with availability of infrastructure in the country far above levels justified by its per-capita income.

Excess liquidity in the system is now finding its way into the property market, making the authorities wary of a property market bubble. With the more affluent population buying multiple homes amid a speculative frenzy that is, in turn, pushing prices sharply higher, the average Chinese home-buyer is becoming increasingly resentful, as affordability is a major issue. Policymakers in China are well aware of the systemic problems any housing boom-bust cycle can cause after having seen the movie play out in the developed world. To avoid the problem from getting out of control, they are likely to keep tightening the screws on the property market until prices start to cool.

The last time they engaged in such action was in early 2008; property transactions as well as prices fell sharply before the authorities took their foot off the brakes after the onset of the global recession. The risk this time is that even stronger tightening is required as speculators – emboldened following the short-lived tightening of 2008 – refuse to back off easily.

Just as the demand outlook for commodity prices is starting to deteriorate, the supply response is getting more aggressive. Besides, commodity producers are in the process of adding significant capacity with prices of most of their products trading well above the marginal cost of production – helped in no small measure by the large financial fund flows and the low cost of stockpiling. The potential problem is that once supply momentum builds, it is hard to reverse as the fixed costs for commodity production are high and the variable costs are low.

Supply and demand dynamics at the start of the last decade were very different. New investment was little as commodity prices had been in a secular decline for 20 years and, back then, hardly anyone anticipated the size of the investment demand emanating from China. The unexpectedly large rise in demand led to a disproportionate increase in commodity prices. Apart from the China demand factor, huge amounts of easy money have of late led to a paper demand for commodities, with exchange traded funds for various commodities attracting record capital inflows.

But, the mega trend of one decade rarely extends into the subsequent one. Nevertheless, the reflation trade has its limits: not all assets can continue to rise simultaneously without the prices of some undermining others. Beyond a certain threshold point, commodity prices not only boost headline inflation but also usually pass through to other items over time in developing economies.

Of course, the proximate cause for the near term weakness is the Greek debt crisis. However, the bigger issue for emerging markets is the cyclical momentum is beginning to roll over as central banks tighten policy due to inflationary pressures. It was only natural for some of the cyclical gloss to come off following the very powerful thrust of the past year. The problem has been further complicated with part of the liquidity pumped into the system to revive credit growth finding the wrong home, from commodity funds to the property market in places such as China.

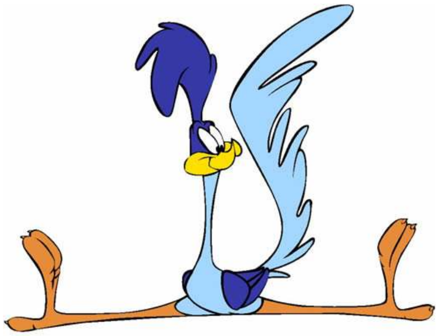
The debate now is whether China will have a hard or a soft landing. If China can slow its economy down to 7-8 % from the unwieldy double-digit pace it is currently running at by letting consumption growth continue at a robust pace while reducing investment spending, its soft landing will result in a structural decline in commodity prices and ease inflationary pressures in countries such as India. The Chinese market will also achieve a higher valuation if it moves to a more sustainable growth path after the usual initial hiccups related to a somewhat slower growth profile.

It's worth recalling that Japan's growth slowed from 8% in the 1970s to 5% in the 1980s, yet the stock market boomed. China's stock market will be the best leading barometer on how the economy is faring in its attempt to engineer a soft landing. The current message from the market is that slower Chinese growth will be more welcome than the pattern of strong growth driven by overinvestment that leads to higher inflation through commodity prices. The model of commodity-intensive, hyper growth cannot continue forever and if there is any merit in Stein's law, then it will stop.

Stein's law – If something cannot go on forever, it will stop.

1.2 STOCK MARKETS

Shape of the stock market recovery



It is not only global stock markets that have traced out a V shape in the 19 months since Lehman. Most world economies have experienced a business-led recovery with technology, infrastructure, materials and energy leading the way. Stocks today are cheapest since 1990 on a 'V-shaped profits boom' basis.

The script of the Greek tragedy and choreography of the Spanish dance are by now baked into the cake. Stock markets move on new news, not old news. You cannot get junkier than junk. What appears as a source of despair should be a cause for reassurance. Greece, as messed up as it is, can still borrow. Pessimists are forgetting that as recently as 20 years ago, responsible borrowers like Germany were paying as much to borrow money as shaky borrowers like Greece and Italy are paying today. Fear of a false factor is always bullish.

Events are making life easy for the Federal Reserve, which, in turn, makes life easier for everyone else. Recent Federal Open Market Committee (FOMC) statement did not signal a start to the process of lifting rates from their current 'exceptional' lows. Instead, it laid out a Goldilocks scenario, in which growth is not too hot, not too cold. Inflation is 'likely to be subdued for a time', while economic activity 'has continued to strengthen'. The Greek crisis has helped; by driving funds to the US and strengthening the dollar, it has helped damp inflationary pressure.

The reasons for strong undercurrents are many.

First, companies slashed their inventories post-Lehman as demand collapsed. However, a light pick up in demand was enough to lead to an inventory restocking boom.

Second was the impact of government stimulus spending.

Third, trade figures and capital expenditures have started to improve, suggesting that companies now have the confidence to plan for expansion as there is much ground to make up.

Fourth, the ISM supply managers' survey – where 50 marks the dividing line between expansion and recession – is now at 59.6, its highest reading since July 2004. Payrolls of US private sector, which started falling since Lehman went under, grew by 123,000 last month.

Fifth, the purchasing manager index, a widely-watched leading economic indicator for the US, is wildly expansive in emerging markets. EMs make up more of global GDP than the US does.

Sixth, in Europe which is lagging the rest of the world, business confidence data from the German IFO and ZEW surveys and Belgian confidence data point to a broader recovery.

Seventh, wage inflation has been relatively benign – in the US, we have seen the first decline in hourly wages in 20 years – offsetting soaring commodity prices.

INVESTORS will do best to recall that even a 'tortoise rally' eventually crosses the finish line. In the short term, the V will continue until all sceptics have given up. Only at that point the stock market will sketch out a W.

1st week of May 2010 – Sensex lost 790 points on Greece's debt crisis

Daily review	30/04/10	03/05/10	04/05/10	05/05/10	06/05/10	07/05/10
Sensex	17,558.71	(172.63)	(248.94)	(49.18)	(100.43)	(218.42)
Nifty	5,278.00	(55.25)	(74.25)	(23.60)	(34.05)	(72.80)

Weekly review	30/04/10	07/05/10	Points	%
Sensex	17,558.71	16,769.11	(789.60)	(4.50%)
Nifty	5,278.00	5,018.05	(259.95)	(4.93%)

2nd week of May 2010 – Sensex recovered 225 points

Daily review	07/05/10	10/05/10	11/05/10	12/05/10	13/05/10	14/05/10
Sensex	16,769.11	561.44	(189.02)	54.28	70.06	(271.27)
Nifty	5,018.05	175.55	(57.45)	20.50	22.25	(85.40)

Weekly review	07/05/10	14/05/10	Points	%
Sensex	16,769.11	16,994.60	225.49	1.35%
Nifty	5,018.05	5,093.50	75.45	1.50%

3rd week of May 2010 – Sensex lost 549 points on euro jitters

Daily review	14/05/10	17/05/10	18/05/10	19/05/10	20/05/10	21/05/10
Sensex	16,994.60	(159.04)	40.20	(467.27)	111.19	(74.07)
Nifty	5,093.50	(33.60)	6.30	(146.55)	27.95	(16.45)

Weekly review	14/05/10	21/05/10	Points	%
Sensex	16,994.60	16,445.61	(548.99)	(3.23%)
Nifty	5,093.50	4,931.15	(162.35)	(3.19%)

4th week of May 2010 – Sensex recovered 417

Daily review	21/05/10	24/05/10	25/05/10	26/05/10	27/05/10	28/05/10
Sensex	16,445.61	23.94	(447.07)	365.36	278.56	196.66
Nifty	4,931.15	12.80	(123.20)	110.65	85.70	63.45

Weekly review	21/05/10	28/05/10	Points	%
Sensex	16,445.61	16,863.06	417.45	2.54%
Nifty	4,931.15	5,066.55	135.40	2.75%

Stocks climb after big Wall Street gains:

World stock markets rose on after big gains on Wall Street as China's expression of confidence in Europe's ability to restore financial stability eased worries about the region's debt crisis. The show of faith in Europe let markets resume a rally that stalled following a report that China was considering cutting its exposure to European debt. The agency that manages China's $2.5 trillion in foreign reserves denied the report and said Europe would always be one of its major investment destinations.

Monthly Review

Month	December 2007	December 2008	December 2009	January 2010	February 2010	March 2010	April 2010	28-May-2010
Sensex	20,206.95	9,647.31	**17,464.81**	16,357.96	16,429.55	17,527.77	17,558.71	16,863.06
Points	Base	(10,559.64)	7,817.50	**(1,106.88)**	71.59	**1,098.22**	30.94	(695.65)
%	Base	(52.26%)	81.03%	(6.34%)	0.44%	6.69%	0.18%	(3.96%

Tough Road Ahead

THE latest decline in the Indian stock market coupled with the unravelling of the Greek sovereign debt crisis has raised the spectre of a double dip recession. And investors are running around for answers as only a few weeks ago Nifty looked poised for a fresh high. However, the optimism was affected by a poor show by the Euro zone and its contagious impact on global investors.

Foreign institutional investors (FIIs) have suddenly turned net sellers on Indian bourses while domestic mutual funds (MFs) continue to sit on the fence. Meanwhile, corporate earnings have been patchy so far with no certainty about the year ahead. Amid all this, investors would do well to make stock specific calls rather than taking a market view. But before you open up your wallet to make fresh purchases, let's pause and run a diagnostic check on the Indian equity market and the factors that drive it.

Twin Pillars: The stock prices are primarily driven by two factors – underlying earnings growth of companies and the liquidity flow or the amount of purchasing power of investors/traders. While the former acts a push factor, the latter pulls the market up as cash-rich investors' bid-up stock prices. So to get a handle on the current wobble on the Dalal Street, we need to get to the bottom of these two factors.

Let's handle the liquidity factor first. The two sources of liquidity (or funds) for Indian equities are – domestic and foreign. The key domestic sources are retail investors, mutual funds and insurance companies. Of these, MFs and insurers play the most important role given their size and influence on the market. Foreign money primarily comes from institutions investors (FIIs) and they now collectively account for nearly a quarter of the fund flow on the Indian bourses. On a cumulative basis, the FIIs inflows into India remain strong despite the recent wobble on the Street. In contrast, domestic MFs have been net sellers on the market since September last year. The corresponding data on insurance money is missing but, it is most likely to be positive or at worst stable since, insurance premiums are committed expenses and their flow doesn't change much in the short-term.

On the balance, however, more money has flowed into the market in the past 12 months compared with the cash that has gone out. This probably explains the continued positive bias on the Street despite the occasional bouts of sell-offs. The future course of the market will be greatly influenced by liquidity flow on the Street in the coming months.

Domestic Factors: Domestic liquidity is greatly influenced by the RBI's monetary policy. Right now, there is an uncertainty regarding monetary tightening. The central bank has not been very aggressive in addressing high inflation. It hiked the key interest rates and cash reserve requirement moderately, leaving the systemic liquidity almost unaffected. But, headline inflation is still hovering in the double-digit zone and there are no signs of easing up of inflationary pressures.

Despite new rabi crop arrivals, food prices continue to remain at higher levels. And now rising raw material costs have pushed up prices of manufactured products. RBI has clearly hinted in its latest policy document that aggressive measures could not be ruled out if inflationary pressures continue to be high. And if that were to happen, domestic liquidity could be sucked out, adversely affecting equity markets.

Global Liquidity: Lack of domestic liquidity could be compensated by higher inflows of FIIs money. This, in turn, depends on global liquidity position. Global liquidity is broadly defined as money supply (M2) growth in the G-4 countries – Japan, the euro zone, the UK and the US. The bail out packages given by these countries during the financial crisis resulted in a surplus liquidity globally, which has spilled over to emerging markets. These countries have not yet started withdrawing cheap and easy money from the system. As a result, foreign capital inflow continues in emerging economies. However, inflation is now rearing its head in most major economies and this may push their central banks to withdraw easy monetary policies soon. In that case, emerging markets, such as India, could see a reversal in capital flows, hurting the domestic equity market.

According to an IMF study, a 10% decline in global liquidity growth is associated with a 2% decrease in equity returns of the liquidity receiving economies, which are essentially emerging markets. The other global factor is the potential loss to the global banking system from any possible sovereign default in Europe. Most global banks and large asset managers, such as pension funds, have big exposure to the European sovereign and if they face a haircut in Europe, they will be forced to repair their balance sheet by selling in other markets. And even if the default is averted through timely intervention, the global investment climate has been vitiated and investors would be risk-averse in the near term.

Earnings Potential: Liquidity becomes a minor issue if an asset shows the potential for higher future earnings. This is especially true in case of equities as it not only provides capital appreciation to investors but also offers the possibility of earning recurring dividend income. So in the long-term, the equity prices should ideally track the growth in corporate earnings and other financial indicators.

Even after the recent correction, Nifty is trading ahead of the underlying fundamentals. This would not have been a major issue if India Inc's growth momentum had remained intact. Running Ahead of Fundamentals shows that there has been an absolute decline in Nifty's EPS, book value and dividend per share in recent months. And there are no immediate signs of a trend reversal either. So far, earning growth has been patchy and pockets of good growth such as shown by the auto sector have been undone by laggards like cement. And in many sectors, the growth has been aided by non-recurring factors such as low-base effect. The silver lining, however, is the fact that that Nifty EPS has been highest in over two years, implying that most companies have recouped the losses they suffered in the late '08 and early '09.

2.1 EMERGING MARKETS

How to deal with surging capital inflows?

A Problem is brewing across much of the emerging world. Many countries, large and small, are on the receiving end of a surge in capital inflows and global liquidity. These flows are broad-based, including bank lending, direct and portfolio investment, plus hot money that move in response to interest rates.

Most of the money flowing into these markets often ends up in equity or real estate, adding to inflationary pressures in both. Moreover, the hot money flows can persist till the incentive to speculate is eliminated. The longer it is before this is addressed, the bigger the problem will be. Just as excess liquidity contributed to problems in the western developed economies ahead of the financial crisis, excess liquidity has the potential to trigger a fresh financial crisis in the emerging markets (EMs).

There is a difference with the West, in that for many emerging economies, this problem is a consequence of success, reflecting optimism about growth prospects. Nonetheless it needs to be addressed with an appropriate and timely policy response. The exact policy may vary for each country.

The best response is greater currency flexibility and a move to *deepen and broaden capital markets*, although this will take time.

Thus there will be more immediate responses, including a further build-up of foreign currency reserves, tightening fiscal policy, macro-prudential measures to curb rising house prices, and even short-term capital controls may be needed in some countries if inflows persist.

All of this creates big policy dilemmas. The question is whether countries and policymakers will implement necessary corrective action?

The first way to deal with the surge in capital flows is through *currency flexibility*. However, allowing a currency to appreciate may be like waving a red rag to a bull: further speculative inflows may be attracted. A number of currencies have appreciated since the bottom of this crisis in March 2009. For instance, the South African rand is up 45%, the South Korean won 41%, Brazilian real 40%, Polish zloty 34% or the Indonesian rupiah 32%.

Some countries, keen to suppress appreciation, have intervened, *building up foreign currency reserves*. This is ominous, as it was one of many problems that fed the crisis.

In the decade following the 1997 economic crisis, Asian countries saw their holdings as a proportion of global reserves rise from one third to two-thirds. Such intervention was justified partly by the aim to remain competitive but was aimed at building safety nets in the event of another crisis. Over the last year, the rise in reserves has been sizeable and has been largely concentrated in Asia, with reserves rising 39% in Hong Kong, 32% in South Korea, 27% in Indonesia and 25% in China.

This has complications, boosting domestic monetary growth when their economies may not need it, adding to inflation worries. Heavy reserve increases can lead to sterilisation, as seen in China, with the need for increased issuance of bills and bonds to soak up the flows. Such sterilisation does not act as a deterrent to persistent capital inflows. Instead, it is a further cost to be borne.

Some of the countries on the receiving end of inward liquidity have current account surpluses, explained by high domestic savings. These countries should bear in mind one of the lessons of last May's Asian Development Bank meeting in Indonesia. Where, a number of features were identified as necessary for Asia: *social safety nets*, *help for small and medium-sized enterprises so that they can be the drivers of sizeable employment growth*, and *the need to deepen and broaden Asia's bond markets*. All these issues are commendable, but their implementation will take time.

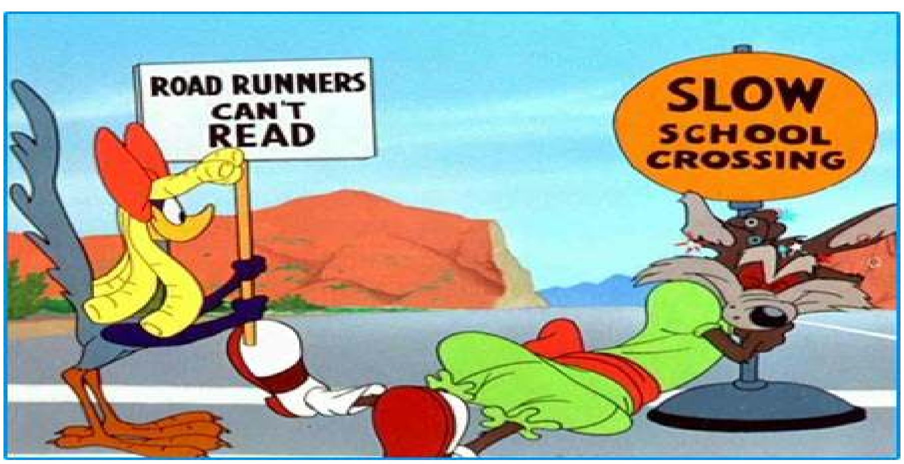
Many emerging economies should be *tightening monetary policy*. Normally, this would take the form of *higher interest rates.* The fear is that they would attract more hot money. Given this, tightening fiscal policy may be an option or the use of macro-prudential measures. These are aimed at curbing rising house and property prices, and may include limits on how much can be borrowed or lent.

The most controversial option can no longer be ruled out: *capital controls***.** These ideally should be implemented as a last recourse and only where such measures would be effective. Brazil's use of a tax on portfolio inflows into equities at the end of last year shows that controls are back on the policy agenda.

As the scale and speed of inflows has intensified, the question then is: in what circumstances are controls justified and in which situations are they likely to be effective? Moreover, even if they do work, exits from controls can be as difficult to manage as their imposition. There can also be contagion, with controls in one country having spill over effects on to others.

There are a series of controls that can be implemented: unremunerated reserve requirements, as implemented by Chile in 1991 or Thailand in 2006; time requirements stating the minimum time for which inflows must remain, as in Columbia, in 2007, or Malaysia, in 1997; limits on the size, as in Taiwan in 2009; a direct tax on financial transactions, as in Brazil in 2009; or regulation of trade between residents and non-residents, as we saw in the Asian crisis in Thailand and Malaysia. The reality is that controls may not always be the best option – they may be an effective stopgap. But imposing capital controls sends a signal that could deter future direct investment inflows as well as causing higher premiums to be paid in the future to compensate for the risk that such controls will reappear.

As capital and liquidity flows into emerging economies, the lesson is to set policy to suit domestic needs. This was a lesson of the Asian crisis itself. For some, capital controls may be effective, but, far better to go for greater currency flexibility and deeper and broader capital markets. These measures may not only help cushion or absorb the inflows but may also help to achieve a balanced global economy.



2.2 BIZ IN CONFLICT ZONE

India Inc wants to play safe

If there were no conflicts, there would have been enough money to buy a Mercedez Benz car for every family on earth. This is an off-the-cuff remark from the globally acclaimed security expert Rohan Gunaratna.

Conflicts, whether triggered by sovereign nations or by non-state actors like Al Qaeda, come with a big price tag, forcing many rich countries to set aside sizeable resources on prevention of such menaces than reacting to terror incidents. In India, a steep increase in the home ministry's budget is an indication that conflicts have a huge cost attached to them.

The last Union Budget made a provision of Rs 30,000 crore for the country's police force alone. Around Rs 1,975 crore of that was earmarked as assistance to states for modernisation of the force, due to growing incidences of Naxal or Maoists violence in natural resources rich areas of Bihar, Jharkhand, Orissa, Chhatisgarh and even West Bengal, where businessmen want to explore the available resources and set up factories. Then there are places such as Jammu & Kashmir. Nearly half a million troops are deployed to man the J&K border with Pakistan and to maintain internal peace. Some estimates suggest it costs the country in excess of Rs 20,000 crore a year. Huge money is also going into managing conflicts in the north-eastern states, where the issue is more ethnic in nature.

All this is a matter of consternation for India Inc too. In the recent past, Indonesia's Salim group put on the backburner a 10,000-acre special economic zone project in West Bengal's Nandigram after violent protests by Maoists-backed locals. South Korea's Posco is facing the heat in the Naxal-infested belt of neighbouring Orissa and in Chhattisgarh mining companies are having a torrid time. Oil cos and tea estates in the north-eastern states have historically been the target of insurgents and violent ethnic groups.

In fact, most conflict zones in the world are replete with natural resources – largely oil and gas – and hence are politically quite potent.

If Indian companies have to grow, they have to tap these resources, but they will also need to deal with these turbulent issues. It's a vicious circle. Industry has to reach out to these areas with development programmes. If you don't, people will remain poor and deprived; if you want to go there but aren't allowed, they will still remain deprived.

Industry body Ficci in a task force report on 'National Security & Terrorism' has warned that future attacks could take place in economic nerve centres. It recommended separate tailor-made plans be prepared for Delhi, Mumbai, Chennai, Kolkata, Bengaluru, Hyderabad, Jaipur and Ahmedabad, in addition to the national plan for strengthening counter-insurgency. Significantly, the report recommended a collaborative approach on a PPP-model that will extensively tap into private sector capabilities for managing risks. In fact, the private sector is now willing to engage not just in protecting vulnerable targets as pure short-term measures, but paying attention to investing in security strategies as a long-term goal.

Industrialisation is less an event and more a process of change. It is the advent of a new culture, structure of work and human relationship that is mandated by our need for growth and prosperity. When the old way is challenged there is bound to be resistance and conflict.

On the ground, however, the current doctrine of doing business by private companies in conflict areas is

being severely criticised by security experts. They complain that many big companies are throwing money in Naxal areas just to buy peace. Several police officials working in Naxal-hit states said that the Naxal war kitty has risen considerably because of liberal doling out of money by private sector companies which have business interests in those regions. In fact, these conflict groups want businesses to come into those regions. It keeps their tills ringing.

India Inc would like to strengthen its presence only in those areas which are likely to be free from persistent conflicts. But here comes the big question as who would be able to map correctly what lies ahead for India's conflict zones. Whereas Assam, which was one of the most peaceful states till 1970s became a hotbed of insurgency in the late 1980s and '90s, Punjab which saw turbulence in 1980s returned to normalcy in the 1990s. Even globally, today's pockets of peace could turn out to be tomorrow's disturbed zones and vice versa.

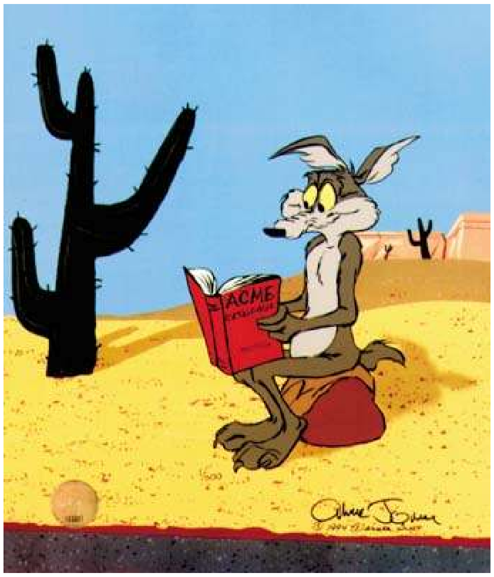
The corporate world which hesitated to invest in Sri Lanka till recently has changed their perception of investing in the island nation after the LTTE was wiped out after a fierce battle last year.

So, what's in store for India's conflict zones? Home minister P Chidambaram has said in a number of recent occasions that problems in the north-eastern states and Naxals are well within the control of the government, but the question remains how to contain them. The official line so far is that India has the capacity to replicate the Sri Lankan model for Maoist areas, but New Delhi is unlikely to resort to aerial attacks to eliminate the militants.

The threat posed by these conflict groups is likely to persist. They are resilient, and are likely to endure and grow beyond the current generation. Oil companies, especially, have always lived through conflicts and are finding innovative ways like blending CSR into business strategy among others to flourish in conflict zones. Bikash C Bora, former chairman and MD of ONGC says, "If however, one is risk-averse and decides to wait for fair weather, chances are that only the marginal assets with much higher premiums will be available on the table," "As in any change management process, three 'C's will help us manage conflicts that emerge from change: Communicate, Calibrate and Create. We have to be focused in our communication of the imperatives of industrialisation, like the demand for jobs," says Mr Mohanty of Posco. The idea should be to calibrate the process in accordance with feedback received and be unswerving in the commitment to create the change... "At the heart of our communication is that we will grow with the community. We will not let any individual fall by the wayside."

2.3 WARNING SIGNALS

'More Turmoil Ahead In Global Financial Markets'



Commodities guru Jim Rogers turns Oracle of Doom as he predicts more turmoil in global financial markets. In an exclusive interview, “He predicts currency crises and more national bankruptcies”.

The currency crisis has been going on for a while. It did not start this week. It started maybe with Iceland or many other countries that have been having problems. The currency crisis is going to get worse. Over the next year or two, we are going to see more, so prepare yourself.

Eventually the euro, unfortunately, is going to break up because it keeps weakening itself from within. If they would let Greece go bankrupt, for instance, it would strengthen the euro, it would strengthen the Eurozone because then people would know you have to maintain a sound economy. You have to maintain a sound currency and everybody would jump in and buy the euro. I would also buy more if that would be the case. Weakening from within and continuing to lend money and paper over problems is not a solution for a sound currency. I do own the euro, but I do not think this is the proper approach.

It is a known fact that global markets are really swayed by movements across the globe. Do you expect to see any cataclysmic events in 2010 or do you think it is going to be a largely benign kind of year?

I have no idea. There will be more currency crises, more currency turmoil over the next year or two or three. We have huge imbalances. All the credit to nations in the world and all the debt – you know who the debtors are and where they are. Those imbalances have not been sorted out yet. Throughout history, most imbalances like this have been sorted out in the currency markets and so we have more problems coming. You may well see some more countries going bankrupt in this period of time.

What are you shorting?

I am shorting a stock market index in the US, I am shorting an emerging market index and I am shorting one of the large western international financial institutions. It is an emerging market index; it is not a specific country. It is an index of many emerging markets and that is mainly because the emerging markets have grown the most during the past few months of this big recovery. So that is where some of the excesses are developing.

Are you bearish on all Asian equity markets or are there any pockets of value that you like?

I am not buying any stock markets anywhere in the world. I have not bought any stock markets for the past 18 months. I have been playing the world economy through the commodity markets for those 18 months and the currency markets. And as I said, now I am starting to sell short but I have nothing to do with any Asian market. I have not bought any market anywhere because I have been leery of this big rally in the stock market. It has been caused by a lot of money being pumped into the world economy.

We are also seeing the impact of the crisis on most commodity markets. Do you think that this is just temporary?

Yes, gold is making all-time highs in some currencies. So some currencies are doing well. But if the world economy gets better, then obviously commodities are going to do better because the world will use more and there are shortages developing. But let's assume the worst. Let's assume world economies do not get better, then I would rather be in commodities in most things because governments are going to print even more money, and whenever you have printed money throughout history, it has led to higher prices for real goods whether it is silver or natural gas. So, I would rather own commodities than most things in the world in the next two or three years.

Do you think another financial crisis is going to be upon us when investors are just going to get scared about banks?

I do not see a bubble in finance like we had two or three years ago. I only see two bubbles in the world, one is the Chinese urban to real estate and the other is the United States' government bond market.

What do you think will happen to emerging markets over the next six months?

Well, I am not quite sure that you would see emerging markets slowing down if Europe did. If Europe and America slow down, that will affect markets everywhere. Europe and America, for instance, are over 10 times as big as the Chinese market. People talk about China, people talk about India, but these are very small markets or economies compared to the major economies in the West and in Japan, so if the West slows down, of course, it is going to affect everybody.

I do not see the emerging markets slowing down and the West reviving because the West is so very big and it needs most emerging markets. Most emerging markets are commodity-based economies and if the world economy does well, the commodities are going to do okay, so I do not see the emerging markets slowing down if the West continues to revive. I started selling short in emerging market index but that's just because the emerging markets were the ones which went up the most in the past few months.

3.1 MUTUAL FUND

Banks moving aggressively into MF space

When it comes to relying someone with one's hard-earned money, banks are the most entrusted of all institutions, especially in India. So much so, that even today, despite there being plenty of other investment avenues, an average Indian investor continues to trust banks with their savings. So, despite various challenges that the MF industry is currently facing, many new players, especially banks, have shown a great deal of interest in launching their own AMCs.

After the launch of Axis AMC last year, IDBI and Union Bank of India (UBI) are the latest banks to join the MF bandwagon. With this, the total number of banks that are actively involved in the MF business stands at 10. And if Indian banks are yearning to be an active participant of the MF industry, it is not without reason. For, in the light of the current circumstances, banks are indeed better placed to run MF business in India than other institutions.

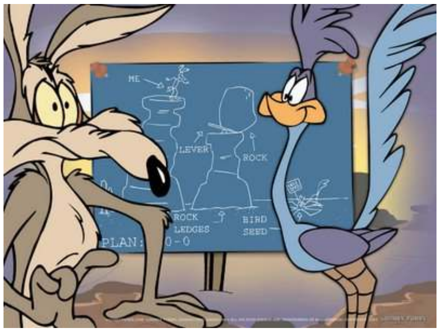
Strong Distribution Network: Facilitated by a large distribution network through their extensive and continuously increasing branch network, banks are indeed better positioned to tackle the main issue of distribution than independent asset management companies that are required to set up distribution networks right from scratch before starting their businesses. Moreover, given their large customer base, it makes a tad easier for them to cross MF products to their existing customers. The existence of a strong distribution network has in fact come to command a far greater importance following the Sebi diktat of introducing no-load regime for equity MFs last year.

No-Load Regime: Under the no-load regime, MF houses have been debarred from charging any commission or entry load from investors at the time of investment. This, in turn, has greatly impacted sales of the equity MF products. Despite the markets making a dramatic recovery in 2009-10, the MF industry could add just about Rs 2,000 crore to its equity assets last year which is far lower than the equity inflows of about Rs 47,000 crore in 2007-08 or Rs 28,000 crore in 2006-07. Even the meltdown year of 2008-09 had witnessed equity inflows of more than Rs 4,000 crore.

Bank Or No-Bank – What It Means For Investor: While bank-based fund houses are definitely at an advantage today in terms of reaching out to the investors, it will, however, be foolish for investors to get prejudiced for any fund house simply because it is backed by a strong bank. For when it comes to investing, performance is the key criteria to be looked out for, followed by the financial strength and soundness of the organisation.

3.2 FUND JUGGLERS

Do you need someone else to manage your wealth?



From the time of the Romans, wealth is something that had to be managed. The wealthiest people in that civilisation were senators, and most of them were generals who were out fighting some of the longest and bitterest battles known in history. They had no time to manage wealth, and so they also had managers who did it for them. Times have moved on since those ancient days of Roman glory, but one thing has remained unchanged – that wealth needs to be managed. The system has become far more complex over the ages. It is much more sophisticated than investing in just land or gold.

Realise why you want to manage your wealth: The first and main decision is to realise why you want to manage your wealth in the first place. Much of making the most of wealth management is about you clearly articulating your needs – are you looking for expertise to plan your retirement and major expenditure, are you looking for new and unique products that you cannot access yourself? If you know what you need, chances are you can get it.

Wealth management important for retirement: In India however, wealth management is crucial because there is no other social security – you may be earning quite a lot right now, but if you keep spending at the same rate, you suddenly stare at difficult times during retirement, after living a life of luxury. In fact, retirement solutions are the main growth driver for the industry in India. But that is not the only a reason.

Even the smarter ones need wealth management: Eight years ago, a call from a bank changed Ragendra's life as it was at that point. A director at a software firm, he was facing financial ruin at 40. After more than 20 years of hard work, he had gambled away his money in the stock market. All he was left with was his house and Rs 9,000. His wife and child had no idea that he was broke. He wasn't even sure they would be able to pay bills for half the month. A financial planner helped him recharge his situation. He told him that he had to change my spending and investment habits. The planner also laid out an array of choices that helped him recover his lost money. Ragendra later became director of multinational company in California. This was just one example to show that even the smarter ones among us need wealth management.

Wealth management help more accessible now: A good reason to go for it is also because it is more accessible now. Deep-rooted cultural moorings, such as keeping money matters strictly private, are also giving way to a realisation that such privacy is not a wise option when the wealth can be grown manifold.

Decision to have your wealth managed requires trust and faith: So now for the golden question – who is the best for you? If you go with a top firm, you get more exposure and solid advisers but they have many clients, that you will be one among many. On the other hand, if you go to a boutique firm, you can get more personalised service but less exposure than what the bigger firm can provide. In the final analysis, the decision to work with a financial planner or wealth manager requires a lot of personal trust and faith. You are not only entrusting someone with managing your money, but also sharing your most important needs and responsibilities. So find someone you trust – whether it is boutique or branded is secondary.

Choose carefully.

3.3 COMMODITIES

Commodity companies are born survivors

While debris from the derivatives debacle and shrinking economies are driving the world crazy, our commodity companies are relaxed, enjoying the equivalent of a beach holiday as they watch the stormy seas from a safe distance. So what makes their business immune to the downturn?

The biggest advantage commodity companies have is their *low expectations*. Commodity companies are happy with a net 2% margin.

Take Rs 11,000-crore Ruchi Soya, the country's largest vegetable oil company. For the last six years, its net profit margin has hovered at around 1%. Its operating margin has varied between 2% and 4% from 2003 onwards. When margins are so tight, costs are already pared to the bone. No commodity company can afford to be wasteful. Even the multinationals watch the pennies fairly closely. Their edge lies in trading giant volumes, not in significantly higher margins.

Commodity companies were never extravagant borrowers even in good times. Indian traders doing mostly cash transactions especially are reluctant to open their books before banks. The processors and manufacturers may have impressive working capital lines but usually operate on the principle of "I just need enough to tide me over until I need more".

Lenders themselves are equally cautious due to the fluctuating value of pledged stocks. So, when bank credit dried up, commodity players were hobbled but not paralysed. Risk from shifting government policy under political pressure is another perpetual risk.

Globally, commodity companies are still mostly family-owned and managed businesses. In India, it is virtually the norm. That automatically means few rock star-like expat CEOs with eight-figure salaries; neat but zero-frill offices; and no fancy travel allowances.

Wage bill is rarely a concern. Bonuses may be large, but they are based on delivered profits and necessary to keep traders interested. Family-run commodity companies may be paternalistic, emotional and wooly-headed in many ways. But in business, they are Hun-like lean, mean and hungry fighting machines, ready to take on the Marines-style MNCs. This takeno-prisoner attitude means that family-owned commodity companies are survivors. It takes more than a slowdown to rattle them.

More importantly, commodity companies sell the very building blocks of modern life. They cater to the fundamental human appetite for food, energy and metals. These appetites can never be satiated in the way demand for mobiles or electronic goods can be. That is why commodity chieftains are obsessed with supply rather than demand. Commodity players can afford to take consumer demand for granted in a way companies selling value-added goods and services companies can't.

4.0 FINANCIAL SECTOR: TRANSFORMING TOMORROW

Road Runner

The Institute for New Economic Thinking's (INET) inaugural Conference at King's College concluded last month, and was a great success. Two hundred of the world's distinguished economists, academics and thought leaders congregated at King's College, Cambridge to discuss the future of the economic profession at the same location where Keynes pondered and debated economic theory over 70 years ago.

4.1 FINANCIAL ADVISORS:

Weigh impact on investors: Joseph E Stiglitz

Anatomy of Crisis

The theory of rational expectations

Economic theory has modelled itself on theoretical physics. It has sought to establish timelessly valid laws that govern economic behaviour and can be used reversibly both to explain and to predict events. But, economics has increasingly turned itself into an axiomatic discipline consisting of assumptions and mathematical deductions – similar to Euclidean geometry. *Rational expectations theory* and *the efficient market hypothesis* are products of this approach. Unfortunately they proved to be unsound.

To be useful, the axioms must resemble reality. *The Rational expectations theory* does not meet that condition. *It postulates that there is a correct view of the future to which the views of all the participants tend to converge.* But the correct view is correct only if it is universally adopted by all the participants – an unlikely prospect. Indeed, if it is unrealistic to expect all participants to subscribe to the theory of rational expectations, it is irrational for any participant to adopt it. Anyhow, rational expectations theory was pretty conclusively falsified by the crash of 2008.

The crash of 2008 also falsified *the Efficient Market Hypothesis* because it was generated by internal developments within the financial markets, not by external shocks, as the hypothesis postulates.

The failure of financial economics brings the entire edifice of economic theory into question - Can economic phenomena be predicted by universally valid laws?

I contend that they cannot be, because the phenomena studied by economics have a fundamentally different structure from natural phenomena. The difference lies in the role of thinking. Economic phenomena have thinking participants, natural phenomena do not. The thinking of the participants introduces an element of uncertainty into the course of events that is absent in natural phenomena.

The uncertainty arises because the participants' thinking does not accurately represent reality. In human affairs thinking serves two functions: a cognitive one and a causal one. The two functions interfere with each other: the independent variable of one function is the dependent variable of the other. When the two functions operate simultaneously, neither function has a truly independent variable. I call this interference reflexivity. Reflexivity introduces an element of uncertainty both into the participants' understanding and into the situation in which they participate. It renders the situation unpredictable by timelessly valid laws. Such laws exist, of course, but they do not determine the course of events.

Economic theory jumped through many hoops trying to eliminate this element of uncertainty. It started out with *the assumption of perfect knowledge*. But as Frank Knight showed in his seminal book, "Risk, Uncertainty, and Profit" published in 1921, in conditions of perfect knowledge there would be no room for profits. The assumption of perfect knowledge was replaced by *the assumption of perfect information*. When that proved insufficient to explain how financial markets anticipate the future, economists developed *the theory of rational expectations*.

That is when economic theory parted company with reality. Some great thinkers, including Friedrich Hayek in his Nobel Prize speech, kept reminding economists of the importance of uncertainty but advances in quantitative modelling led to the neglect of this so-called Knightian uncertainty. That is because quantitative methods cannot take into account any uncertainties that cannot be quantified. Collateralised Debt Obligations and Credit Default Swaps and risk management models produced by these quantitative methods played a nefarious role in the crash of 2008.

4.2 FINANCIAL PLANNERS

Value unlocking for all stakeholders: Joseph E Stiglitz

Anatomy of Crisis

The concept of reflexivity

The meltdown of the financial system in 2008 forces us to go back to the drawing board and look for a more realistic approach. I believe that we have to start with recognising a fundamental difference between human and natural phenomena. This means that financial markets should not be treated as a physics laboratory *but as a form of history*.

The course of events is time-bound and one-directional. Predictions and explanations are not reversible. Some timelessly valid generalisations can serve to explain events but not to predict them. I have started to develop a set of generalisations along these lines by introducing the concept of reflexivity. Reflexivity can be interpreted as a two-way feedback mechanism between the participants' expectations and the actual course of events. The feedback may be positive or negative.

Negative feedback serves to correct the participants' misjudgements and misconceptions and brings their views closer to the actual state of affairs until, in an extreme case, they actually correspond to each other. In a positive feedback loop a distortion in the participants' view causes mispricing in financial markets, which in turn affects the so-called fundamentals in a self-reinforcing fashion, driving the participants' views and the actual state of affairs ever further apart.

What renders the outcome uncertain is that a positive feedback cannot go on forever, yet the exact point at which it turns negative is inherently unpredictable. Such initially self reinforcing but eventually self-defeating, boom-bust processes are just as characteristic of financial markets as the tendency towards equilibrium. Instead of a universal and timeless tendency towards equilibrium, equilibrium turns out to be an extreme case of negative feedback.

At the other extreme, positive feedback produces bubbles. Bubbles have two components: a trend that prevails in reality and a misconception relating to that trend. The trend that most commonly causes a bubble is the easy availability of credit and the most common misconception is that the availability of credit does not affect the value of the collateral. Of course it does, as we have seen in the recent housing bubble. But that is not sufficient to fully explain the course of events.

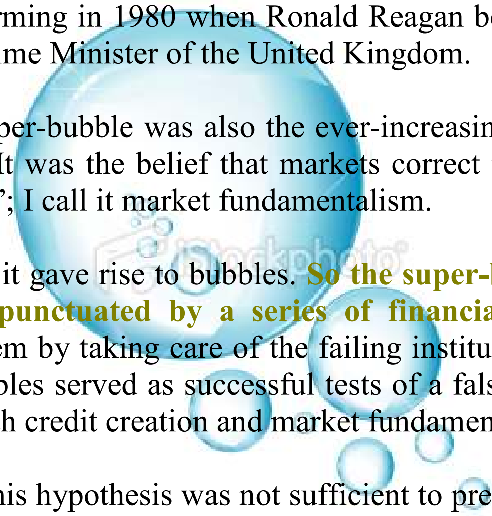
4.3 CREDIT COUNSELORS

Resolve convertibility and recompensation issue: Joseph E Stiglitz

Anatomy of Crisis

The theory of super-bubble

I have formulated a specific hypothesis for the crash of 2008 which holds that it was the result of a “super-bubble” that started forming in 1980 when Ronald Reagan became President of the United States and Margaret Thatcher was Prime Minister of the United Kingdom.



The prevailing trend in the super-bubble was also the ever-increasing use of credit and leverage; but the misconception was different. It was the belief that markets correct their own excesses. Reagan called it the “magic of the marketplace”; I call it market fundamentalism.

Since it was a misconception, it gave rise to bubbles. **So the super-bubble was composed of a number of smaller bubbles -- and punctuated by a series of financial crises.** Each time the authorities intervened and saved the system by taking care of the failing institutions and injecting more credit when necessary. So the smaller bubbles served as successful tests of a false belief, helping the super-bubble to grow bigger by reinforcing both credit creation and market fundamentalism.

It should be emphasised that this hypothesis was not sufficient to predict the outcome of individual crises. For instance, I predicted that the emerging market crisis of 1997/98 would lead to a collapse of global capitalism and I was wrong. Nor is it sufficient to fully explain actual outcomes. For that, one needs to take into account the specific historical circumstances. .

Let me illustrate this by examining the origins of the super-bubble. For this, I need to go back beyond 1980 at least to the early 1970s.

4.4 RISK MANAGEMENT CONSULTANTS

Educate – Engineer and Enforce: Joseph E Stiglitz

Anatomy of Crisis

The Living History of the Last 30 years

At the end of World War II when I entered the financial markets, banks and financial markets were strictly regulated and international movements of financial capital were practically at a standstill. The restrictions were relaxed gradually, but at a glacial pace.

As late as the beginning of the 1970s, the American banking system was still frozen into immobility. The industry was highly fragmented and regimented. A dull business attracted dull people who were more concerned with job security than with profits. Bank shares were traded by appointment.

But I detected some signs of life. Walter Wriston at Citibank trained a new breed of profit oriented bankers who fanned out from Citibank to other banks. Then in 1972, Citibank held a dinner meeting for security analysts – an unheard of event. I was not invited but it prompted me to publish a report entitled “The Case for Growth Banks” in which I argued that some banks were poised to embark on balanced growth by equity leveraging, i.e.: selling shares at a premium. The bouquet of bank shares I recommended did, in fact, rise by some 50% within a year.

Then came the first oil shock in 1973. The stock market tanked, ruling out equity leveraging. But, at the same time the recycling of petrodollars was left to the money centre banks.

They formed holding companies and established subsidiaries in London to escape the restrictions of the Glass-Steagall Act. That was the beginning of the *eurodollar markets* and of large-scale lending to emerging economies. It soon turned into a boom. Countries like Brazil experienced rapid growth, fuelled by foreign credit. The misconception in the lending boom was that the debt ratios which measured the credit worthiness of the borrowing countries were independent of the flow of credit.

Then came the second oil shock in 1979 and the determined effort of the Federal Reserve under Paul Volcker to bring inflation under control. The Fed fund rate shot up into the high teens and the boom turned into a bust. In 1982

Mexico threatened to default. This was the onset of the first major financial crisis the response to which fuelled the growth of a super-bubble. The international banking system would have collapsed if the authorities had not banded together to save it. They established what I called the "*collective system of lending*". The central banks ordered the banks under their control to roll over their loans and the international financial authorities extended enough additional credit to the heavily indebted countries to enable them to remain current on interest payments and redemptions.

The IMF imposed harsh conditions on the debtor countries while the regulatory restrictions on the banks were actually relaxed in order to allow them to earn their way out of a hole. After several years, when the banks built up sufficient reserves, the debtor countries were encouraged to reorganise their debts by issuing so called Brady bonds and the banks had to take some losses.

The net result was a lost decade for Latin America but a big boost to the international banking system. Financial markets were deregulated and globalised. This stood in stark contrast with earlier financial crises of the nineteenth and twentieth centuries when each time a crisis occurred, regulations were tightened in order to prevent a recurrence. That is how central banking and market regulations had developed and became an integral part of the financial system.

What set this occasion apart from previous ones? Undoubtedly it was the market fundamentalist belief that markets are self-correcting, and best left to their own devices. But the need of the banks to earn their way out of a hole also played a part. This was the specific historical context in which the super-bubble developed. The system that emerged was called the Washington Consensus.

It was characterised by what was called "moral hazard," but was really an asymmetry between center and periphery. Countries at the periphery of the financial system were subject to harsh market discipline; but when the system itself was endangered, all bets were off. This gave the banks at the center a competitive advantage and they gradually came to dominate the global financial system.

The globalisation of financial markets spread like a virus. Since financial capital is an essential ingredient of production, once the U.S and the U.K. embraced market fundamentalist principles, other countries could resist them only at their peril. The financial sector of the U.S. and U.K. grew like Topsy, accounting for more than a third of corporate profits towards the end of the super-bubble in 2006.

In the absence of systemic reforms, the international banking crisis of 1982 repeated itself fifteen years later with only minor variations. The banks had learned a lesson from 1982. The collective system of lending taught them that it is better to securitise loans and sell them to others than to keep them on their books because that way the central bank could not compel them to roll over loans that have gone sour.

By the time the next emerging markets crisis struck in 1997, most of the loans had been securitised, greatly complicating the task of the international authorities. As a result, there was no collective system of lending except in South Korea and there were no Brady bonds. The periphery countries had to bear an even larger share of the losses than in 1982.

Deregulation allowed financial innovators to introduce new forms of synthetic securities at will. Securitisation was further encouraged by the misguided rule in the Basel II accord which allowed banks to hold securities on their balance sheets without any reserve requirements because the securities were readily saleable. This may be true for individual banks but not for the banking system as a whole, as the LTCM crisis in 1998 demonstrated. Since the synthetic securities were designed on the basis of false principles, they played a major role in the crash of 2008.

The point I am trying to make is that developments in the financial markets cannot be understood without considering them in a historical context.

Financial markets have changed out of all recognition during my lifetime. Things that would have been inconceivable 50 years ago have become commonplace. Conversely, it seems inconceivable today that the economy could function without derivatives and other complicated instruments.

What will happen now will also be greatly influenced by the historical circumstances.

The banks once again have been allowed to earn their way out of a hole and they are now lobbying to be allowed to carry on as before. Yet the danger of moral hazard is greater than ever before: all systemically important institutions have been effectively guaranteed against failure. We ought to impose strict regulations to ensure that the guarantee will never be invoked but that will be much more difficult to achieve than deregulation.

Globalization dos not work in reverse. Regulation is still in the hands of national authorities and it will be difficult to get them to put the common interest ahead of their national interests.

I should like to emphasise, however, that it is not enough to study history; we must also learn some lessons from it. We need to abandon rational expectations and the Efficient Market Hypothesis and build our theory of financial markets on the recognition that imperfect understanding – I call it fallibility -- is the human condition. But what is imperfect can be improved, and right now there is plenty of room for improvement – both in rethinking economics and rethinking regulations. I am afraid the current discussions miss the main point: namely that the recent financial crisis was not only a market failure but also a regulatory failure. And what matters now is not so much who regulates, but how. Regulators ought to undertake a course of critical self-examination – Chinese style. .

Is Greece The Next Lehman?

Is Greece the next Lehman? No. It isn't either big enough or interconnected enough to cause global financial markets to freeze up the way they did in 2008. Nor should you take seriously analysts claiming that we're seeing the start of a run on all government debt. That's the good news. The bad news is that Greece's problems are deeper than Europe's leaders are willing to acknowledge, even now – and they're shared, to a lesser degree, by other European countries.

Many observers now expect the Greek tragedy to end in default; I'm increasingly convinced that they're too optimistic, that default will be accompanied or followed by departure from the euro.

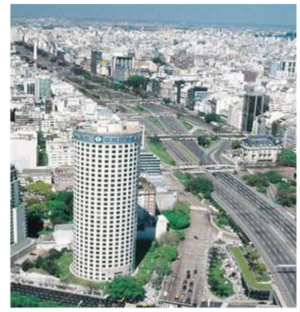
In some ways, this is a chronicle of a crisis foretold. I remember quipping, back when the Maastricht Treaty setting Europe on the path to the euro was signed, that they chose the wrong Dutch city for the ceremony. It should have taken place in Arnhem, the site of World War II's infamous "bridge too far," where an overly ambitious Allied battle plan ended in disaster.

The problem, as obvious in prospect as it is now, is that Europe lacks some of the key attributes of a successful currency area. Above all, it lacks a central government.

Consider the often-made comparison between Greece and the state of California. Both are in deep fiscal trouble, both have a history of fiscal irresponsibility. Greece's Parliament has, in fact, approved harsh austerity measures. But California's fiscal woes just don't matter as much, even to its own residents, as those of Greece. Why? Because much of the money spent in California comes from Washington, not Sacramento. State funding may be slashed, but Medicare reimbursements, Social Security checks, and payments to defence contractors will keep on coming. What this means, among other things, is that California's budget woes won't keep the state from sharing in a broader US economic recovery. Greece's budget cuts, on the other hand, will have a strong depressing effect on an already depressed economy.

So is a debt restructuring – a polite term for partial default – the answer? It wouldn't help nearly as much as many people imagine, because interest payments only account for part of Greece's budget deficit. Even if it completely stopped servicing its debt, the Greek government wouldn't free up enough money to avoid savage budget cuts. The only thing that could seriously reduce Greek pain would be an economic recovery, which would both generate higher revenues, reducing the need for spending cuts, and create jobs. If Greece had its own currency, it could try to engineer such a recovery by devaluing that currency, increasing its export competitiveness. But Greece is on the euro.

So how does this end? Logically, I see three ways Greece could stay on the euro. First, Greek workers could redeem themselves through suffering, accepting large wage cuts that make Greece competitive enough to add jobs again. Second, the European Central Bank could engage in much more expansionary policy, among other things buying lots of government debt, and accepting – indeed welcoming – the resulting inflation; this would make adjustment in Greece and other troubled euro-zone nations much easier. Or third, Berlin could become to Athens what Washington is to Sacramento – that is, fiscally stronger European governments could offer their weaker neighbours enough aid to make the crisis bearable. The trouble, of course, is that none of these alternatives seem politically plausible.



What remains seems unthinkable: Greece leaving the euro. But when you've ruled out everything else, that's what's left. If it happens, it will play something like Argentina in 2001, which had a supposedly permanent, unbreakable peg to the dollar. Ending that peg was considered unthinkable for the same reasons leaving the euro seems impossible: even suggesting the possibility would risk crippling bank runs. But the bank runs happened anyway, and the Argentine government imposed emergency restrictions on withdrawals. This left the door open for devaluation, and Argentina eventually walked through that door. If something like that happens in Greece, it will send shock waves through Europe, possibly triggering crises in other countries. But unless European leaders are able and willing to act far more boldly than anything we've seen so far, that's where this is heading.

4.6 INCLUSIVE CEOs

Innovative responses to problems: Joseph E Stiglitz

Can euro be saved?

The Greek financial crisis has put the very survival of the euro at stake. At the euro's creation, many worried about its long-run viability. When everything went well, these worries were forgotten. But the question of how adjustments would be made if part of the eurozone were hit by a strong adverse shock lingered. Fixing the exchange rate and delegating monetary policy to the European Central Bank eliminated two primary means by which national governments stimulate their economies to avoid recession. What could replace them?

The Nobel laureate Robert Mundell laid out the conditions under which a single currency could work. Europe didn't meet those conditions at the time; it still doesn't. The removal of legal barriers to the movement of workers created a single labour market, but linguistic and cultural differences make American-style labour mobility unachievable.

Moreover, Europe has no way of helping those countries facing severe problems. Consider Spain, which has an unemployment rate of 20% - and more than 40% among young people. It had a fiscal surplus before the crisis; after the crisis, its deficit increased to more than 11% of GDP. But, under European Union rules, Spain must now cut its spending, which will likely exacerbate unemployment. As its economy slows, the improvement in its fiscal position may be minimal.

Some hoped that the Greek tragedy would convince policymakers that the euro cannot succeed without greater cooperation (including fiscal assistance). But Germany has opposed giving Greece the help that it needs. To many, both in and outside of Greece, this stance was peculiar: billions had been spent saving big banks, but evidently saving a country of 11 million people was taboo!

A series of half-offers and vague promises, intended to calm the market, failed. Just as the United States had cobbled together assistance for Mexico 15 years ago by combining help from the International Monetary Fund and the G-7, so, too, the EU put together an assistance programme with the IMF. The question was, what conditions would be imposed on Greece? How big would be the adverse impact?

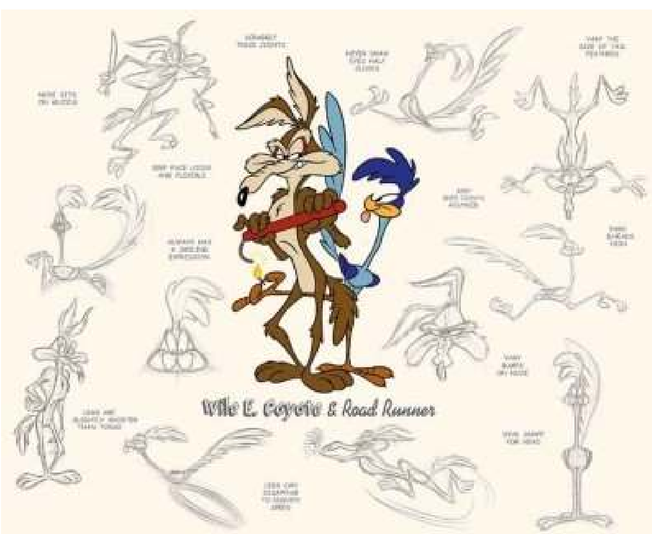
For the EU's smaller countries, the lesson is clear: if they do not reduce their budget deficits, there is a high risk of a speculative attack, with little hope for adequate assistance from their neighbours, at least not without painful and counterproductive pro-cyclical budgetary restraints. As European countries take these measures, their economies are likely to weaken – with unhappy consequences for the global recovery.

It may be useful to see the euro's problems from a global perspective. The US has complained about China's current-account (trade) surpluses; but, as a percentage of GDP, Germany's surplus is even greater. Assume that the euro was set so that trade in the eurozone as a whole was roughly in balance. In that case, Germany's surplus means that the rest of Europe is in deficit. And the fact that these countries are importing more than they are exporting contributes to their weak economies.

THE US has been complaining about China's refusal to allow its exchange rate to appreciate relative to the dollar. But the euro system means that Germany's exchange rate cannot increase relative to other eurozone members. If the exchange rate did increase, Germany would find it more difficult to export, and its economic model, based on strong exports, would face a challenge. At the same time, the rest of Europe would export more, GDP would increase, and unemployment would decrease.

Germany (like China) views its high savings and export prowess as virtues, not vices. But John Maynard Keynes pointed out that surpluses lead to weak global aggregate demand – countries running surpluses exert a "negative externality" on their trading partners. Indeed, Keynes believed that it was surplus countries, far more than deficit countries that posed a threat to global prosperity; he went so far as to recommend a tax on surplus countries.

The social and economic consequences of the current arrangements should be unacceptable. Those countries whose deficits have soared as a result of the global recession should not be forced into a death spiral - as Argentina was a decade ago.



One proposed solution is for these countries to engineer the equivalent of devaluation – a uniform decrease in wages. This, I believe, is unachievable, and its distributive consequences are unacceptable. The social tensions would be enormous. It is a fantasy.

There is a second solution: the exit of Germany from the eurozone or the division of the eurozone into two sub-regions. The euro was an interesting experiment, but, like the almost-forgotten exchange-rate mechanism (ERM) that preceded it and fell apart when speculators attacked the British pound in 1992, it lacks the institutional support required to make it work.

There is a third solution, which Europe may come to realise, is the most promising for all: implement the institutional reforms, including the necessary fiscal framework that should have been made when the euro was launched. It is not too late for Europe to implement these reforms and thus live up to the ideals, based on solidarity, that underlay the euro's creation. But if Europe cannot do so, then perhaps it is better to admit failure and move on than to extract a high price in unemployment and human suffering in the name of a flawed economic model.

4.7 TECH SAVVY PROFESSIONALS

Take first step to ensure efficient and reliable system:

Fiscal lessons from eurozone

Many economists say fiscal deficits don't matter: India has run fiscal deficits of up to 10% of GDP for three decades, yet has enjoyed record growth. Many are Keynesian enthusiasts, seeing government spending as the solution to any growth slowdown. These economists must think again after the fiscal crisis in the Eurozone.

European countries that ran high fiscal deficits in good times, and went for even bigger deficits to provide a Keynesian stimulus out of the Great Recession – Greece, Portugal, Spain, Ireland and Italy – are in serious trouble.

Greece has a fiscal deficit of 13.5% of GDP. Its public debt/GDP ratio is 115%, but may hit 140% by 2014 despite austerity measures. So, markets doubt Greece's solvency.

Portugal is also under attack in bond markets. Its fiscal deficit is 9.3% of GDP and public debt/GDP ratio is 77%. Italy has a high public debt/GDP ratio of 116%, but is among the seven biggest economies in the world and so hopes to survive the Eurozone crisis. Spain's public debt/GDP ratio is only 53%, but its fiscal deficit of 9.3% is high enough to catch contagion from Greece.

Keynesian stimuli have taken all these countries to the edge of disaster, not economic revival. Keynesian stimuli have flopped in the past too. In the 1970s, western countries found that Keynesianism was a recipe for stagflation. In 1976, British Prime Minister Callaghan said, "We used to think that you could spend your way out of a recession and increase employment by cutting taxes and boosting government spending. I tell you in all candour that the option no longer exists and that insofar as it ever did exist, it only worked on each occasion since the war by injecting a bigger dose of inflation into the economy, followed by a higher level of unemployment as the next step."

Japan suffered a Keynesian fiasco in the 1990s. Several decades of rapid growth created a huge asset bubble that peaked in 1989. Rather than let it burst, Japan sought to deflate this bubble gradually. It is still deflating 20 years later, and prices are still falling. Falling prices discourage spending: people wait till prices fall further. During deflation, a monetary stimulus becomes impossible since interest rates cannot be cut below zero. Result: Japanese Keynesianism has produced little growth for two decades.

Keynes developed his ideas within the framework of a closed economy. More government spending in a recession, he argued, raised demand and hence used up spare capacity in the economy. This is not always true even in a closed economy – as we have seen, it can end in stagflation.

But in an open economy, a Keynesian stimulus can stimulate imports rather than domestic production, so the stimulus leaks out to other more competitive economies.

During the recession of 2001, huge US trade deficits meant that the US stimulus leaked out, benefiting mostly China and the Opec countries. For structural reasons (low US savings rate, artificial Chinese exchange rate) the trade deficits continued even after the recession ended.

Europe's current travails have revealed further pitfalls. In a common market, any member's stimulus readily leaks into other members. This benefits mainly Germany, the most competitive European country.

The biggest losers are relatively uncompetitive, low-productivity economies – Greece, Portugal, Spain. As Eurozone members, they cannot devalue to improve their competitiveness. So, a Keynesian stimulus creates huge government debt without lifting growth or jobs.

Greece depends heavily on tourism: its industry is uncompetitive. The 2007-09 recession left huge unused capacity in tourism. But Greece's fiscal stimulus could not create a domestic tourism surge to use up spare capacity: it simply leaked into imports.

Portugal used to be the low-wage textile champion of the EU as long as textile quotas protected it from Third World competition. But the Uruguay Round mandated the phasing out of textile quotas by 2005, leaving Portugal with an uncompetitive industrial core. No Keynesian stimulus could improve utilisation of textile capacity when cheap imports were available. No wonder Portugal has recorded barely 1% annual GDP growth in the last decade, at a time when most of the world had a veritable boom. Countries with structural problems cannot spend their way to fast growth.

Spain too has structural problems: its wages are too high in relation to its productivity.

A Keynesian stimulus can work in a recession, subject to several caveats. First, contra-cyclical government policies should aim in good times for a fiscal surplus that can be wound down in bad times. Unfortunately Keynesianism has come to mean government spending to spur growth at any time, even when there is no recession. Keynes himself would have advocated a surplus in good times. But aiming for such a surplus is now regarded as high conservatism, not Keynesianism.

What lessons flow for India? First, fiscal deficits do indeed matter. They matter less when a country has underperformed for so long that it has big catch-up possibilities that fuel growth, and this explains why India has not suffered like some other countries.

Yet the taming of fiscal deficits and inflation in 2004-09 led to sharply reduced interest rates that were crucial in making India competitive in its 9% growth phase. The Fiscal Responsibility and Budget Management (FRBM) is a crude tool, yet did indeed help cut the fiscal deficit.

The FRBM target of lowering the fiscal deficit to 3% of GDP is sensible in good times, leaving scope for expanding it to 6.5% in a recession without causing a Greek tragedy.

Second, Greece and Portugal have demonstrated that fiscal deficits in countries with structural problems can send the debt/GDP ratio skyrocketing without stoking growth. India has many structural problems despite having advantages too, and so should beware fiscal excesses.

Third, Greece has shown that a monetary union is a bad idea that leads to loss of control over exchange rates. So, India must shoot down proposals for an Asian monetary union.

4.8 CONTINUING LEARNING CENTRES

Take informed decisions:

Irrationality of global capital markets

Global capital markets are not perfect. Nor are they rational, or even oftentimes effective. A quick look at the performance of the capital markets over the last 15 years just confirms this.

In 1993, foreign investors pumped billions of dollars into short term, local currency, fixed income instruments in Mexico, otherwise known as Cetes. The logic was simple. Cetes were yielding more than 10% in pesos when short-term US treasuries were yielding 3% or less. Of course foreign investors were taking currency risk but as long as more of them kept piling into Mexico, the peso kept appreciating – making it a lucrative trade. In February 1994, the US Federal Reserve started increasing interest rates. Through the rest of the year smart locals kept pulling their funds out of Mexico while ‘herd mentality' foreign investors kept piling in. In December, the Mexican Central Bank, in the face of a huge trade deficit, was forced to devalue the currency, and as a consequence, Cetes investors were forced to take a significant bath on their investments.

Similar episodes occurred later in 1998 after the Asian crisis during the devaluation of the Brazilian real, and again during the Russian GKO crisis. In each instance, the smart early investors “discovered” the trade, others then piled herd like into securities they understood little, and were eventually suckered into huge losses amounting to billions of dollars.

The improbable run up of the Nasdaq to more than 5,000 in 1999-2000 , on the back of an “internet revolution” , after which it has been languishing at around 2,000 for the last 10 years is yet another example of this irrationality , but this time in one of the world's so-called “developed” capital markets.

Unfortunately the current global financial crisis takes the cake. After the US real estate crash of 1987, house prices started rising in 1995 and continued their upward movement for the next several years. By 2003, i.e., less than seven years later, the housing index had more than doubled and it was already becoming apparent that real estate was reaching unsustainable levels. Nevertheless from 2003 to '07, the index increased by another 50%. It was also accompanied by a frenetic period of activity in the mortgage market during which all sorts of risky structures were peddled to willingly gullible and increasingly leveraged consumers. These included back-ended principal and interest payments, ARMs, interest only, zero equity mortgages, etc. These mortgages were then repackaged and sold on to more highly paid but just as gullible investors and bankers in the US and other countries.

It should have been pretty clear to most capital markets players, and certainly to those in senior positions or in the risk departments, that given the steep run up in asset prices the market would correct, and would do so rapidly when it did. And yet, even though by mid-2008 real estate prices had declined only about 10% to 15% from their peaks, we had the cataclysmic collapse of Bear Stearns in March, followed by the near collapse of the entire global financial system. In hindsight, it is quite remarkable that a set of the most highly paid professionals in the world could have got it so insanely and totally wrong. And we are talking about highly sophisticated institutions, employing some of the best and brightest talent from all over the world. What made these investors take such really awful decisions which cost their investors so much? What in the world were they thinking?

It's almost as if the markets collectively get into a self-induced, mass hypnosis. To a point where reality is willingly suspended. As a result of such occurrences, faith in the efficiency of global capital markets has surely been shaken, if not lost entirely. The market has got it wrong so often and so spectacularly that one wonders whether all the research that is done and market theories that are espoused – random walk, efficient markets, technical analysis, etc, - are anywhere close to reality.

Now there is the possibility that the next big bubble is beginning to inflate. Again the capital markets are wilfully suspending credulity. And this one could be really big. For many years China has been growing rapidly. Its stock market has been among the best performing in the world. On the back of a deliberately cheap currency policy China's exports have swamped the world. It will shortly cross Japan to become the world's second largest economy. Per capita income has almost trebled in the last 10 years. Infrastructure has boomed and the country is unrecognisable to those who revisit it after a gap of a few years. In many sectors China adds capacity in a single year equivalent to India's cumulative installed capacity. It has become the world's largest consumer of many commodities (and the world's largest polluter). By any measure, these are phenomenal achievements.

And yet uneasy lies the crown. Much of the capacity that has been created is not being used. In sector after sector, there are excess capacities. The currency cannot be kept cheap forever and when it gets to realistic levels, it will surely impact the external sector negatively. Worryingly, the response of the government to the current crisis has been a further opening of the bank lending pigot to create even more capacities. Economic growth cannot endlessly come from capacity creation. Chinese planners understand this and are now doing their best to ensure that consumer demand manifests sufficiently to absorb all the excess capacity, being created But if this does not happen the banking sector will be left with a huge amount of non-performing and unproductive assets. Markets will go into a tail spin, the government will be forced to step in and things could well go out of control.

As an aside, funding to the US deficit will stop. Managing this transition from an investment-driven model to one where consumer demand takes up the slack, with the consequential impact that higher consumer spending will reduce the savings rate and thereby the investment rate and the government's ability to spend, will be a huge economic challenge. And there is a risk, however small, that it might well fail.

Still the Chinese stock market is trading at multiples higher than that of most other markets. Several of the world's 10 largest banks by market cap are Chinese. The systemic risk is high and growing, but once again, global capital markets are wilfully turning a blind eye. In reality, the situation is potentially quite sticky and the continued rise of Chinese asset prices, and by consequence, global commodity prices, is potentially the next big bubble built on misplaced optimism and hope, and the herd mentality disease. There is an increasing element of systemic risk in the global markets and this will continue – until the next big correction hits the “irrational” capital markets right between the eyes.

4.9 ONE-STOP-SHOPS

Dedicated to offer related services under a roof;

Debt throes!

We ignore rising public debt at our peril.

Should we be concerned about high and sharply-rising public debts? Opinion is divided. Optimists point to how in the aftermath of World War-II, government debts in excess of 100% of gross domestic product (GDP) were common. Yet there were no defaults. So, is it possible that worries about excessive public debts are exaggerated, even if the unfolding Greek tragedy suggests otherwise? After all, barring a few exceptions, nominal government bond yields have remained low and have fallen in some cases. Will that happy state of affairs continue?

A recent BIS paper is less hopeful. It warns that governments should not be lulled into complacency by the ease with which they financed their deficits in the past.

For one, in the aftermath of the financial crisis, future output is likely to be permanently lower for a while. As a result, government revenues will be lower and expenditures higher, making consolidation more difficult. Moreover, large public debts have significant financial and real consequences. The recent sharp rise in risk premia on long-term bonds issued by several industrial countries suggests that markets no longer consider sovereign debt low-risk.

The impact of high debt-GDP ratios on growth is non-linear, with adverse output effects tending to rise as the debt-GDP ratio approaches the 100% limit. In addition to higher risk premia and increased cost, a second risk associated with high levels of public debt comes from potentially lower long-term growth. A higher level of public debt implies that a larger share of society’s resources is permanently being spent servicing the debt. This means that a government intent on maintaining a given level of public services will have to raise more taxes. There is also the possibility of crowding out of private investment. Last but not least, the existence of a higher level of public debt is likely to reduce both the size and the effectiveness of a future fiscal response to an adverse shock. This was evident during the latest crisis. Countries saddled with very high public debt did not expand fiscal policy as much as other countries.

From the monetary policy perspective, deteriorating public finances can trigger a sudden increase in long-term inflation expectations. When the public is no longer willing to hold public debt, the government may have to resort to monetisation. Anticipation of this may lead to an increase in inflation today as investors reassess the risk from holding money and government bonds. In such an environment, fighting rising inflation by tightening monetary policy would not work, as an increase in interest rates would lead to higher interest payments on public debt, leading to higher debt, bringing the likely time of monetisation even closer. Second, uncertainty about the timing and extent of fiscal consolidation plans complicates the central bank’s ability to forecast where policy rates need to be set. A high public debt raises the risk of political and economic pressures on monetary policymakers to inflate away the real value of debt. The payoff to doing this rises the larger the size of the debt, the longer its average maturity, the larger the fraction denominated in domestic currency, and the bigger the fraction held by foreigners.

For now, we in India can take comfort from the fact that our public debt-to-GDP ratio is nowhere near 100%. But what is undeniable is that if we include the debt of public sector undertakings and other quasi-government entities in our debt-GDP ratio, the picture will look much more alarming. Inflation is already high and, unlike many advanced countries, there is no appetite for Indian paper overseas. It helps, of course, that the debt is in rupees and we also have a high domestic savings ratio; but don’t count on it.

4.10 Global OUTLOOK

Take notice from global events:

Sovereign debt risk: Impact on Asia

The recent developments in Greece and Europe have been a pointed reminder about structural issues related to too much debt in some of the developed world economies. The €110 billion emergency lending facility from EU and IMF wasn't enough to calm the markets, and the debt concerns threatened to spread beyond Greece and the EU to other markets. But, like the measures taken before – for the benefit of Greece – a stabilisation fund is just buying time for distressed borrowers.

The fiscal policy action taken in these countries during this "extra time" is essential. If yet another rescue mechanism isn't followed by aggressive austerity measures, the problem would just continue to fester – and could eventually manifest itself elsewhere. Well the end game could be a default or inflation, or both. In our view, the latter is the more likely outcome, through massive further monetary easing.

What does this all mean for Asia Ex-Japan (AXJ) economies? Although, fundamentals of all AXJ economies are strong, global linkages do expose them to these developments. To be sure, as of now all leading indicators and current data points indicate a very strong trend in domestic and external demand. However, the key risk now emanates from potential emergence of round II of severe stress in the European and global financial system, funding shortage and downside risks to global growth.

If sovereign credit problems continue to deepen, in the first stage, investors will remain focused on the external balance sheet linkages more than the trade linkages, which will emerge as an issue later. If the risk aversion trend continues, the market is likely to be concerned about external balance sheet linkages, including forex reserves to short-term external debt ratio, current account balance, dependence on capital inflows, exposure of the banking system to wholesale funding, and commercial banks' holding of European sovereign bonds.

Last time, the region was separated into two groups: Korea, Indonesia, and India; and China, Taiwan, and Asean ex-Indonesia. The former group suffered more than the latter. An almost similar distinction can be operative in the region this time as well, if the risk aversion were to be sustained.

Certain idiosyncratic factors in these three economies make them more exposed to such global conditions then others. Both Korea and Indonesia still have relatively less comfortable forex reserves to short-term debt ratios. Moreover, Korean banks have significant dependence on wholesale funding exposing them to volatility in funding markets. Indonesia tends to suffer from added pressure as foreign investors cut risks by selling its local debt paper. Foreigners own about 24% of the outstanding SBI (Sertifikat Bank Indonesia) debt paper, which works out to about $8 billion. India, on the other hand has a reasonably high ratio of forex reserves to short-term external debt, but it runs a high current account deficit of $31 billion (2.5% of GDP) in 2009 and has a high dependence on capital inflows. Foreign capital inflows can play an important role in influencing private corporate capex in India.

IN THE second stage, if the funding markets stabilise in short period, the final impact on AXJ GDP will depend on the eventual downside to global growth, the trade exposure of various AXJ countries, and the ability of policymakers to generate counter-cyclical policy support. Based on these parameters, the countries in the region can be ranked in the following three groups:

Group I (Less Impact – India, Indonesia, and China):

Indonesia and India will be less affected from the downside in global growth due to their relatively balanced economic model with a large contribution from domestic demand to GDP growth. However, it will be important to have stabilisation in global capital markets soon, particularly for India, to ensure that the growth momentum is not affected sharply because of reversal in capital inflows. Traditionally net exports have been a significant contributor to China's growth, compared with that of India and Indonesia. Still, China has the best macro balance sheet in the region as reflected in its large forex reserves balance, high current account surplus, low fiscal deficit and low public debt, as well its ratio of external debt to GDP. China, therefore, is best positioned in the region to initiate countercyclical policy measures.

Group II (Moderate Impact – Korea):

While Korea's dependence on external demand is high; the adverse impact on its exports tends to be softened by its large exposure to China. Moreover, Korea has also adequate fiscal policy room to defend against the downside from global growth.

Group III (Most exposed – Taiwan and Asean excluding Indonesia):

These countries have very high dependence on global growth and exports. In fact, Singapore, Taiwan and Malaysia would be affected more than Thailand, which has a relatively lower export orientation, even though Thailand would also lack the political environment to initiate strong countercyclical fiscal policy measures.

Bottom-line:

The key will be the duration of this global risk aversion cycle. If the global capital markets stabilise soon, strong growth would continue, with bigger risk of asset-price bubbles and inflationary pressures building up in the region. However, in the event of sustained risk aversion in the global financial markets, the region's external demand and investment recovery will be at risk. In that case, AXJ policymakers will need to start implementing the structural reforms needed to accelerate domestic demand on a sustainable basis instead of attempting just a cyclical response from monetary and fiscal policy.

4.11 ISSUES OF THE PRESENT

Freedom to get & fail in the system of free enterprise:

Fear of double-dip recession remains high

The risk of a double-dip recession hasn't abated, even after news of the huge European bailout in response to the Greek debt crisis. World markets soared initially on the announcement of the nearly $1-trillion rescue plan, and then declined.

But as the economist John Maynard Keynes cautioned long ago, such market reactions are basically a "beauty contest", with investors trying to predict the short-term reaction that other investors think still other investors will have. In other words, don't view these beauty contests as a heart-felt response to a fundamental change in the economy. In fact, there is still a real risk of a double-dip recession, though it can't be quantified by the statistical models that economists use for forecasts.

Instead, the danger stems from the weakness and vulnerability of confidence, whose decline could bring markets down, further stress balance sheets and cause cuts in consumption, investment and local government expenditure. Ultimately, the risk resides largely in social psychology. It is the fear of fear itself, of which Franklin D Roosevelt famously spoke.

From 2007 to 2009, there was widespread concern about the risk of an economic depression, but that scare has been abating. Since mid-2009, it has been replaced by the milder worry of a double-dip recession, as a count of Web searches for those terms on Google Insights suggests. And with that depression scare still fresh in our minds, sensitivity to the possibility of another downturn remains high.

To be sure, many economists doubt that a double-dip recession is in store. One reason may be that we have just had three solid quarters of real growth in the gross domestic product. In the past, when inflation-adjusted GDP has come out of a decline and posted three or four quarters of gains, it has never immediately begun to fall again, at least not since quarterly numbers began to be issued in 1947.

So, once GDP gains momentum this way, it generally doesn't stop in its tracks. And there have been encouraging factors, like continuing low interest rates, as well as lower inventory-to-sales ratios and lower growth of stocks of new homes and consumer durables, which suggest that pent-up demand, will lead to more sales. But forecasters who focus on the next four quarters may be missing the real worry that many people harbour about the economy.

We use a definition of a double-dip recession that doesn't emphasise the short term. Instead, we see it as beginning with a recession in which unemployment rises to a high level and then falls at a disappointingly slow rate. Before employment returns to normal, there is a second recession. As long as economic recovery isn't complete, that's a double-dip recession, even if there are years between the declines.

Under that definition, there has been only one serious double-dip recession in the last century – and it was serious indeed. It started with the 1929-33 recession, which was followed by a recession in 1937-38. Between those declines, the unemployment rate never moved below 12.2%. Those two recessions, four years apart, are now typically lumped together as one event, the Great Depression.

Many negative factors persisted between those dips. High among them was a widespread sense then that something was amiss with the economy. There was a feeling of uncertainty that discouraged entrepreneurship, lending and spending, and most important, hiring.

We have to deal with a similar, though less extreme, problem today.

Many of us are unsettled by images that are preventing a return to normal confidence, images of rioting in Athens, or of baffled American traders during the nearly 10% drop in the stock market on May 6. And if the BP oil spill is not soon contained, and eventually wreaks havoc on the gulf economy, we may need to add it to the list, too.

Consider the May 6 stock market plunge. Though it reversed quickly, it awakened fears of instability, which can change the atmosphere and delay recovery from a recession, possibly even until the next recession comes around.

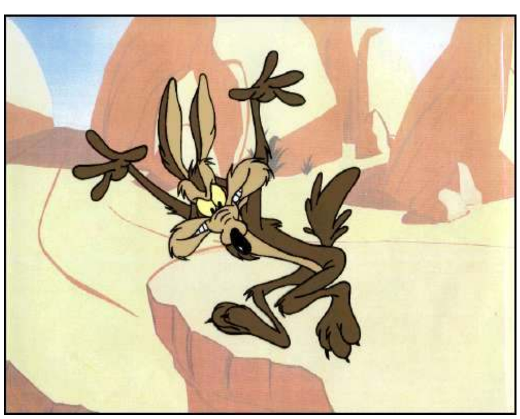
There has been a similar historical example. On September 11, 1986, the Standard & Poor's 500-stock index fell 4.8%, then the biggest one-day percentage drop since April 21, 1933. It called public attention back to the Great Depression, even though the decline was reversed within a couple of weeks.

The New York Times attributed that one-day drop to "anxiety, with computer spin," referring to trading programs that generated huge sales. Readers were left with ambiguous interpretations of that drop, as they have been in the wake of the recent one-day decline. That 1986 event stuck in people's minds. It was followed a year later by several aftershocks, then by what is still the biggest one-day drop in history, the 20.5% fall in the S&P 500 on October 19, 1987.

Fostered by mass psychology, the same kind of aftershocks could occur in the next year or two. This time, in our more delicate economy, the consequences could be more severe.

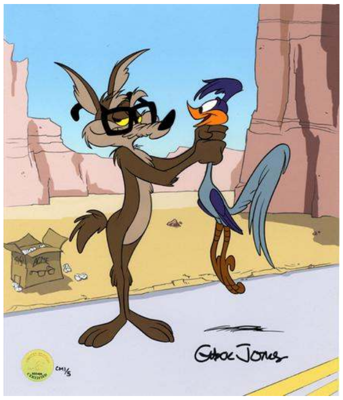
Since 1989, we have been compiling the Buy-on-Dips Stock Market Confidence Index, now produced by the Yale School of Management. It shows that confidence to buy on market dips has been declining steadily for individual investors since 2009. (The measure is holding steady for institutional investors.) Will individuals continue to support the market, which is now highly priced?

Confidence indexes and other measures of public thinking show gradual trends, often over years, that don't match up precisely with economic events, which are often sudden. We need to look at short-run events, like the market reaction to the Greek bailout, as no more than side effects. Slowly moving changes in our animal spirits represent the real risk of a double-dip recession.



5. BANKING SECTOR

Banks make a killing in Ulips



Three years ago, Ms TS, 52, sought to renew her Rs 2 lakh fixed deposit with a large private bank. The bank executive offered to put her money into a scheme that would generate far better returns than any fixed deposit.

Ms TS, who was then diagnosed with a critical illness, was looking for a safe investment and felt she could trust her bank, which was quite a reputed one. Three years later when Ms TS sought to redeem her investment, she was told that her investment needed ‘topping up’ every year for three years and since she did not do that she would get back only Rs 65,000 against the Rs 2 lakh that she had invested.

What Ms TS came to realise was that she had put money in a regular premium unit-linked insurance plan which was mis-sold to her as an ‘investment’. “The guy from the bank came to my house, saw me in my wheelchair and would have known that I could not afford to pay Rs 2 lakh every year as I was struggling to pay my health bills,” she says. Yet the executive encouraged her to invest in the plan and obtained her signatures on a sheaf of documents which she unwittingly signed.

In a similar incident, Ms AS, a 41-year-old homemaker, was offered an investment scheme instead of a term deposit plan. When she made it clear to her banker that she did not wish to buy insurance, he assured her that it was a short-term investment plan and not an insurance product. After issuing the cheque, she did a bit of research and discovered that the scheme was a pension plan issued by a life company and suited largely for long-term savings. She managed to get her proposal cancelled in time, but she had to contend with a grumpy branch manager who made it appear as if it were all her fault.

If you are looking at setting aside a portion of your earnings to build a retirement corpus, Ulips are a great product. If you choose to invest in a regular income Ulip you may even generate a better return than mutual funds after adjusting for the cost of protection. Why then should Ulips be mis-sold? There are two reasons. First, because it is easier to sell a short-term ‘investment’ product to someone searching for better returns than to convince a twenty-something to set aside funds for his retirement. Second, although it is easier to sell a single premium plan, the commissions are 17 times higher on regular premium policies.

So the best way that a distributor can increase commission is to pass off the regular premium plan as single premium one with an option to make regular payments. Banks are getting bolder in their ways as they are going unpunished by the regulator and are rewarded by insurance companies for pushing up sales. Typically, such sharp practices come to light in the numbers. For instance, if a traditional policy were mis-sold as a single premium plan, the practice would show up in a spike in 13-month lapsations. But in Ulips, many policies have auto debit features which keep the cover and consequently the policy alive even if there is no return for the policyholder.

Such cases of mis-selling are not new. The regulator has in the past imposed requirements that insurance companies obtain the signature of the prospect on an illustration which shows the kind of returns she can expect. However, companies and agents continue to work around these safeguards. In many cases, tall promises are made by an anonymous lead generator over the phone while the signatures on the forms are obtained by another executive. In some cases, agents forge the prospect’s signature on the illustration.

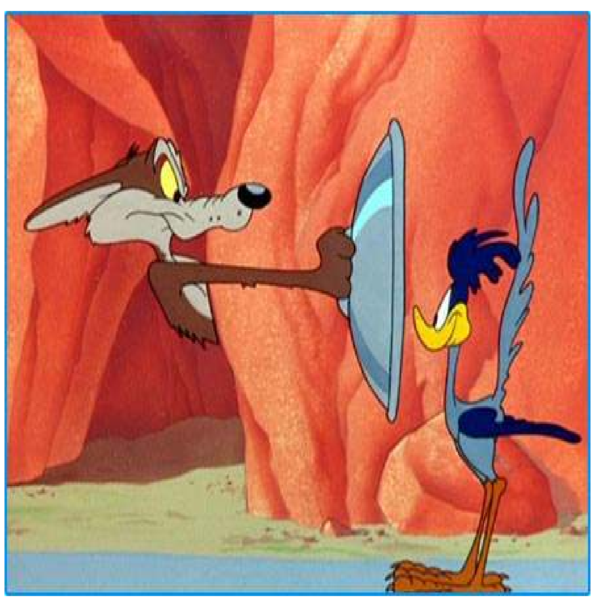
Insurance companies are well aware of the prevalence of mis-selling, but tend to overlook them certifying that these are unavoidable and prevalent in every industry.

It is here that the industry needs to go back to the basics of insurance. One of the cornerstones of the principles of insurance is that of ‘Uberrima Fides’ or utmost good faith. In any other contract, while the principle of ‘Caveat Emptor’ or let the buyer beware applies, in insurance both the company and the proposer are dependent on the other’s word.

For instance, a policyholder is supposed to declare to the insurer not only all the information that he wants to know but also any information that he ought to know which would influence his decision to provide cover. Similarly, the individual believes that the insurance company will fulfil its part of the bargain in settling a claim. To the extent that a bank is a corporate agent of the insurance company, the promises made by bank or any agent are equal to promises made by the insurer. Unfortunately, there has not been any major penalty on mis-selling which many insurers are now declaring to be unavoidable.

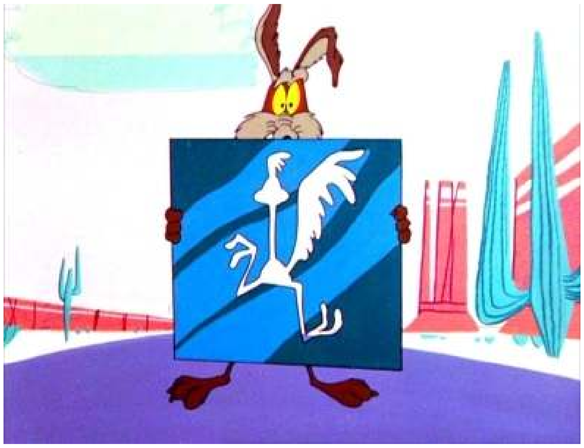
The insurance regulator, IRDA, is already locked in a turf war with the Securities and the Exchange Board of India. Engaging banks on the issue of mis-selling could create tensions on a new front between RBI and IRDA. It, therefore, make sense for the regulator to enforce compliance through insurance companies. There is one more reason why life insurers should be held responsible for mis-selling by banks. Agents in the life insurance are exclusive distributors for one company and more like franchisees than distributors. Life insurers are also required to perform financial underwriting of every proposal and ensure whether the policy suits the proposer.

On the individual agent front, companies are pruning their agency force and focusing more on productive and professional agents. However, banks have a long-way to go before moving to need based selling. In the absence of a regulatory push at this stage, there could be a strong backlash against bank assurance which is touted as the distribution channel of the future.



6. TAX UPDATES

Tough days for tax evaders & aides in new tax regime



The income-tax authorities may soon get sweeping powers to investigate and prosecute those suspected of hawala transactions, creating a strong deterrent for the channel used extensively for money laundering. Taxmen will also have powers to arrest without a warrant an accused found facilitating hawala.

The proposed changes are likely to be included in the direct taxes code and could shift the burden of proof on the accused. Besides, this is the first time that the income tax law will seek to punish not just the tax evader but also the one who aids the process. The onus of proving the source or origin of hawala transactions will lie with the accused.

“More powers are needed to collect information or to prove the act of,” said S S Khan, a former member of the CBDT, who also headed a panel that examined all issues concerning hawala transactions. The proposal has its roots in an earlier CBDT committee set up to examine all the issues related to hawala transactions, difficulties in tackling hawala transactions and its operators.

The board has also written to the law ministry for creation of special courts for fast-tracking prosecution of tax evasion cases, including hawala. Hawala refers to transfer of funds using informal channels such as money brokers usually overseas. It could also involve laundering money by channelling it through multiple accounts or showing non-existent sale or purchase of goods. Any person aiding in hawala process by allowing deposit from an unexplained source in his bank account or by issuing bills for sale of services or goods without actual transfer may be notified as a hawala entry operator, as per the proposal.

The new code, which will replace the five-decade old tax law, is currently in the works and the CBDT is expected to put out the second draft of the proposed law in public domain in one or two months.

“While the provisions would have been designed to catch the ‘big fish’, something as petty as a false expense claimed by an employee could invite imprisonment, both for him and the guy who helped him with the false receipt,” said Amitabh Singh, partner, Tax & Regulatory Services, Ernst & Young suggesting that the provision may be harsh.

In 2004, the finance ministry had amended the income tax law and made falsification of books of accounts or documents punishable by three months to three years of imprisonment.

The ministry is now making the law more rigorous to tackle laundering. Moreover, with these changes, these offences will be cognizable. For cognizable offences, authorities do not require to furnish a warrant to carry out an arrest.

The CBDT has also written to the revenue department to include offences such as concealment of income, not filing income tax returns, failure to deposit tax deducted at source and giving false evidence under the ambit of Prevention of Money Laundering Act or PMLA.

Inclusion of these offences under PMLA will ensure faster trial.

7. INFLATION

Inflation cools to 9.59% in April 2010

Inflation cooled to 9.59 per cent in April, although prices of a number of food items and non-food items such as metals rose.

The fall is partly due to a high base effect - which means the inflation numbers in the year-ago period had already started rising making the current rate of growth look relatively small. Last year this time, inflation was 1.31 per cent, against 1.2 per cent in March 2009. In March this year, wholesale prices-based inflation was at 9.90 per cent. In Kolkata the government's chief economic advisor Kaushik Basu said inflation would fluctuate in the next three months before falling.

With inflation easing, economists do not anticipate any immediate policy actions from the Reserve Bank as industrial growth is showing signs of deceleration and the Eurozone debt crisis may affect fund flows.

Factory production in March expanded by a slower than expected 13.5 per cent. Elsewhere, the stock markets turned edgy after investors worried about the efficacy of a Euro 110 package approved by EU-IMF to bail out Greece from its debt obligations.

"With the global uncertainty and lower than expected March industrial growth numbers, RBI would not adopt any drastic step and rather resort to a gradual approach towards rate hike," said StanChart Bank Regional Head of Research, India, Samiran Chakraborty.

According to the monthly inflation data, potato prices fell 28.70% in April, and onion prices dropped 11.62%. However, vegetables overall rose 31.90%, which means that prices, except for potatoes and onions, are rising much faster. Sugar prices fell by 5.74% on monthly basis, but turned costlier compared to last year. For April, food inflation stood at 16.87 per cent against 16.65 per cent in the previous month with prices of pulses rising by 2.47% and milk by 2.96%.

On yearly basis, these prices rise much faster--pulses by 30.42% and milk by 21.95%. Also fuel prices rose 12.55%, essentially because the Budget hiked customs and excise duty on petrol and diesel.

The main area of concern, however, remained metal, since hardening global prices are putting pressure on domestic rates. Iron and steel prices rose 11.40% in April on monthly basis and basic metal alloys and metal products turned expensive by 6.72%.

Govt doubles natural gas price

The government has doubled the price of natural gas produced by ONGC and Oil India from nomination blocks that will make the fuel used in automobiles and households in Mumbai and National Capital Region of Delhi costlier by 20-35%.

The government raised administered price mechanism (APM) gas price to $4.20 per unit at par with Reliance Industries' KG-D6 gas price, discovered on the basis of market principles. The $4.2 per unit price is already approved by an empowered group of ministers. APM gas is a term used for gas blocks awarded to state-run energy firms on nomination basis.

8. MISCELLANEOUS UPDATES

FCPA: Compliance Comes Calling

Take an Indian conglomerate preparing to acquire a Belgian company. The last thing it needs to worry about is US criminal laws, right? Wrong – and indeed, buying the Belgian concern without thoroughly analysing its compliance profile could mean buying tens of millions of dollars in criminal liability.

The compliance challenges posed by the vigorous pursuit by the US of alleged Foreign Corrupt Practices Act (FCPA) transgressors have been compounded as other countries, most prominently Germany and the UK, have adopted and begun active enforcement of anti-foreign corruption laws of their own.

On January 19, for example, the US unveiled 22 indictments of individuals, including UK citizen Pankesh Patel, as a result of an undercover operation with FBI agents posing as sales agents offering to corruptly facilitate foreign contracts. Patel and 20 other defendants were handcuffed in front of their peers right on the floor of a Las Vegas trade show.

In his allegedly corrupt pursuit of defence contracts in Africa, Patel had meetings within the US, and sent paperwork in furtherance of the underlying scheme to the US. His indictment is an application of FCPA provisions catching foreign persons that take steps within the US to further overseas corruption.

For our hypothetical Belgian marketing company, though not directly subject to the FCPA, it might have FCPA liability if it had corruptly carried out business operations for US companies, or sent dollar-denominated wire transfers for corrupt purposes.

Another trend worth noting for non-US companies is the expectation of active supervision on the part of senior corporate executives. US enforcers have held executives at headquarters responsible for misconduct occurring in the field, on the basis that the executives failed to supervise far-flung personnel or failed to design internal controls to prevent misconduct.

Other countries are also raising the bar to prevent bribery. In part, this is due to diplomatic pressure from the US but also the efforts of the OECD and the UN, both of whom have sponsored conventions that are now in place mandating that their signatories take certain actions in the fight against corruption. India is party to the UN convention.

The Siemens case in which it paid a record settlement of $800 million in fines and disgorgement of profits was mirrored by a fine of equal magnitude paid to the German regulator.

In 2009, the UK had its first successful corporate prosecution for overseas corruption for the activities in Africa of a steel bridge manufacturer. Whilst the UK penalties paled into insignificance compared to the US settlements, it reflects a higher profile approach to combat corruption by the UK authorities.

This is reflected in their recent pursuit of BAE Systems, one of the world's biggest defence contractors, for alleged bribes to certain east European and African government officials. The case has been settled, with BAE Systems admitting to 'accounting inaccuracies' regarding a payment to a 'marketing agent' in Tanzania.

The settlement has been castigated by various UK lobby groups as a sell-out but, nonetheless, the fine of £30 million is a record and amounts to a tidy sum when combined with the related US settlement of $400 million.

Of equal significance for the UK is the Bribery Bill now before Parliament that introduces a specific offence of bribery of a foreign official and also a new criminal offence for relevant commercial organisations for failure to prevent bribery by 'associated persons'.

This could include not only employees and subsidiaries but potentially third-party agents and joint venture companies.

What does all of this mean for Indian companies planning foreign acquisitions or raising money abroad?

First, foreign anti-corruption laws like the FCPA apply much more broadly than generally understood.

Second, Indian multinationals should not only benchmark themselves against foreign peers in terms of size, innovativeness and profitability, but also in terms of compliance. In fact, they need a full compliance structure that benchmarks well against their international peers.

Third, Indian companies seeking an overseas listing must be prepared to invest in the development of a comprehensive compliance programme that goes beyond a mere code of conduct and contains meaningful elements of communication, training, monitoring , revision and, critically, enforcement.

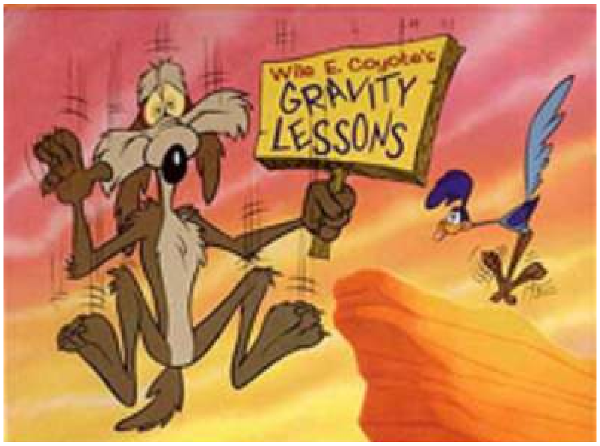
The same goes for Indian companies dealing with western multinationals whether in the context of investments or simply commercial contracts.

In the new economic era, there should be a lot of tempting dishes for corporate India.

Just make sure your lawyers providing foreign law advice have tasted them first!

9. KNOWLEDGE RESOURCE

Why the Greek rescue won't work



Greece has been dubbed the 'public sector's Lehman Brothers. Parallels have been drawn with this large bank failure. It had to be rescued because a default on its part could have led to a wider crisis. Time was of the essence: the greater the delay in effecting a rescue, the greater the cost. As in the case of bank failure, taxpayers have to pick up the tabs.

The impact of a large bank failure on the system is understandable. Greece is a small economy. Its GDP is a little over 1% of world GDP. Why would the bankruptcy of a small economy warrant serious concern? If Greece were to default on its debt, banks in Greece as well as in other countries could be in trouble. A default would cause Greek government bonds to lose at least half their value. Banks in Greece and other countries would be impacted. The Economist estimates EU banks' holding of Greek government bonds at €76 billion. Many of these banks have already been supported by governments following the sub-prime crisis. The rescue mounted by the EU-IMF 10 days ago, it is contended, has helped stave off another banking crisis at a time when economic recovery in the EU is sluggish.

Just three weeks ago, the package required for Greece was estimated at €40 billion. The package finally pushed through by the EU-IMF amounted to €110 billion. The EU-IMF has since announced a package worth €750 billion for all eurozone economies. This is a stabilisation mechanism comprising loans as well as guarantees. How much of it will be used to top up the rescue package for Greece is anybody's guess.

In a crisis such as this, the costs of rescue to governments and international agencies mount with time because private investors begin to flee. However, it is incorrect to say that the cost of the Greek rescue itself is €110 billion. This is merely the amount that the EU and the IMF have to lend to Greece to prevent an immediate default. The entire amount is not a cost unless Greece defaults on all of it. Assuming that Greece ultimately repays this amount, the cost of the rescue would be the difference between the market rate of interest and the interest that the EU-IMF is charging.

A Greek default would have had serious consequences all round. But the basic question needs to be asked: was a rescue preferable to a default? Is it true that a Greek default would have had catastrophic effects similar to those of the failure of Lehman in 2008?

The historical evidence is that there are strong incentives for countries to default. In their book, *This time is different,* Reinhart and Rogoff document the record of sovereign defaults through history. They write, "Serial defaults on external debts are the norm throughout every region in the world, including Asia and Europe." This undistinguished record has continued through the twentieth century in Africa, Asia, Latin America and Europe. Several Latin American countries have spent nearly 40% of their time since independence in default. Greece itself has been in default nearly half the time since 1800.

Two other facts are worth noting.

Today's high-income countries have made the transition from being emerging markets after a long history of default. This implies that, for the defaulter, the consequences of default are bearable. Secondly, in general, the effects of country default can be absorbed by the world economy.

In light of these facts, what is the argument against Greece defaulting today? Its primary fiscal deficit is around 9-10% of GDP. This is financed by external flows. If Greece were to default, external flows would cease. This means that Greece would have to shrink its economy by 9-10 % at one go which would be very painful indeed. But that is theory. In practice, external flows do not cease when a country defaults. A default leads on to debt restructuring. Lenders write off some of the debt because it is in their own interest to do so. If Greece were to default today, it is estimated that lenders would lose 50-70 % of their money. They are bound to negotiate a restructuring where they lose a lesser proportion, say, 30%.

Going by the Economist's estimate for EU banks' investment in Greek bonds of €76 billion, a 30% loss would amount to €23 billion. This loss would have to be borne by the banks. EU governments could share half of this loss by infusing capital into banks. For Greece, there would be enormous benefit. A default or orderly restructuring could shave about 30% off its external debt and make adjustment easier.

Compare these costs of restructuring with the costs of the rescue. The EUIMF lending rate is about 5% or about four percentage points less than the market rate on 10-year bonds for Greece. This means the cost of the rescue package of €110 billion is around €4.5 billion. This is the cost to taxpayers outside Greece.

And the costs to Greece? Greece has agreed to fiscal consolidation of 11% over a three-year period. This will mean huge job losses in the public sector, higher taxes and reduced wages and pensions. That is why riots have broken out in Greece.

We can now see why rescue has been preferred to default or restructuring. Under the rescue, the costs are to be borne overwhelmingly by Greece. Under restructuring, the costs would have been borne equitably by foreign banks, foreign taxpayers and Greek citizens. The Greek rescue is all about bailing out banks using public money. The parallel is not so much with Lehman as with AIG.

Greece has gone along with the rescue because the political and economic costs of defying the EU could be steep. But we can understand why neither the Greek package nor the larger eurozone package has restored confidence in the markets. The markets believe that the costs of adjustment for the troubled EU economies are just too great to be politically acceptable. They believe the rescue won't work.

Banks holding EU government debt must be part of the solution. Their governments can help them bear the loss. Only a formula that distributes the costs of adjustment more equitably between the distressed economies and the healthier economies of the EU will work. The lesson is obvious: if you are part of an economic union, you end up sharing the costs, not just the benefits.

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