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The Securities Academy and Faculty of e-Education

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Editorial preamble

1.1 THE MOJO IS BACK

Fed's monetary policy supercharging growth in emerging markets

Once a soufflé collapses, it rarely rises again. That has indeed been the experience of most developed economies following the global financial meltdown, with economic growth still flattish and equity markets on seemingly a long road to nowhere.

But the fluffy stuff is not just back in many emerging markets, it is puffing up to levels last reached at the height of the 2003-07 economic boom. In fact, portfolio inflows have already surpassed the 2007 peak of $89 billion with emerging market debt and equity so far pulling in more than $100 billion in fresh money. India, Indonesia, Turkey and Brazil are among the countries where analysts now believe that the 2003 step-up in economic activity was actually a trend for the foreseeable future.

At least in some parts of the world then, abundant liquidity has helped recreate last decade’s golden era of economic growth. The pace of expansion in emerging markets doubled to 7.2% a year from 2003 onwards following a long period of lacklustre growth that averaged 3.6% on an annualised basis between 1980 and 2002. The surge in their growth trajectory stalled after the economic meltdown of 2008 as export growth directed to the freely-spending US consumer took a hit, as did the easy access to cheap capital.

Strong exports and the global credit bubble were significant factors behind the growth leap in the developing world; it was no coincidence that the levitation act of emerging markets began in earnest from mid-2003, once the US economy started to sharply recover as the Fed aggressively cut interest rates. It was natural to assume that unless a V-shaped economic recovery occurred in the US following the Great Recession, growth rates in emerging markets would downshift this decade with external demand contributing less to growth and capital flows possibly slowing on account of lingering investor caution.

However, in reality, the recovery in the developed world has been U-shaped and exports are not providing developing countries as big a boost to their growth, as in the 2003-07 period. Consensus estimates suggest that average growth in emerging markets as a whole will settle at a trend rate of 5.5% - lower than the annualised 7.2% rate of 2003-07. But that is still far above what prevailed in the 1980s and 1990s, and the higher growth is being facilitated by the capital that comes gushing back in, once again reducing the cost of funding to record low levels.

Furthermore, the composition of the emerging market growth mix has changed.

The developing countries that gained mostly through the trade channel in the 2003-07 era are now experiencing the slowest recoveries; their trend growth in the years ahead should be relatively slower compared to the previous boom period. Trend growth is settling at a lesser rate in Russia, South Africa and even China.

The fastest bounce-back is in those emerging market economies where capital inflows played a major role in propelling growth higher and where domestic demand prospects are exciting. As long as global financial market conditions remain benign, growth momentum in the latter group of countries is likely to remain strong. Emerging markets with naturally-buoyant domestic demand can continue to grow at the new-era growth rates of 2003-07, even as the developed world settles into a lower growth paradigm.

But will the current frenetic pace of flows continue into emerging markets and keep the good times rolling? The obvious answer is that as long as the Fed and other developed-country central banks keep real interest rates low, capital will just flow to the best growth opportunities available. The Fed, for its part, seems only more intent to keep pushing on a monetary string and its intentions to engage in another round of quantitative easing have only sent more money rushing into emerging markets.

The risks to capital flows are if developing countries for some reason are compelled to pursue growth-unfriendly policies or if an event takes place that causes major global risk-aversion. And the biggest threat to the emerging market story is inflation. While the positive side to the ultra-loose monetary policies is increased capital flows, the negative aspect is the difficulty in directing liquidity that can often end up finding the wrong home. Recent examples include the oil price bubble in the first half of 2008 and traces of an echo bubble in some commodity and property prices in late 2009 and early 2010. Policymakers in emerging markets were forced to respond to such misbehaviour, especially in China that needed to crack down on the local property market earlier this year.

Policy tightening steps have so far not dented any of the growth enthusiasm in developing countries as they have been gradual in nature. A retreat in commodity prices during the spring and summer months also dimmed the spectre of inflation. However, ever since Federal Reserve chairman Ben Benarnke made his intentions clear in late August that he would do whatever it takes to reflate the US economy, commodity prices have again cut loose. The 30% surge in agricultural-based commodity prices over the past quarter is seriously worrisome given the high weight of food in the emerging market consumer’s basket. Core inflation in many developing countries has anyway been inching higher and – nearly 4% currently – already at levels similar to the later stages of the previous boom.

Another potential blow to capital flows is a sovereign debt problem in one of the bigger European nations. Spreads on Greek, Irish and Portuguese debt continue to widen but the market has been able to largely ignore this of late because the size of these economies is relatively small at around $300 billion each. But a more pronounced effect on risk appetite and capital flows is possible if the situation in a trillion-dollar economy such as Spain, which too has terrible debt dynamics, begins to spin out of control.

On a related point, whenever the price of oil has reached close to $90 a barrel, it has always posed a problem for the global economy.

Until any of these risks materialise, money will keep flooding into emerging markets and nurture the impression that the growth levitation act of 2003-07 in the developing world was not just a fluke but the start of a new era.

1.2 STOCK MARKETS

Bull market is back

Few of world's stock markets have offered a haven from fears of double-dip recession and Europe's debt crisis as India. Investors have sought sanctuary in India's growth story and foreign capital flows have all the makings of a Bollywood blockbuster.

Indian equities trade at more than 18 times 2010 forecast earnings (five-year average is 16.2). In comparison, emerging market equities generally trade on an average of 12 times 2010 earnings, while Russia trades at just 6.7 times. The fundamentals behind India's growth story – abundant liquidity and strong domestic demand – remain robust.

We still have lingering fears about a double-dip recession in the west. The fact is that today, big global economies are intertwined. So the US will get another recession only if the whole world does. P&G hopes to add a billion customers in emerging markets over five years – it already serves four billion globally. Food chains like McDonald's, Yum! Brands, and Wendy's / Arby's are ever more reliant on Chinese, Indian, Brazilian and Russian diners to fuel growth. Emerging world today seems to regard the developed world, particularly the US, as a sort of erstwhile Roman Empire; yet, their prosperity is interdependent.

With surging Chinese demand copper stocks in LME warehouses have fallen to 3,80,125 tonnes (31% down from February peak of about 5,50,000 tonnes). Copper is set to test all-time high of $8,940 a tonne set in mid-2008. During 1980s and 1990s, China's 'steel intensity' (steel consumption /GDP) was falling. However, since 2000; China's steel intensity growth has outpaced GDP growth.

Investors looking for some good news on rising prices need look no further than their breakfast plate. The soaring wheat has pushed up the cost of toast, corn for their cereal is up 30% over the last couple of months, coffee is at 13-year high and even sugar to sweeten it is significantly expensive. Anyone who bought into agricultural commodities in 2010 should be eyeing their meal with delight. The S&P GSCI Agricultural index is up 34% since June, as droughts combined with strong emerging market demand. As much as $80 billion tracks the GSCI indices, with billions more tracking others.

The movie Wall Street was a high-water mark for financial industry of the period. Indicators like Hindenburg Omen and head-and-shoulders patterns are making headlines. In July 2009, a head-and-shoulders pattern emerged in S&P 500, but stocks continued to rally. We remain sanguine and expect global stocks to rally strongly in October.

Beginning of the month – Sensex up 376 points

Daily review	30/09/10	01/10/10
Sensex	20,069.12	375.92
Nifty	6,029.95	113.45

Weekly review	30/09/10	01/10/10	Points	%
Sensex	20,069.12	20,445.04	375.92	1.87%
Nifty	6,029.95	6,143.40	113.45	1.88%

1st week of October – Sensex down 195 points

Daily review	01/10/10	04/10/10	05/10/10	06/10/10	07/10/10	08/10/10
Sensex	20,445.04	30.69	(66.02)	133.37	(227.76)	(65.06)
Nifty	6,143.40	16.05	(13.65)	40.65	(66.15)	(16.85)

Weekly review	01/10/10	08/10/10	Points	%
Sensex	20,445.04	20,250.26	(194.78)	(0.95%)
Nifty	6,143.40	6,103.45	(39.95)	(0.65%)

2nd week of October – Sensex down 125 points

Daily review	08/10/10	11/10/10	12/10/10	13/10/10	14/10/10	15/10/10
Sensex	20,250.26	89.63	(136.55)	484.54	(190.24)	(372.59)
Nifty	6,103.45	32.40	(44.95)	143.00	(56.55)	(114.70)

Weekly review	08/10/10	15/10/10	Points	%
Sensex	20,250.26	20,125.05	(125.21)	(0.62%)
Nifty	6,103.45	6,062.65	(40.80)	(0.67%)

3rd week of October – Sensex up 41 points

Daily review	15/10/10	18/10/10	19/10/10	20/10/10	21/10/10	22/10/10
Sensex	20,125.05	43.84	(185.76)	(110.98)	388.43	(94.72)
Nifty	6,062.65	13.30	(48.65)	(45.20)	119.40	(35.45)

Weekly review	15/10/10	22/10/10	Points	%
Sensex	20,125.05	20,165.86	40.81	0.20%
Nifty	6,062.65	6,066.05	3.40	0.06%

4th week of October – Sensex down 134 points

Daily review	22/10/10	25/10/10	26/10/10	27/10/10	28/10/10	29/10/10
Sensex	20,165.86	137.26	(81.73)	(216.02)	(64.33)	91.30
Nifty	6,066.05	39.75	(23.80)	(69.35)	(24.95)	30.00

Weekly review	22/10/10	29/10/10	Points	%
Sensex	20,165.86	20,032.34	(133.52)	(0.66%)
Nifty	6,066.05	6,017.70	(48.35)	(0.80%)

Sensex ends Oct with loss; first in five months

The benchmark index of the Bombay Stock Exchange (BSE) posted its first monthly decline in five months, but closed 0.5% higher on Friday, propped up by a late surge in ICICI Bank, which soared after posting better-than-expected quarterly earnings.

Investors await an eventful week – marked by US Federal Reserve's two-day meet ending Wednesday, the Reserve Bank of India's policy review on Tuesday and Coal India's listing on bourses on Thursday – for directional cues. Most economists in a Reuter's poll on Thursday expected the central bank to raise rates by at least 25 basis points to rein in stubbornly high inflation in the fast-growing economy. It would be the sixth increase since mid-March.

Top private lender ICICI Bank rose 6.5%, its best single-day gain in more than 15 months, as it beat forecasts with a 19% rise in quarterly net profit, helped by robust credit growth and fewer bad debts. The stock rose as much as 7.7% to Rs 1,174, its highest level since February 2008. The 30-share BSE index edged up 0.46%, or 91.30 points, to 20,032.34, with only nine of its components closing in the green.

There is not much to read in this month's decline. There were just bouts of profit sales after the rally we saw in September. It declined 0.2% this month, first monthly drop after May. The benchmark index had gained 11.7% in September which was its best gain in 16 months. It is not a panic situation or a sign of big worry. We expect the Sensex to test a new record high by end-December. The 30-share index is still up 14.7% year to date, as foreign funds have invested $24.7 billion in Indian equities in the period. It is around 1,200 points away from its all-time high witnessed in January 2008.

Though most earnings did not disappoint the street, they lacked big positive surprises, which investors had started to factor in the price. India along with Singapore, Indonesia, Thailand and Philippines slowed in terms of earnings momentum in the last three months from the previous three months while Hong Kong, China and Malaysia showed an improvement. Cigarette-to-hotel business ITC firmed 2.3% as its September quarter net profit rose 23.5%.

Metals pack lost sheen as base metals fell across the board ahead of US GDP data and the Fed meeting. Non-ferrous metals producer Sterlite Industries and aluminium producer Hindalco dropped 1.1% and 2.8%, respectively, and Tata Steel, world's seventh-largest maker of the alloy shed 2.4%.

Yearly/Quarterly/Monthly Review

Month	December 2007	December 2008	December 2009	March 2010	June 2010	September 2010	October 2010
Sensex	20,206.95	9,647.31	17,464.81	17,527.77	17,700.90	20,069.12	20,032.34
Points	Base	(10,559.64)	7,817.50	62.96	173.13	2568.22	(36.78)
%	Base	(52.26%)	81.03%	0.36%	0.99%	14.51%	(0.18%)

2.1 INDIAN ECONOMY

India will soon start to outpace China: Economist

WASHINGTON: India will soon start to outpace China, thanks to a young and growing workforce and its "much-derided democracy" says The Economist.

The cover story on "How India's growth will outpace China's" in its latest issue attributes "India's surprising economic miracle" largely to its private sector saying, "The country's state may be weak, but its private companies are strong."

Despite the poor headlines generated in the run up to the Commonwealth games, "India is doing rather well," the internationally regarded magazine said noting, "Its economy is expected to expand by 8.5 percent this year."

"It has a long way to go before it is as rich as China - the Chinese economy is four times bigger- but its growth rate could overtake China's by 2013, if not before.

"Some economists think India will grow faster than any other large country over the next 25 years. Rapid growth in a country of 1.2 billion people is exciting, to put it mildly," it said.

Citing demography as one of the two reasons why India will soon start to outpace China, the magazine noted "China's workforce will shortly start ageing; in a few years' time, it will start shrinking. That's because of its one-child policy - an oppressive measure that no Indian government would get away with."

"India is now blessed with a young and growing workforce. Its dependency ratio - the proportion of children and old people to working-age adults - is one of the best in the world and will remain so for a generation," it said. India's economy will benefit from this "demographic dividend", which has powered many of Asia's economic miracles.

"The second reason for optimism is India's much-derided democracy."Indian capitalism is driven by millions of entrepreneurs all furiously doing their own thing."Since the early 1990s, when India dismantled the "licence raj" and opened up to foreign trade, Indian business has boomed."

"Ideas flow easily around India, since it lacks China's culture of secrecy and censorship. That, plus China's rampant piracy, is why knowledge-based industries such as software love India but shun the Middle Kingdom." "Given the choice between doing business in China or India, most foreign investors would probably pick China, The Economist said." But as the global economy becomes more knowledge-intensive, India's advantage will grow."

IMF raises India's growth forecast to 9.7%

The International Monetary Fund raised its India growth forecast for 2010, citing robust industrial output and strong macro-economic indicators, but warned that global economic recovery remained fragile.

IMF said in its World Economic Outlook report that Indian economy will expand 9.7% this year, up from the July forecast of 9.4%. The latest IMF forecast draws heavily on the April-June 2010 quarter GDP numbers, which showed India's GDP grew 10% at market prices, and the 13.8% industrial growth in July, driven by a robust manufacturing.

Asia's third-largest economy is projected to slow down to 8.4% in 2011. The IMF indicates considerable slowing down in 2011 possibly on account of weaker domestic demand and agricultural output coming back to normal levels.

The multilateral lender sees investments playing a greater role in the Indian economy. "Recent activity (10% year-over-year growth in real GDP at market prices in the second quarter) was driven largely by investment, and the contribution from net exports is projected to turn negative in 2011, as the strength in investment further boosts imports," the report said.

The Washington-based multilateral lender joined a number of independent agencies such as the Asian Development Bank, Goldman Sachs and rating agency CRISIL, which recently raised their growth forecast for India. India's official growth estimate for 2010-11 is well below that of IMF at 8.5%, but a large part of the difference is due to the methodology. The IMF estimates are based on market prices whereas official agencies calculate GDP growth at factor cost. Some difference is also due to IMF estimates being for calendar year while India follows an April-March fiscal.

The world economy, led by emerging markets, is forecast to grow by 4.8% in 2010 before falling back to 4.2% next year, but a sharper global slowdown is unlikely, the IMF said.

China is expected to grow at 10.5% in 2010 and 9.6% in 2011, it said, while lowering its US forecast for the year to 2.6% from 3.3% projected in July. The report said Latin America had recovered strongly and expected real GDP growth at about 7%.

The IMF has taken note of the increasing capital inflows and suggested a coordinated action as the best way of dealing with them, scoffing at the unilateral action by countries that has implications for others. The need for careful design at the national level, and coordination at the global level, may be even more important today than they were at the peak of the crisis a year-and-a-half ago, said the report, cautioning against any unilateral action by countries. "The best response to capital inflows may be a coordinated one, especially when they are driven by global factors or have global implications," it said, adding that resistance to currency appreciation by one country could discourage others.

2.2 INDIA INC

India Inc growth story gets better

India is doing well. The International Monetary Fund (IMF) has come out to state that the economy will grow by 9.7 percent in 2010 and 8.4 percent in 2011. That India has well and truly recovered from the recession is now well-established and it is currently undergoing a transition from the public stimulus to private sector-led growth.

The economy is on the fulcrum of an increasing growth curve. India is growing faster than just about every other country with China being the only exception. Given this backdrop, one can say the economy is back on track and the major drivers for further growth are in place.

According to a leading consultancy house, the economy will grow fivefold in the next 20 years. This is probably why the foreign institutional investor (FII) investments in India are continuing unabated despite the rising valuations.

Good recovery

India is probably one of the first countries to recover from the recession. Watched like a hawk by the Reserve Bank of India (RBI), India could avoid excessive leverage and mortgage defaults, and hence went into recession with lesser burden. This also helped it recover faster.

The government's focus on growth has helped in the recovery process. Calibrated and periodic stimulus programmes were undertaken by the government to stimulate growth. Slowly, stimulus-led growth has moved forward due to the private sector participation. Going by the macroeconomic numbers, this growth curve has just started and may lead to exponential private sector growth.

Factors supporting growth

Some economists think India will grow faster than any other large country over the next 25 years. They feel two factors will be major contributors to this growth. The first factor is the information technology revolution that is taking place in the country.

This is led by mobile connectivity. The rapid penetration of mobile services to the hinterland has brought about a connectivity that is about to bridge the difference between 'urban India' and 'rural India'. For the rural parts that suffered severely due to very poor infrastructure, like lack of roads and electricity, mobile connectivity is a means to overcome deficiencies of physical infrastructure.

Mobile is no longer a talking device to connect to family and friends. It is now a business tool to conduct various operations like banking, gathering information and trading. This technological revolution could prove to be the game changer for the country.

The second advantage India has is that of its dependence ratio - the proportion of children and senior citizens to working-age adults - is one of the best in the world and will remain so for a generation, in the opinion of many economists. They say that India's economy will benefit from this 'demographic dividend', which has powered many of Asia's economic miracles in the past.

Demographers say the emerging world will stay young while the rich world ages. In 2020 the median age in India will be 28, compared with 38 in America, 45 in Western Europe and 49 in Japan. These factors will come into play in the shift of power from West to East in the next 40 years in the world.

A rising young population, if proper skilled, can transform the economy with higher earnings, savings and investments. The urban population will double from the 2001 census figure of 290 million to perhaps 590 million by 2030. India has to spend USD 1.2 trillion on urban infrastructure, or at eight times today's rate.

The country will require more infrastructure facilities in the form of homes for people to stay, roads, ports, airports, railways etc. Building up these facilities will spur the GDP growth in the country.

Risks

The rosy picture painted by global economists while comparing India with other countries does have key risks. Having a large population is one thing. But getting them ready for employment is another.

In fact, it has been recently announced that India is ranked 67th in the global hunger index. This is an indication of the fact that in India, the proportion of hungry people has increased significantly in the recent times.

It is imperative that India sets a programme to capture its democratic dividend by increasing its infrastructure for education and upping the quality of education to make everybody employable. Infrastructure is woefully inadequate today not only in education but in all spheres, be it roads, ports, airports or railways.

The infrastructure facilities are bursting at seams for today's population levels. It is difficult to conjure up the rosy picture of global economists if the government's infrastructure spending does not increase manifold.

India Inc, 2010-20: The Rising Fortune

The Indian economy is firmly set on a high-growth path for the next decade. A young population, growing middle class, rising income levels and higher discretionary spends will ensure that demand for a wide range of goods and services remains high for several years to come. This offers the country's corporate sector an opportunity for tremendous growth. In the process, there will be several major forces that will define the way domestic companies operate and evolve.

What are the key forces that will evolve?

One of the most important trends will be an increase in competition. There are several reasons for this, some of which are already beginning to play out. To begin with, the country's leading companies will seek to enter new businesses to benefit from the opportunities that the economy is throwing up. We can also expect to see large global corporations looking to step up their India presence, as the country's increasing integration with the global economy provides easier access to its markets for producers based outside the country. Moreover, if capital flows continue as expected, we could see the rupee appreciating further, making imports more competitive.

CRISIL estimates that the Indian economy, led by growing consumption and increasing investment needs, can grow to $4.6 trillion by 2020 – in nominal terms, assuming constant exchange rates – indicating an addition of around $3.2 trillion to GDP over the next decade. Clearly, established domestic companies will be keen to benefit from this growth. Several companies will expand into new sectors – such as housing, retail, power generation, infrastructure, financial services, travel and tourism, education, healthcare, etc – as opportunities present themselves. Many leading Indian companies and groups have already initiated steps to implement this strategy. They are likely to emerge as strong competitors in the market place, backed by their superior financial flexibility.

The same factors will make the country an even more attractive market for MNCs. In the years to come, many MNCs will focus even more on India. Many MNCs today are struggling with weak demand growth in the developed economies; India will be among the few large economies that offers considerable growth potential. Thus, the importance of Indian market for MNCs already present in the country will grow further; MNCs that do not operate here can no longer afford to ignore not being present here. As a result, the leading global players will commit significant amounts of capital, and invest considerable senior managerial resources, to try and achieve a more meaningful presence.

Consequently, we expect the market share of MNCs to increase in many sectors over the next few years. MNCs will look to expand their strong presence in brand-driven consumer-facing sectors such as automotives, consumer durables and fast-moving consumer goods. They will seek to penetrate deeper in growth sectors such as pharmaceuticals, and capital goods for power, construction, mining and telecom. They will also enter segments – such as metals and mining, chemicals and petrochemicals and infrastructure – where their presence has traditionally been small.

We expect MNCs to adopt a combination of the following elements:

- Establishing a presence by building manufacturing capability,
- Entering into alliances or joint ventures with Indian companies to reduce time to market,
- Acquiring Indian companies to enhance (or establish) presence,
- Customising products for the Indian market,
- Optimising the price-value equation of their products and
- Leveraging local resources to meet global requirements

The country's growing integration with the global economy, as indicated by its free trade agreements, growing trade and rising capital flows, both to and from India, will also drive a greater intensity of competition. The integration – in the form of reduced tariff and preferential access provisions – will allow greater access to the domestic market to producers based outside India. It will also mean that investment decisions will be guided by these provisions and relative competitiveness in manufacturing, adding a new dimension to the competitive dynamics in the country's corporate sector.

An additional source of competition can emerge for domestic companies from appreciation in the value of the Indian rupee. The rupee has been volatile over the past three years, and has either depreciated or appreciated, depending on the pace and direction of capital flows. We believe that given the country's attractiveness as an economic destination, the velocity and quantum of capital flows to India (both debt and equity) will remain high. This would lead to further appreciation in the value of the rupee, making imports more competitive in the process.

Increasing competition does not mean that the outlook for the domestic corporate sector is negative. On the contrary, domestic companies are well positioned to compete effectively in the global and domestic markets. Over the next decade, they will focus on improving the diversity in their earnings profile, and on scaling up operations. This will allow them to defend their business profiles against intensifying competition.

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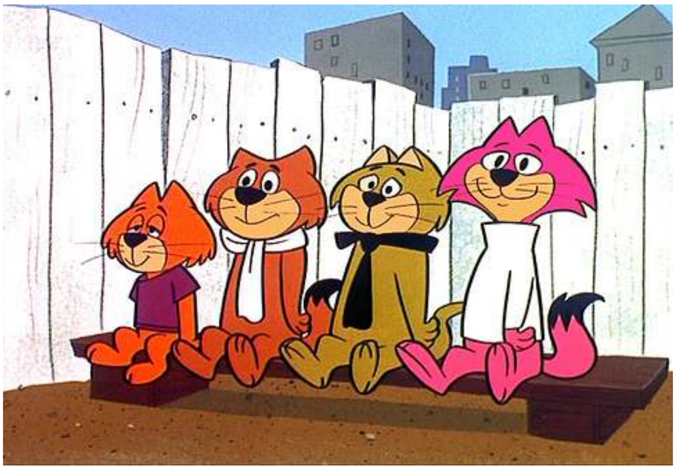


2.3 INDIA

India a hit for foreign investors

Two years ago, when the crisis on Wall Street reached its pinnacle, the high-flying Indian stock market fell with a thud as foreign investors took nearly $5 billion out of the country.

The situation is very different today. In September, foreign investors poured $7.1 billion into Indian stocks and bonds – a monthly record for foreign investment in India's securities market. The major stock indexes appear poised to breach the highs that they set in early 2008, when many analysts first argued that fast-growth developing countries were "decoupling" from the developed world.

Talk of decoupling is in the air again, especially here in India.

The United States, along with much of Europe and Japan, may stay in the economic doldrums for some time. But many economists and policy makers here say that the problems in developed economies could benefit emerging nations like India, as Western hedge funds, banks and other investors hunt for growth opportunities.

With an economic growth rate of nearly 9 per cent and a stock market that is more open to foreign investors than mainland China's, India has become a destination of choice for financial investors. In the first nine months of the year, foreigners invested $28.5 billion in Indian stocks and bonds – more than twice what they invested in the comparable period of 2009.

The Sensex index, India's equivalent of the Dow Jones industrial average, is up about 22 percent in the last 12 months and 114 percent since the end of 2008, and is now just a few hundred points away from the record high set in January 2008.

The Indian rupee has appreciated about 4 percent against the dollar so far this year.

The rest of the world is starved for growth, said an analyst and trader at Eastern Advisors, explaining why his New York-based hedge fund has increased investments in India and other emerging markets in the last year. And India is still producing relatively high real rates of GDP growth.

The strength of the market has been a boon for Indian companies, as well as the Indian government, which has been selling shares in state-owned firms.

There are also plenty of sceptics, of course, who say that the Indian stock market may be getting dangerously frothy. And Indian individual investors, burned by the 2008 crash, have shown more wariness than foreign money managers.

But foreign investors are moving money to emerging markets in part to take advantage of a growing gap between near-zero interest rates in the United States and Japan, and rising rates in India, Brazil and elsewhere. A key benchmark rate set by the Reserve Bank of India stands at 6 percent, up 1.25 percent since March. As the difference between rates grow, traders can make more money by borrowing cheaply in dollars and yen and investing that money in higher yielding stocks and bonds in developing economies.

The Institute of International Finance, an association of financial firms, estimates that emerging markets will receive $825 billion in private capital flows this year, up from $581 billion in 2009.

Some analysts and policy makers are increasingly worried about the torrent of cash flowing from developed to developing countries.

In developed countries, the flows undercut the efforts of officials in Washington, Brussels and Tokyo to revive their economies by pumping money into the economy at low interest rates. And in developing countries, the flows threaten to raise the value of currencies, making their exports less competitive and potentially inflating bubbles in stock and real estate markets.

Some Indian analysts say they fear that the increasing bullishness about developing nations is sending stocks here to dizzying heights that may not be justified, even in light of the country's high growth rate, which some expect to slow somewhat in the coming months.

Moreover, these people say investors appear to be ignoring the lessons of the recent financial crisis, which did not remain confined to the developed world.

"There are fairly serious risks of frothiness in equity markets escalating if capital continues to pour into India," said Eswar S. Prasad, an economics professor at Cornell. "We may be in the boom phase of a boom-bust cycle, with all the risks that entails."

Prasad, who has advised the Indian government on economic issues, says he worries that foreign investors in India could suddenly decide to withdraw their money, as they did in 2008, if the Indian economy slowed or if global markets were rattled by another crisis. That reversal could then pull down real economic growth in India by depriving the country of capital.

In 2008, for example, India's growth rate fell to 6.7 percent, from 9.2 percent, partly because foreign investors took billions of dollars out of Indian stocks and bonds and slowed down new investments. The slowdown severely hit real estate developers, airlines and other companies with large capital requirements.

One big concern today is that the majority of the foreign money flooding into India is going into the stock market, rather than into new projects and start-up companies. While flows into the stock market have more than doubled, foreign direct investment into India fell more than 24 percent in the first seven months of the year, to $12.5 billion, compared with the comparable period a year earlier.

Unlike holdings in the stock market, which can be sold quickly when traders in London or New York get nervous, direct investments in factories, stores and companies are more difficult to sell and are usually held for longer periods, economists say. Still, Indian officials, bankers and economists say they do not worry much about a repeat of 2008. Their optimism appears to be based in part on the belief that investors are unlikely to find better opportunities elsewhere in the world.

India, these people say, is beginning a long period of high growth because its population is young and demanding more goods and services. The government is slowly beginning to improve infrastructure and further loosen control over the economy. And the financial system here is healthier than in Western countries, where banks still have many bad loans on their books.

2.4 INTERNATIONAL

Intervention Is the Name Of The Game

It's the silly season for currency interventions. Recently, Guido Mantega, finance minister of Brazil warned an 'international currency war' has broken out, as Brazil's central bank scrambled to buy close to $1 billion a day for almost two weeks – about 10 times its daily average – Mantega was only voicing what many governments have already expressed privately.

That for all the calls for collective action and bonhomie displayed at various G20 meetings, when it comes to ground realities, it is each country for itself!

So, what's new about that?

What is new is that unlike in the past when 'currency intervention' was always a developing country refuge, a third world stratagem that first world countries eschewed, this time round, first world countries are nothing loath to join the game.

Last month, Japan joined Switzerland in intervening in the foreign-exchange market. As the yen surged to a little short of 90 to the dollar, the strongest in 15 years, the central bank, fearing a strong yen would jeopardise recovery, sold an estimated $20 billion yen. The last time it intervened to sell yen in the foreign-exchange market was in 2004, when the yen was around 109 per dollar.

It is not the only one. The Swiss central bank has been intervening to prevent the appreciation of the Swiss franc against the euro for close to six months now. The last time it intervened was in 2002.

The Japanese and the Swiss are not alone. South Korea, host to the next G20 meet, has shown as much alacrity in intervening to keep the won weak; so have Taiwan and Singapore. In the developing world, meanwhile, currency intervention has become much more frequent. China, an old hand at the game, has been joined by Brazil, the Philippines, India and Malaysia, to mention just a few.

The danger is if intervention becomes the norm, rather than the exception, the resultant 'currency war' will not leave any winners. Worse, it will mean goodbye to any hopes of rebalancing the world economy.

Why is that important?

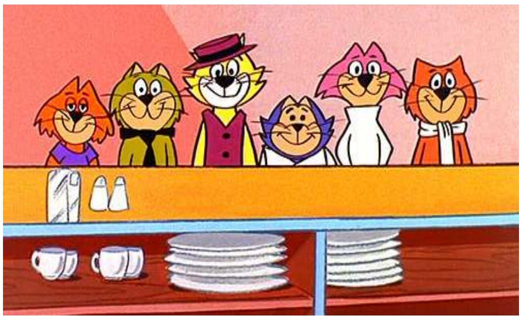
Because as long as the global economy remains perilously unbalanced, the next crisis is not far away. Orderly currency realignment is, therefore, critical to rebalancing. But, that calls for coordinated action by the major world economies (read G20) – not haphazard, beggar-my-neighbour intervention of the kind that seems to be the fashion now. The reason is simple. Cheap money policy in the US that causes the dollar to weaken against other currencies will help boost US exports and rein in the US current account deficit. Provided no country intervenes! So, left to itself, this realignment in currency values is a part of the remedy the world is seeking. But this is where the catch lies! China, the world's largest exporter, continues to suppress the value of the renminbi.

In the pre-crisis days, when economic growth was strong, most countries were prepared to look the other way and restrict their response to jaw-jaw. Not any longer! Today, as countries struggle to remain competitive in the global market, many seem to have decided to copy the Chinese. Hence the proliferation of currency interventions aimed at making currencies cheaper in order to boost exports.

The problem is this 'if you can't beat them, join them' philosophy could be catastrophic for global recovery. As each country looks to its own backyard, it is going to become much more difficult to reach a consensus on currency realignments.

Exactly 25 years ago, the major global economic powers could hammer out the Plaza accord that led to an orchestrated weakening of the dollar, a resurgence of the US economy and a corresponding decline of the Japanese. That was possible back in the 1980s as the US was the unchallenged economic superpower. Today, such a one-sided accord would be almost unthinkable. South Korea, the host of the upcoming G20 meeting in November, is reluctant to even highlight the issue on the agenda, partly out of fear of offending China, its neighbour and main trading partner.

Yet, there is no getting away from the need for some kind of coordinated action.



A situation where every country intervenes against its own currency in the foreign exchange markets in a spirit of competition rather than cooperation is not a zero-sum game. Smaller, less competitive countries like India are bound to get hurt more. Moreover, intervention comes at a cost.

In the Indian context, accumulation of foreign exchange reserves and release of additional liquidity into the system adds to domestic liquidity, neutralising the RBI's efforts to tighten liquidity to rein in prices. The additional liquidity could be sterilised but sterilisation, too, has a cost since the domestic rate of interest is usually higher than the return on foreign exchange reserves.

Non-intervention is not an option either; not in a scenario where more and more countries are intervening.

So where does that leave us?

If both intervention and non-intervention are bad, what is the only option that remains? Global cooperation! For the moment, however, coordination seems further away than ever. In a globalised world if each country behaves like John Connolly (who once famously retorted 'our currency, your problem,' to a European delegation worried about the impact of a cheap dollar on their exports) and starts a competitive devaluation of its currency, the resultant fallout will soon encompass the whole world.

If the slogan of the forthcoming G20 meet in Seoul, 'shared growth beyond crisis,' is to be realised, the G-20 must act before it is too late. Before the cocky 'our currency, your problem' approach that seems to colour every country's approach today gives way to a humbler but truer 'your currency, our (collective) problem' view, that should inform our 21st century world!

2.5 WARNING SIGNALS

Tax on inflows

If administrative measures such as restricting FII sub-accounts do not curtail the inflow of excess capital. India must revisit levying a Tobin tax on inflows.

With a record inflow of more than $21 billion from foreign portfolio investors into Indian equities, year to date, it is time to revisit the possibility of using some form of Tobin tax as a policy tool to moderate foreign inflows and to improve the quality of such flows.

Tobin tax, suggested by the Nobel laureate economist, James Tobin, envisages a tax on foreign exchange transactions to cushion exchange rate fluctuations by levying a penalty on short-term financial round trips into another currency.

In a more generic form, this could be a tax on financial transactions to curb short-term speculative trades and to encourage long-term investments.

However, such taxes can have the effect of raising the cost of allocating capital, thus reducing the efficiency of financial intermediation and causing distortions in the functioning of financial markets.

While an introduction of a tax would certainly dent India's free market credentials, there are clearly limits up to which burgeoning forex inflows can be managed by resorting only to non-tariff-type barriers.

Some variants of Tobin-type taxes have been tried in many countries including Brazil, Chile, Argentina, the Philippines, Malaysia and Israel, to name a few. The results have been some what mixed with foreign investors continuing to invest if there is a compelling case to do so even after factoring the distortions caused by the Tobin-type tax.

The security transaction tax introduced in India in 2004 is a Tobin-type tax, which caused some short-term rumblings in the market, but it was business as usual after a few months.

At nearly $300 billion, India has more than adequate forex reserves and therefore in an ideal situation, foreign capital inflows should roughly match the current account deficit.

In addition to India's attractiveness as an investment destination, forex inflows into India are influenced by the prevailing investment climate elsewhere in the world.

As inflows mount, the rupee appreciates, or if the exchange rate is kept stable to help exporters, forex reserves accumulate. The rupees released to the system while accumulating forex reserves would lead to increased levels of inflation. To curb this, interest rates would need to be raised, which in turn could attract even more capital flows.

Sterilisation of the excess rupee liquidity is another option, but this requires the banking system to be willing to hold the additional supply of low-yielding government bonds. This also involves a cost to the state on account of the negative carry between the yield on its forex assets and the interest rate on the sterilisation bonds.

Unbridled international capital flows thus leave central banks with the onerous task of fighting exchange rate appreciation of the domestic currency on the way in and depreciation on the way out.

In the late 1990s,at the time of the Asian crisis, the Malaysian government had taken the extreme step of locking in foreign investments into stocks for a year. China continues to maintain a depreciated currency and centralised credit allocation to keep its exports humming despite strong capital inflows, resulting in massive trade surpluses that are invested abroad.

The US has been calling for a revaluation of the Chinese currency on a scale that is comparable to the Plaza deal that was agreed between five leading western countries in 1985 to revalue the yen.

With prospects of further quantitative easing in the US and Europe, capital inflows into the emerging world could reach unprecedented proportions in the coming months. The scale of capital flows into the Asian emerging markets is already exceeding that seen at the peak of the previous cycle in 2006-07 by about 60%. Capital is heading Asia's way, whether it wants it or not and it is time central banks find judicious ways to tame the impending volatility without threatening the broader economy.

India has an arsenal of non-tariff-type barriers to foreign inflows in the form of limits on foreign holdings of rupee-designated debt paper, controls on external commercial borrowings, sector-specific limits and in some cases, prior approvals on foreign holdings in the equity capital of Indian companies.

In addition, foreign investors are required to deal with high levels of uncertainty relating to several unsettled issues in tax administration and bureaucratic controls on foreign investor access, etc.

In times of burgeoning inflows in the past, the security market regulator has tweaked regulations relating to participatory notes to moderate such flows. The recent measures at tightening the registration process by denying access to foreign institutional investors and sub-accounts that have not met with the expected transparency standards relating to their holding structure can be seen as yet another measure to not only clean up the system but also to moderate inflows.

Tobin-type taxes may need to be considered only if a stage is reached where foreign inflows cannot be managed by administrative measures like the ones detailed above.

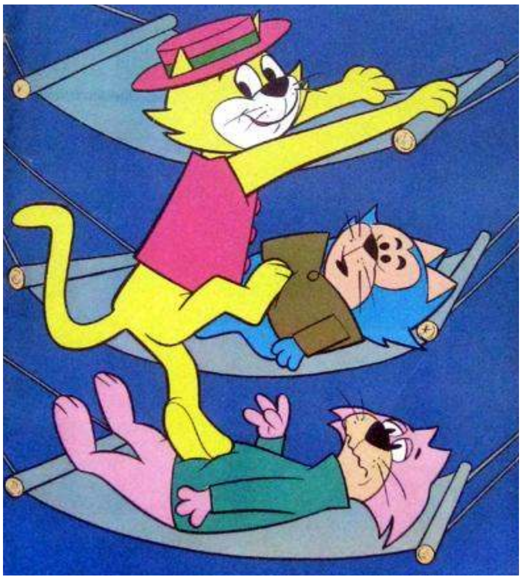
However, with several Indian companies and stock indices being traded in the international bourses, introduction of a Tobin-type tax would most likely end up exporting the business of trading in Indian stocks. This can have serious consequences affecting the liquidity and depth of the Indian stock markets.

One recent example is the increased activity in Nifty futures in Singapore after the introduction of the securities transaction tax in India.

While it is important to ensure that excessive capital inflows do not cause serious disruptions to the Indian economy, it needs to be recognised that efficient financial intermediation and a dynamic financial sector are essential for the proper functioning of a market economy like India.

3. ALTERNATIVE ASSETS

How to make money without stocks



Normally, you will hear phrases like 'book profits', 'sit on cash' and so on when the stock market inches close to psychologically-significant figures. However, this time around, if you pin back your ears, you may also hear someone whispering 'alternative assets'. It is not just the stock market which is close to breaking a historical high, other traditional assets like gold are also hovering around record highs. Things are fluid on the fixed income side as well. And, with interest rates hardening, it is not a great time for long-term investors in debt either.

With the markets touching new highs, we are asking investors to book some profits in equities and hold cash or build their alternative assets portfolio. Alternative assets are non-traditional assets with potential economic value that is not found in a standard investment portfolio. Alternative assets could be precious metals (gold and silver), private equity funds, real estate funds, commodity ETFs (exchange-traded funds) or structured products.

The total assets under management under alternative assets are currently pegged at around `18,575 crore. With Indian investors looking for different options for portfolio diversification, alternative assets will grow at a rate of 100% over the next three years.

Alternate products are offered to clients who already have some experience with equities and bonds and are looking for portfolio diversification. They could constitute about 10% of the portfolio, depending on the risk profile of the client. Generally, alternative assets are recommended to clients who have already built a large portfolio comprising equity and debt and are looking for an opportunity to invest in some uncommon assets.

Precious Metals: Despite gold prices moving up in the past one year, it is the most preferred alternative asset. The yellow metal is preferred by one and all not only in India but across the globe. It has a low correlation with other asset classes such as equities and debt and is considered a safe haven during times of economic crises. Some even regard it as an alternate currency.

Gold is a safe haven, liquid asset and acts as a hedge against inflation and currency shifts. Hence, we recommend clients to allocate around 5% of their portfolio to gold. Experts say investors should hold gold in the form of exchange-traded funds (ETFs), as there is no risk to storing them, the cost of buying is low and the asset has high liquidity.

We have also been recommending silver ETFs as an add-on to gold ETFs to high net wroth individuals. However silver ETFs are listed in the UK and the US, and investors would have to buy using the $200,000-window for overseas investments offered by the Reserve bank of India (RBI). This is tough as you would need to have a trading account with an overseas broker.

Structured Products: Simple structured products with capital-guarantee products are offered to clients, with some participation in the Nifty/gold upside. Take the case of an investor who invests `100 in this product, with a maturity of three years. The fund will allocate `80 to debt and `20 to equity (Nifty). An

8% interest on the `80-debt component will give approximately `24 as interest in three years, which ensures that the principal (`100) is intact. If we assume that `20 allocated to Nifty futures or gold futures doubles in three years, the investor will get `40. Thus, at the end of the term, the investor gets `144, or an absolute return of 44%, on his investment. While this is a simple structured product, there are more complex products with Nifty participation, gold as an underlying – they are created on demand from clients and market situation.

Private Equity: Private equity funds typically make investments in companies with a short established track record and are in need of funds to expand. It is a pooled investment vehicle. This route is used to make investments generally in unlisted entities, with a high growth potential. The returns could be high, in case the company succeeds, as you invest in it in the early stages of its growth. Typically, you need a time horizon of around 5-7 years for such an investment. While you go for diversified private equity funds, you can invest in thematic or sector-specific private equity funds. Sector-specific private equity funds have a far higher risk than diversified funds, since investments could be limited to a single sector and in case of a downturn, things could turn ugly. Some recent sector-specific funds include Kaizen Education Fund, Asian Healthcare Fund, Tata Capital Healthcare Fund and Enam Infrastructure Fund.

Real Estate: Indians have an intrinsic liking for real estate, and many of them buy land. It has been considered as one of the most tangible sources of wealth accumulation. With land growing increasingly scarce in India, the value of real estate holdings is expected to grow. Real estate investors earn returns by way of rentals and value appreciation of the property. One can choose to invest in commercial or residential properties. Real estate funds are better vehicles to invest in real estate opportunities.

Anand Rathi and Knight Frank recently launched a rental yield fund. The fund is based on rental yields and invests in commercial real estate. Rental yield funds invest in properties that have been rented out based on the premise that such properties have lower risk compared with properties under development. In addition, rented properties also provide a regular income to investors. The total assets in real estate funds in India is around `6,753 crore.

4. FINANCIAL SECTOR: TRANSFORMING TOMORROW

Currency War

It comprises competitive measures by governments to improve their trade by manoeuvring exchange rates. A cheap currency, vis-à-vis the dollar, adds to the competitive advantage to the exporter. Countries such as China, Brazil, South Korea and Japan have taken measures to devaluate their currencies which would help them boost exports and create jobs.

An attempt by the government to prevent its currency from appreciating too steeply and too fast against competing nation is what is seen as currency war between different countries. The history of currency wars dates back to the Great Depression era when major economies devalued their currencies as a part of a measure to give preference to local goods over imported ones.

When competitors devalue their respective currencies, domestic exporters tend to lose out on the price advantage as buyers prefer to buy from a cheaper currency. This in turn hurts income as well as the jobs in the export sector and the prospects for the economy. The central bank at such times tries to intervene – buy dollars and create an artificial demand for the dollar, devaluing the value of the local currency in the process and retain some price advantage for the exporter. But buying dollars involves a fiscal cost as the central bank has to pump in equivalent amount of rupees and again mop it up by selling bonds. These bonds need to be serviced by the government. This would in turn worsen the fiscal position.

4.1 FINANCIAL ADVISORS:

Weigh impact on investors:

'Beggar thy neighbour' policy

Currency wars are a part of what is described as a 'beggar thy neighbour' policy – attempts by a country to solve its economic problems by causing worse difficulties in other markets. When all countries engage in such policies, it turns out to be a race to the bottom.

As countries compete to devalue their currencies to save the interest of their exporters, it collectively reduces demand for foreign goods, something that world economies cannot afford at a time when the process of global recovery from the after affects of the crisis of 2008-09 is still underway.

Also , competitive currency devaluation is happening at a time, when some of the developed economies have a soft money situation, wherein monetary regulators are on a quantitative easing spree, lowering their interest rates, which is making emerging economies trying to regulate their inflation an arduous task, as direction of the capital flows has turned towards them.

There is also the fear of a bubble, which will burst once developed economies are back on track and the flow of capital shrinks. This shrinking is expected to be first reflected in the currency markets.

The United States is looking for global support at forums such as the G20 to the IMF, so that there can be collective pressure on China to ease up on the Yuan. IMF feels that it is the right place to make progress on the currency question. Emerging nations are not very keen to range themselves in this battle.

G-20 accord

In the wake of the subprime crisis, the G20 coordinated its fiscal and monetary actions to avoid an economic catastrophe. It succeeded in averting a possible repeat of the Great Depression.

In recent months, as most people have come to believe that the worst is over, the sense of emergency is gone. Cooperation has given way to bickering. Quarrels have erupted amongst the G20 as to how best to sustain the ongoing recovery. As a result, growth in the advanced economies remains sluggish and is acting as a drag on the global economy.

The US blames emerging markets, mainly China, for not doing enough to foster recovery. The US itself faces criticism from some of its own economists, not just from emerging markets. The meeting of finance ministers in Seoul failed to resolve the quarrels in the G20 although it may have succeeded in averting a trade war for now.

'Global imbalances' are widely believed to have been an important factor underlying the subprime crisis. Everybody knows what is to be done. The US and other advanced economies need to export more and consume less. China and other emerging markets with large current account surpluses need to consume more and export less. Neither has happened, at least not to the extent required.

The US believes this is because China and other emerging markets refuse to allow exchange rates to rise to reflect market forces. The emerging markets say keeping the dollar weak by relying entirely on loose monetary policy is a form of exchange rate manipulation. They cannot afford to allow the dollars flooding into their economies to dictate their exchange rates as any sharp reversal of inflows could prove destabilising.

At the recent Seoul summit of G20 finance ministers, the US changed tack in order to secure agreement on policy coordination. US treasury secretary Tim Geithner dropped the American insistence on exchange rate alignment and instead sought agreement on keeping current account imbalances within an agreed limit - say, 4% of GDP.

This would allow emerging markets to contain their surpluses in ways other than appreciation in their nominal exchange rates. Emerging markets could achieve an adjustment in the real exchange rate through a rise in inflation. Or they could simply try to reduce the surplus of savings over investment which is mirrored in a current account surplus.

The proposal has a serious catch to it. As Gavyn Davies points out in the Financial Times, only four economies would be breaching the 4% current account surplus target: Saudi Arabia, Germany, China and Russia. Of these, Saudi Arabia and Russia would be excluded because the Geithner proposal allows exceptions to be made for countries with large commodity-producing sectors.

Germany is not intervening in the markets to keep its currency undervalued and the IMF projects that its current account surplus would fall below 4% by 2015.

So, the latest US proposal can easily be construed as targeting a familiar villain, China. Davies also notes that there are only two countries with a current account deficit of over 4%, Turkey and South Africa. The US itself runs a current deficit of 3.2% and would be conveniently excluded from making any adjustment!

Not surprisingly, the US proposal failed to win approval in Seoul. The G20 merely agreed to "move towards more market-determined exchange rate systems that reflect underlying economic fundamentals and refrain from competitive devaluation of currencies". That statement fails to tell us exactly who should be doing what.

Where do we go from here? The US must recognise that it cannot shift the burden of adjustment entirely onto emerging markets. This, in turn, means it has to revisit its current approach of relying wholly on monetary policy to revive the US economy. Fiscal policy will have to play the role Keynes had famously assigned to it in a recession. An impressive array of US economists - Paul Krugman, Christana Romer, Bradford de Long, Joseph Stiglitz, to name a few - happens to think so.

It is becoming clear that monetary policy by itself cannot do the trick. Since interest rates are close to zero, the Fed has resorted to a second round of 'quantitative easing' - the infusion of money into the system through the purchase of long-term government bonds. But this is just not stimulating private demand.

Private consumption has fallen sharply in order to correct the excesses of the subprime crisis. Private investment is being held back by what Greenspan believes to be the lack of investor confidence. It is also possible that private investment is being constrained by banks' unwillingness to lend. When banks can borrow at virtually zero interest, they can make easy money in the markets. They do not have trouble themselves with risky loans. In such a situation, government spending alone can pick up the slack in demand.

Unfortunately, the Greek debt crisis earlier in the year seems to have coloured the perceptions of policymakers. They were quick to conclude that any further fiscal stimulus was unsustainable. But there are economies and economies.

The US is not Greece. Greece had to correct its course because the market rates on Greek government bonds soared. As Christina Romer points out, even today the markets are willing to lend to the American government at the lowest 20-year interest rate since 1958. American government spending will not only revive the US economy, it will strengthen the world economy and restore the financial markets to health.

The IMF's latest World Economic Outlook carries the results of an internal study. The study scotches the notion that fiscal consolidation can stimulate growth even in the short-run by boosting household and business confidence. It corroborates the Keynesian view that fiscal consolidation in the short-run typically results in contraction of output.

The lesson for the US is clear: For now, fiscal and monetary stimulus must go hand in hand. At the same time, Congress can reassure the markets by approving plans for long-term consolidation. The US cannot expect China and other emerging economies to shoulder the entire burden of adjustment. Adjustment, like charity, must begin at home.

4.2 FINANCIAL PLANNERS
Value unlocking for all stakeholders:

Policy Option

Ultra-low interest rates in rich countries are fuelling massive fund flows into emerging markets, pushing up their currencies and inflating prices of stocks, property and other assets.

World Bank President Robert Zoellick said emerging nations should consider various measures to control short-term capital flows.

But IMF deputy managing director, Naoyuki Shinohara, said it was natural and welcome for money to shift into economies with strong growth and policymakers should not try to curb such flows or use intervention to defend specific currency targets.

When there are occasionally volatile moves in the market, intervention cannot be ruled out. But it's totally undesirable for a country to intervene consistently to keep currencies at a certain level.

Shinohara, who was Japan's currency tsar before assuming the IMF post, warned Tokyo faced a losing battle trying to go against the tide and weaken the yen as monetary conditions in the United States and Europe are expected to remain easy. This is not something that Japan can control. If Japan tries to adjust this, it will distort markets. Tokyo should instead focus on structural reforms and monetary easing to beat deflation. Zoellick, however, was careful not to critic Japan and other nations which have stepped into markets to weaken their currencies.

Prime Minister Naoto Kan reiterated that sharp currency moves cannot be ignored and the government would act decisively as needed.

Signs of a "currency war" are growing as major industrial nations want to keep their exchange rates weak to help their struggling exporters while emerging economies such as Brazil and South Korea are taking or planning steps to curb capital inflows.

IMF Managing Director Dominique Strauss-Kahn warned, “Using exchange rates as a policy weapon to undercut other economies and boost a country's own exporters "would represent a very serious risk to the global recovery." U.S. Treasury Secretary Timothy Geithner said. “Instead, nations with large trade surpluses should let their currencies rise to prevent a devastating round of competitive devaluation”.

4.3 INCLUSIVE CEOs
Innovative responses to problems

Deceptive empiricism

GUIDO Mantega, honourable finance minister of Brazil, is to be credited with the latest buzzword – 'Currency Wars'. Senor Mantega had stated that "we're in the midst of an international currency war".

In one of those remarkable feats of deceptive empiricism, that is now unfortunately commonplace, the US dollar has fallen by about 25% against the Brazilian real since the beginning of last year, making the real one of the strongest performing currencies in the world.

It is first necessary to set the record straight. At the end of July 2008, before the global crisis erupted, the Brazilian real traded at 1.56 to the US dollar. In late September 2010 it traded at 1.71, that is, 10% lower. What then about the "25%" which had made "the real one of the strongest performing currencies in the world"? That was because during the crisis, the real was the worst performer against the US dollar: from 1.56 in July 2008 to 2.62 in early December 2008, a massive drop of 68%. In contrast, the euro fell 24%, the Indian rupee by 22%, the Korean won 55% and the Chinese renminbi by 0%. The Japanese yen appreciated during the crisis by as must as 23% at one point. In fact, all Asian currencies, having first lost much less (or actually gained) ground vis-à-vis the US dollar, have also recovered more ground – whether it be the yen, renminbi, rupee, Malaysian rignitt or Taiwan dollar. Only the Korean won is in a position comparable to the real.

If it had been only this bit of tendentious and mendacious reporting, it would have been par for the course in a world where distortions and deliberate misleading are considered valid weapons in our time of peace. It is, however, disconcerting to find the use of the phrase 'currency wars' in briefing statements of senior officials of the IMF. Does that august body subscribe to the deluded narrative which has concocted this so-called 'currency wars'? In fact, should it not be its obligation to straighten the facts?

Some national governments are comfortable to see their currency zip all over the place, while others value stability and restraint, both in their actions and statements. It should not surprise social scientists, but it will perhaps many economists, that in such matters, there is an issue of culture. Just as leading European continentals look down upon the crazy Anglo-Saxon appetite for boom and bust, much preferring to lock up the excesses of individualism in the brick and mortar of massive government – run by clever civil servants or generals (take your pick) and not by the déclassé trader. So do Asian governments differ in placing great importance on stability, hence on gradual change and no sudden about-turns, please.

Just 13 years ago, the IMF, backed by the developed West, sought to amend its articles to define currency convertibility away from current account convertibility towards "capital account liberalisation" , the term "liberalisation" replacing "convertibility" at the last moment being a nod to the then ongoing Asian currency crisis. And today, we get advice from many in the West on how capital flows are a concern and controls may be a good idea. Of course, having so greatly profited from capital, developing a disdain now is not unexpected. It is an inevitable and defining characteristic of old elites.

THE crux of the matter is of course the adamant refusal of the US economy to look up by the politically acceptable degree, despite all the mega-doses of stimulus medication. The advisers to the current administration clearly had excessive regard for the power of fiscal stimulus, irrespective of the circumstances. And perhaps, the evidence suggests an equally great lack of familiarity in the determinants of business decisions. They basically told the citizenry that the trillions of dollars being spent, the debt to be billed to them, would lift the economy up by the scruff of its neck; unemployment would be checked at 8%; and the economy would soon grow by 4%. Unsurprisingly, none of that transpired.

With unemployment in double-digits, the recovery sluggish and the public mood darkening, the diagnosis (partially correct) is that the stimulus did fail to live up to promises made. Why? Because, it (the resultant incremental demand) leaked out through imports to China. The obvious question is — did you not think of it before spending the trillions? However, the deeper question remains: how to reinvigorate the dynamism of the American economy?

It is only by achieving this, will “global (trade) imbalances” be fundamentally resolved. If China were to revalue its currency wholesale tomorrow – which it won’t – the American consumer will mostly end up paying more, at least for some time to come. It is unlikely to create American jobs in manufacturing. Furthermore, the many new regulations that the present administration has brought into force are more likely to undermine American business energy than otherwise. Finally, the US seems singularly unwilling to have a confrontation with anybody and the China currency issue is perhaps the most classic.

Talking about Chinese currency manipulation (and what China may do with the $2.8 trillion foreign currency assets) is domestic political currency, but not foreign policy. That is unlikely to change. Days after the House of Representatives passed the enabling Bill to act against China, the Senate adjourned without discussing the issue. Considering that Congress adjourned without taking a vote on the budget, not taking the currency Bill forward may appear as small change.

However, it is unlikely that after the elections of November 2, there will be a change in the unwillingness to have a face-off. This perhaps stems from a realisation that while it is convenient in domestic politics to speak thus, not only will a confrontation with China have many unpredictable consequences, but the domestic policy arguments for such action may indeed be seriously flawed.

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4.4 ISSUES OF THE PRESENT

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

Inflation & deficit may rise if capital inflows spike up

Low rates in the developed world and quantitative easing increase the possibility of spike in capital inflows to India.

Morgan Stanley's global economics team expects interest rates in the G3 to remain low for a longer period. Indeed, the team expects average policy rates in G3 – comprising the US, eurozone and Japan – to remain close to 0.6% until end-2011. Moreover, the team thinks the Fed could announce additional quantitative easing, which would involve about $1.2 trillion of asset purchases.

Over the last few weeks, there has been a significant increase in capital inflows into the region, and this has raised the debate on managing capital inflows to ensure that it does not add to inflation and asset bubble risks.

So far, capital inflows have not been a concern. Capital inflows into India have been well below the peak in F2008. In the previous cycle, 12-month trailing sum of capital inflows had reached a peak of $106 billion as of March 2008. Based on trends in forex reserves and our estimate of current account deficit and revaluation in non-dollar currencies in forex reserves, we believe that during the last 12 months, capital inflows would have been about $65-70 billion. Moreover, high current account deficit is absorbing bulk of the capital inflows. We believe that during the 12 months ending September 2010, the current account deficit would have been about $50 billion, largely offsetting the capital inflows. We believe that the recent appreciation of the rupee against the dollar seems to be creating a notion that the balance of payment surplus has risen sharply. We believe this trend was a reflection of the weakening of the dollar rather than an appreciation of rupee. On trade weighted basis, the rupee has not appreciated much during this period. For example, since July 1, while the rupee has appreciated against the US dollar by 4.8%, it has depreciated against the euro by 6.1%.

While so far capital inflows have been manageable, there is a risk that capital inflows into India may rise further from the current levels if US Fed implements additional quantitative easing in early November. If capital inflows do rise sharply toward $100 billion or more, the complexities of policy management will increase in the context of current macro environment with strong GDP, high inflation and rising current account deficit.

What will be the policy response going forward if capital inflows rise sharply?

The RBI will hesitate in allowing currency appreciation: On the real effective exchange rate (REER, trade-weighted basis adjusted for inflation differentials) basis, the currency is already close to the 2007 peak. Considering that the current account deficit is already high, the RBI may hesitate in allowing a major appreciation in nominal trade-weighted exchange rate. If capital inflows rise sharply in the first stage, the RBI may intervene more in the forex market.

Currently, interbank liquidity is already tight and the RBI has been injecting funds on a daily basis.

Hence, initially the RBI may not even need to sterilise the liquidity arising on account of forex intervention. In case the magnitude of capital inflows is large, the central bank can start issuing market stabilisation scheme bonds and reverse repos to sterilise the increase in liquidity arising from forex intervention (buying dollars, selling rupees). In the second stage, as capital inflows continue to rise above $100 billion, there is a chance the government may initiate some soft measures to discourage debt-related inflows.

Aggressive tightening in monetary policy will be a challenge: Although inflation has been moderating, it remains high. So far, the burden of managing inflation risks has been on monetary policy. After cutting the repo rate by 425 bps from the peak of 9% between September 2008 and April 2009, the RBI has lifted it up by 125 bps. Short-term markets rate has risen by 225 bps. However, real interest rates still remain negative and will likely remain very low even as the short-term rates rise further and inflation moderates over the next six months. Although so far the debt-related capital inflows have been manageable, there is an increased risk that these inflows may start rising if the RBI tightens monetary policy aggressively. Moreover, as the corporate sector is able to fund itself more easily from the capital market, the ability of the monetary policy to influence aggregate demand will be limited.

Policy response to rising capital inflows

Fiscal policy needs to play more active role, going forward: We believe that fiscal stimulus has probably played a bigger role in growth recovery since the credit crisis compared to monetary policy. In F2008, the consolidated fiscal deficit (including off-Budget expenditure) stood at 5.8% of GDP, the lowest since F1983. However, pre-election spending , a wage hike for government employees and stimulus related to the credit crisis meant that consolidated national expenditure to GDP shot up by close to 4 percentage points between F2008 and F2010. Moreover, the government had also provided support through a cut in indirect taxes, which has not been fully reversed as yet. The consolidated fiscal deficit (including off-Budget expenditure) increased to 10.8% of GDP in F2009 and remained high at 10.3% of GDP in F2010 compared to 5.8% of GDP in F2008.

Although the central government will report a reduction in fiscal deficit in F2011, this has been largely supported by one-off items like collection in 3G and broadband wireless access (BWA) licence fees and higher collections from divestment in SOEs. The expenditure to GDP (including off-Budget oil subsidy) will remain closer to the peak in F2011 and the aggregate demand push remains intact. Indeed, in the first five months of the current financial year, the central government's expenditure has increased by 30% year-on-year.

We believe the time has come for the government to tighten the fiscal policy swiftly to manage the aggregate demand as the private sector spending is rising quickly. In the absence of this move from the government, we believe inflation and current account deficit could only rise if capital inflows spike up.

5. BANKING SECTOR

The Federal Reserve's relevance test

WITH interest rates near zero, the US Federal Reserve and other central banks are struggling to remain relevant. The last arrow in their quiver is called quantitative easing (QE), and it is likely to be almost as ineffective in reviving the US economy as anything else the Fed has tried in recent years. Worse, QE is likely to cost taxpayers a bundle, while impairing the Fed's effectiveness for years to come.

John Maynard Keynes argued that monetary policy was ineffective during the Great Depression. Central banks are better at restraining markets' irrational exuberance in a bubble – restricting the availability of credit or raising interest rates to rein in the economy – than at promoting investment in a recession. That is why good monetary policy aims to prevent bubbles from arising.

But the Fed, captured for more than two decades by market fundamentalists and Wall Street interests, not only failed to impose restraints, but acted as cheerleaders. And, having played a central role in creating the current mess, it is now trying to regain face.

In 2001, lowering interest rates seemed to work, but not the way it was supposed to. Rather than spurring investment in plant and equipment, low interest rates inflated a real-estate bubble. This enabled a consumption binge, which meant that debt was created without a corresponding asset, and encouraged excessive investment in real estate, resulting in excess capacity that will take years to eliminate.

The best that can be said for monetary policy over the last few years is that it prevented the direct outcomes that could have followed Lehman Brothers' collapse. But no one would claim that lowering short-term interest rates spurred investment.

Indeed, business lending – particularly to small businesses – in both the US and Europe remains markedly below pre-crisis levels. The Fed and the European Central Bank have done nothing about this.

They still seem enamoured of the standard monetary policy models, in which all central banks have to do to get the economy going is reduce interest rates. The standard models failed to predict the crisis, but bad ideas die a slow death.

So, while bringing down short-term T-bill rates to near-zero has failed, the hope is that bringing down longer-term interest rates will spur the economy. The chances of success are near-zero.

Large firms are awash with cash, and lowering interest rates slightly won't make much difference to them. And, lowering the rates that government pays has not translated into correspondingly lower interest rates for the many small firms struggling for financing. More relevant is the availability of loans. With so many banks in the US fragile, lending is likely to remain constrained. Moreover, most small-business loans are collateral-based, but the value of the most common form of collateral, real estate, has plummeted.

The Obama administration’s efforts to deal with the real estate market have been a dismal failure, perhaps succeeding only in postponing further declines. But even optimists don’t believe that real estate prices will increase substantially any time soon.

In short, QE – lowering long-term interest rates by buying long-term bonds and mortgages – won’t do much to stimulate business directly.

IT MAY help, though, in two ways. One way is as part of America’s strategy of competitive devaluation. Officially, America still talks about the virtues of a strong dollar, but lowering interest rates weakens the exchange rate.

Whether one views this as currency manipulation or as an accidental by-product of lower interest rates is irrelevant. The fact is that a weaker dollar resulting from lower interest rates gives the US a slight competitive advantage in trade.

Meanwhile, as investors look outside the US for higher yield, the flood of money out of the dollar has bid up exchange rates in emerging markets around the world.

Emerging markets know this, and are upset – Brazil has vehemently expressed its concerns – not only about the increased value of their currency, but that the influx of money risks fuelling asset bubbles or triggering inflation.

The normal response of emerging market central banks to bubbles or inflation would be to raise interest rates – thereby increasing their currencies’ value still more.

The US policy is thus delivering a double-whammy on competitive devaluation – weakening the dollar and forcing competitors to strengthen their currencies (though some are taking countermeasures, erecting barriers to short-term inflows and intervening more directly in foreign exchange markets).

The second way that QE might have a slight effect is by lowering mortgage rates, which would help sustain real estate prices. So, QE would produce some – probably weak – balance-sheet effects. But potentially significant costs offset these small benefits. The Fed has bought more than $1 trillion of mortgages, the value of which will fall when the economy recovers – which is precisely why no one in the private sector wants to buy them.

The government may pretend that it has not experienced a capital loss, because, unlike banks, it is not required to use mark-to-market accounting. But no one should be fooled, even if the Fed holds the bonds to maturity.

The attempt to ensure that the losses are not recognised might tempt the Fed to rely excessively on untested, uncertain, and costly monetary-policy tools – like paying high interest rates on reserves to induce banks not to lend.

It is good that the Fed is trying to make amends for its dismal pre-crisis performance. Regrettably, it is far from clear that it has changed its thinking and models, which failed to maintain the economy on an even keel before – and are certain to fail again. The Fed’s previous mistakes proved extraordinarily costly. So will the new mistakes, even if the Fed strives to hide the price tag.

6. TAX UPDATES

Taxing inflows: Wrong time, wrong place

Will the government impose a tax on capital inflows to curb the surge in foreign capital? The chances are remote, going by finance minister Pranab Mukherjee's statement that the surge in FII inflows is not a problem and only reflects the confidence among foreign investors on the India growth story.

A few months ago, the Prime Minister's Office (PMO) also made it clear that it does not want to rock the boat on the tax treatment of capital gains made by foreign institutional investors (FIIs) investing in listed Indian shares. It rejected the finance ministry's proposal to tax capital gains made by offshore investors who sell their shares a year after holding them, saying a change will dampen portfolio investments into the country. The proposal was dropped in the Direct Taxes Code (DTC) Bill.

So, FIIs that are investing heavily in Indian stocks for better returns will continue to enjoy tax breaks on long-term capital gains even after April 2012, if the Bill is approved in its present form. Foreign institutional inflows are likely to cross $20 billion in 2010. However, it is reckoned that a tax on capital inflows could make the country a less attractive destination for investors.

Brazil, however, taxed capital inflows to prevent a speculative bubble and further appreciation of its currency following the global crisis. Last week, it raised the foreign inflow tax and imposed more capital controls to check hot money inflows. This does not mean all economies should follow suit.

The International Monetary Fund, for instance, has said that the use of capital controls as a policy tool is justified "if the economy is operating near potential, if the level of reserves is adequate, if the exchange rate is not undervalued and if the inflows are likely to be transitory". Clearly, no one size fits all and every country has to formulate its own strategy to deal with the problem of hot money inflows.

India should desist hasty tax policy changes whether they impact foreign or even domestic investments, now that the standing committee on finance chaired by former finance minister Yashwant Sinha, has started vetting the DTC Bill. In fact, Budget 2011 should steer clear of changes at the conceptual level, given the government's commitment to overhaul direct tax laws from April 2012.

The DTC Bill, which will replace the five-decade-old income-tax law, has proposed to lower tax rates for individuals and corporates from April 2012. It could undergo changes, based on the standing committee's recommendations. All the more reason, therefore, for the government to go with existing tax policies for one more year.

However, in the run up to Budget 2011, corporates will push for lowering their tax burden and seek sectoral concessions. Today, companies enjoy a host of tax exemptions and, hence, their effective tax rate is significantly lower than the statutory tax rate of 30%. So, the case to lower the tax rate further but keeping exemptions intact is weak.

Likewise, demands for a cut in the tax rates for individuals cannot be ruled out, with food inflation showing no sign of abating. The government must address supply constraints and not dole out more tax concessions. Revenues are needed to meet the growing expenditure needs. The UPA-II government can take some unpopulist measures given that this is only its third year in office.

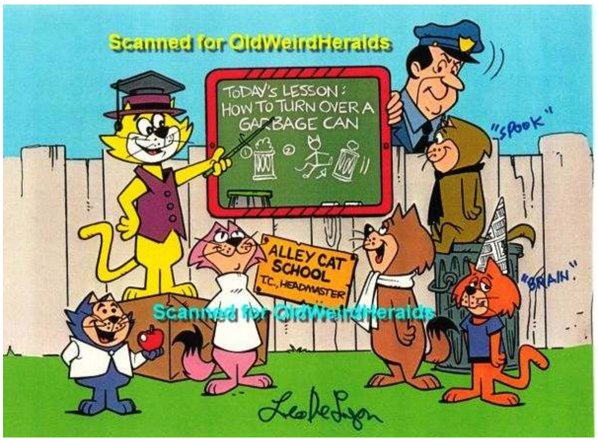
Two years ago, the government was forced to provide a stimulus through rate cuts and accelerated spending to bring the economy out of the woods. With the economy on a firm footing now, the focus should be on fiscal consolidation and not change tax policies to appease a few stakeholders.

The DTC Bill though has some radical policy initiatives including tightening regulation to ensure that India gets a share of the tax pie in cross-border deals. Already, the government has raised a `11,000-crore tax demand on telecom major Vodafone on a cross-border deal involving indirect transfer of Indian shares. The company has contested the claim and the Supreme Court is hearing the case. But disputes of this kind will cease if there is no ambiguity in law.

More changes are needed in the DTC Bill to broaden the tax base. These have to be well-thought through as we need simple and transparent tax laws to make the country an attractive investment destination. The government should not miss a historic opportunity and must prepare the ground next year to implement the DTC from April 1, 2012. Budget 2011 should, therefore, declare a holiday on new tax policy proposals instead of giving more tax holidays.

7. SECURITY LAWS UPDATES

How Little Some Know About the IPOs



It is astonishing how little some know about the IPOs as revealed by the fact that they complain about overpricing when regulations actually facilitate under pricing and the grey market.

It is easy to slam merchant bankers, particularly when fear and harassment are still the regulatory philosophies. But merchant bankers have thick skins – they would have taken the slam through one ear, slammed it out of the other and will continue the status quo. Some CEOs were there long before the regulator and have seen all chiefs come and go. And they will see many more.

Merchant bankers are in a Catch-44 situation – caught between the devil, the deep sea, a rock and a hard place – i.e., regulator, media, investors and promoters. Let alone overpricing, they are also accused of maximising promoter interests and not investors.

But if merchant bankers are overpricing IPOs, then has the price discovery process failed? If the market is oversubscribing, then where is the overpricing?

Rather than overpricing issues, merchant bankers under-price them.

With margins and pro-rata allotment, under-pricing is a well-engineered financial conspiracy among promoters, merchant bankers, their in-house broking outfits (syndicate) and fixers.

Under-pricing creates a good grey market and the listing day tamasha when the stock price is like a gymnast on a trampoline. Since only the syndicate knows who has the shares, they make money in the frenzied listing-day trading when grey market bets are covered.

What is lost in fees is recovered by brokerage.

In fact, stocks have to be fully priced in the short term so that only long-term investors come in.

Instead of worrying about pricing, which is not its concern, let the regulator and investor forums take a look at other aspects like the abridged prospectus (aka raddhi) – never in any industry has so much been printed that no one will ever read. What a waste of paper and trees.

Of IPOs since 2007, 62% are trading below their offer prices. Stocks have to always quote higher than their issue price? Then back we go to the famous "at par" pricing or the more infamous CCI formula, which was tougher than Einstein's relativity theory. But "at par" is also a price and recall how issues highlighted as 'at par' took investors and yes, you know who, for a ride.

And can we have statistics whether PSUs have done better than private sector issues? Because when it comes to pricing, the country's biggest promoter is also a greedy Gordon Gecko. That's why the much despised discretionary allotment has come back in the avatar of "anchor investor" just before the PSU IPOs. To enable our netas and babus to allot under priced shares to their favourites.

8.1 MISCELLANEOUS UPDATES

The Great Recession & unemployment

The opening remarks in the introduction to the discussion document 'The Challenges of Growth, Employment and Social Cohesion", prepared jointly by the IMF and the ILO – *Recessions leave scars on the labour market; the Great Recession of 2007-08 has left gaping wounds* – capture vividly what recession and unemployment do to the human psyche.

Overcoming scars and gaping wounds is no easy task. Therefore, policymakers and economists alike need to reflect on where they have gone wrong in theory and policy, which together had led to the economic crisis and the Great Recession of 2007-08.

The joint IMF-ILO paper comes in the backdrop of surging unemployment across much of the developed world (9.6% in the US, for example). In the emerging world, while unemployment is a 'given', the situation is now threatening to acquire alarming dimensions. High unemployment rates in the developed world are leading to bans on offshoring and outsourcing activities of firms, which were otherwise transferring some of the prosperity from the 'rich North' to the 'poor South'. What, therefore, are the critical issues which need focus?

Rising unemployment levels, unchecked by monetary and fiscal measures aimed at boosting aggregate demand, draw attention to trade-offs involved in some of the policies which economists have been advocating. These need to be recognised and addressed.

First:

There is a trade-off between greater employment and protection of labour rights and labour legislation. While labour protection remains a valid goal of policy, we must accept that overemphasis on this could promote labour-saving technology, contributing to the problem of rising unemployment.

Secondly:

Interests of the developed and the developing world are often at cross-purposes, on employment. Rising employment in the developing world could mean fewer jobs in the developed world. Some developed world politicians might champion protectionism but possibly not for ever, because of the inter-twining of economic and political interests in the real world polity of today.

Thirdly:

There is also a conflict between increasing factor productivity, enabled by technology, and the objective of creating jobs for all. Surely, one cannot abandon the quest for scientific improvement, technology and knowledge for a better world. Yet, one needs to figure out how this ostensible conflict can be resolved, without compromising employment generation.

Fourthly:

Aggregate demand needs to be adequate so as to not choke off the impulse for future growth.

And, finally:

There is the need to ensure balanced and sustainable growth so that global imbalances do not destabilise growth and prosperity in future. There is, therefore, ample justification for state interference with market fundamentals.

- Sectors and fields which create possibilities for greater employment need to be encouraged through a conscious effort.
- Encouraging higher levels of farm productivity would clearly lead to greater employment and output. Promotion of industrial and manufacturing activity needs re-emphasis.
- Thirdly, action is required to identify sectors where fresh unemployment has occurred. These sectors need scaling down.
- Finally, economists need to ensure that as they put in place the much-needed new economic paradigm, like the proverbial three little pigs from the English fairy tale, they build a house of bricks, and not of straw or sticks, which comes down at the first 'huff and a puff' of the big bad wolf in the form of economic crisis/recession.

Given the changing nature of global realities, transnational production and other activities, and the growing knowledge across the internet, this may require looking beyond national boundaries, and to a world beyond narrow domestic walls.

Perhaps that vision and that vision alone will enable resolution of the conflicting economic objectives pointed out earlier.

8.2 INFLATION

High prices cost growth benefits

Inflation begets inflation, and the rise in the prices of one commodity impacts another. So, the inter-relation among prices of various commodity groups and the quantity-price interaction need to be understood. The other issue relates to the productive aspect of price rise and the non-productive aspect, also known as core inflation. Core inflation is that component of price rise that grows due to its own momentum and, thus, does not provide an incentive to the producer.

From the consumer's point of view, whether the core inflation component is neutralising the beneficial effect of growth is an important question. Our analysis is based on the monthly data from April 1996 to June 2009. The reference point for inflation is the wholesale price index (WPI) with 1993-94 as the base. The revised WPI, with base 2004-05, released on September 14, has not been included here.

To analyse the growth in prices, we have considered the following commodity groups:

- Foodgrain;
- Fruit and vegetables;
- Milk;
- Eggs;
- Oilseeds;
- Manufacturing products; and
- Fuel, power and lubricants

Except for oilseed prices, evidence suggests that one price group impacts the other.

The clustering of prices also confirms that the rate of growth in prices of manufacturing products, foodgrain and milk are associated.

Fuel and manufacturing prices are also inter-related.

Besides, the prices of fuel, fruit and oilseeds are, again, inter-connected.

The causality test suggests that foodgrain prices influence the prices of the manufacturing products, but not vice versa.

The causality between manufacturing and fuel prices is bi-directional.

Both fuel and manufacturing prices affect the prices of oilseeds.

Fuel prices also cause changes in the prices of foodgrain, and,

The prices of foodgrain, fruit and vegetables mutually reinforce on each other.

Clearly, price rise in one sector has its spill over effect on other sectors – and the overall cost of living.

So, it is futile to argue that substitution possibilities between commodity groups can essentially leave the consumer unaffected by the adverse effect of price rise.

As for the relationship between inflation and other macro variables, declining inflation is usually expected to make the Sensex rise. Conversely, increased FII inflow may accelerate the rise of the Sensex and, in turn, fuel inflation. But our long-term data suggest that there is no strong relationship between foodgrain and manufacturing prices with the Sensex. Interestingly, prices of fruit and vegetables and oilseeds show a negative correlation of –0.405 and –0.135 with Sensex, respectively. Domestic fuel prices explain only 2% of the variance in the index of industrial production (IIP). This is understandable because the domestic fuel price does not necessarily reflect the changes in international market. The Sensex influences FDI and new investment, and, therefore, enters as a determining factor for fuel prices. Food and milk prices, IIP and real effective rate of foreign exchange play an important role in explaining substantive variations in Sensex, which is also seen to influence the real effective foreign exchange rate.

Money supply influences prices of some primary commodity groups. However, if prices are believed to have an impact on the money supply, manufacturing prices reveal it clearly. As for real interest rate, the IIP accounts for a substantive part of the variance, indicating the impact of investment demand on the cost of borrowing.

The overall price growth for all commodities does not seem to be much different between the two sub-periods, 1996-2000 and 2001-09. However, decomposing the price rise in terms of core and non-core inflation — the former is independent of the quantity — seems to have increased substantially in the second sub-period. Foodgrain and manufacturing prices reveal that of the total rise, the core inflation accounted for around 96% and 91%, respectively, between 2001 and 2009, whereas their respective shares were 69% and 37% in the first sub-period.

This would mean that in the second sub-period, the non-productive component of inflation has gained momentum. Besides, the manufacturing prices have caused a sharper rise in the overall inflation in the second sub-period while foodgrain prices drove inflation in the earlier period. For controlling price rise, greater emphasis is needed on the manufacturing prices, even though foodgrain prices have grown at a rapid pace in the last year.

The person day unemployment rate both in the rural and urban areas increased in 2004-05 relative to 1999-2000 or 1993-94. This is in sharp contrast to the standard Philips Curve postulation, which suggests that price rise reduces unemployment rate. The person day unemployment rate is mostly due to underutilisation of the workforce, and this is prevalent among poor households. Price rise possibly reduced the demand for certain services provided by the low-income households.

The core inflation in foodgrain, which has been considerably high both during 1996-2000 and 2001-09, seems to have outweighed the positive effect of economic growth and, thus, the extent of decline in poverty in the post-reform period has been rather modest. The rise in manufacturing core inflation in the second sub-period suggests that the role of industry to produce mass consumption goods at a reasonably low price remains unrealised. This may have affected manufacturing exports and domestic demand adversely.

9. KNOWLEDGE RESOURCE

Economics for Parrots

It is said that the early 19th century British economist J R McCulloch originated the old joke that the only training a parrot needs to be a passable political economist is one phrase: "*supply and demand, supply and demand.*" Even US Fed chairman Bernanke recently said that McCulloch's economics - the economics of supply and demand - was in no way discredited by the financial crisis, and was still extraordinarily useful.

It's hard to disagree with Bernanke's sentiment: economics would be useful if economists were, indeed, like McCulloch's parrots - i.e., if they actually looked at supply and demand. Much of economics has been discredited by the manifest failure of many economists to be as smart as McCulloch's parrots were.

Supply and demand, supply and demand

Consider the claims - rampant nowadays in the US - that further government attempts to alleviate unemployment will fail because America's current high unemployment is "structural".

A failure of economic calculation has left the country with the wrong productive resources to satisfy household and business demand. The problem, advocates of this view claim, is a shortage of productive supply rather than a shortage of aggregate demand.

It's easy at least for an average parrot to tell whether a fall in sales is due to a shortage of supply or a shortage of demand. If a fall in sales is due to a shortage of demand while there is ample supply, then, as quantities fall relative to trend, prices will fall as well. If, on the other hand, the fall in sales is due to a shortage of supply while there is ample demand, then prices will rise as quantities fall.

What do we see now? There are no places in the US economy where wages or product prices are rising more rapidly than expected. There are no places where a shortage of qualified labour or of available capacity is sufficiently great to induce managers to pay more than they have been used to paying for good hands or useful machines.

McCulloch's parrot would call this conclusive. The coexistence of high unemployment with falling inflation and no bottleneck-driven price or wage spikes tells us that 'structural' supply-side explanations of America's current high unemployment are vastly overblown.

Or consider the claims - also rampant these days - that further government attempts to increase demand, whether through monetary policy to alleviate a liquidity squeeze, banking policy to increase risk tolerance or fiscal policy to provide a much-needed savings vehicle, will similarly fail.

These measures, too, are supposedly doomed because they all involve increasing governments' liabilities, and financial markets are at a tipping point with respect to sovereign debt. If governments that have already tapped-out their debt-bearing capacity now issued more debt or money or guarantees, they would deal a mortal blow to confidence.

Once again, an adequately trained parrot, unlike many economists nowadays, would ask whether the economic problems that current levels of government debt are causing reflect too much public debt supplied by governments or too much public debt demanded by the private sector. If the problem were that supply is too great, then new emissions of government debt would be accompanied by low prices - that is, by high interest rates. If the problem were that demand is too great, then new emissions of government debt would be accompanied by high prices - that is, by low interest rates.

Guess which one the US and many other countries have? For a parrot, that's a no-brainer: the public-debt problem is not that governments have issued so much debt that investors have lost confidence, but that governments have issued too little debt given the enormous private-sector demand for safe places to park wealth. The problem, the parrot would say, is that households and businesses are still trying to build up their stocks of safe, high-quality assets, and are switching expenditures from buying currently-produced goods and services to increasing their shares of an inadequate supply of government liabilities.

When economic historians examine the Great Recession, their overwhelming consensus is likely to be that its depth and duration reflected governments' refusal to try to do more, not that they tried to do too much. They will agree with the parrot that falling inflation showed that the macroeconomic problem was insufficient demand for currently produced goods and services, and that the low level of interest rates on safe, high-quality government liabilities showed that the supply of safe assets - whether money provided by the central bank, guarantees by banking policy, or government debt provided through deficit spending - was too low.

The question that will be a mystery to them is why so many economists of our day did not know how to say: "supply and demand, supply and demand."

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