MENDING THE MELTDOWN: ENGINEERING A RECOVERY

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THE GREAT INDIAN DREAM

“A Society where man is at the centre of all activities, a society where exploitation of man by man has been abolished, where he is cared for as an in a family, where “to each according to his need” is practised, a society where non bureaucratic National Economic Planning is given due importance for sustainable optimum growth, where adequate social safety net is a reality and yet market’s advantages are fully taken care of for creativity and entrepreneurship, such a society can be truly described as humane society and the vision as “Humanism”.

Dr. M K Chaudhuri
The Great Indian Dream, 2003, Macmillan India,New Delhi

“Let us together dream of a country where poor are not just merely reduced to statistics but where there are no poor. Let there be a day when small children are taken to a poverty museum like science museum where they shiver at the plight of the way people used to live in the last millennium. Let this dream take the form of a revolution and as long as our dreams keep outweighing our memories, India would remain a young and dynamic nation on this path to global equality. And for this let the wait not be for eternity. Let us together achieve this in the next 25 years.”

Prof. Arindam Chaudhuri
The Great Indian Dream, 2003, Macmillan India,New Delhi
**IIPM: THE FUTURE IS HERE**

Since its incorporation (1973), IIPM has been an institution with privileged traditions, in the diversity of its fraternity, its global outlook, its world class research and its commitment to alternative national economic planning process.

It can be said, without much oversimplification that there are no ‘underdeveloped economies’. There are only ‘under managed’ countries. Japan 140 years was ago was an underdeveloped country by every material measurement. But it very quickly produced management of great competence, indeed of excellence. The policy inference is that ‘management’ is the prime mover and ‘development’ is the consequence. At IIPM, every one considers that development is a matter of human energies rather than economic wealth. And the generation and direction of these human energies is the task of ‘management’. Accordingly, we formed The Great Indian Dream. Unlike any other dream, this is one dream which each one of us are determined to realise and that too in our own lifetimes. Each bit of cynicism and condemnation from pessimists makes us evolve even stronger and determined.

All our endeavours and initiative is towards realisation of this dream, where in we produce committed ‘bare foot’ managers and entrepreneurs who are needed by nation, on an insistent basis. As an educational institute, we aim at initializing a three dimensional personality in IIPMites, viz.

- Pursuit of knowledge in economics and management
- Commitment to economic, social, political and technological upliftment of masses and
- Cultivation of taste for literature, fine arts and etc.

Economists often have limited access to the practical problems facing senior managers, while senior managers often lack the time and motivation to look beyond their own industry to the larger issues of the global economy. It has set before it the twin tasks: to reorient education and research to meet the needs of both the private and public sectors and to establish the link between the National Economic Planning and the development of private enterprises in Indian economy. IIPM dares to look beyond, and understands that what we teach today, other adapt tomorrow. IIPM’s service output (education, research and consulting,) is a unique combination of two distinct disciplines: economics and management. Through this integration, IIPM helps guide business and policy leaders in shaping the Indian and global economy, bringing together the practical insights of industry with broader national and global perspectives.

A hallmark of IIPM is that it is armed with the comparative advantage of engaging the committed, passionate and brightest management post graduates and undergraduates, who pursued the education at IIPM and subsequently joined it, to realise the dream. IIPM alumni, spread across the globe, holding crucial decision-making positions in the corporate sector, are bonded by the one ideology of making a positive difference, turning that ideology into a movement itself.

The India Economy Review is another humble initiative towards the realisation of the same and more distinctly, engaging the broader publics and pertinent stakeholders.

**SEARCH, SIEVE, SCHEME...**

In economics, like in everyday existence, it is imperative to hear, perceive and consider what others have to say. Each issue of The IER brings together a selection of important contributions on a particular theme, authored by some of the brightest minds in different areas of Indian economics. The provocation for publishing these issues arises from the fact that over the years economic journals have become copious, exclusive and expensive. The economics of these journals has required a greater access to the practical problems facing senior managers, while senior managers often lack the time and motivation to look beyond their own industry to the larger issues of the global economy. IIPM dares to look beyond, and understands that what we teach today, other adapt tomorrow. IIPM’s service output (education, research and consulting,) is a unique combination of two distinct disciplines: economics and management. Through this integration, IIPM helps guide business and policy leaders in shaping the Indian and global economy, bringing together the practical insights of industry with broader national and global perspectives.

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**ACKNOWLEDGEMENTS**

The IIPM Think Tank likes to thank all the internal faculty who have been instrumental in coordinating with many authors all across India and according their unstinted support. The assistance of Prof. R.Krishnan (IIPM Lucknow) Prof. Amlan Ray (IIPM Lucknow), Prof. Tareque Laskar (IIPM Bangalore) and Mr. Robin Thomas (IIPM Ahmedabad) has been more valuable than, perhaps, they realise. Mr. Arun Roy, Research Associate at Planman Media, New Delhi particularly did all that it was possible to do for this issue of IER. Lastly, Prof. Shyam.S.Pujala (Dean, IIPM Hyderabad) deserves a special mention for his eager and energetic support, without which this issue would not have been possible.

** search, sieve, scheme...**
Dear Reader,

It has been three months since the effects of the worldwide financial crisis were first experienced and it is definitely a much bigger media story in current times. Every person is concerned but where is the balance in media coverage? As usual, it favours only certain sections. This publication investigates the crisis across many sectors, regions and issues and we do much more than a crisis report.

In various articles, we take a look at what the state might do to capture this vital moment and lead a fairer future for all and an opportunity to reinvent. Trillions of dollars of state money can be deployed to do things differently.

You’ll find fascinating articles ranging from an Austrian (school of economics) answer to the financial meltdown to M.R Venkatesh’s passionate plea to rethink our western regulatory model, through to an articulate proposal for establishing a new world order. In fact, authors like J.W Smith have gone the extra mile in terms of how to start building a fairer economy by leveraging property rights law, as applied to nature’s resources and technologies. Many featured authors in this issue are developing a new campaign for a ‘Clean Start’. Now is the time and need to craft a carefully constructed spending plans and developmental deals to create economies that are equitable and sustainable for the current economic pain calls for a fresh look at the development process and financial architecture itself. Such a direction presumes a careful review of our preconceived knowledge of what works and what won’t. To avoid the r-word, this is what must be done.

One: Applying a little unconventional thinking, the revival package must also adequately focus upon agricultural and rural sector, unlike the customary policy attention on industry alone.

Two: Step up political and other institutional reforms, which in turn act as confidence boosters.

Three: We need a review of economic planning and diplomatic practices to leverage the current momentum in regional cooperation and global partnerships where it matters the most.

As we are at the IIPM Think Tank, we will keep you updated on periodic basis on developments, and in particular, the ideas for India. All our pervious papers and positions are available on the new website. We also lined up exciting new research assignments in store on topics that include entrepreneurial economics and many other areas of Indian economics, while extending our work in national economic planning—both understanding the impacts of economic decisions and policies and working toward more efficient and effective outcomes.

Best,

Prasoon.S.Majumdar
Managing Editor

M.N.V.V.K. Chaitanya
Deputy Editor
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Recession: No More Self Denials

Recessionary conditions are now widespread all across the developed world. According to the latest projections by the IMF the situation is going to only worsen in 2009, when major economies, of the world will experience a de-growth. The world economy as a whole will also expand by just about 3%, the slowest since 2002.

More worrying is the emerging view that the recession may be prolonged, probably acquiring a U shape or even an L shape.

An economic recession is broadly defined as a downturn in the GDP of a nation for at least two successive quarters. And,

<table>
<thead>
<tr>
<th>Year</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S</td>
<td>2.8</td>
<td>2.0</td>
<td>1.4</td>
<td>(-) 0.7</td>
</tr>
<tr>
<td>U.K</td>
<td>2.8</td>
<td>3.0</td>
<td>0.8</td>
<td>(-) 1.3</td>
</tr>
<tr>
<td>Germany</td>
<td>3.0</td>
<td>2.5</td>
<td>1.7</td>
<td>(-) 0.8</td>
</tr>
<tr>
<td>Japan</td>
<td>2.4</td>
<td>2.1</td>
<td>0.5</td>
<td>(-) 0.2</td>
</tr>
</tbody>
</table>

Source: IMF
The slowdown in the U.S and the rest of the world is ominous warning for India. And it shows that the GDP growth has slipped from 9.3% (September 07) to 7.6 (September 08). Four quarters of slower growth sure don’t qualify for recession. But macro indicators definitely make us see amber lights, though not red flashes yet. Growth in the IIP index has declined from 12.2% (October 07) to (-) 0.4% (October 08), the first reported contraction in 15 years. The ABN AMRO Bank sponsored Purchasing Manager’s Index shrank from 57.3% in September 08 to 45.8% in October 08.

### Table 2: Types of Recession

<table>
<thead>
<tr>
<th>Nomemclature/Type</th>
<th>Shape</th>
<th>Example</th>
</tr>
</thead>
<tbody>
<tr>
<td>Protracted (L - shaped)</td>
<td>![L shaped diagram]</td>
<td>Throughout the decades of 90s Japanese economy stagnated. Indiscriminate lending policies led to an asset bubble followed by a collapse in property and share prices. The response to asset bubble burst was delayed.</td>
</tr>
<tr>
<td>Brief (V - shaped)</td>
<td>![V shaped diagram]</td>
<td>Short and shallow, this type lasts for a year or less, as in the U.S in 1990/1 and 2001. The 2001 recession was caused by the bursting of the dotcom bubble.</td>
</tr>
<tr>
<td>Stubborn (U – shaped)</td>
<td>![U shaped diagram]</td>
<td>This one rears its head slowly, stays put for some more years, and finally, equally slowly, retreats. During the 1970s stagflation (stagnation + inflation) lasted in the U.S for 8 years.</td>
</tr>
<tr>
<td>Double Dip (W – Shaped)</td>
<td>![W shaped diagram]</td>
<td>In 1980 the U.S economy, recovering from a recession, was hit hard by the relentless inflation curbing policies. These unsuccessful policies led to further skyrocketing of unemployment in 1981/2</td>
</tr>
</tbody>
</table>

if the GDP of a country drops by at least 10% then it is called depression. Hence 1930s witnessed Great Depression in the U.S.

### The Contagion Effect on India

India had been growing at average GDP growth rate of nine percent for the past four years, with a saving rate of 35%. For us economic growth is not an option; it is a requirement for creating employment and improving the living standards of large segments of impoverished population. The shift in the growth curve had strong structural foundations of a favourable demographic shift (more than 75% of the population being under 30 years of age), improved competitiveness in the world market (as evident through M&A across the world by Indian companies), and growing per capita income approaching the inflexion point. So any slipping down is bad news both emotionally and for the economic welfare.

The slowdown in the U.S and the rest of the world is ominous warning for India. And it shows that the GDP growth has slipped from 9.3% (September 07) to 7.6 (September 08). Four quarters of slower growth sure don’t qualify for recession. But macro indicators definitely make us see amber lights, though not red flashes yet. Growth in the IIP index has declined from 12.2% (October 07) to (-) 0.4% (October 08), the first reported contraction in 15 years. The ABN AMRO Bank sponsored Purchasing Manager’s Index shrank from 57.3% in September 08 to 45.8% in October 08.
November 08. Since an index figure of 50 is taken as 'no change', this number is a pointer to possible future contraction in the IIP. Consumption figures are not encouraging either. Commercial vehicles sales declined by 49% while passenger cars sales fell by 19% this November. The corporate tax collection, an advance indicator of how corporate earning may shape up, too fell from Rs.7700 crore (November 07) to only Rs.4561 crore (November 08), a significant slide of 41%.

Finally, while India’s overall export growth during April-October ’08 was a healthy 20.6%, this hides a sharp deterioration in growth in recent month. During October ’08 exports actually declined (-12%) in dollar terms.

Only a Brave Heart is Going to Welcome the New Year

The economy is sure caught in the throes of global recession. The economic storm that hit the Wall street and gathered momentum in developed economies has definitely reached Indian shores by Q2 FY 09. The slowdown in the U.S and the rest of the world is a bad news for India. The U.S is India’s largest trading partner. Already exports are showing signs of flagging. On one hand Indian exporters face cancellation of order; on the other even payment are being delayed.

But more than that it is the global credit crunch as an outcome of the U.S financial crisis that will really impact India. This squeeze on funds is expected to severely dent capital account inflows into the country and hurt the India’s growth story. For instance in 2007-08 India received almost $108 billion through the capital account (including FDI, FII investments, foreign debt, ECB, and NRI flows). This figure is expected to decline sharply this year.

Most of the agencies have revised downward their growth estimates for India for the year 2009.

It is not that there are no silver linings. Inflation has slowed down to single digit. This in turn should eventually lead to reduction in interest rates. Good monsoon and consequent growing rural incomes should take up some slack from falling urban demand. Investment pipeline – even though depleting – is still strong. But all this is not enough. According to a recent HSBC report, initially many argued that India’s relatively sizeable domestic market would ensure that its economy and financial market could remain insulated from global financial turmoil. Alas! This was not to be. The equity market has already dropped 60%; rupee has depreciated 20% leading to increased import cost but no significant increase in exports due to world recession; and the fear is growing that the economy has slipped into credit crunch since the lenders are treading cautiously, and are not willing to reduce their spread and profit margin. Net result is that both the GFCF and PFCE are likely to be adversely hit. During the Q2 FY 09 PFCE increased by only five percent, lower than the eight percent growth in Q2 FY 08. Given weak private consumption growth, halt/delay in investment plans have become more frequent.

Bail Out Plan and its Efficacy

So a rescuing act is sorely needed to create productive assets and run the virtuous cycle of employment – income – consumption – revival. The government has in fact taken already three big steps in the form of easy monetary policy, expansionary fiscal measures, and cut in fuel prices. According to an HSBC note, low oil price should provide a boost of 0.4% to real GDP growth in 2009-10 and 0.5% in 2010-11. Similarly, a 50 bps drop in all interest rates should add a similar amount to GDP growth, though after 12-24 months. According to Pronab Sen, the chief statistician of India, an increase in government consumption, currently 14% of total consumption, is triggering a spurt in demand. Besides, recent excise cuts have been passed on by many players in the form of reduced prices.

The aggressive monetary policy loosening of the past two

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Table 3: India: GDP Growth Estimates

<table>
<thead>
<tr>
<th>AGENCY</th>
<th>REF YEAR</th>
<th>ESTIMATE (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>GOI</td>
<td>2008-09</td>
<td>7.8</td>
</tr>
<tr>
<td>IMF</td>
<td>2009</td>
<td>6.3</td>
</tr>
<tr>
<td>World Bank</td>
<td>2009</td>
<td>5.8</td>
</tr>
<tr>
<td>Goldman Sachs</td>
<td>2009-10</td>
<td>5.8</td>
</tr>
<tr>
<td>Citigroup</td>
<td>2009-10</td>
<td>5.5</td>
</tr>
</tbody>
</table>

Source: Multiple sources
month has helped pull the reins on a slowing economy. But fiscal policy measures are the ones which are the fastest and most reliable way of encouraging short term economic growth at a time when a serious downturn is underway. This may prove to be Achilles Heel for Indian policy makers, however. A fiscal package must be timely, targeted, temporary and adequately funded in a proper manner. The Indian package fails on three out of four of these criteria.

India is in fact constrained in its ability to indulge in any substantial fiscal pump priming on account of its current and fiscal account deficits. The massive off balance sheet deficits such as oil and fertilizers bonds have pushed the combined fiscal deficit of the central and state governments to beyond 10% of GDP.

Ironically, despite 5 years of high GDP growth annually India still does not enjoy fiscal elbow room to address the ongoing slowdown. While a booster shot in the form of fiscal sops is very much called for – given the condition of slow growth, single digit inflation, declining exports, lower tax collections, crumbling stock markets, falling corporate profits, and a tight liquidity position – the high fiscal deficit gives hardly any room for maneuverability. Until recently software exports, FII Inflows, inward remittances, and surplus on account of trade in invisibles had all helped finance the trade deficit. Not anymore.

To regain the growth momentum India needs to grapple with three major challenges. The foremost is the crisis of confidence that has engulfed us following the massive deleveraging in the global financial sector and a sharp correction of asset price. The second is the drying up of channels of liquidity. While availability of liquidity has been addressed by RBI, its channelizations to productive activities still remain an issue. The final challenge pertains to the global recessionary winds that have affected the export oriented sector.

The government has decided to use fiscal measures to a great extent, one of the components being project spendings. However, sanctioning millions for infrastructure projects is likely to result in time and cost overruns. According to a recent study, of the 515 centrally sponsored projects, 234 are delayed. A mere two percent of all projects are ahead of schedule. Overall, there was a cost overrun of 10.6%. According to another internal report of the NHAI, the regulatory authority had started 47 projects in the second phase of the North – South – East – West corridor in October 2004 and set a deadline to complete them by October 2008. Not a single of them has been completed yet.

Under the first phase of National Highway Development Program, 6,359 km road infrastructure was to be completed at a cost of Rs.30,300 crore. But by the end of 2007, only around 4760 km were built at an excess cost of Rs.33,655 crore. Mind you this was under public private partnership initiative. So, one can imagine the outcome of the economic stimulus program. The assets created under public spending schemes don’t last very long. Moreover, project with a technological bias such as highway upgradation don’t have a large multiplier effect since they do not use much labour compared with old style road building projects. So, Keynesian recipe of pump priming in technology intensive environment will be much less effective.
Since a fiscal stimulus works by generating a multiplier effect on the economy, thereby boosting aggregate demand; it is important that the benefits accrue to those who are most likely to spend the money immediately. Thus the poorest and those pushed to the brink of poverty due to slowdown, the ones who generally don’t have saving cushion, who cannot borrow and hence are faced with the option of cutting back consumer spending at such times, should be the major target groups.

So interest sops on housing loans of upto Rs.20 lakh (announced by the banks on December 15, 2008), with EMI of Rs.20,000 – 30,000 per month, in a country where the per capita income is Rs.5,000 per month and the average housing loan size is Rs.7.5 look more like appeasement of vocal middle class rather than being a well thought out revival package. The decision to allow corporates to buy back their foreign currency convertible bonds with rupee resources at a time when we are struggling to conserve our forex reserve may actually lead to jeopardizing of our dollar payments. Loans to project that are viable only at ‘low’ interest rates simply run the risk of becoming unviable when rates will rise, as they will, when the govt. is forced to borrow more to finance its present spending. So such rebates and sops, which disproportionately benefit the better off, are selectively ineffective. Faced with bleak economic expectations individuals prefer to postpone – if they can – their consumption; instead they save or repay debts with the additional money released by tax rebates. Tax concessions to incentivise corporate investments again come up against the same set of ‘rational expectations’ in a depressed economy, prompting the institution to postpone investments.

While worsening of fiscal deficit is a non issue during the current troubled times – as said by Montek Singh Ahluwalia, P.C. Chidamabaram and other government functionaries rightly – the government has to ensure that the worsening is within limits and money is spent wisely. At 10% of GDP the deficit imposes a very heavy burden on coming generations. This would not have been objected against if the past record of government action would have convinced us about its prudence. But the above examples clearly caution us against entertaining any such thoughts.

In any case by offering sops to the people with lower marginal propensity to consume the multiplier effect is likely to be lower. In a recent study the Economic Policy Institute of the USA found out that food stamps and direct cash transfer to the poor are the most economically efficient stimulus followed by unemployment insurance, infrastructure spending, and assistance to states. Tax cuts infact were found to be least effective and most economically inefficient strategic option. Thus despite all their weaknesses poverty alleviation programs are the ones that should be accelerated further.

Applying a little unconventional thinking, a revival package is always focused on the industrial sector. In the current scenario too beyond removing dysfunctional government controls on production, storage, and distribution of agricultural produce, the agenda is one of roads, water, and electricity with credit and insurance thrown in. The rest of Bharat Nirman is not taken into account. But a relatively ignored success story since 2005 is that of increase in growth rate of
agriculture and allied activities to 4.84% compared to 0.89% in the first three years of Tenth Plan. Most of the growth has come through commercialization and diversification in agriculture, coupled with private sector participation on account of freeing up of agricultural markets. Thus, in addition to fiscal policy and monetary policy sops, the government in India needs to push this agenda too. Higher agricultural income would mean two beneficial outcomes. One, if sources of growth are mostly endogenous (as in agriculture) externally induced global shocks will have less impact on GDP and employment. And, two, higher agricultural income also means increased demand for manufactured products besides other multiplier effect.

Well, while thinking along innovatively, why not prepone national election? One big financial trigger that has the potential to unleash spending in the local economy without substantial government expenditure is general election. Several thousands of crore are spent on election related products and services which are produced and consumed locally. On its part the corporate sector should work towards cost rationalization and enhancing competitiveness. In the previous downturn in the late nineties many Indian companies laid the foundation for the world class competitiveness through rightsizing, consolidation, supply chain management, inventory management, and so on. This is the right time to step up economic and institutional reforms. These will act as confidence boosters. Act in haste and repent at leisure, however, is more likely to be the end result of the rescue package that seems to have been stitched together. 

(The views expressed in the write-up are personal and do not reflect the official policy or position of the organisation).
Genesis of the Meltdown, Challenges for India and the Road Ahead
The World Economy is tending to move towards global recession. Despite strong fundamentals Indian Economy is increasingly getting sucked into the meltdown. This paper looks into the genesis of global meltdown; the evidence of a global recession and its determinants; and the possible implications for India. This involves the analysis of the sub prime crisis in the United States of America and Europe and its consequences. The paper explores the possible downside and upside risk for global growth and the emerging evidence which points towards the possibility of global recession.

Emerging economies like India were initially considered to be the islands which may escape the brunt of the crisis. This possibility is increasingly getting negated. India in particular is considered to have strong fundamentals. The paper looks into the fundamentals of Indian Economy and tries to appreciate the possible interplay between the global weakness and strong domestic fundamentals and goes on to explore the possible road ahead.

The Genesis

At the genesis of the global meltdown lie the infamous American and European Sub Prime Crisis. In the fifties American Congress passed a legislation wherein commercial banking and investment banking were completely de-linked, implying that a commercial bank can not open an investment bank. In the seventies the American and European Economy saw a slow down and the American and European banks (Including Japan) were finding it difficult to invest their investible surpluses. This is also the time when East Asian Economies were liberalizing themselves, including capital account convertibility. Convergence of interest saw large scale capital moving from the western financial institutions into these economies. Three decades later, i.e. end of the nineties, the Asian Bubble went burst. Consequently the movement of large scale capital to East Asia got impeded. The availability of large scale funds and the desire for increased profitability forced American and European institutions to take refuge behind financial innovations. Financial innovations were used to lend to those borrowers who were otherwise ineligible under the conventional banking system. In the late nineties the legislation which separated Commercial Banking from Investment Banking was repealed facilitating such innovations based liberalization and sub prime lending.

A Sub-prime loan is a type of mortgage loan made to borrowers who have at least one of the following characteristics: (1) low credit scores; (2) the inability to post the traditional 20 percent down-payment for a home; and/or (3) the inability to fully document their income. As a result, these borrowers do not qualify for conventional mortgages and the best market interest rates. In the mid-to-late 1990s, US mortgage lenders began offering mortgage products to would-be homebuyers who did not otherwise have the credit history to qualify for a mortgage loan. Millions of Americans (same is true for Europe as well) who could not previously afford to buy a home were obtaining these mortgages, which in turn created a huge boom in demand for housing. At the same time, this resulted in a dramatic rise in appraised home values, which in turn led existing homeowners to treat their houses as the piggy bank source of home loan credit lines.

Financial innovations were brought into picture to make such lending work. Figure 1, capture the genesis of Sub Prime Lending and the way the financial innovation was used to accommodate sub prime borrowers. The system worked in three stages. In ‘Part I’ (Figure 1) an agent was slipped in between the borrower and the lender. The agents while accepting the collateral were also factoring in the future price rises. Accordingly, those collaterals which otherwise were not appropriate for the quantum of lending involved suddenly were considered viable on the basis of potential price (facilitated by housing boom). Given the risk involved all such weak loans were pooled (figure 1). In ‘Part II’ a Special Purpose Vehicle (SPV) was brought into picture and all liabilities as well as future proceeds were transferred into a bankruptcy-remote
The SPV then uses an underwriter to issue and market various residential mortgage-backed securities ("RMBS"). These securities were split up into tranches. Tranches are sections or slices of the same security. Rating agencies generally issue a credit rating on the securities or tranches. Higher credit ratings are assigned to those tranches benefiting from credit enhancements, such as priority on payment of the funds the RMBS generates and/or credit insurance purchased from a third-party bond insurer. In 'Part III' Institutional or individual investors such as hedge funds or managers of Collateralized Debt Obligations (CDOs), purchase the securities and then re-securitize the RMBS, along with other assets, into a CDO.

The Commercial Papers (CP) generated in the initial years was all sold and there was demand for more. Consequently the SPVs started producing more CPs or RMBS. The sale of the same only meant that the SPVs were flush with funds. And these funds had to be invested somewhere. The agents were therefore pressed to bring in more borrowers. Naturally, the lending norms were further diluted to accommodate lesser and lesser deserving borrowers in order to deploy the huge funds available. The consequent spiral that got generated only led to the continued dilution of the Capital Adequacy and Prudence norms. The system went burst once the housing prices turned negative (Figure 2) turning the very foundation of subprime lending upside down.

The sub prime crisis is about the collapse of the unregulated, $3 trillion over-the-counter market for complex structured assets, some of which happen to contain sub prime residential mortgages. The sub prime structured asset crisis of 2007 represents a sharp reversal in how global investors view all securitized assets and custom derivative structures, such as collateralized debt obligations or CDOs. The “sub prime crisis” is less about the credit quality of the mortgage loans behind a
given bond issue and more about how banks package loans and other assets using complex derivative structures, ratings from Moody’s and S&P, and private mortgage insurance. More than a simple financial disruption, the subprime crisis is a “slow motion” systemic event which holds enormous long term implications for the global economy, the business models of entire industries and financial institutions, and for consumers. It truly is a story of flawed Securitisation model. In place of the implicit guarantee of the US Treasury with GSE paper, Wall Street substituted a paid rating from Moody’s or S&P and a guarantee from thinly capitalized municipal bond insurers or even hedge funds. Result is an enormous market comprised of unregistered securities which appear to be deliberately opaque and are thus unstable; which has virtually no support from dealers or investors; and for which banks retain de facto liability. Figure 3(impact on Consumer Confidence) and Figure 4 (impact on Share Market) capture the essence of the crisis that emanated in the US and Europe. Unfortunately, this crisis has now spiralled into a global slowdown with indication of a potential global recession.

Indian Story: The Fundamentals
In the backdrop of the meltdown and in order to understand the possible implications of this meltdown for India it will be appropriate to look into the fundamentals of Indian Economy. For appreciating the fundamentals of Indian Economy this paper analyses (A) GDP and Structure of the GDP; (B) Savings and Investment Scenario of the Economy and (C) Trends in Foreign Direct Investment and Foreign Portfolio Investment.

GDP and Structure of GDP in India
During 1991 to 2008 India has travelled a long distance. Industry centric reforms have catapulted a crisis ridden economy into one of the stronger economies of the world. By the beginning of 21st century India had emerged as a strong and vibrant economy and thereafter it has moved from strength to strength. Figure 5, only captures this truth. The GDP growth during 2000-01 to 2007-08 has shown a continued rising trend. As a matter of fact this rising trend both in GDP (Figure 5 A) as well as per capita income has continued for more than 30 years and has only tended to accentuate with every passing decade. GDP growth rate has gone up from 4.3% during 1970 – 91 (Pre Reforms) to 7.3 % during 2000-08. Per capita income has also not remained far behind.

Figure 5(B), captures the growing trend during 2002-08 and highlights the extra ordinary role played by industry and services sectors in the growth of the economy. The growth story
is extraordinary and has very few parallels anywhere in the world. It also highlights the strong fundamentals of Indian economy.

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Figure 6, brings forth the structure of GDP in the country. It is obvious from the diagram that:

1. Capital formation has risen from 24% to 27% during 2002 to 2008. This is one of the highest proportions of capital formation happening anywhere in the world.

2. Government final consumption expenditure as a percentage of GDP has declined from 13% to 10%.

3. Private final consumption expenditure also shows a nine percent decline. It falls from 64% of GDP to 55%.

4. Net export of goods and services has move from -1% to -3%.

This is a very reasonable summary of the strong fundamentals of Indian economy. The structural changes in GDP that have been taking place are only strengthening the fundamentals of the economy.

Figure 7, highlights rising domestic savings and investment. Investment and Savings of the economy on the one hand determines the capacity of the economy to finance its own development. It also defines the dependence of the economy on rest of the world. This aspect of economic fundamental becomes important in the backdrop of the fact that Global Capital and consequent Foreign Investment is likely to shrink as a consequence of the meltdown. It is obvious from the diagram that Indian development story is being financed very substantially by our own domestic resources. Our dependence, unlike other emerging economies, on foreign investible resources is only limited.

Figure 8, captures the trend in foreign direct investment and foreign portfolio investment during 1999-2000 to 2006-07. Over the years both portfolio investment as well as FDI has risen very substantially. In initial years particularly till 2005-06 portfolio investment has risen faster than direct investment. While portfolio investment has tended to stabilise FDI has continued to increase during this period and in 2006-07, it has substantially out performed portfolio investment. FDI worth around $ 20 billion in 2006 - 07 is only a statement of growing attractiveness of India as an investment destination. The growth of foreign exchange reserves from 40 billion dollar in 2000-01 to 301 billion dollars in June, 2008 is just another expression of strong fundamentals.

**The Challenges**

The American and European sub prime crisis and the consequent Global Meltdown throws up extraordinary challenges for the Indian Economy. At the minimum, the impact of the crisis
calls for looking at three major challenges and these include:
1. Prospects for World GDP Growth and the Possible Downside Risk
2. Global Risk Factors
3. Possibility of Global Recession

This paper analyzes the above three and then moves on to assess the fundamentals of Indian Economy in the backdrop of these challenges.

**World GDP Growth:** The first set of challenges emanates from the gloomy prospects for world GDP growth. Figure 9, presents IMF estimates for world GDP growth.

The figure captures the trend path of World GDP from 2005 to 2009. From 2007, the baseline forecast shows downward trend with a possibility for strong further downside. Unfortunately the 90% confidence interval projections suggest very strong
downside. Analysis of the risk factors only puts a stamp of near certainty on these projections.  
**Global Risk Factors:** IMF considers following to be the Global Risk Factors:-
1. Financial conditions  
2. Domestic demand in the United States;  
3. Domestic demands in Europe and Japan,  
4. Domestic demand in emerging economies  
5. Inflation risk,  
6. Oil markets and  
7. Global imbalances  

Figure 10, captures global risk factors as estimated in October 2007; April 2008 and currently. Interestingly financial conditions; Domestic demand in the United States; Domestic demand in Europe and Japan, Inflation risk, Oil markets and Global imbalances are seen as downside risk in October 2007 and April 2008 estimates. 2007 and April 2008 estimates suggest Demand in emerging economies as an upside risk. However, the turn of events after April, 2008 has seen weakening of domestic demand in emerging economies as well. Consequently the current estimates project this also as a downside risk factor. Obviously, the picture of the global economy looks very gloomy.  

**Recessionary Trends:** The scenario looks much darker on the charts. The World has seen four recessions since 1980. And the kind of trend that is observed during these recessionary periods seems to be developing again. The Recession since 1980 are captured in Figure 10.  

It is obvious on the charts that Early 1980s; Early 1990s; Late 1990s and the initial years of the twenty first century were marked by recession. The trend that is building now (Figure 11) is not very encouraging. In addition United States is already in recession and so are Germany, U.K. and Japan. The trend shown in Figure 11 and the fact that some of the largest economies of the world have slipped into recession are ominous signs. Global recession is looks to be a real possibility in 2009.  

Weakening global economy throws up a real challenge for Indian economy. Unfortunately the challenge is further compounded by the fact that the recessionary situation which is...
developing has been triggered by housing burst. There is enough evidence to suggest that recessions which were triggered by housing burst result in much more severe unemployment situation.

Figure 12, documents the truth that recession which have been triggered by housing burst result in much higher levels of unemployment as compared to other recessions. The implications are obvious.

The Crisis and the Road Ahead

It needs to be noted that the recessionary trend is only now converting into a global recession. Major economies like US, Germany, Japan etc are already in recession. The demand contraction is only beginning to deepen. This naturally will hit Indian exports sooner rather than later. Economic contraction will ensure that foreign investment of every shade will soon dry out for some time. These are impacts which are yet to happen. And in an economy which already is expected to slow down this is likely to spoil the party further.

However, given the fundamentals of the Indian economy our dependence on the global economy is limited. Twenty first century India is driven by 37% (of GDP) worth of capital formation annually (Figure 6). This however is almost wholly
**Figure 8:**

(Values in Billion Dollars)

Source: RBI

**Figure 9: Prospects for World GDP Growth (percent change)**

Source: IMF Estimates
financed by domestic savings (36%). The foreign component of the investment is only around one percent of GDP. As far as withdrawal of foreign investment is concerned a major share of Foreign Investment in India is now accounted for by FDI (Figure 8). In 2007, FDI jumped to $20 billion almost twice as much as Portfolio Investment. Understandably this will provide lots of stability to foreign investment. Thus both the weight that foreign investment enjoys in overall investment scenario as well as the nature of investment contributes to the fundamentals of the economy and provides reasonable ammunition to the economy to meet this emerging challenge. Same is equally true for GDP and its composition. It need to be mentioned that the fundamentals of Indian economy are strong and is one of the best positioned economy to meet this challenge.

However, this is only a relative statement. It in no way signifies that India will remain untouched by the crisis. Given the nature of the challenge, irrespective of the fundamentals, the slow down in Indian economy is unavoidable. Banks, Financial Services, Realty and Infrastructure are some of the worst effected sectors already. Mere fall of Lehman Brothers has affected various sectors of the economy. The impact on the realty sector is seen in the table 1.

All those projects which were not complete by mid 2008 have all been impacted. The impact on the Financial Sector is...
The threat is much bigger and Lehman Brother episode was just a small expression of the large challenge. Vulnerability of Indian economy is only obvious. It is well known that declining consumer confidence and investor nervousness, like in other countries, has already hit Indian Economy. The initial stock market declines were truly defined by this alone. The second visible challenge came from the extraordinary withdrawals by FIIs. Number of FIIs were earning reasonable profits through their portfolio investment in emerging markets like India. However, financial meltdown in their own countries and the necessity to remain afloat in there forced them to withdraw from countries like India. So far FIIs have withdrawn over Rs 70,000 crore from Indian markets. This along with falling confidence levels has led to share market crash in India. As a result, the stock markets have plummeted from over 20,000 (Sensex) in January 2008 to around 8500 in November 2008.

This is also the period when Indian Financial institutions were also facing the heat in these western economies. Consequently, RBI allowed them to withdraw over $ 20 billion or over Rs 90,000 crores from India. In other words over 1,60,000 crore worth of liquidity was withdrawn from Indian economy. This was also aided by high POL prices and consequent expenditures on the oil pool. Sudden Withdrawal of nearly two Lac crores from the economy, due to the above developments, has affected the liquidity position within the economy.

During this period the extraordinary inflationary situation in the country made government and RBI to implement contrac-

Source: IMF staff estimates. Shaded area represents periods of global recession.
The wrong recipe and the resultant liquidity crisis ensured that the crisis was brought to our doorstep much earlier than expected.

Economic survey 2008 revealed that Industry which has driven the economy this far was slowing down. The industrial growth rate had come down from over ten percent to just over seven percent. This was a clear sign for appropriate interventions. It is here that we faltered. Despite good fundamentals we brought the crisis closer to ourselves. This only is indicative of the vulnerability of today’s modern economies. It also highlights the role of policy interventions.

It needs to be noted that industry has grown at phenomenal rates for 17 long years. Given the unidirectional (only industry centric) development saturation in industrial growth and subsequent slow down was imminent. Continued growth of industry needed demand expansion in other sectors particularly in agriculture. India’s economic reforms which were started in 1991 continue to remain an incomplete process. Broadly the reforms so far have been industry centric and urban in nature. The rural and agro content have been more or less missing. Given the nature of India's economy, second generation reforms which will revolve around rural and human development is almost a necessity. In face of the current challenge this incomplete reforms process opens up a window of opportunity.

For too long, we have been driving a three engine aircraft with one engine (Industry). Unidirectional growth, while it catapulted a crises ridden economy to the big league, now shows signs of saturation. Time has come when the remaining engines (Rural/Agriculture and Human Development) will have to be opened both to meet the needs of domestic economy as well as to meet the contraction of global demand. If we are able to do that the possibility is that we might be able to generate domestic demand which can overcompensate the possible fall in demand which will emanate from contraction in global capacities. India today stands at a threshold. The best course forward is to take the reform process forward i.e. bring forth second generation reforms. On the one hand.

Sources: Claessens, KOse, and Terrones (forthcoming); Estevao and Loungani (forthcoming); and IMF staff estimates.

*OECD = Organisation for Economic Cooperation and Development
Box I: Implication of Lehman Bank Failure on Financial Sector

ICICI- reported exposure of $80 mn, $12 mn provisions
Expected loss at $28 mn

Emkay Global- Lehman Holdings at 4.05%

Edelweiss- 2.6% stake bought by lehman

Axis Bank-reported exposure $1.5 mn through mark to market forex counter party deal.
Impact negligible

SBI- reported exposure at $5 mn, expects to recover 70%

PNB- reported exposure at $5 mn
Expected loss at $2 mn

BOI- reported exposure at $11 mn
Expected loss at $5 mn

BOI- reported exposure at $10 mn
Expected loss at $4 mn

Table 1: Lehman's PE Investments in India

<table>
<thead>
<tr>
<th>Investment</th>
<th>Amt (US$ Mn)</th>
<th>Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hyderabad IT Park Project of Peninsula Land</td>
<td>12.5</td>
<td>2008</td>
</tr>
<tr>
<td>Unitech's Mumbai Pune Expressway</td>
<td>175</td>
<td>2008</td>
</tr>
<tr>
<td>Hotel Project of Future Capital</td>
<td>200</td>
<td>2007</td>
</tr>
<tr>
<td>DLF Assets Private Limited</td>
<td>200</td>
<td>2007</td>
</tr>
<tr>
<td>Anant Raj Industries</td>
<td>66</td>
<td>2006</td>
</tr>
<tr>
<td>Unitech's Mumbai Project</td>
<td>16</td>
<td>2008</td>
</tr>
</tbody>
</table>

Source: Published reports

hand, it will provide the necessary completeness to the Indian Reforms Program. On the other hand, it will open up new capacities to overcome the possible contraction emanating from Global recession. Unleashing of the Rural and Human Development Sectors do hold the key towards a resurgent India. The fundamentals of Indian economy in their current form will ensure that when this gloomy phase is over Indian Economy will show the fastest recovery amongst the comity of nations. However, the road that passes through second generation reforms has the capacity of shifting the global balance towards Asia faster then expected.

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(The views expressed in the write-up are personal and do not reflect the official policy or position of the organisation.)
The Great Indian Growth Story: Taming the Recession Monster
Saumitra Mohan
Chief Executive Officer,
Siliguri Jalpaiguri Development Authority, West Bengal
The recent sub-prime crisis in the United States stemming from the problem of failing home loans and municipal bonds, has cast a grim shadow on the economic growth around the world. Stock markets all over the world have taken a severe beating, following foreign institutional investors’ (FIIs) and mutual funds’ selling spree due to fear of slowing growth rates. With stock markets nose-diving, weakening capital markets and prices of basic commodities including that of food going northward, the fear of an economic recession in the global economy is looming large. Even though initially it appeared that it is only the United States which is afflicted with the recession, but now the flu has overwhelmed the larger global economy including India as well. It is really a moot point today as to what does a country like India need to do if the crisis really deepens further as the same has serious implications for the domestic economy, which so far seems to have been doing reasonably well. In India, we are already witnessing a liquidity crunch resulting in RBI taking special measures to bolster the economy. The projected growth rate is already down and is hovering around seven percent now. The stock markets here continue to be in fits notwithstanding assurances from the different authorities.

As we know very well by now, the global economy is prone to go through cyclical boom and bust. Hence, there is nothing extra-ordinary about the looming recession or stagflation threat. However, the global economic situation is not the same today as it was during the 1930s forcing the Roosevelt Administration to come with the celebrated ‘New Deal’ proposals. These proposals were predicated on Keynesian prescriptions of increasing public expenditures to cope with the raging recession in the US economy. The situation is also quite different from the crisis of 1971 when the fixed exchange rate system collapsed, precipitating the ushering of the extant system (a judicious mix of both fixed and floating exchange rates.)

Before we really get down to the brass-tacks, trying to manage recession and its implications, one has to appreciate that the situation is definitely not the same today as it had earlier been. With the deepening and thickening of the process of globalisation, the inter-dependence among the countries of the world has become more complex. Slowly but steadily, the economic balance of power has gradually shifted and changed the global realities.

There was a time when the US or the Europe would lead the world economy by their sheer weight and the latter was greatly affected by the negative or positive vibes emanating from either of the two. The global dependence on these blocks through cascading trading ties made it impossible for the world to avoid any development in those countries. More so, because of the fact that many countries in these blocs were also colonial powers with colonies in rest of the world. The developing world was hugely dependent on the developed West for almost all their needs. The ‘dependency’ school literature centred around ‘development of underdevelopment’ has talked about it in detail.

This monopoly situation also made these leading economies quite imperious vis-a-vis the developing/underdeveloped countries often forcing the latter to toe their lines. But the processes of globalisation and liberalisation have afforded a semblance of independence for some of the weaker economies. The emerging complex interdependence of economies has facilitated a diversification of trading ties to the advantage of some of the developing countries. These developing countries, today, have been bandwagoning with each other to better secure their economic interests vis-a-vis the developed world.

That is why many believe that the threat of recession to such countries including India and China is not as real as it is made to appear. They are said to be reasonably insulated from the ill effects of the US recession for the simple reason that they are not as overly dependent upon the US as some of the countries are. It is the latter countries, who have skewed economic ties with the US, are feeling the pinch more. So, countries like Japan or South Korea or some countries in Europe which have deeper economic ties with the US and don’t have diversified trade profile, should really have genuine reasons to worry. The US recession can really dampen the pace of growth in these countries by way of reduced exports and inflow of foreign exchange.

The countries like India and China should, however, not get panicky as their trading ties are much more diversified.
Both these countries, accounting for almost half the world population, have only a small portion of their trade linked to the US. Of their total exports, not more than 20 per cent go to the US. Besides, these two countries' growth has been more or less dependent on a sound foundation of strong domestic consumer market. The middle class in these countries has been growing handsomely to provide a broad-based consumer base with substantive purchasing power capacity. It is the consumption behaviour of this growing middle class that has become the latest target of the US for the snowballing food crisis in the world.

If these two countries have managed to survive the negative impact of the US recession, the reason lies in the fact that the high economic growth rate of both these countries are propped by a strong domestic consumer base. So, while you had the US or the Europe leading and influencing the world economic growth at one time or even now, the situation may be different very soon with these two countries leading the global growth by the sheer weight of the size of their economies. By being less dependent on the US, now reeling under a recession, these economies are better insulated and secure than any other country.

This fact is well realised by everyone else and that is why even when the US had been experiencing an economic slow-down, countries like India and China have been trusted with more and more investment in the form of increasing FDI, FII, NRI remittances and deposits thereby increasing demand for the Indian rupees. This had resulted in building an upward pressure on the rupee, making it further dearer after appreciation of its exchange rate vis-a-vis dollar and other leading currencies. What is surprising is the fact that financial markets are still trusting dollar over rupee as vindicated by the increased demand for the former resulting in rupee's fall vis-a-vis dollar. FIIs' and others' withdrawal from the Indian stock markets are symptomatic more of panic than anything else. However, a falling rupee may make our exports more competitive thereby giving some reason to cheer about for the exporters.

The US economy is experiencing recession also because of its inability to cut the production costs. The developing countries with their cheap labour and skilled manpower provide better investment options to industries thereby motivating many of them to relocate and outsource their operations. This has not only resulted in reduced employment opportunities for the Americans, but has also reduced their purchasing power, thereby affecting demand and inducing recession.

So, it is advisable that the developed countries including the US should open up their economies to the cheap labour from the developing countries as that would help them revive not only their sagging economies by making their industries more competitive, but would help the larger world economy also. The developed world should also do away with the sundry non-tariff barriers erected for disallowing cheap products from the developing world from entering their economies. Economic growth anywhere helps economic growth everywhere by creation of purchasing power and creation of demands for more manufactures and services. By doing this, the developed world would only be furthering the cause of
‘liberal capitalism’ which they show ardently espouse. The so-called ‘Washington Consensus’ would not only get a further boost, but would also become more just and humane.

The fact also remains that so far Americans have been living off borrowed money (parked in the form of US treasury bonds by the developing countries including India and China), made available to them at increasingly cheaper interest rates thereby creating an unsustainable bubble which seems to be bursting now in the wake of the raging sub-prime crisis there. With the snowballing of the global financial crisis, if these countries decide to withdraw their money, the US recession would become further painful.

So arguably, these two countries i.e. China and India should have less reason to worry about the US recession as their growth is self-induced than dependent completely on exports. However, such a recession should definitely be seized as an opportunity to further strengthen and streamline their macro-economic financial structure and thereby put their own house in order.

So, at a time when the US Fed has been trying to prime pump its economy by way of reducing the interest rates substantively, countries like India need to be more careful where its central bank has been following a ‘dear money’ policy for quite some time in its bid to contain the ‘inflation demon’. But as we know that it was Keynesian economics of welfarism which saw the US economy out of recession in the thirties meaning thereby that we need to spur public expenditure more than contain it. That is why, a moderate inflation is always said to be healthy for any economy as that is the sign of a growing economy backed by a growing demand. In light of this, the recent steps taken by RBI are really welcome.

If inflation has been rising in this country, the reasons for the same have to be found and fixed. If the huge demand for
cement and steel for infrastructure strengthening in China for the upcoming Olympic is a reason for growing prices of these commodities, then we need to make policy and administrative interventions to contain their prices including increasing the production. Applying brakes on cement and steel exports is definitely not advisable though market forces have already steadied the prices of these products.

While rising oil prices had been a matter of concern for quite some time, the fall in the same also has not helped the matter much. We need to find ways to identify the real problem and tackle the same at appropriate level. But raising interest rates and cash reserve ratio (CRR) was definitely not a right approach. Such moves would not only have a dampening impact on the entrepreneurship, but would have also discouraged investment and further growth. The same would not only result in blocking huge amount of idle money from being utilised for productive purposes, but would also increase the state debt by enhancing the financial burden for servicing those savings by higher interest rates. So, the corrective steps by RBI recently are in sync with the realities.

Now, reduced interest rates would make government’s own borrowing cheaper, thereby making substantial resources available for public expenditure. It would also positively help the fiscal situation by lowering our fiscal deficits. A high inflation rate has been around also because of the growing food prices. It is felt that the tendency to siphon out fertile land for industries or for bio-fuels or decreasing investment in agriculture has led to reduced productivity and production thereby directly fuelling the inflation. One feels that there is an urgent need for a second ‘Green Revolution’ and more public investment in agriculture. One just hopes that the recently launched National Agricultural Development Scheme shall be able to address this problem better.

Last but not the least, the very fact that inflation has not yet resulted in wide scale public discontent and outrage and still continues to be a debating issue confined only to the political class is because of the fact that rising prices have been accompanied with increasing purchasing power capacity of the public. With more demand chasing fewer supplies, it is at the level of supplies that we need to intervene.

The government needs to ensure that more investment, both private and public, are suitably made to further produce the basic goods and products for availability to the common public at an affordable price and that itself would take care of the inflation problem. More broad-based investment would not only result in more demand creation, but would also put in place adequate supplies to cater to those demand, thereby spurring economic growth further. Such a step would also keep the dreaded recession at a reasonable distance or well in control.

There also seems to be a crisis of confidence among the major players of the financial and capital market. There is a need to inform and educate them suitably so that no panic-induced reaction is witnessed in the economy. The common public also needs to be similarly made aware of the different aspects of the problem. The magic world lies in ‘investment’. We need more spending from all corners, public and private, at all possible levels so that the so-called liquidity crunch is gone and global economy including ours is back on the rails once.

(The views expressed are author’s personal views and do not reflect those of the Government).
DEFYING A SLUMP-A MACRO ECONOMIC POLICY APPROACH

Dr P.M.Mathew
Professor of Economics,
Christ University, Bangalore
The origins and nature of global economic crisis are deepening day by day. The financial crisis has exploded into a systemic crisis affecting the whole world. The global economy is now passing through an unprecedented and unusual financial turmoil. The possibilities of the science of economics and the prescriptions of economists are all the more sought after now. Even the seasoned economist Allen Greenspan who was the chairman of the Federal Reserve System in the USA had to recently admit that “he had been partially wrong in his hands off approach towards the banking industry, and that the credit crunch had left him in a state of shocked disbelief.”

In the current global financial market environment, countries with the twin macro problems of high current account deficits and tight banking sector liquidity are likely to suffer a major deceleration in growth. Today’s crisis is a deep crisis of confidence triggered by a proliferation of bad real estate loans now driving banks and financial institutions into bankruptcy. The credit crunch since September 2008 has seriously affected the expansion plans of firms. Terror strike
at the financial capital of India too will have a fairly major impact on both portfolio as well as FDI inflows. This will affect the risk premium associated with India. The nationalization of Bradford and Bingley in the UK and the financial support for Fortis in Europe highlights the dangers of the contagion. The four factors responsible for the crisis are:

1. Continued economic expansion with inflation for 15 years. There was in fact a liquidity glut. Regulators failed to notice the asset price inflation, especially in real estate.
2. During good times financial institutions especially investment banks grew very large. They made risks and profits. It is said that they accounted for forty percent of US corporate profits against the normal 10%. Huge salaries were paid to those who sold complex financial products, credit derivatives and other securities whose risks were not understood.
3. Investment banks did not have sufficient capital to support the risks on their balance sheets.
4. Major failures of leadership at most financial institutions was another reason. Deal makers took charge and risk managers were sidelined. Credit was mispriced.

Impact on India
The relative freedom from the global financial tsunami that India is enjoying now is largely due to the wise and judicious policies of the central monetary authority and the Government of India. Though it is not possible to completely insulate the Indian economy from the impacts of the global financial crisis, the constituents of the Indian financial sector have not experienced the kind of financial turmoil that is being faced by the powerful financial institutions of the western world. India has ensured that its regulatory checks and balances prevent any undue exposure to global risk and the financial sector is prepared to cushion adverse situations. It was pointed out that India has not been a major investor in US subprime mortgages, and that the institutions of subprime lending, of no doc mortgages and of securitization of mortgages are not prominent in India. But the seemingly inexorable rise in the Indian stock market has been clipped. The sensex rose about eight-fold from 2003 to the beginning of 2008, but now has had a correction.

The risk averseness of the Indian banks were not the result of their own policy approach. It was largely due to the recommendations of the veteran central banker Mr. Narasimham. The Narasimham report gave a policy frame-work for the Government of India and the RBI to formulate the structure of India’s banks and financial institutions. The Narasimham report recommended for adequate capitalization, good provisioning norms and well-structured supervision. The Government of India and the RBI accepted and implemented these recommendations. The RBI enforced strict capital adequacy norms and if any financial institution or bank exceeded the specific limits of exposure to stock markets, it would have to give more capital. This effectively insulated the banks and financial institutions from volatility of the bourses. Also the Indian banking system is basically owned by the public sector. The Government of India has avoided total capital convertibility.

Impact on India
India is not much affected because our growth is not export driven. Nevertheless, investment has declined. Had we embarked on total capital convertibility, we would have been exposed to much greater problems. Indian banks in India hardly hold any toxic securities and their exposure to Lehman brothers, the only investment bank that went bankrupt, was small. The impact of the financial crisis came through FII disinvestment. The repatriation of funds necessitated sale of dollars against rupees by the RBI. Consequently foreign exchange reserves with the RBI declined and corresponding rupees in the banking system disappeared in to RBI kitty. The finance ministry and the RBI acted just in time to increase liquidity by reducing SLR and CRR and setting up a committee to keep a watch on liquidity. The capital market will remain weak and volatile. That is because of the disinvestment by FIIs and of the fear that the financial crisis will percolate down to the real economy. US and the European Union have run in to recession. Indian economy is not much affected because our growth is not export driven. Nevertheless, investment has declined because companies could not raise capital abroad and depended entirely on domestic sources of funds.

A Policy Approach
The critical issues today are liquidity restoration and reduction in the rate of interest. The rate of interest was increased because of the high rate of inflation, not realizing that inflation was not due to overheating of the economy but due to rise in international commodity prices. India is not invulnerable to the
current crisis. She urgently needs to take many of the same actions that are called for in other countries. Some serious works needs to be done to improve the quality of the financial markets, both expanding regulation and consumer protection, but also expanding the scope of integrity of the markets and their retail products. Work needs to be done to democratize finance, to make enlightened risk management available to everyone, by subsidizing financial education and advice.

Sustained expansion and rising consumer demand are expected to help the country ride out a global recession. A new international financial architecture needs to be built. Mere monetary solutions were not sufficient, globally co-ordinated fiscal solutions were needed to resolve the current crisis. For the first time in the history of the world we have coordinated multi-country, multi-level rate cut. We are in a globally integrated world and globally co-ordinate action is essential. Developing countries were not the cause of this crisis, but they are amongst the worst affected. It is now a known fact that America was exporting toxic mortgages around the world, in the form of asset backed securities. The contraction of exports, a credit crunch and lower flows of capital and FDI would slow down their economic growth and push millions of people back in to poverty, with adverse effect on health, nutrition and education levels. Further as the Prime minister has stated, “they would reduce growth impulses in the world economy”. Bringing the present crisis under control as early as possible should be the immediate priority.

The continued weakness of the real economy suggests that the steps we have taken to increase liquidity must be supplemented by co-ordinated fiscal stimuli. Central banks from the US, Europe and Asia slashed rates in a co-ordinated move. The traditional monetary policies like interest rate cuts have not been a successful strategy in avoiding the current financial downturn. The move of the major central banks failed to have the desired effect on world financial markets. There is a need to take resources to the developing countries. Towards this end the World Bank and the IMF must be provided with adequate additional resources to fulfill their responsibilities. There is a need to introduce regulatory reforms in the financial system. We have to improve existing standards and align them internationally. We need much better multilateral surveillance of both macro economic and financial developments. It is important to realize, in this Keynesian world, that mere increase in liquidity will not solve the problem of expectations. Governments will have to stimulate demand through direct expenditure. A possible solution to the recession lies in an innovative allocation of foreign exchange reserves in developing countries along with a careful reading of Keynes.

Expanding investment in infrastructure can play an important countercyclical role. Projects and programmes are to be reviewed in the areas of infrastructure development including pure public sector projects and PPPs, to ensure that their implementation is expedited and does not suffer from fund crunch. Expenditure in social sectors such as health and education are to be enhanced and progress in agriculture development is to be closely monitored. Government should take all necessary monetary and fiscal policy measures on the domestic front to protect growth rates.

Big changes are needed in financial and capital markets but governments must avoid the trap of a regulatory overreaction. Excessive regulation can do damage too, by inhibiting future financial innovations, market integration and growth. This recession will not lead to a depression of the sort that the 1930s witnessed. Thanks to the massive rescue plans now in place. The world is saved from another depression by massive bail out plans and state interventions. The country cannot afford another round of casual approach to the economic threat that loom large.

References and Additional Thinking

1. Robert Prechter, ‘Conquer The Crash: You Can Survive and Prosper in a Deflationary Depression’
2. Roger Lowenstein, ‘When Genious Failed: The Rise and Fall of Long-Term Capital Management’

(The views expressed in the write-up are personal and do not reflect the official policy or position of the organisation.)
MENDING THE MELTDOWN:
Fending off the Interventions and Resurrecting the Market

Madhusudan Raj
Mises University 2008 Alumnus, Ludwig von Mises Institute, Auburn, Alabama, U.S.A

Introduction
The emerging economic crisis in USA and the global economy presents a phenomenon which started to appear frequently in different economies around the world during late 18th century with the advent of central banking in England. In the science of economics\(^1\), this phenomenon is called, The Business Cycle. It is important that when we are trying to recover from the present economic crisis, we must first understand the whole phenomenon of the business cycle. After that, we must understand the causes of the business...
cycle which are presented by a proper theory of business cycle. In this short paper my goal is two-fold. First to make the business cycle phenomenon clear to the readers and present the economic theory of business cycle which discusses its main cause. After having a full grasp of the theory of business cycle, I will then present the solution of the crisis. The discussion follows in three different sections. Section 2, will present the understanding of and the proper theory of business cycle. In section 3, I will argue against the efforts of various governments and their central banks to solve the present economic crisis. Using the business cycle theory developed in the preceding section, I will demonstrate why the present efforts of various governments and central banks won't work and in fact will prove to be counter productive and even more disastrous. Section 4, will then discuss what we need to do for a quick recovery from the present meltdown and what we need to do in the long run to stop the problem of the business cycle from recurring.

The Cause of the Crisis
For finding the solution of any problem requires one to first have a clear understanding of the problem and its causes. Here, I first discuss the distinction between the business cycle and business fluctuations. Once we understand the business cycle then I present its causes.

Business Cycle and Business Fluctuation
Both the phenomenon of the business cycle and day to day business fluctuations are vastly different from each other. The distinction between them must be made clear to understand what causes day to day business fluctuation and what causes the business cycle. Business fluctuations are part of routine life where prices of individual goods or services fall or rise on daily basis. The rise and fall is due to changes in the market forces of demand and scarcity of the goods or service in question. As analyzed by the Austrian economist, price is determined primarily by the subjective valuations of all consumers. Other factors affecting price are the given circumstances under which the consumer finds himself while choosing the marginal unit and the relative scarcity of the goods or service. For example, during a natural disaster such as a flood, the price of milk rises rapidly because the given circumstances of flood make milk scarcer. Similarly prices of individual products rise and fall on a daily basis with the change in underlying economic data. It must be emphasized here that, this rise and fall in individual product prices or even prices in some sector of the economy, like automobile industry or agriculture products etc., can not be considered as a cycle. These are individual events happening in one or the other sector of the economy. These fluctuations are corrected automatically by the market if left alone to work. For example, during flood, if we let the price of milk rise for sometime then it will automatically induce producers from other areas to start producing more milk because now milk industry is more profitable during flood time. Once this new supply enters the flood hit place it will increase the supply of milk and will remove the scarcity of milk. This removal of scarcity itself will lower the prices of milk in few days time. Market will automatically resolve the milk problem. So we don't need any special attention for such daily events. Market easily sorts out gluts and scarcities. Like the rise and fall of prices of individual products in the market, everyday many individual businesses silently cease its operation when they make losses. Individual business closures are very normal in Market. Profit and loss is the market mechanism through which inefficient and unproductive businesses are weeded out while efficient and productive business remains and continues their activity to serve the consumers most effectively.

But the phenomenon of business cycle is very different. It requires special attention because the causes of business cycle are not in built in the market process. Let's first understand what business cycle is.

Business cycle is a general boom and bust phenomenon which occurs at the economy wide level. It is a macroeconomic phenomenon having crucial microeconomic roots. The phases of an economic cycle are typical. It starts with a mild boom in economic activity (when everything seems very rosy), then the boom expands rapidly and that starts to result into inflation and then a final slowdown of the economy, the recession. What is very peculiar of the business cycle is the phase of recession. During the recession, we see economy
wide mass business failures, like the present one where the housing market, majority of banks and auto industries are collapsing one by one. What seem to be so profitable industries in the boom period suddenly become unprofitable. Due to these business closures large scale unemployment results. The capital structure of the economy changes where resources start to flow from unprofitable industries to other sound industries. During the boom period also the economic activity seems very unusual where most of the goods and services' prices tend to push up dramatically. Inflation slowly emerges in the economy and it spreads from one sector to another sector. This is what is the character of the general boom and bust cycles. It is very different from the daily business fluctuations.

After understanding what business cycle is, it is important to understand its causes. Any good business cycle theory should explain all the phases of cycle within the framework of general theory of economics. It must explain why during the recession period mass business failures results, why the capital structure starts to change (many projects fails and resources flows from this projects to other more viable projects), why unemployment results and why during the boom period economic activity increases dramatically, money supply is continually increasing and in the end it all ends with an inflation and subsequent recession. There are many theories of business cycle in mainstream economics but they all either don't fit into the general framework of economic theory or fail to explain the business cycle properly. The only theory which successfully integrates itself into economic theory is The Austrian Business Cycle Theory (ABCT) as developed first by Ludwig von Mises (Mises1953) and subsequently by Friedrich Hayek (Hayek1967) and Murray Rothbard (Rothbard2000).
resources are employed in these new projects they are less available for producing other consumer items which are required for present consumption. As the newly created money starts to enter market it increases the purchasing power of those in whose hands it goes first. On one side consumers acquire new income and on other side their time preference haven’t changed and thus they start to spend their money in market for present consumption. On the other side production of consumer goods is not taking place because resources are flowing in long term production processes. This slowly starts to result in inflation. Price rise slowly spreads from one sector of the economy to the other sector with the flow of money from one sector to another. Once the money spreads fully it results into inflation.

Now as Inflation emerges in the economy, suddenly government becomes concerned about it. To combat this inflationary situation, central bank starts increasing the interest rate by using tight monetary policy. With this increase in interest rate, the entrepreneurs realize that the new projects which they started during the boom period are not backed by real saving and are thus not profitable and sustainable. Mass business failure takes place. Murray Rothbard called this phenomenon of mass business closure, a cluster of errors, where many businesses suddenly discover many errors in their past decisions. The artificial boom inevitably results into a recession. People employed in those projects now become unemployed until they find work in activities suited to consumers’ preferences.

What is important here to understand is that, recession is a necessary outcome of the artificially created boom by the central bank. The recession is the process through which market starts to correct the capital structure of the economy. Through that whatever mal-investment has taken place during the boom period now starts to liquidate and those resources slowly starts to flow in correct industries to fulfill consumers’ immediate demand.

But, if during this period government again starts to intervene in the market adjustment then the mild recessions can result in a deep depression such as the Great Depression of 1929. The present economic crisis could result in a big depression because governments around the world are meddling heavily in market adjustment process of recession. I now discuss how the recession becomes a depression and why the present efforts of governments around the world are unnecessary and in fact counter productive.

Why the Present Meddling with the Market Won’t Work?
The action of government during the recession period is typically to prevent the recession at any cost. They fail to
understand that recession is necessary to liquidate the mal-investment of the boom period. It is necessary for realignment of capital structure and the production process according to consumer time preferences. The typical response of government and their central banks is to pump more money into the market during the recession period. These Keynesian policies are based on flawed economic reasoning that a recession takes place because consumers suddenly start spending less. What actually results due to this pumping of money is more distortions of market interest rate and further distortions in the adjustment process. More distortions in market will require a longer time for readjustment and thus recessions becomes depressions. Governments and their central banks fail to understand that the process which was started by creating money out of thin air can never be corrected by the same process of creating more money out of thin air.

Without real savings, economy will never grow. Artificially created wealth gets wiped out one day. Fiat money can only result into booms and busts. By printing more money one can not make poor people rich or a poor nation rich. Living beyond one’s means is not possible in the long run.

### The Ultimate Remedy

After getting the full grip of the theory of business cycle it is clear what we need to do in the short run for a recovery and more importantly what we need to do in the long run to prevent the business cycle from ever occurring.

In short run, we should need to do nothing. Doing nothing sometimes is a more beneficial action than doing everything and deteriorating the situation further. We need to let the market do its work. The market in a very short period of time will reallocate all the resources in right channels of production and will adjust the capital structure of economy in line with consumers’ time preferences. Through recession the market will liquidate all mal-investments. In the short run all the unnecessary projects will shutdown and we should allow this business closures instead of bailing them out one by one, as they are doing right now. People will increase their savings in the recession period and that is good. We should not meddle with consumer’s desire to save more during recession. In fact this saving is necessary in recession because this
increased saving can, to some extent, help some of the businesses to survive in recession period. Consumers by making this actual savings available to some of the businesses can help them in avoiding bankruptcies and also preventing them from laying off their workers. It can also prevent the loss to the equity holders. Once the recession period is over, economic activity will return to normal. People will find employment in more viable activities again. Prices will come down to their normal market level which will increase the standard of living of people slowly.

And in the long run, if we wish to prevent the business cycle from ever happening then the key lies in taking the control of money back from government and restoring it again to market. We need to adopt three crucial steps:

1. Money essentially is a commodity and it should be produced in the market itself like any other commodity. For restoring the money in the market place and to take back the control of money supply from the government, we need to adopt the market based commodity money. Commodity money can either be gold or silver or both gold and silver, as existed in historical periods. This is what is needed for stopping government from printing money out of thin air. Public mints should give its way to the private coinage.

2. Secondly, we need to abolish the central banks. This means abolishing the RBI from India. Central banks are the root cause of this whole problem. A central bank is just like any other central plan authority which worked under communist/socialist/market socialist countries. Theory and history both shows that central planners and their plans never work. They can only create problems for people. Central banks’ monetary policy and its fixing of interest rate is the prime cause of boom and bust cycle. If we want to stop the booms and busts then we need to abolish all the central banks around the world.

3. Even in the absence of central banks, private banks (through the process of credit expansion under a fractional reserve banking system) can distort the market interest rate creating a boom and bust. The whole system of fractional reserve banking is unethical and thus we need to stop it too. All banks must operate on a 100 per cent reserve banking norm. If banks have 100 customers with 100 rupees worth of reserves then that bank must, all the time, keep 100 rupees reserves with it. In short the money creation process of banks should be stopped. Stock and bond markets are good places for the businessman for getting people’s savings for their business investments. Banks-of-credit (as oppose to the banks-of-deposit) will also perform the function of providing consumer’s savings to the businesses. In short, 100 percent free banking system should replace our present day fractional reserve banking system.

These three steps are necessary for stopping booms and busts from ever occurring. We must let free market work in the very crucial sphere of money. Money is too important subject to be handed over to government who is always eager to exploit it.

Endnotes

1. Economics is a study of human action, also known as Praxeology.
2. At the very outset of this paper I make it clear that it will be impossible for me to discuss all the issues which will arise in reader’s mind after reading my paper. Because of space constraints I will be very brief. But I will give detailed references so that one can go and find answers of their queries by reading those references.
3. Studying this cause and effect relationship is the backbone of any scientific inquiry as made clear by famous Austrian economist Carl Menger, in the first sentence of his seminal work The Principles of Economics (Menger2007, p.51.) Menger started his magnum opus with the following statement: All things are subject to the law of cause and effect.
4. To understand the mechanism of profit and loss thoroughly please refer to, (Mises2008).
5. Many people, including many renowned economist blame the free market for causing the business cycle e.g., J.M. Keynes developed whole new economics (The Keynesian economics) by refuting Say’s Law of Market. Later on in this article I will show, why all those people who blame the market are mistaken in their views or present flawed reasoning on their part to refute workings of the market.
And those who blame the market for today’s crisis, fail to see the fact that we simply don’t have any free market working anywhere. What we actually have is the hampered market, raft with government interventions and regulations.

Although not regular and thus not predictable.

In the following section we will see why the mild recessions sometimes can take a form of a deep depression e.g., the great depression of 1929 in America. It is highly likely that the way government across the world is reacting towards the present crisis, this recession can also turn into big depression like 1929 or even worst than that.

Price rise is just the effect of the process of inflation. It’s not the cause of Inflation. We will see in subsequent section the main cause of Inflation. There I will define Inflation from an Austrian point of view.

This is called the Cantillon Effect.

For a short introduction to the Austrian Business Cycle theory, please refer to (Ebeling1996).

This is called the easy money policy of the central bank.

Austrian economists define inflation differently. I quote Henry Hazlitt for the definition, Inflation is an increase in the quantity of money and credit. Its chief consequence is soaring prices. Therefore inflation - if we misuse the term to mean the rising prices themselves — is caused solely by printing more money. For this the government’s monetary policies are entirely responsible (Hazlitt2004).

To resolve the so called liquidity problem.

Because of many constraints again it is difficult for me to discuss the fallacies of Keynesian economics. For a thorough reading on this please refer to (Hazlitt1959) and (Hazlitt1995).

For example, central banks around the world have now lowered the market interest rate to combat the recession. RBI is also pushing huge amount of paper money in the market.

Thus, as against the mainstream view of market responsible for depressions, it is the government and central banks who are responsible for big depressions, with the business cycles.

We certainly die in long run as Lord Keynes said, but we live long enough to suffer from the government policies.

And we also leave a wrecked economy for our future generation as a legacy of our present follies.

For a discussion of the market based commodity money please refer to, (Rothbard1974).

The campaign for ending the US Federal Reserve Bank has already started in USA and it is backed by the leading proponent of sound money, Ron Paul. Their website is here - http://www.endthefed.us/.

For a discussion of the flaws and unethical practice of fractional reserve banking system (FRB) please refer to, (Soto2006).

References and Additional Thinking


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Preserving financial sector CONFIDENCE not monetary easing, is key

Arvind Subramanian
Senior Fellow, Peterson Institute for International Economics and Senior Research Professor, Johns Hopkins University, USA
Brand India is being buffeted by the global financial crisis. India has been more financially integrated than was generally supposed, and hence more affected by financial contagion than expected. The stakes are high because policy hesitancy or missteps could turn mild contagion into virulent disease.

One lesson that countries are learning is that during a crisis of confidence, policy-makers have to get ahead of the curve in order to reassure markets. Governments have discovered the hard way that responses that are reactive, piecemeal, and uncoordinated risk undermining rather than adding to confidence. A formidable policy arsenal needs to be deployed to have any chance of restoring stability. In western financial markets confidence is returning, slowly, only after a series of ambitious actions, boldly initiated by the UK and then followed by Europe and the US, as many economists advocated.

Between last week’s actions to shore up the financial system and Monday’s cut in interest rates, Indian policymakers can legitimately claim to have risen to the challenge. But will these actions be enough? What more will be necessary?

Broadly, more will need to be done on the financial sector side in order to do less on the monetary policy side. Put differently, if confidence in the financial system is not restored, the easing, even substantial easing, of monetary policies that we have recently seen may not have enough traction, and may even entail risks.

First and foremost, the plight of individual financial institutions should be addressed. A benchmark should be that no Indian bank should have credit default swap (CDS) spreads exceeding 300 or so basis points. It is likely that perilously elevated CDS spreads reflect problems with foreign funding. So, high on the action list would be to provide foreign currency resources from the Reserve Bank of India’s reserves. The RBI’s liquidity injections operations that have so far been in rupees need to be expanded to foreign currency.

One way to do this would be to hold foreign currency auctions for all domestic financial institutions to meet either their own needs or those of their corporate clients that face foreign currency funding pressures. The Fed and ECB responded to dollar shortages in Europe through extensive swap operations that made available enormous lines of dollar credit in European markets. The RBI foreign currency auctions should be held quickly and flexibly so that liquidity can virtually be provided on tap. The RBI’s foreign exchange reserves have been accumulated for rainy days, and these are not just rainy but stormy days, justifying their liberal use today.

If these measures prove inadequate, the government may need to step in to guarantee the foreign-currency debt of domestic financial institutions. This may need to be complemented with government re-capitalisation, especially if private banks are unable to raise capital from private sources within a very short period of time. India just cannot afford to have financial institutions that are flashing amber or red in these times.

Moving beyond individual institutions, and given the crisis of confidence, it may be worth requiring all banks to raise their capital adequacy ratio (CAR) to about 15-18%,
within a short period. If meeting this higher CAR requires additional government capital injection, that should be seriously considered. Ways could be found for this capital to be returned to the government once the crisis subsides. If all banks were seen to be meeting this high standard, it could have a significant impact in reassuring markets. The rationale for the higher ratio, apart from the confidence boosting impact, is the more substantive one that banks’ non-performing assets are bound to rise as the economy weakens. An apparently cushion-providing 15% CAR today could very easily become an 8% CAR within a short space of time.

Next, it might be worth imposing additional transparency requirements on all the major banks to reassure investors and the public. Uncertainty in this environment leads to markets believing the worst. All banks should therefore be required to immediately clarify and publish key variables of concern, including foreign currency exposure, especially on the liability side, the extent and sources of wholesale funding, and exposure to derivatives and other such instruments. A strong transparency effort, under the RBI’s supervision, could have an important reassuring function.

Finally, what about exchange rate and monetary policies? On the former, the RBI should refrain from foreign exchange intervention, which at the moment sends contradictory signals because it sucks out liquidity at the very time that the RBI is pumping enormous amounts of liquidity back into the economy. Far better to use the RBI’s foreign exchange reserves to meet the foreign funding requirements of domestic financial institutions rather than to defend some level for the rupee.

On monetary policy, the RBI has been doing the juggling act of easing interest rates and injecting rupee liquidity, on the one hand, while trying to encourage capital inflows and discourage outflows through a variety of measures such as raising interest rates on foreign currency deposits. Make no mistake that there is an inherent tension, even plain contradiction, between these actions, which the RBI has been able to avoid because residents, unlike foreign investors, are not fleeing rupee assets. The risk of aggressive easing is that it might trigger the move away from rupee holdings, at a time when confidence in the rupee is so shaky, when current and prospective depreciation would offset the favourable effects on inflation from declines in commodity prices, and when credit is still growing at a whopping 30%. It is worth noting that while the repo rate has been cut to 8%, the call rate — which reflects market conditions — is at 6%, below CPI inflation, resulting in negative real interest rates.

A loss of confidence in the rupee is an outcome devoutly to be avoided. At this juncture, restoring confidence in individual financial institutions and the financial system is key to achieving that objective and to avoid unreasonably burdening monetary policy.

“Brand India” has come to connote not just rapid growth but a reasonable ability of policymakers to respond to challenges. Of course, this response will be assessed by outcomes. But critical to this assessment will be whether processes for arriving at outcomes are effective, and specifically, whether all concerned institutions play their rightful roles and maintain their credibility. “Brand India” must pass all these tests. 

(Editors Note: This article first appeared on www.VoxEU.org. Reproduced with permission. This first appeared in the Indian newspaper Business Standard on October 24th, 2008. The views expressed in the write-up are personal and do not reflect the official policy or position of the organisation.)
The present crisis which broke out in September with the failure of investment bank Lehman Brothers in the US actually has its roots in the era of cheap money starting in the 2000s. The rapid economic growth seen globally was fed by low cost of capital and was boosted by all round optimism, the euphoria of the positives of globalization and confidence of policy makers that markets would lead a sustainable growth path. Though there were numerous alerts, notably from the Bank of International Settlements, academics like Robert Shiller, Nouriel Roubini, Axel Leijonhufvud etc., the fact is that none of the participants wanted to pull the punch bowl away when the party was in full swing. To top it all, high growth was accompanied by low inflation and this happy situation had the world ignoring the build up in asset prices, which was itself a
warning of the problems ahead. A correction had to come, and it is well known that the larger the bubble, the longer and steeper the correction. As Stephen Roach of Morgan Stanley pointed out in the Financial Times recently, “In an era of globalization, we became intoxicated with what cross-border linkages were able to deliver on the upside of a boom. But the boom went to excess and spawned a lethal globalization of asset bubbles, the inevitable bust now poses an exceedingly tough hangover.”

One of the main problems with the boom this time is that households have taken the brunt of the shock, having overextended themselves in the housing and consumer markets, especially in the US. Yet so far, there has been little relief with the government and the Treasury planning merely to prevent the downfall of the financial sector. Though policy rates have been slashed ruthlessly, borrowing rates for final users have come down only marginally. Clearly, the effectiveness of monetary policy has reduced significantly. And this is a problem globally. In a recent speech, Lorenzo Bini Smaghi of the European Central Bank stated the crux of the problem, “This crisis is different from the others because it affects confidence, which is at the root of a market economy.” Banks are not lending, because they fear unexpected withdrawal of funds by their clients, leaving them no recourse but to accumulate liquid and riskless assets. Further they are worried that counterparties may not be in a position to reimburse the loans, which restricts their credit operations. For the situation to resolve, according to Smaghi, the governments have to give credible reassurance that they will back banks to the hilt, which will allow the flow of funds to restart again.

Meanwhile, while the financial imbalances have been given full weightage in policy and crisis fighting, the real sector was not given sufficient attention. Dr. Subbarao, RBI Governor pointed out, that ‘Forgotten in the euphoria of financial alchemy is the basic tenet that the financial sector has no standing of its own; it derives its strength and resilience from the real economy. It is the real sector that should drive the financial sector, not the other way round.’ While there are numerous issues with fixing the financial sector problems, it is therefore the real sector that should be at the center of any policy solutions, if we are to achieve a solid and sustainable recovery.

The Indian financial sector has little exposure to the sub-prime mortgage mess. However, there is considerable impact of the Western crisis coming through to the domestic economy via monetary, financial and real channels. So while there was a lot of talk of emerging markets decoupling from the developed world, the sudden contraction in the last few months even in India has disproved the decoupling thesis. The problems essentially lay in the severe liquidity crunch, with banks not wanting to lend to even creditworthy units, with investment and hiring plans hit as firms seek to offload inventories and rein in new orders. The ABN AMRO survey of purchasing managers of more than 500 firms has seen a contraction in new orders, output and export orders in November, the first time since the index was created in 2005. In general, the mood appears to be, ‘Let’s wait it out till January and see how things go.’ Here again, it is sentiment that has been hit hard in India, in the financial and real sectors.

With all forecasts for growth this year rapidly being revised downwards, the question to ask is, ‘Is there nothing that can stop this fall?’ The truth is that the basics of the economy are still unaffected – agriculture growth is up with good monsoons, this will boost rural incomes to add to demand. With government salaries also increasing, there is an additional demand boost in the consumer markets. Prices have come under control because of the sharp drop in crude oil prices. There are, of course, sectors that have been badly affected: garments, gems and jewellery, IT and ITES, basic manufacturing, organized real
There are also those that have been less affected: foods, FMCG, healthcare, education, unorganized real estate, consumer durables etc.

At the present moment, looking ahead, the outlook for the future can be briefly outlined as follows: For the next two quarters (Q3 and Q4 of 2008-09), India and the world will be well into the downward phase and growth will probably worsen even further. In Q1 and Q2 of the next year, 2009-10, there will be some improvement in India on account of rural demand multipliers, but international recessionary conditions will persist. From Q3 of the next year and beyond that, India will be in the growth range of 6.5%; the world should start to emerge again from its low points.

Thus the prognosis for the long term (i.e. more than twenty four months) is very good still for the country, while for the short term of less than six months the outlook is very poor; the key however will be in the medium term of six to twenty four months. Though the pessimism is short term, it has generated a crisis that will need more than just government spending, and nor can we look at the outside world or any boost, since all countries have been hit with a downturn.

What is to be the role of the government? Actually, there is little that they can actually get off the ground; there will be some reforms, some announcements, some increases in infrastructure allocations and an attempt to bring in international funding. However the efforts at increasing expenditures will also lead to a higher fiscal deficit, and this will in turn lay the foundation for a higher level of inflation in the coming few years.

It is thought by some that investment drives growth. That reality is somewhat different. It is the expectation of growth that drives investments. Ask any investor, or a CEO, or a bank manager – plans are made now based on the outlook for the future. So, it is sustaining the growth expectation that needs to be the policy objective, not getting a few billion dollars from the World Bank. What the government should do more actively is to fight the ruling pessimism, which has set in quite deep in India, just as it has abroad. The government wants to show an optimistic face, but no one really believes it anymore. So then how do we get out of this rut that we are thinking our way into? The answer, strangely, remains the same as before – confidence, action, and reforms.

So What Should the Government Do Specifically?

First accept that we have a crisis at hand. Level with everyone - there is a problem, and we are going to take corrective action, we will maintain overall growth and equity objectives.

Second, break the larger problem into smaller ones, in most cases solutions are known. And in many of these cases there is little opposition to them. This include, for instance, financial inclusion, increasing public transport, amending laws affecting internal trade, ramping up IT spending within the government (e-governance) etc. Implement them or if that is not possible, commit to them in a time bound manner. The success of VAT implementation has already shown us the way on how these policy changes can be brought in. Third, in many of these cases there can be a consensus – build a least common denominator agenda. Ask other political parties for their affirmation. If they don’t agree (which is probable) so be it, but at least we would have tried. Fourth, don’t wait for good news. There is no good news coming from anywhere, except what we generate by our own actions. Fifth, take action even if that does not lead to instantaneous results. Let the politicians and the bureaucrats visit the offices of businesses and associations rather than the other way round. The only credible action is one where the actor is seen to put in effort. Sixth, level with the banks and solve their uncertainty problem now that the liquidity problem has been taken care of. Seventh, don’t show optimism without credible action, for that only looks like a farce and further feeds pessimism. And absolutely do not ask people to stop lay-offs or reduce prices.

Clearly, even if outcomes are uncertain, our confidence in our abilities should not be inhibited.
The **GLOBAL MELTDOWN**:
PROSPECTS FOR
INDIA’S ECONOMY

I. Introduction
Some believe that it all boils down to trust. But curtailing a
discussion of the global meltdown with such a pithy remark
would be getting ahead of the story. Trust does not explain the
technicities of what constitutes a financial crisis; nor what
precipitated the current crisis. Lack of trust may help to
explain how a financial crisis spreads, affecting countries that
were not involved in the initial crisis; but it won’t explain the
details of how to engineer a recovery from the crisis. However,
the crisis won’t be over until trust has been restored.

II. What is the Financial Crisis?
At the heart of the current global meltdown is a financial crisis
in the credit markets of developed countries that is wider and
deeper than any other in the last 75 years. The word credit
comes from the Latin word credere – to believe. When
investors do not believe their investments will yield a positive
return, they lose confidence in the investment and attempt to
minimize their losses. Relatively small losses can cascade into
much larger losses if investors lose their trust in credit
markets. When this loss of confidence happens on a massive
scale, the credit markets cease to function properly, exacerbat-
ing the crisis for even credit-worthy borrowers. For example,
in a recent global survey, 17 percent of companies seeking
external funding were unable to obtain the funding, up from 9
percent in October (McKinsey & Company, 2008). A vicious
downward spiral ensues when firms are unable to obtain
credit. Initially, they cut back on production and lay off some
workers, next laid off workers as well as those fearing a lay off
cut back on spending, then firms respond to declining demand
by cutting back further on production and laying off more
workers, etc.

III. What Precipitated the Financial Crisis?
Some commentators will focus on one single event, claiming
that this particular event precipitated the financial crisis.
However, many events are likely candidates: was it the massive
inflow of capital into the US from abroad that sparked
excessive credit expansion; was it the failure of the US Federal
Reserve Bank (Fed) to act swiftly; was it financial sector
deregulation; was it lax corporate governance? Instead of
focusing on one factor, it is more realistic to view the financial
crisis as a series of events none of which was serious enough
alone to threaten investor confidence, but together they
created more risk than the financial system could handle.

First, the credit expansion in the US resulted from massive
inflows of capital to finance its current account deficit.
However, this imbalance alone could have been managed, as
the dollar depreciated against other currencies. Indeed, the
imbalance remained for several years while world economies
were growing. Second, the evidence shows that the Fed was
not neutral during this growth period because it began raising
Third, financial sector deregulation during the 1990s opened the door to greater competition and new financial products. It was believed that large financial firms, who were given more competitive freedom, would act with due diligence to protect their long-run viability. In retrospect, these firms did not act with appropriate caution. Instead, they aggressively sold new financial products collateralized debt obligations (CDOs) or mortgage-back securities (MBSs). These products (a package of securities) were complexly structured with different tranches having different risks, but they offered relatively high rates of return.

Interest rates on June 30th, 2004, over four years ago. Some would argue that the Fed was too late in raising interest rates and others would respond that the Fed should not have raised interest rates, or raised them too fast. The Fed’s stance on economic bubbles has been to let nature take its course because deliberately bursting the bubble can be dangerous and costly (Lahart, 2008). For example, the dot.com bubble of excessive asset price increases in 2000 was contained without the Fed bursting the bubble. However, the housing market bubble was different due to this market’s relatively high reliance on credit.

Financial deregulation opened the door to greater competition and new financial products
Investors eagerly purchased these assets without sufficient understanding of the risks. After all, the US economy has been expanding since 2001, why should investors worry too much about risk. Unfortunately, the bond rating agencies had no experience in rating these new products, but after a back-and-forth negotiating process with the issuer the rating agencies gave the products high marks. Investors would not have purchased these products to such a large extent if they thought they were overly risky. Between 2000 and 2006 the growth in these products was exponential from $500 billion to $2.6 trillion (Kodres, 2008).

Fourth, in order to produce these new products, mortgage lenders followed an “originate-to-distribute” model where they made their money on the origination fees of the loan and then passed the set of loans on to investors, who relied on the rating agencies to assess the risk (Khor and Kee, 2008). But the mortgage lenders did not have to worry about the ability of borrowers to repay since they only acted as a conduit. If lenders (financial firms) are not performing adequate due diligence on the borrowers, and if rating agencies are negotiating ratings (with the issuers who pay them) instead of making an independent assessment on the packaged securities, then the investor is purchasing something that contains far more risk than expected (Dodd and Mills, 2008). These risk management problems can be characterized as principal-agent relationships, where the agents – the lenders and raters – are assumed to be acting on behalf of the principals – the investors; but instead the agents are acting on their own short-term interest. The agents clearly had more information than the principals, who presumably could have managed the risks better with full information. Full information (complete transparency) on the risks might have dissuaded some risk adverse investors from purchasing these CDOs and MBSs, which would have meant less profit for the agents. The flaws in this type of incentive structure, which lead to lax corporate governance, are all too evident now.

Another flaw in the governance of financial corporations was that the large financial firms believed they were too big to fail. They thought that the Fed would step in with a fresh injection of liquidity. This belief caused them to take more risks than they would have without the assurance of Fed action. This problem is called a moral hazard, where the presence of insurance fosters more risky behavior than would have otherwise occurred. If only one financial firm had taken excessive risks, the system could have handled the outcome. But when almost all large financial firms took excessive risks, the system collapsed. The risk management models did not capture systemic risk.

IV. How Does the Crisis Affect the International Economy?

Since financial capital can be moved instantaneously, small changes in perceived risk can produce massive shifts by global investors. An example of such a shift is the Asian financial crisis in the late 1990s. It started when lenders lost confidence in the ability of borrowers from Thailand to pay back short-term loans denominated in dollars. The borrowers believed the pegged exchange rate would remain stable, but the peg was reduced. Then the lenders who saw the risk on their loans in Thailand rise became worried that other Asian countries would also devalue their currencies. These lenders, who had made similar dollar-denominated loans to borrowers in other Asian countries, became reluctant to roll over the short-term
loans in these countries. This action caused the crisis to spread like a contagious disease spreads from one infected person to a healthy person. Once financial contagion occurs, healthy borrowers are at a risk of becoming afflicted.

The global economy is so interconnected that the economic meltdown in industrial economies can affect countries like India through this process of contagion. In the early 1990s, real GDP growth followed a similar trend line for both advanced economies and emerging and developing economies, around three percent (see Figure 1, dotted line). By 1995, the trend line for advanced economies started decreasing while the trend line for emerging and developing countries started increasing. A large part of this increase can be attributed to the robust economic growth of India and China. Due to our global economic interconnectedness, actual GDP growth for both advanced economies and emerging and developing economies is forecast to drop substantially in 2008, from eight percent to almost five percent for emerging and developing economies and from two percent to slightly negative for advanced economies. The IMF projected global economic weakness would continue during most of 2009 (IMF, 2008).

V. What is India’s Exposure to the Crisis?
The debate over whether India can remain immune to the global financial crisis has been going on for some time. Since the summer of 2008, opinion has been gradually shifting as to the severity of its impact. Confidence over its invulnerability has given way to a gradual recognition that India is not immune to the global meltdown. The government recognized some key problems early on and moved to deal with the liquidity crisis on a consistent basis to keep up the trajectory of the economy on a growth path. More reasoned opinions emerged showing the channels through which the financial crisis affected India. Reviewing the timeline over the last few months, shows how an understanding of India’s vulnerability evolved.

In September: A key Indian industrialist, Reliance Capital Chairman Anil Ambhani, noted that the developments in the Indian equities and currency markets were due to the country’s economic integration with the world economy. He believed the global financial crisis would have a moderate

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**Figure 1. Real GDP Growth and Trend (Percent Change)**

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Many financial firms took excessive risks and the risk management models didn't capture systemic risk.

Source: IMF staff estimates
effect on India. He attributed this effect to the county’s policy makers who have proceeded cautiously (9/16/08).

In Early October: Prime Minister Manmohan Singh stressed the need to insulate India from the ill effects of the international financial crisis. (10/1/08). However, his commerce and industry minister Kamal Nath stated the same day at the Indo-EU Business Summit that India could not remain insulated from the turmoil in the global banking and financial system (10/1/08).

Others indicated that India remained largely insulated from the global meltdown due to its conservative approach to economic reforms in the financial services sector. Pension, insurance and other financial services regulators felt that a slow and steady pace of opening of the Indian economy had paid off in the long run. Although the Indian stock market had become volatile, it had not crashed in line with expectations. (10/5/08) The existence of nationalized banks in India, with its compulsory priority sector lending for agriculture and rural areas was also cited as a factor for India remaining largely insulated from the global financial crisis (10/5/08).

The opposition party leader Jaswant Singh said there was an impending financial crisis in the country due to the international contagion especially in the insurance and pension funds segments (10/06/08). He blamed banks for over-lending like US Banks citing a report that one of the leading banks had called back 2,00,000 cars bought with borrowed money from it. He stressed the need for India to look into areas of instability such as the real estate bubble and retail credit availability which would have serious consequences for the economy.

Finance Minister Chidambaram stated that India can weather the global financial storm, citing the agility of the Securities and Exchange Board of India (SEBI) and the Reserve Bank of India (RBI) to move quickly with corrective action as regulators (10/07/08). There were positive signals showing that the Indian economy was on the fast track with increase in tax collections, higher export levels and impressive growth in several industries.

In a message delivered to the International Monetary and Financial Committee of The World Bank, the Indian finance minister Chidambaram said that emerging market economies (EME) like India were less affected by the financial crisis (10/12/08). He attributed this situation of EMEs due to their policy improvements, prudent practices, strengthened reserves and strong performance in recent years.

Given that India’s inflation was affected by supply side pressures on key agricultural commodities, increase in the prices of iron and steel, pass through impact of high international crude prices on domestic prices, and the high level of domestic demand, it was important for India to contain inflation, maintain the growth momentum, preserve financial stability, and work more vigorously on fiscal consolidation.

By Late October: Prime Minister Manmohan Singh noted in the Lok Sabha that India was experiencing the ripple effects of the financial crisis and that a number of steps had been taken to minimize the impact (10/20/08). India’s sound, well-capitalized and well regulated banking system had very little exposure to the sub-prime mortgage assets. The banks were providing credit in line with anticipated credit targets. However the financial contagion had caused a contraction in other forms of commercial credit namely External Commercial Borrowings (ECBs) and...
international suppliers credits used by the corporate sector in the country. This had led to a liquidity crisis in the system. In order to deal with the credit crisis and provide liquidity to mutual funds, the Reserve Bank of India (RBI) cut the Cash Reserve Ratio (CRR) by a total of 250 basis points and the Statutory Liquidity Ratio (SLR) by 1.5 percentage points between the first week of July and mid-October to enable banks to borrow more money. The government also pumped Rs.250 billion to the banking system under the debt waiver and debt relief scheme. Further, the limit of investment by Foreign Institutional Investors (FII) in corporate bonds was raised from $3 billion to $6 billion. Also, advisories were provided by RBI and the Ministry of Finance to provide adequate credit to borrowers, including export credit and working capital.

Finance Minister Chidambaram mentioned India would be affected indirectly by the financial crisis as the cash crunch would affect financial markets although on a limited scale (10/20/2008). He noted that India's financial system had “sound fundamentals” and a transparent efficient market. He thought it was important that through close cooperation with other countries, the financial crisis not be allowed to impact on the abysmal living conditions of the poor people of the world. He stated that the double digit inflation in the country was due to India’s dependency on foreign imports of oil and 94 percent of the week-to-week inflation could be attributed to the high price of petroleum products. India had achieved food security due to record production of food grains.

Chandrashekhar and Ghosh in a thought provoking article showed how the fragility in Indian finance has been evident for sometime and could not be solely attributable to the international financial crisis contagion (10/21/2008). They examined five different ways the contagion has affected India.

First, foreign institutional investors (FII) have become sellers in Indian markets, in order to retrench assets to cover losses in their home countries. The rapid fall in the foreign exchange reserves has led to a weakening of the rupee.

The second route by which the contagion has affected India is the exposure of Indian banks or banks operating in India to the impaired assets of the sub-prime crisis. The RBI has estimated the losses of Indian banks due to collateralized debt obligations and credit default swaps to be a modest $450 million by July 2008. The mark-to-market (MTM) losses of Indian public banks totaled around $90 million and of other private banks around $360 million.

The third ripple effect was due to losses sustained by non-bank financial institutions (mutual funds in particular) and other firms who have had exposure to the country’s stock and currency markets. The RBI has allowed banks to provide loans to mutual funds against their certificates of deposits (CDs) or in order to buy their own CDs before maturity, suggesting such losses may be quite substantial.

The fourth way the financial crisis has affected India is due to curtailment of credit by banks and financial institutions as they weather an uncertain environment. These have affected the rate of growth of credit for housing loans, automobile loans, and credit provided to individuals during the 2007-08 fiscal year, all of which have slowed from expansion rate levels achieved over the previous fiscal year during 2006-07. The reduction in debt financed consumption and investment expenditures would adversely impact the growth in the country.

Finally, recession in the United States and other advanced economies implies lessening exports of IT related software, merchandise and other services which would lead to an
have innovative mechanisms to raise finance for development (10/25/2008). Prime Minister Manmohan Singh asked for increased resource flows from World Bank and the IMF for infrastructure investments which could act as powerful stabilizers.

US: At the White House Summit on International Development, the focus was on sharing best practices in India and not allowing the global financial crisis to prevent attainment of the UN millennium development goals (10/21/08). The focus was on bringing peace, prosperity, and stability to countries.

EU: At the European Union summit in Brussels, both UK and France stressed the need for common action to deal with the financial crisis that would not only include the developed countries from the world’s richest nations but also major emerging economies such as China and India (10/16/2008 and 10/23/2008). There was recognition of the fact that it was important to radically restructure the IMF and The World Bank. This would require a vision similar to the one that created the present international monetary system at Bretton Woods.

G20: At the G-20 summit convened in Washington DC, the leaders of all countries promised to use all economic and financial tools to lend stability and to support the sound functioning of financial markets (10/13/208, 10/30/2008, 11/14/2008, and Bradford and Linn, 2008). India stated that the process of development and the achievement of the millennium development goals should not be compromised and the IMF and The World Bank should be strengthened to ensure that the impact of the financial crisis on developing countries was minimal. It was important to set up a new international financial architecture for the IMF and The World Bank. These institutions should also provide special financial packages for infrastructure projects in India to help the country maintain its growth momentum. India would also work in tandem with countries like China, Mexico, Brazil and South Africa within the G-20 for a coordinated response to the financial crisis.

Multilateral Institutions: The World Bank concluded that India would be affected by the financial crisis through its exposure to international financial institutions and contracts including derivatives that had undergone large value changes (10/24/2008). India had experienced stock market losses and outflow of foreign capital. Yet the country had greatly minimized the impact because of its strong economic fundamentals, prudent debt management, and proactive monetary policy. The global slowdown could yet affect the economy due to outflow of capital funds, slowdown of private and public investment, higher interest rates, and reduced export demand.

The IMF head Dominique Strauss-Kahn noted that the global financial system was teetering at the brink of a systemic meltdown. The financial meltdown provided the IMF with a mandate to foster multilateral cooperation to restore and safeguard international monetary and financial stability (10/12/2008). The Indian UN representative Nirupam Sen asked the IMF to note that projects around the world were stopping due to loss of financing and liquidity. These stoppages were an extra burden on top of the burden on developing countries caused by soaring food and fuel prices. It was important to broaden the competence and jurisdiction of the IMF to include financial transactions rather than to limit to monetary aspects or balance of payment problems (10/7/2008).

VIII. Opportunities and Strategies
The Associated Chambers of Commerce and Industry of
India (Assocham) provided a number of steps that the government could take to deal with various impacts of the global meltdown (10/14/2008 and 11/03/2008). These included: Infusion of liquidity into the economy to enable expansion of key economic activities that were affected by lack of credit; increasing government spending on infrastructure projects; distribution of undisbursed money in the budget to states and territories to maintain the pace and momentum of economic growth; expansion of credit at competitive rates to stimulate private investments; provision of credit to SMEs and exporters to shore up employment; boosting credit for the housing sector and specifically for low cost housing schemes as they have a salutary impact on employment opportunities in the economy; and removing restrictions imposed on agro products to boost the export sector hit by the recessions in the US and Europe.

In reviewing the steps taken so far, India has been proactive, working quickly and effectively in light of rapidly changing information and international developments over the past few months. It has used domestic fiscal and monetary policy to minimize the fallout from the global financial meltdown. It has also worked in tandem with other international partners abroad to support a coordinated response to shore up stability and confidence in the international financial system; to revamp and reform the financial institutions like the IMF and World Bank, in light of an altered 21st century reality; and to design a new governance system that monitors the international economy more effectively. India has, as a major emerging economy, championed the need to keep development assistance flowing to developing countries which had already been affected by rising food and fuel prices before the global financial crisis unfolded. India, however, must remain vigilant as there may be many more twists and turns to the financial crisis. It is yet too early to predict the duration of this ensuing global recession. However, it is the globally-coordinated steps pursued by India that will help to quell the growth of the crisis and eventually infuse a renewed confidence in the global financial structure. It all boils down to trust.

References and Additional Thinking
• Economic Times. (10/21/08) “Financial Crisis has not


(The views expressed in the write-up are personal and do not reflect the official policy or position of the organisation.)
increasing trade deficit and less of export led growth.

In balance, the financial crisis may not be the principal cause for the downturn in the Indian economy, but the effects of the crisis can be viewed as contributing factors. According to the authors the government needs to rethink its liberalization policy and focus on some of the fiscal alternatives to deal with the crisis such as public expenditure and development rather than simply pump more liquidity into the system. **In Early December** : The government announced a fiscal stimulus package that included tax cuts (a four percent rate cut on ad-valorem duty) along with spending increases for various sectors (e.g., housing automobile, infrastructure).

VI. Growing Strains on the Economy

**Macroeconomic Growth** : In mid-September, according to the pronouncement of the Indian minister of state for commerce and industry Ashwani Kumar, no adverse impact was foreseen on India’s growth rate or the investments it had been attracting. However, two months later by mid-November, India’s Prime Minister, Manmohan Singh, admitted to a negative impact on the Indian economy (10/20/2008). It is now anticipated that the Indian economy which was growing by nearly nine percent for the past four years would decelerate and grow between 7-7.5 percent in the current financial year. For the following year, it would depend upon the severity of the global recession and the speed with which capital global flows would return to normal. Recently, Goldman Sachs has revised the GDP growth number to 6.7 percent in fiscal year 2008-09 and 5.8 percent during fiscal year 2009-10 (11/12/2008). This revision downwards is due to negative export growth, slowing consumption demand, and financial sector shocks.

**Stock Market Jitters** : Approximately a year after the sub-prime crisis manifested itself in the United States and after the massive financial collapse of September 2008 in that country, the seemingly inexorable rise of the stock market has been heavily clipped in India as a result of the financial crisis. Although the Sensex had risen eight fold between 2003 and early 2008, it is now down by over 40 percent from June 2007 levels (see Figure 2).

**Foreign Direct Investment (FDI) Inflows** : The FDI inflow was $29.9 billion during the 2007-08 fiscal year, an increase of 35.4 percent over the previous year. The majority of these investments were garnered by construction and real estate, computer software and hardware, telecommunications, and services. In the current year, the minister for commerce and

Figure 2. Daily Movements of Sensex in 2008

Source: Chandrasekhar and Ghosh (10/21/2008).
industry, Kamal Nath, has estimated that FDI inflows would surpass the target of $35 billion although the flow might ebb due to liquidity crunch globally. Recent trends suggest that even as FIIs pull out large chunks of money, the strong growth of FDI inflows between April – September this year have negated the FII sell off drain on foreign reserves. However, $5 billion of FDI during April-September is not strictly investments in greenfield projects. They are money invested by non-resident Indians (NRIs) for acquiring existing shares or are reinvestments of earnings by multinationals into their own companies.

India’s Forex reserves have dropped by nearly $55 billion since January 2008 or by nearly $70 billion since May 23rd when the reserves touched a record $316 billion. The reserves have been falling steadily in dollar terms due to a marked appreciation of the dollar by 20 percent vis-à-vis the rupee from Rs. 39 to Rs.50 to a dollar (see Figure 3). As of November 28, 2008, the Forex reserves stood at $245.7 billion down from nearly $300 billion at the start of the year. The Forex reserves has been depleting over the past few months due to the global meltdown as FIIs have resorted to heavy selling in the equity market. At the same time, the Reserve Bank of India has tried to protect the depreciating Rupee (INR) through aggressive selling of dollars in the currency market.

**Mergers and Acquisitions** : Both outbound as well as inbound mergers and acquisitions markets have been affected by the global financial crisis (10/9/2008). Overseas branches of Indian banks are quoting interest rates of 800 basis points over the Libor amounting to a doubling of the interest within the quarter. Indian firms eyeing foreign acquisitions in US or Europe or Latin America through local funding are either aborting deals or stretching the deal closure time. Some Indian companies with sufficient cash flows are finding it difficult to get shareholder approvals due to the pounding taken by the Indian stock market. A more conservative approach taken by Indian banks to funding debt is also expected to impact on the post bidding rollout scenario.

**Deflation Worries** : There is fear of deflation as domestic and global demand drops due to the financial crisis (10/31/2008). The slowing of consumption demand may result in piling of goods putting a downward pressure on price and increased joblessness in the economy. There are also genuine worries from Asia to Latin America that major producers like India and China which have greatly expanded production capacity in recent years may resort to dumping on world markets in order to keep factories running and reducing unemployment.

**Sector Impacts** : India’s famed Bollywood industry is being affected by the global financial crisis (10/15/2008). Filmmakers and large production houses are anticipating a lean phase ahead. It is likely to be difficult to make big budget films and sell it at twice its cost as has been the past norm. Distribution companies may sell Indian theatrical rights to other parties to
reduce risks and cut losses. Circumspection in the industry may result in eschewing big budget productions, acknowledging the need for a recovery plan for all movies, and refocusing attention on the production of good quality movies.

In the IT sector, the leading software firms in India may be big losers due to the financial pandemic (10/5/2008). This is because their important clients tend to be the erstwhile giant investment banks and the profitability of these software firms is likely to be reduced significantly in the short run. However, these firms may show greater resilience in the long run as they rein in newer clients, develop virgin markets, and offer even more innovative services. Additionally, the Business Process Outsourcing (BPOs) and the Knowledge Process Outsourcing (KPOs) small and medium size firms which hire over 700,000 people in India are likely to be adversely affected by the US financial crisis as a large part of their business comes from financial and banking firms in the US which make up for over 60 percent of their export services.

The current global financial crisis also provides India an opportunity to develop the nuclear sector and improve its energy security. According to Shyam Saran, the prime minister’s special envoy on the Indo-US Nuclear deal there has been a significant slowing down of sourcing nuclear plants in the advanced countries and signs of softening in the world’s uranium market. India could take advantage of this situation before the window of opportunity created by the financial crisis ceases to exist as the problem abates.

VII. Tentative Steps to Deal with the Crisis
In early October, Prime Minister Manmohan Singh stated that India must be part of the solution to the financial crisis (10/6/2008). He noted that after China, India’s economy was the second largest in terms of growth and although the financial crisis mostly affected the developed economies India was a significant actor and had a role to play. Toward this end, India is engaged in forging cooperative strategies to deal with the crisis with developed countries as well as emerging economies in bi-, tri-, and multi-lateral forums.

China: President Hu Jintao and Prime Minister Manmohan Singh signaled that the two Asian economic powers would join hands to assist in the global economic recovery (10/25/2008). China has already experienced a slowdown in industrial profit growth and fiscal income. The world’s currency markets have also exposed the Chinese banking system to higher foreign asset risk. In the case of India, the RBI was taking monetary action to deal with credit squeeze and also to stimulate economic growth (10/25/2009 and 11/01/2008).

IBSA: In a trilateral summit between India, Brazil and South Africa (IBSA), the three countries have pledged to assist the G-8 countries in designing an international financial architecture that will effectively prevent the financial crisis from happening again (10/11/2008). As three important emerging economies representing Asia, Africa, and Latin America, they will use the imperative provided by the turmoil in the global markets to enhance South-South cooperation. The three countries share a unifying vision of transnational economic and social partnership which stresses free trade, promoting inclusive growth, connectivity, and energy security (10/13/2008). IBSA leaders agreed to establish a coordinating mechanism involving the finance ministers and the Governors of the Central Banks of the three countries in order to confront the financial crisis (10/15/2008).

ASEM: At the Asia-Europe Summit held in Beijing, the 45 member group called for joint global action to deal with the financial crisis. The countries involved affirmed that they would work in a mutually beneficial way to make positive contributions to sustainable development. India sought support for having a Global Monitoring Authority to strengthen the regulatory and supervision mechanism as well as to
GLOBAL CRISIS...
MELTDOWN AND RESURRECTION:
India as the Economic and Political Catalyst for World Transformation

Glen T. Martin
Professor of Philosophy, Radford University, USA, and Secretary-General, World Constitution and Parliament Association

My effort to understand the economic and political potential of India is closely linked to my personal experiences in many visits to India as well as my concern for the fate of our planet and its peoples. As Secretary-General of the World Constitution and Parliament Association concerned to understand our human situation as deeply as possible, I have interacted with the street children of Delhi and Mumbai and repeatedly walked the streets of Kolkata at 5 AM stepping over the bodies of some of the tens of thousands of people sleeping on those streets. I have watched the raw sewage from the millions of Chennai citizens pouring into the Bay of Bengal. I have been guided by local social workers through some of the many horrific slums of Kolkata, Chennai, and Mumbai, seen child labor and watched piece workers make articles for multinational corporations for close to starvation wages.

Behind the Meltdown: The Problem of Institutionalized Greed

These books describe the devastation of life on Earth caused by the world’s present economic system, necessarily enforced by militarism from the world’s imperial powers. However, to understand our world today requires that we understand the roots of the current world system in the European expansion during the 16th to 20th centuries within which the present world economic and political system developed. This system of sovereign nation-states was first formally recognized in the 1648 Treaty of Westphalia that ended the 30 Years War in Europe. These early imperial centres proceeded to divide the world among themselves, appropriating for themselves the cheap slave labor and resources of the majority of humankind who were organized as colonies of these imperial centers of power. The imperial powers controlled this system conceptually with their ideologies of sovereign nation-states, civilizational superiority, and the economics of Adam Smith: “free trade” as a cover for their nationalistic competition to
control the global wealth-producing process in their own interests (Smith, 2006, Chs. 1-4). They affirmed the ideology of unlimited capital expansion (at the expense of nature and the poor) as the only possible route to development and prosperity but attempted to channel this process of expansion (in ways that were anything but “free trade”) to the ruling classes of their respective nation-states.

With decolonization (which largely took place within the twentieth century), many of these colonies (including India) were discharged from their former colonial masters as wretched basket-cases of nations, impoverished financially, culturally, technologically, and structurally. Just as the colonies had been kept weak and impoverished by the sovereign overseers, after decolonization they became subject to manipulation, overthrow, destabilization, or outright domination by one or the other of their former colonial masters. They also became subject to financial control by the World Bank, IMF, and multinational corporations. Hundreds of millions of poor now live in these countries as in prison camps, unable to leave and utterly unable to improve their own condition – controlled economically, politically, and often militarily from abroad.

The Director-General of the World Trade Organization in the 1980s wrote an article for the Wall Street Journal that began with the sentence “Globalization is a reality of our time.” This globalization, as Vandana Shiva has pointed out, is a prescription for the dispossession of 80% of the planet’s population. This “reality of our time” is not an accident, any more than the colonial exploitation and impoverishment of the majority of humankind was an accident, any more than centuries of slavery and violence against peoples of color was an accident. It is a carefully planned and constructed process of the most powerful economic and political forces in the world to convert the economies of the world to serve their own interests.

**Derivatives and Debt-Money:** The problem of the global meltdown is often said to be derivatives. Derivatives are a direct consequence of banking not democratically regulated for the common good. They are speculative bets, made mostly with borrowed money, on the fate of stocks, on the future of corporations, on foreign currencies, on whether interest rates will rise or fall – on almost anything. They do not constitute investment in the production of goods and services so often touted as the beating heart of capitalism. However, they represent the very essence of the institutionalized greed that has historically characterized all capitalism. According to the Bank of International Settlements as of a year ago, the total face value of derivative bets worldwide amounted to $596 trillion, about ten times the gross domestic product of the entire planet. Since these are unregulated and largely unprotected bets (speculations) made by major banks and investment companies and several times over beyond the assets of these companies, a failure of any significant portion of the system might well create a bursting the bubble effect impacting the rest of the system.

**This is Exactly what Happened:** a collapse of the interdependent network of derivative speculations bringing down the banking systems of the entire world, causing, as always, immense suffering to the poor of the world. The meltdown in India is a mirror of the worldwide meltdown. But the problem of a flawed banking system is not limited to the irrational system of derivatives, as Ellen Hodgson Brown (2007) has shown: a gigantic lie beyond the global banking system claims that money creation must be done for use by private banks in the form of public debt. The people of the US alone are in debt to the process of money-creation for use by private banks to the amount of over ten trillion dollars as of September 2008. The system of private profit is predicated on public subsidies as well as the expectation of externalizing the costs of doing business onto nature and society. A rational and just banking system would abolish both these absurdities and would be predicated on creating general prosperity rather than extreme wealth for the few at the expense of the majority of people and nature.

**Justice, Freedom, and Full Economic Prosperity**

The problem of making India an economic powerhouse for the 21st century and eliminating poverty in India is clearly linked to India’s relationship to the rest of the world system. If the world system after the meltdown is reestab-
lished on the same principles of institutionalized greed and legally protected exploitation of nature and people, then India will likely continue to mirror the extremes of wealth and poverty and destruction of nature found worldwide. If the world system is transformed into one based on rational economic and political principles, then India could become a powerhouse commensurate with its size and substantial resources, as it should be. But because of its immense size and potential, the resurrection of India need not depend on the prior transformation of the world system. As we will see below, India could free itself substantially from the collapse of the world system by forming the core of an economic and political federation potentially open to all, and she could accomplish these same positive goals quite rapidly from within. India needs to become the vanguard of a truly democratic and powerful economic order for the rest of the world.

It should be clear from the above that the immense problems faced by human beings on the Earth are all interrelated and interdependent. You cannot solve the problem of poverty without dealing with the on-going destruction of the environment that diminishes resources and makes real wealth in terms of goods and services ever-more elusive. Nor can you solve these problems without dealing with the problem of militarism and inevitable arms races that suck ever-more wealth into these environmentally destructive, counter-productive, and destructive activities. You cannot deal effectively with healthcare and the control of sickness and disease without dealing with militarism, the environment, and poverty. Economics cannot be disentangled from the entire matrix of our human condition on the Earth.

The economics of prosperity cannot be created without the cooperation of effective democratic government, for the historical oligarchy of the rich will not, and cannot, create universal prosperity. And the democratic government created for the purpose of economic prosperity must, at least potentially, be capable of dealing with the nexus of global problems beyond the scope of today’s present-day nation-states. It would not be of much benefit to eliminate poverty in India in the next ten years when the global environment may well not support higher forms of life within the next 50 years. As a recent article puts it, “Sir Nicolas Stern, former Chief Economist of the World Bank, estimates that the direct economic consequences of climate change – leaving aside the social and environmental effects – will be a depression greater than the Great Depression of the 1930s and a financial cost higher than the Depression and the two world wars combined” (http://laborstrategies.blogs.com/global_labor_strategies/2008/11/todays-economic-crisis-in-historical-perspective.html). The world is interdependent and interrelated. Any solution must at least be a global solution and must deal in an integrated way with the nexus of global problems.

The roadmap toward a new economic paradigm is included within the Constitution for the Federation of Earth (see www.worldproblems.net). This Constitution unites the national units of the world into a federation and predicates global economics on global prosperity rather than scarcity. Under Article 17, the Earth Federation will be activated in three stages, the first operative stage being reached when merely 25 nations (or global political units with a minimum population of 100,000 each) have ratified or when there has been a direct referendum of 100 World Electoral and Administrative Districts. This initial portion of the world’s population would be joined together under the Earth Constitution in a federation in which poverty would be very rapidly eradicated, health-care for all would be developed,
the environment would be protected and restored, and the stage set for the abandonment of militarism. Seeing this success, other nations of the world would rapidly join until, within a very few years, the 90% of the Earth’s population would be included and the final operative stage of the Earth Federation will have been reached.

India alone, with its immense population, and with some 35 internal states and union territories, could satisfy these conditions to initiate the first operative stage of the Earth Federation. It could be the powerful shining example for the rest of the planet inviting other peoples and nations to the rapid joining of its initial Earth Federation until the economics of the entire planet became rational and democratic.

Article 1 of the Earth Constitution specifies the “Broad Functions of the World Government.” These six broad functions form the central responsibilities of the Earth Federation and are the central justification for its creation: (1) To prevent war and secure disarmament, (2) To protect universal human rights, including life, liberty, security, and democracy, (3) To obtain equitable economic and social development for all peoples on Earth, (4) To regulate world trade, communications, transportation, currency, standards, and use of resources, (5) To protect the global environment and the ecological fabric of life, and (6) To devise solutions to all problems beyond the capacity of national governments. Each of these articles addresses a global crisis that is clearly “beyond the capacity of national governments.” There can be no meaningful economics that does not effectively engage these crises.

The Earth Constitution creates a democratic world commonwealth directed to the common good of humanity and future generations. It is non-military by law (Article 2) and democratic at every level, leaving economic and political self-determination to the nations insofar as these conform to universal human rights and world law (Article 14). In the second operative stage outlined in Article 17, all nations joining the Earth Federation must begin to demilitarize. All transnational corporations are regulated by the World Parliament, and global banking is mundialized with one Earth Currency having the same value throughout the Federation.

The Earth Federation now regulates the international actions of demilitarized nation-states through world laws legislated by the World Parliament. Conflicts are settled through the world court system and violators are subject to arrest and prosecution by the world Attorneys General and the World Police. Similarly, transnational corporations are regulated through the democratic legislation of the World Parliament. Their expertise and organizational infrastructures can now be used to promote universal prosperity while protecting the environment. Coca Cola, Kentucky Fried Chicken, Monsanto, or Union Carbide can no longer exploit and devastate the people of India.

The economic powerhouse arises as the Earth Federation issues debt-free, interest-free money to promote the prosperity, truly free trade, and well-being of the people of Earth while protecting the planetary environment. Individuals, corporations, state and local governments may all take advantage of low interest or interest-free development loans that are not premised on exploitation of the debtors.
in the service of private profit. Money and banking are now used in the service of the common good of the people of Earth and in protection of the “ecological fabric of life” on our planet. The rich can no longer exploit the poor (or debtor nations) through a system of loans and debt that has so far created such misery for the peoples and nations of Earth.

Article 4 of the *Earth Constitution*, entitled “Grant of Specific Powers to World Government,” item number 17, reads: “Establish and operate world financial, banking, credit and insurance institutions designed to serve human needs; establish, issue and regulate world currency, credit and exchange.” To do this effectively, Article 8 of the Constitution establishes the “World Financial Administration.” Section G. 1. F. reads:

Pursuant to specific legislation enacted by the World Parliament, and in conjunction with the Planetary Banking System, to establish and implement the procedures of a Planetary Monetary and Credit System based upon useful productive capacity and performance, both in goods and services. Such a monetary and credit system shall be designed for use with the Planetary Banking System for the financing of the activities and projects of the World Government, and for all other financial purposes approved by the World Parliament, without requiring the payment of interest on bonds, investments or other claims of financial ownership or debt.

Our global monetary system today is 99% composed of privately created debt-money (Brown 2007). Because of this, we live in a world of global scarcity and desperation requiring, as we have seen, massive military training for counter-insurgency warfare and massive military interventions by imperial nations designed to protect and promote the present world domination on behalf of wealthy investors. The *Earth Constitution* is explicit that money must be created by the Federation as debt free money addressed to the common good and planetary prosperity. Unproductive financial speculations, such as derivatives, will be prohibited by law, as will unsustainable production externalizing its costs onto nature and society for the sake of private gain.

Under the authority of Article 19 of the *Earth Constitution*, a Provisional World Parliament has begun operating since 1982. During its ten sessions to date, the Provisional World Parliament has passed some 42 World Legislative Acts (WLA) designed to implement and develop the infrastructure of the Earth Federation under both the spirit and letter of the *Earth Constitution*. These acts are not binding on the final world parliament once the Constitution is ratified. However, they serve to elaborate the content and spirit of the Constitution, and they will likely serve as a compelling model for the final World Parliament.

These acts include the creation of a World Economic Development Organization (WLA 2), an Earth Financial Funding Corporation (WLA 7), a Provisional Office for World Revenue (WLA 17), a World Patents Act (WLA 21), a World Equity Act (WLA 22), a World Public Utilities Act (WLA 38), and an act for a World Guaranteed Annual Income (WLA 42) (see www.worldproblems.net). Together they are laying the economic foundations for a global market economy based on human rights, promotion of the common good, and a democratic world order that benefits
everyone, not just the present ten percent of humanity who today own 85 percent of all the global wealth (Brown 2007, p. 271).

As early as the first session of the Parliament in 1982, when WLA 2 was passed creating the World Economic Development Organization (WEDO), the Parliament saw through the deception of debt-based money creation. Among the means of funding for WEDO is the directive to develop the financing potential and procedures defined under Article 8, Section G, paragraphs (d), (e), (f) of Earth Constitution to base finance on people’s potential productive capacity in both goods and services, rather than on past savings. Even though the Constitution gives Parliament the right to levy taxes, no such process is necessary within the sound monetary policy formulated by WEDO.

From this principle of funding under the Earth Constitution, that is, the creation of debt-free fiat money and credit based on the potential of those funded to produce sustainable goods and services, follow all the other principles of the Provisional World Parliament that are building the infrastructure for an equitable and just world order. With government-issued debt-free money, the Earth Federation will hire tens of millions of unemployed people in the Third World to restore the environment, replant the forests of the Earth, and restore the degraded agricultural lands of the Earth.

It provides a “new deal” for the people of Earth. The tens of millions hired to restore the environment will have money to exchange in their local economies. In conjunction with interest free loans or grants for building infrastructure, sanitation systems, education, healthcare, and many private and public sustainable new enterprises, local economies will “take off” in that dynamic circulation of money within communities that economists speak of as economic health. Inflation is easily controlled by maintaining a balance between money supply and available goods and services, which a public banking system can easily do. However, the need is so great that sustainable production must develop rapidly and continuously along with research into sustainable technologies, alternative energy, and cooperative forms of living (such as the research being done today in Auroville, India).

The Constitution guarantees everyone on Earth a minimum wage entirely sufficient to live with dignity and freedom (under Article 13). It provides every person on Earth with free health care, free education, and ample insurance in case of accident or old age. Once the militarized sovereign nation-state is removed, along with gigantic corporate and banking institutions dedicated to maximizing private profit for the few, economic well-being is not difficult to achieve. India is the subcontinent most suited to initiate this process of world transformation.

The world order can be fairly easily transformed into one of planetary peace with justice and prosperity. The present world-system of scarcity and domination is a result of the principle inherent in money created as public debt to private financial elites and on a global system of maximizing private profit at the expense of nature and the common good of the people of Earth. Perhaps the most fundamental secret is in “democratic money”: money issued debt free in the name of the productive capacity of the citizens of Earth to produce sustainable goods and services, issued by a public banking system run for the common prosperity of all.

Practically speaking, the origins of this economic transformation (requiring, as we have seen, transformation in other areas of human life) could well begin in India, given its immense population and resources. India historically has produced some of the greatest philosophies and religions of world history. Today, we understand that the new paradigm for human life must integrate all fundamental aspects for life on our planet, from the elimination of militarism, to protection and restoration of the environment, to the economics of prosperity rather than scarcity.

The Constitution for the Federation of Earth provides both a roadmap and a new paradigm for rapid, sustainable development. It forever frees not only the people of India but potentially the people of Earth from imperialism of militarized nations and the exploitation from global centers of capital. Yet India is unique because she contains within herself the resources to initiate this global resurrection of our desperate human condition. Within the Earth Constitution, we not only find a path for concrete action, but just as important, a vision of our higher transformative possibilities, all of which are uniquely applicable to India. [10]

(The views expressed in the write-up are personal and do not reflect the official policy or position of the organisation.)
Casino Capitalism and Collapse of the American Economy

Susmit Kumar
President, Prout Institute of the United States, Lansing, Michigan, US

A Brief History of the Global Economy

Until 700 to 800 years ago, the various continents exhibited little difference in wealth and poverty. The industrial revolution in Europe, however, created vast differences in wealth between rich and poor countries due to the fact that the colonies were deprived of the use of the “new technologies.” As shown in Tables 1 and 2, the economies of Third World...
countries like India, China, and Brazil were comparable to those of what are now the developed countries until 1750, but due to exploitation of their resources and trade restrictions their economies declined.

During the 18th century, for example, the British imposed trade restrictions on Indian textile exports, which were better than British machine-manufactured textiles, to safeguard its own textile industry. India experienced zero per capita growth from 1600 to 1870, the period of growing British influence. Per capita economic growth from 1870 to independence in 1947 was a meager 0.2 percent per year, compared with one percent in the UK.

The UK and other European countries achieved tremendous economic growth in the 1800s at the expense of the economic growth of their colonies until the two world wars ended this scheme. The US then took over economic leadership when European nations had to take American war loans and due to the boost these wars gave American industry. The US supplied billions of dollars’ worth of munitions and foodstuffs to the Allies during two World Wars, and the Allies had to borrow money on the New York and Chicago money markets to pay for them. By the late 1940s, the US gross domestic product (GDP) was almost half of the world’s GDP, and American companies were working at full capacity. This contrasts dramatically with post-war Europe, most of whose factories had been completely destroyed. In addition, technological advances in both ocean and air transport during the war made the transportation of goods cheap, integrating the American economy into the world economy.

The war also caused the demise of the world’s two main colonial powers, Britain and France. Britain’s national debt was about 250 percent of its GDP in 1946. This forced them to grant independence to most of their colonies, which were too expensive to keep within the colonial fold.

World War II also saw the emergence of the U.S.S.R., which initially demonstrated tremendous economic growth. Soviet rulers claimed that they would surpass the economic might of the West, but after a few decades the Soviet economic miracle fizzled out once the drawbacks of communism, including inefficiency and relatively poor productivity, crept into the Soviet economy. This finally led to the collapse of the Soviet empire in 1991.

Due to the Korean War, the Japanese and South Korean economies were rebuilt on the ruins of World War II. After the oil price increases in the late 1970s and subsequent inflation, US industries started shifting their production to East Asia, creating the four “Asian Tigers,” namely, South Korea, Hong Kong, Taiwan, and Singapore. Since these four countries were too small to produce all the manufactured goods needed for the US consumer market, Chinese businessmen in Hong Kong, Taiwan, and Singapore invested in countries like Indonesia, Thailand, and Malaysia, where the Chinese origin people had a monopoly on industry. This finally led to the rise of China. The losers were American workers, who were laid off on a large scale. The advent of information technology in the mid-1990s created jobs in the US, but to satisfy the profit demands of Wall Street investors, CEO’s had to send information technology jobs to countries like India, Ireland, and Philippines.

**Post-1990s Casino Capitalism**

Let us discuss the 1997 East Asian crisis, the recent record gasoline prices and the current global economic crisis to see how casino capitalism is playing havoc with the common people.

With the entry of China in the US consumer market in the 1990s, its trade surplus started increasing at the expense of other East Asian countries, notably Thailand, South Korea, Malaysia, Indonesia and Philippines. In 1994, China devalued its currency Yuan by 35 percent whereas other East Asian countries delayed devaluation until 1997; however, the
damage was already done as their imports began to exceed their exports and they became vulnerable to currency speculators. Thailand had the weakest economy in the region because of its high debts, which were about 38 percent of GDP. When currency traders saw the vulnerability of the Thai economy, they bought several forward contracts worth more than $15 billion and flooded the international market by selling bahts, the Thai currency, in May 1997. Thailand's central bank initially spent more than $16 billion in its failed attempt to prop up its currency. When its FOREX dropped into the danger level, it had to unpeg the baht from the dollar, resulting in a free-fall for the Thai currency. It led to domino effect in entire region, leading to sharp devaluation of currencies, massive loss of jobs and stock market crashes. In Thailand, people invested a lot of money in real estate, but since there were not enough buyers, the real estate market crashed. It was due to Thailand's real estate sector that most East Asian economies eventually suffered, but currency speculators made a lot of money.

After watching the IMF at work during the 1997 East Asian economic crisis, Joseph E. Stiglitz, 2001 winner of Nobel Prize in economics, wrote in April 2000:

"I was chief economist at the World Bank from 1996 until last November, during the gravest global economic crisis in a half-century. I saw how the IMF, in tandem with the US Treasury Department, responded. And I was appalled."

"The IMF may not have become the bill collector of the G-7, but it clearly worked hard (though not always successfully) to make sure that the G-7 lenders got repaid."

It was he who described the crisis best:

"The IMF first told countries in Asia to open up their markets to hot short-term capital [It is worth noting that European countries avoided full convertibility until the 1970s]. The countries did it and money flooded in, but just as suddenly flowed out. The IMF then said interest rates should be raised and there should be a fiscal contraction, and a deep recession was induced. As asset prices plummeted, the IMF urged affected countries to sell their assets even at bargain basement prices. It said the companies needed solid foreign management (conveniently ignoring that these companies had a most enviable record of growth over the preceding decades, hard to reconcile with bad management), and that this would happen only if the companies were sold to foreigners—not just managed by them. The sales were handled by the same foreign financial institutions that had pulled out their capital, precipitating the crisis. These banks then got large commissions from their work selling the troubled companies or splitting them up, just as they had got large commissions when they had originally guided the money into the countries in the first place. As the events unfolded, cynicism grew even greater: some of these American and other financial companies didn’t do much restructuring; they just held the assets until the economy recovered, making profits from buying at fire sale prices and selling at more normal prices."

In his US Senate testimony in May 2008, Michael Masters, a hedge fund manager, blamed speculators for the record rise in oil prices, citing US government data that over the last five years demands from speculators (848 million barrels) were almost the same as the Chinese oil demand (920 million barrels) over the same period. In his weekly New York Times column, Paul Krugman criticized Michael Masters’ theory of hedge funds as being mainly responsible for the oil price rise, by claiming that the price of iron ore paid by Chinese steel makers to Australian miners had jumped by 95 per cent. Iron ore is not traded in the global exchange. But Krugman failed to consider the fact that the price paid by Chinese Steel makers to Australian miners was the delivered cost to China and it reflected the higher transportation costs due to record gasoline prices. Gasoline prices had more than doubled in the last one year when this deal was signed.

Four dollar a gallon gas prices created havoc in the US economy. The best-selling gas-guzzling SUV market dropped drastically, causing auto manufacturers like GE, Ford and Chrysler to close down their manufacturing plants and showrooms and lay off tens of thousands of workers. Although oil companies were raking in record tens of billions of dollars in profits each quarter, higher gas prices were causing a rise in transportation costs, raising the price of all food products in super markets. This increased inflation. It affected the sales of supermarkets like Walmart and Kmart as higher food and gas prices left fewer dollars in the pockets of lower income people to spare. All over the world, hundreds of millions of people
fell below the poverty line because of double digit inflation due to rising food costs. Oil-importing countries like India had to spend up to two to three percent of its GNP as subsidy on gasoline as a substantial rise in gasoline price would have destabilized the entire country.

Derivatives are behind the recent global economic crisis. Derivatives are financial contracts whose values are derived from the value of something else (loans, bonds, commodities, equities (stocks), residential mortgages, commercial real estate, loans, bonds, interest rates, exchange rates, stock market indices, consumer price index, weather conditions or other derivatives). These can be termed as modern financial casino games. Warren Buffett famously described derivatives bought speculatively as "financial weapons of mass destruction."

As an example, a credit default swap (CDS) is a credit derivative contract between two parties. In mid-1990s, CDS was invented by a JP Morgan Chase team. The CDS buyer makes a series of payments to the CDS seller, and in return receives a payoff if the underlying financial instrument defaults (a mortgage, loan, bond, etc.). Unlike insurance, the CDS buyer does not need to own the underlying financial instrument (i.e. loan, bond, etc.). In mid 2008, the global derivatives market was close to $530 trillion. The global CDS market increased from $900 billion in 2000 to $55 trillion in mid 2008. In comparison, the value of the New York Stock Exchange was $30 trillion at the end of 2007 before the start of the recent crash. American International Group (AIG), the world's largest private insurance company, had sold $440 billion in credit-default swaps tied to mortgage securities.

When the housing bubble burst, the CDS' tied to mortgage securities began to send shock waves throughout the global market. To prevent a chain reaction, the US government had to rescue AIG and get a $700 billion fund from the US Congress to bailout Wall Street firms, as AIG and several others were running out of money after being downgraded by credit-rating agencies because of mounting losses, which triggered a clause in its credit-default swap contracts to post billions in collateral.

**Collapse of the American Economy**

The debt crisis started by the Reagan administration is becoming unsustainable. Although the Clinton administration was able to balance the budget, and even had budget surpluses in last two years, it was unable to rein in the balance of payment (BPO) deficit, which has increased from $140 billion in 1997 to $738 billion in 2007. Figure 1, shows the US debt from 1960 to 2007. The chart clearly shows that the debt rose at a faster rate during republican administrations. The curve is concave during the Clinton administration, when the increase in the debt was the slowest. The Bush administration, to compound the difficulty, has increased US fiscal debt from $5.6 trillion to $9 trillion because of tax breaks and increasing defense expenditures. Taking advantage of the fact that the dollar is the global currency, the Fed prints money whenever it feels necessary in order to fund the two deficits we now have—the trade deficit and the budget deficit. However, these large, accumulating sums are not sustainable.

Figure 2, shows the US BOP as a percent of GDP from 1930 to 2007, and figure 3, shows the BOP in billions of dollars from 1990 to 2007. The BOP has deteriorated very fast since 2000, with the beginning of the Bush administration, and is now in uncharted territory. In terms of percent of GDP, this is the first time the BOP has been allowed to drop to this level in American history. During the mid-1980s when it started going into what was then also uncharted territory, the US had to sign the 1985 Plaza Accord (shown as the vertical line in figure 2) and cooperated in a controlled depreciation of the dollar in order to increase its exports. At that time, all the main players in the global economy—Japan, West Germany, France, and the UK—were dependent on the US for their security and so helped it in this endeavor. China and Russia are the world’s largest and third largest FOREX holders now, however, and most of their FOREX is in dollars; they may not do what the US wants. They have seen the fate of the “bubble economy” of the late 1980s and 1990s in Japan due to the Plaza Accord, and will likely hesitate to sign a similar accord. They may even prefer to see the US economy collapse rather than protect it.

Figures 4 and 5, show the BOP’s of selected countries. All countries except UK and India have positive BOPs in the past several years. The main reason behind the negative BOP of India is the import of gasoline. India needs to follow in the footsteps of Brazil and find a substitute for petrol as soon as possible, otherwise it may face an economic crisis because it is the only country in BRIC that has a negative BOP. India has the second highest arable land after the US and hence it can produce a sufficient amount of ethanol. In Brazil, no small vehicles run on pure gasoline; instead they use ethanol-mixed
gasoline, which is available all over the country.

Due to the housing crisis, the US trade deficit is expected to reduce slightly. In 2007, the US BOP reduced to $738 billion from $811 billion in 2006. According to April 2008 IMF estimates, the US BOP deficit will continue to be above $600 billion for the next five years - $614 billion in 2008, $605 billion in 2009 and $676 billion in 2013. On the other hand, its two main adversaries, China ($1.5 trillion at the end of 2007, $1.9 trillion at the end of 2008 and $2.4 trillion at the end of 2009) and Russia ($445 billion at the end of 2007, $583 billion at the end of 2008 and $708 billion at the end of 2009) will be amassing FOREX (Foreign Reserves) at alarming rates. It is worth noting that China and Russia had only $168.9 billion and $24.8 billion FOREX, respectively, in 2000.5

According to economist Allan H. Meltzer at Carnegie Mellon University, “We [US] get cheap goods in exchange for pieces of paper, which we can print at a great rate.” However, the mountain of US bonds foreigners are accumulating means the country is going deeper into debt to fund its import binge. According to William R. Cline, a scholar at the Institute for International Economics, “Sooner or later, the rest of the world will decide that the US is no longer a safe bet for lending more money.”6 According to Brad Setser, an economist with Roubini Global Economics, LLC, in New York, in order to pay for its imports the US needs to attract foreign capital at the rate of about $20 billion a week [i.e. to finance $1 trillion dollar twin deficit a year, consisting of $700 billion trade deficit and $300 billion budget deficit]. This is equal to selling three companies the size of the maritime firm supposed to be purchased by Dubai Ports World.7 “We are basically selling off the furniture to pay for Thanksgiving dinner,” says Peter Morici, a professor at the University of Maryland’s business school in College Park. According to him, foreigners could own within the next decade more than a fifth of the nation’s

| Table 1. Total Industrial Potential (U.K in 1900 = 100) (Triennial Annual Averages, except for 1913) |
|---------------------------------|----------|----------|----------|----------|----------|----------|----------|
| DEVELOPED COUNTRIES            | 1750     | 1800     | 1830     | 1860     | 1880     | 1900     | 1913     |
| Europe                         | 34.4     | 47.4     | 72.9     | 143.3    | 253.1    | 481.2    | 863.0    |
| Belgium                        | 29.6     | 41.2     | 63.0     | 120.3    | 196.2    | 335.4    | 527.8    |
| Belgium                        | 0.4      | 0.7      | 1.3      | 3.1      | 5.7      | 9.2      | 16.3     |
| France                         | 5.0      | 6.2      | 9.5      | 17.9     | 25.1     | 36.8     | 57.3     |
| Germany                        | 3.7      | 5.2      | 6.5      | 11.1     | 27.4     | 71.2     | 137.7    |
| Italy                          | 3.1      | 3.7      | 4.2      | 5.7      | 8.1      | 13.6     | 22.5     |
| Russia                         | 6.4      | 8.3      | 10.3     | 15.8     | 24.5     | 47.5     | 76.6     |
| Spain                          | 1.6      | 2.1      | 2.7      | 4.0      | 5.8      | 8.5      | 11.0     |
| Sweden                         | 0.3      | 0.5      | 0.6      | 1.4      | 2.6      | 5.0      | 9.0      |
| Switzerland                    | 0.2      | 0.4      | 0.8      | 1.6      | 2.6      | 5.4      | 8.0      |
| Great Britain                  | 2.4      | 6.2      | 17.5     | 45.0     | 73.3     | 100.0    | 127.2    |
| Outside Europe                 | 4.9      | 6.2      | 9.9      | 22.9     | 56.9     | 145.9    | 335.2    |
| Canada                         | -        | -        | 0.1      | 0.6      | 1.4      | 3.2      | 8.7      |
| US                             | 0.1      | 1.1      | 4.6      | 16.2     | 46.9     | 127.8    | 298.1    |
| Japan                          | 4.8      | 5.1      | 5.2      | 5.8      | 7.6      | 13.0     | 25.1     |
| THIRD WORLD                    | 92.9     | 99.4     | 111.5    | 82.7     | 67.0     | 59.6     | 69.5     |
| China                          | 41.7     | 48.8     | 54.9     | 44.1     | 39.9     | 33.5     | 33.3     |
| India                          | 31.2     | 29.0     | 32.5     | 19.4     | 8.8      | 9.3      | 13.1     |
| Brazil                         | -        | -        | -        | 0.9      | 0.9      | 2.1      | 4.3      |
| Mexico                         | -        | -        | -        | 0.9      | 0.8      | 1.7      | 2.7      |
| WORLD                          | 127.3    | 146.9    | 184.4    | 225.9    | 320.1    | 540.8    | 932.5    |

total $35 trillion or so in assets of every kind – corporations, businesses and real estate.\(^8\)

President-elect Barack Obama is going to spend trillions of dollars in the next couple of years on development projects to get the country out of the present deep recession; but, this huge spending has the potential to crash the entire US economy because of massive foreign debts. It all depends on how foreign investors like China react to these massive new US debts, i.e. it is a million dollar question whether China will cooperate with the US so that the US can spend itself out of a deep recession or not, because China is holding $2 trillion. In a similar situation, the US and German banks did not help Gorbachev in the late 1980s that led to the collapse of the U.S.S.R.

After record-breaking prices in the early 1980s, oil prices plummeted in the second half of the decade. Oil was the main export and source of hard currency for the U.S.S.R. Insufficient investment and lack of modern technology needed to harness hard-to-reach oil fields prevented her from expanding production, however, and in fact Soviet oil production began to decline. The government was also borrowing heavily to modernize its economy. These two factors led to a rise in Soviet external debt. In 1985, oil earnings and net debt were $22 billion and $18 billion, respectively; by 1989, these numbers had become $13 billion and $44 billion, respectively. By 1991, when external debt was $57 billion, creditors (many of whom

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### Table 2: Shares of “New Technology” Industries in the Total Manufacturing Output by Regions (in percent)

<table>
<thead>
<tr>
<th></th>
<th>Developed Countries (excluding Japan)</th>
<th>Third World (excluding Japan)</th>
<th>World (including Japan)</th>
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<tbody>
<tr>
<td></td>
<td>UK</td>
<td>Other Countries</td>
<td>Total</td>
</tr>
<tr>
<td>1750</td>
<td>0-1</td>
<td>0</td>
<td>(a)</td>
</tr>
<tr>
<td>1800</td>
<td>6-10</td>
<td>1-3</td>
<td>2-4</td>
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<tr>
<td>1830</td>
<td>32-40</td>
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<td>12-17</td>
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<tr>
<td>1860</td>
<td>60-70</td>
<td>18-24</td>
<td>29-36</td>
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<td>1880</td>
<td>62-74</td>
<td>30-38</td>
<td>40-48</td>
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<tr>
<td>1900</td>
<td>68-78</td>
<td>49-57</td>
<td>52-61</td>
</tr>
<tr>
<td>1913</td>
<td>72-80</td>
<td>55-65</td>
<td>60-65</td>
</tr>
</tbody>
</table>

(a) Less than 0.5 percent.


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### Figure 1. US Debt

![Figure 1. US Debt](source: www.treasurydirect.com)

### Figure 2. US Balance of Payments

![Figure 2. US Balance of Payments](source: US Department of Commerce (Bureau of Economic Analysis)}
were major German banks) stopped making loans and started demanding repayments, causing the Soviet economy to collapse.9  

As discussed in my book, The Modernization Islam and the Creation of A Multipolar World Order, the 1930s Great Depression resulted in the rise of Hitler, who tried to establish a thousand years of Third Reich, but instead paved the way for thriving democracies in most of Europe and decolonization in Asia and Europe. Similarly, the coming Great Depression will result in the collapse of capitalism, a secular and democratic Middle East, and enduring peace for the entire humanity.  

Endnotes and Additional Thinking

3 Ibid., pp. 129-130.
5 World Economic Outlook, IMF, April 2008, p. 258, and p. 266.

(The views expressed in the write-up are personal and do not reflect the official policy or position of the organisation.)
How US Politicians and Bankers Built a Financial Debt House of Cards

Rodrigue Tremblay
Emeritus Professor of Economics and Finance, University of Montreal, Canada

“People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices.”

“All for ourselves, and nothing for other people, seems, in every age of the world, to have been the vile maxim of the masters of mankind.”

Adam Smith (1723-1790), (The Wealth Of Nations, 1776)

“This economy of ours is on a solid foundation.”

President George W. Bush (January 4, 2008)

“While the crash only took place six months ago, I am convinced we have now passed the worst and with continued unity of effort we shall rapidly recover.”

President Herbert Hoover (1874-1964), (May 1, 1930)

Why does the world economy seem to be caught every 60 some years [http://www.thenewamericanempire.com/tremblay=1083] in a financial and banking turmoil that threatens to collapse the real economy? The answer has to be sought in human greed and political corruption [http://www.thenewamericanempire.com/tremblay=1060.html] that seem to collaborate in pushing to the extreme all types of speculative and parasitic practices.

Between 2002 and 2007, we have witnessed the culmination of such an example of greed and corruption on a very high scale, as an unstable pyramid of artificial financial debt instruments was built to higher and higher unsustainable levels, to the benefit of unregulated financial operators who raked in hundreds of billions in excessive profits, juicy fees and obscenely high year-end bonuses. [http://www.concentrationofwealth.blogspot.com/2006/12/16-bil-sachs-of-loot.html] Similarly, parasitic speculators [http://online.wsj.com/public/article/SB120036645057290423.html] took advantage of the situation that regulators had allowed to develop, and they made billions (not millions) speculating against the shaky house of cards of mortgage-backed securities. These are the winners: bankers and speculators. The losers in that charade are about everybody else: homeowners, investors, taxpayers, retirees, and workers who are poised to lose their jobs and incomes, as a consequence of the failure of government to prevent these financial excesses.

Indeed, the problem is both political and financial and this has to be understood in order to disentangle the web of causes that produces a financial and economic collapse. It is that combination of political corruption and racketeering financial and banking practices that creates the right environment for a major crisis to develop. Why each 60-some years? Essentially because the lessons learned the hard way by a grandparents’
generation, sixty some years ago, are forgotten by a succeeding spoiled brats current generation, and the same past mistakes and fresh ones are made anew.

On that score, the big financial crises of 1873-1880 and 1929-1939 had pretty much the same type of causes as the one we are entering into today: the collapse of public and private basic morality [http://www.TheCodeForGlobalEthics.com] among a very small elite that pushes its exploitation of public institutions to the breaking limit. For such a small elite, there comes a time when all means justify the supreme goal of enriching itself at the expense of the rest of society. All combines, tricks and schemes become acceptable and justified by pious ideological slogans such as “the market always knows best”, the new “wealth (no matter how acquired) will trickle down”, or, for the more delusional ones among them, “God is placing all that money in my hands, therefore, I must be doing good”!

The immediate technical question that must be answered is how a casino-like financial capitalism [http://www.thenewamericanempire.com/tremblay=1087] was allowed to develop? Why were banking practices twisted in such a way as to turn capital into the equivalent of casino chips?

Indeed, banking’s primary function is to allow capital to be used in the most productive ways. It is the primary function of financial intermediaries [http://www.answers.com/topic/financial-intermediary] (banks, savings & loans associations, stock exchanges, etc.) to convert savings into productive capital (plants, roads, etc.). Investments are kept tradeable and liquid by secondary capital markets. Properly regulated to avoid combines and scams, capital markets usually function smoothly.

It is when politicians, or regulators themselves, throw out such regulations that things can get ugly. In the US, a few disastrous steps were taken in 1999, 2000, 2004 and 2007, which can explain the current financial crisis.

A Decade of Planned Deregulation

Indeed, under the advice of then Fed chairman Alan Greenspan, a libertarian at heart, the Republican controlled Congress and the Democratic Clinton administration passed two laws designed to deregulate the American financial industry. First, in 1999, it passed the Gramm-Leach-Bliley Act [http://banking.senate.gov/conf/] (GLBA) that, in effect, abolished the 1933 Glass-Steagall Act, [http://www.investopedia.com/terms/g/glass_steagall_act.asp] which had regulated investment banking, and which established tight barriers between the banking and insurance industries. With this new law, the large unregulated Wall Street investment banks and commercial banks, as well, could enlarge tremendously the range of their financial activities.

Then, in a one-two punch, the lame-duck 2000 US Congress went further and reintroduced legalized gambling into the financial sector, a prohibition that had been in place since after the 1907 financial crisis. Indeed, by adopting the Commodity Futures Modernization Act of 2000, [http://www.pianet.com/NewsCenter/BizPolitics/10-15-08-7.html] Congress, and President Bill Clinton who signed it, exempted outright financial gambling from state gaming laws. With the new law, the entire American financial system could be turned into a large unregulated casino where everything goes (legally).

Another step toward a near complete deregulation of previously regulated financial activities was taken in 2004, this time by the regulatory agency of the Securities and Exchange Commission (SEC). Indeed, on March 28, 2004, the Securities and Exchange Commission (SEC) [http://www.
nytimes.com/interactive/2008/09/28/business/20080928-SEC-multimedia/index.html] removed the ceiling on risk that the largest American investment banks could take on so-called securitized loans. [http://en.wikipedia.org/wiki/Securitization]. Such loans were based on mortgages, but also on credit card debt, auto finance debt, student loans, etc. Finally, the Securities and Exchange Commission took the last step toward deregulating financial markets when in the the month of July 2007, weeks before the onset of the subprime crisis, it removed the “uptick” rule [http://www.thestockbandit.net/2007/07/03/short-selling-uptick-rule-ends/] for short selling any security.

The Story of the Two Bubbles

The table was then set for what could turn out to be the biggest financial mismanagement in history. It was the product of two interrelated bubbles: [http://remington-work.blogspot.com/2007/12/two-bubbles-housing-and-financial.html] a housing bubble and a financial debt bubble.

The housing boom was fed by extraordinarily low interest rates and by lowered lending standards for mortgages. Indeed, from 2002 to 2005, under chairman Alan Greenspan, the Fed maintained excessive monetary liquidity in the financial system and short-term interest rates fell to one percent, with real interest rates negative.

Indeed, after the tech-bubble burst in 2001, and the March-November 2001 recession, the Greenspan Fed aggressively lowered the Federal Funds rate from 6.5 percent to one percent in 2004, the lowest it had been since 1958. It is widely accepted today that this aggressive monetary policy lasted too long and has played an important role in fueling the housing bubble.

But the housing bubble would have only been an above normal top within the 18-year Kuznets cycle [http://en.wikipedia.org/wiki/Business_cycle], (from a 1987 top to the 2005 top) if it had not been reinforced by an extraordinary debt bubble.


“When one looks at a graph provided by the US Bureau of Economic Analysis (BEA) and which shows the relative importance of total outstanding debt [http://online.barrons.com/article/SB120251582071855267.html?mod=b_hpp_9_0002_b_this_weeks_magazine_home_right] (corporate, financial, government, plus personal) in relation to the economy, one is struck by the fact that this ratio stayed around 1.2 times GDP for decades on. Then, something big happened in the early 1980s, and the ratio started to rise, with only a slight pause in the mid-1990s, to reach the air rarefied level of 3.1 times GDP presently, nearly 200 percent more than it used to be.”

That “something big” was the combination of the breaking up of the regulation apparatus we have already mentioned, and the appearance of new risky financial instruments.

Reckless Lending

On one hand, first came the “subprime lenders” or what some call the predatory mortgage lenders. Spurred by an incentive system that rewarded risk-taking (big bonuses), mortgage banks and other lenders began to accommodate subprime borrowers with dubious credit by extending mortgage loans to homebuyers who would not have qualified in other times. —They lowered their lending standards.

Non-traditional home loans were advanced to borrowers who had no documented incomes. Some loans were interest-only loans with down payments of five percent or less. Some were adjustable rate loans (ARMs), with low rates for one or two years to be reset later at much higher rates. In 2006, about 25 percent of American mortgages were subprime and close to 20 percent were adjustable rate loans. Mortgage lenders and home buyers alike assumed that home prices were not going to fall on a national basis or that the Fed would intervene to save the industry by slashing interest rates.

The New Alchemy Finance

On the other hand, the main reason of such lending recklessness was the facility with which subprime lenders could sell their risky mortgages upstream to bigger players, investments banks for example, which undertook to buy them, pool them into mortgage bonds and re-channel them into new financial instruments through a process of aggressive securitization.
These new “structured investment vehicles” (SIVs), which fall into the large class of derivative products, came under various names such as “Collateralized Bond Obligations” (CBOs) or “Collateralized Debt Obligations” (CDOs). They had the characteristics of short-term asset-based commercial paper that were backed by the underlying income producing mortgage assets downstream and were graded according to a certain risk of default. —The asset-based security (ABS) was born. [For reference, let us keep in mind that total derivative products around the world amount to more than $500 trillion, or more than ten times the output of the global economy. This is a staggering overhang on the world economy when something goes wrong.] More than one trillion and a half dollars of these asset-backed financial products were sold, not only in the US, but all over the world. However, the market for such artificial or fictitious financial instrument began to tighten significantly when the housing bubble burst in 2005 and 2006, a wave of foreclosures and mortgage defaults hit the industry. It got worst after the August 2007 subprime crisis, and it became de facto frozen in the spring of 2008, after the demise of the investment bank Bear Stearns. The credit rating agencies (Moody’s, Standard & Poor’s and Fitch) had no choice but to lower their artificially high ratings on asset-based securities (ABS), and the prices of ABS plummeted.

Enter now another new financial instrument that made matters much worse and led directly to the crisis: the Credit Default Swaps (CDS). Because of the lack of proper government regulation, this new financial product really became, in financier Warren Buffett’s words, a true financial weapon of mass destruction. Essentially because it became the tool of choice for the newly legalized activity of high level financial gambling by entities that were unrelated to any genuine lending operation. Indeed, as we will see below, in a panic environment, large off-shore hedge funds with their large pools of money could literally raid imprudent and weakened financial institutions with so-called “naked” short sell orders that far outnumber the buy orders from any potential buyers. In other words, they were in a position to corner the market. Initially, in order to protect against the risk of default on the new asset-backed securities (ABS), some insurance companies—but also some investment banks themselves—began to issue bilateral “insurance” contracts against the newly created ABS. These were called Credit Default Swaps (CDS). In theory, they were supposed to offer protection against the possible default of an investment instrument, such as an asset-backed security. The issuer of ABS, or an investor looking for protection, could buy such an insurance contract and pay a premium, which was a small fraction of the asset being protected, say five percent. Understandably, when housing prices were on their way up, with little risk of mortgage default, the cost of such “protection” was low, and conversely, in a period of price decline, the risk of default increases. This was a financial innovation, the so-called “insurance against default”, that opened the floodgates of money to be invested in the new financial instruments. Indeed, it allowed investors such as pension funds and other institutions which have a fiduciary obligation to buy only high-quality securities, to legally buy artificially highly rated (but risky) ABS securities, or to invest in hedge funds which specialized in leverage trading in derivative products.

But the hic is that the issuance and use of such financial “insurance” contracts were not regulated by any government agency, because the word “insurance” was not used; instead, they were considered as simply a protection against the “default” of payment on a financial security. And that’s where the gambling part enters the picture: only ten percent of CDS are genuine insurance contracts held by investors who really own asset-backed securities (these are covered CDS); 90 percent of them are rather held by speculators who trade CDS, while not owning any asset-backed securities to be protected (these are naked CDS). To picture the situation, we can consider such “naked” CDS as a form of high valued
casino chips that one can buy to bet on the likely future value of a financial security, just as someone could bet on the issue of a horse race. Except that in this kind of unregulated financial gambling, as we will see, the owner of the chips can influence the outcome of the race by intervening in the race itself. In other words, the game is rigged.

The Financial Sector as a Vast Casino

To repeat, and contrary to ordinary regulated insurance contracts, Credit Default Swaps (CDS) can be bought and sold by speculators who are not directly involved in the mortgage business. They deal in “naked” CDS. As a comparison, for example, it is illegal to buy ordinary life insurance on the life of someone with whom a buyer is not related, in order to avoid evident abuses. Not so with CDS, as it is the case with “naked” CDS. And because of the 2000 Commodity Futures Modernization Act passed by Congress, no state has the power to regulate this new form of sophisticated gambling. The result is astounding: it is estimated that the notional value of credit default swaps outstanding today is about $62 trillion (four times the size of the US economy). This, in itself, is an indication of how popular the “naked” CDS innovation was as a way to bet on the collapse of the entire asset-backed securities construction. This is also a clear sign that, in a crisis, it would be all but financially impossible for the issuers of CDS to meet their obligations. In other words, disaster was just around the corner. This is an event that any regulatory agency should have seen coming.

Indeed, when housing prices hit the expected top of their cycle, in the spring of 2005, and began falling, especially in 2006, the price for CDSs was still relatively low. So, some astute speculators undertook to buy CDSs and simultaneously began selling short the ABS that had been issued by investment banks, such as Lehman Brothers, in the correct expectation that mortgage-backed securities were bound to lose value with the expected rise in home foreclosures and mortgage defaults. For instance, one large speculator [http://online.wsj.com/public/article/SB120036645057290423.html] is reported...
having reaped, in 2007, an estimated $3 billion-plus for himself, which made it the largest one-year gain in Wall Street history, for a single individual. Many speculative hedge funds played the same game and raked in billions of dollars in easy-made gambling profits.

Who Pays for the Excesses?
Where did all this money came from? It came from the loses suffered by investors in investment banks and in some large insurance companies, and it came from taxpayers who had to advance a lot of money to prevent these financial firms from failing. The first losers, initially, were the very financial firms which had initially engaged, very profitably we must say, in the new risky finance, i.e. insurance companies, such as American International Group (AIG), [http://www.nytimes.com/2008/09/17/business/17insure.html?ref=us] (which was reported to have $400 billion CDS outstanding on its books when it failed), or from highly leveraged investment banks such as Bear Stearns, [http://www.nytimes.com/2008/03/25/business/25sorkin.html?adxnnl=1&adxnnlx=1225119638-y1PEOpsmCLbOtPspTcMBw&oref=slogin] Goldman Sachs, [http://topics.nytimes.com/top/news/business/companies/goldman_sachs_group_inc/index.html?inline=nyt-org] Morgan Stanley, Lehman Brothers, [http://www.nytimes.com/2008/09/15/business/15lehman.html?pagewanted=all] Merrill Lynch and others which specialized in buying primary subprime mortgages and in issuing asset-backed securities (ABS) in their place. They have suffered huge losses on their ABS and CDS. So much so that some of these financial firms saw their capital base nearly completely disappear, making them de facto insolvent and creating the credit crisis that we know.

The Government at the Rescue
To prevent a complete collapse of the financial system, the US government (Fed, US Treasury and FDIC) had to step in to prevent these large financial institutions from filing for bankruptcy, with multiple rescue and bail-out plans, with the notable exception of Lehman Brothers, which was left to fail on September 15, (2008). The U.S. Treasury also had to inject some $200 billion in the government sponsored Fannie Mae and Freddie Mac [http://topics.nytimes.com/top/news/business/companies/fannie_mae/index.html?inline=nyt-org] in preferred shares, in order to solidify their mortgage lending operations and their $5.3 trillion joint debt.

Consequently, large amounts of public money, in excess of $2 trillion, are now being used to settle the risky bets that large banks took over the years and which went bad. Public money is also being used to subsidize large banks to acquire smaller banks, in an unprecedented restructuration of the entire American banking sector. Such a government intervention will likely contribute to shore up the US financial sector by strengthening its consolidated balance sheet. It remains to be seen, however, if some of the money will trickle down to the real economy.

Conclusion
The US based financial crisis has now become worldwide and is spreading. [http://www.thenewamericanempire.com/tremblay=1099]

The root cause of this financial mess is due to the fact that the lessons of the far away past with its financial crises, and those of a more immediate past, have not been learned. Indeed, one would have hoped that lessons would have been learned from the 1980s Savings & Loans crisis and from the demise of the huge hedge fund, Long Term Capital Management, in the 1990s. But greed and corruption seem to have overtaken wisdom and to have prevented proper governmental oversight.

In the United States, over the last two decades, two parallel banking systems have co-existed, sometime even within the same institution. While one, the traditional banking system, was regulated, the other one, the investment banks and hedge funds and the credit derivatives market, was a shadow system that was hardly regulated at all. Not surprisingly, it is in this unregulated sector that the worst excesses have taken place, as one ever more risky financial innovation led to another. These excesses have resulted in creating a shaky pyramid of fictitious financial debt that has no, or little, relation to the underlying real economy of production of goods and services. How these excesses are going to be unwound will dictate how the world economy is going to fare in the coming years.

At the very least, the return to reality risks being painful and every effort should be deployed to mitigate its consequences for the greatest number.  

(The views expressed in the write-up are personal and do not reflect the official policy or position of the organisation.)
The election is all but over, but the debate over who is responsible for the financial crisis is just beginning to become more intense in the United States. President Obama has pledged swift action to restore the economy, but it is not clear yet if his new Justice Department will prosecute the white collar criminals and, fraudsters whose flaunting of regulation and misrepresentations of the value of...
MENDING THE MELTDOWN

mortgage backed securities helped destabilize first the American economy and now the world’s.

We know that, the Federal Bureau of Investigation has opened a criminal investigation of 26 companies, indicted 400 mortgage scammers and started 1,400 criminal white collar cases. There are 40 task forces allegedly looking into the deceptions at the heart of the subprime pyramid scheme.

But now we also know that the Bush Administration made the prosecution of white collar crime a lesser priority with more agents tasked to chase terror suspects than the men and women who brought our economy down.

Reported Newser:
"A short-staffed FBI is laboring to keep up with white collar crime linked to the nation’s financial crisis, the New York Times reports. FBI officials predicted millions of dollars’ in mortgage fraud years ago, but the Justice Department wanted agents focused on counter-terror. When the FBI warned of a fraud “epidemic” in 2004, only 15 of its 13,000 agents were on the case."

On top of that, many in the media prefer to fudge on who is responsible, blaming irresponsible borrowers equally with irresponsible lenders. In this way, the problem becomes binary with two co-guilty parties, each canceling the other out. Under this logic, the ghetto family that was talked into taking out a subprime loan shares the blame with multi-million dollar marketing operations and investment banks with a well conceived schemes for transferring wealth from the poorest among us to the richest institutions.

FBI has opened a criminal investigation of 26 companies and indicted 400 mortgage scammers

This cynical pox on all their houses was expressed by Rick Newman in a blog on US News.

“Yes, there were villains, and, yes, there were dupes. But everybody got greedy. That includes homeowners who wanted more house than they could afford, along with bankers who wanted higher returns than they could get from conventional securities. If Wall Street committed a crime, then Main Street was an accomplice. And now they’re both feeling the pain."

This squares the circle and sounds reasonable. It's also wrong. Just ask financier Eric Hovde who writes in the Washington Post:

“Looking for someone to blame for the shambles in US financial markets? As someone who owns both an investment bank and commercial banks, and also runs a hedge fund, I have sat front and center and watched as this mess unfolded. And in my view, there’s no need to look beyond Wall Street -- and the halls of power in Washington. The former has created the nightmare by chasing obscene profits, and the latter have allowed it to spread by not practicing the oversight that is the federal government’s responsibility.”

Anderson Cooper at CNN for one -- and he may be one of the few -- says now IS the time to assess blame and CNN is doing reports on the top ten culprits of the crisis. Usually the CEOs of the companies in trouble (AIG, Lehman etc.)"

When tens of billions of dollars in phony securities were written down, when as many as five million families lose their homes, when the economy collapses you have to look deeper at the actual crimes that were committed, starting off with violations of anti-discrimination laws and rules designed to insure that folks knew what they were buying and had their deal clearly explained. Most didn’t. You also have to look at business practices and lack of regulation. That is why the FBI broadened its investigation. Soon 177 agents were on the case and forty task forces were at work. They were being pressured from below by Attorney Generals from many states who were responding to complaints. One of them was New York’s ex-Governor Eliot Spitzer who penned an Op-Ed in the Washington Post just before his sexual picadillo blew up into a scandal that forced him to resign, he wrote:

"Several years ago, state attorneys general and others involved in consumer protection began to notice a marked increase in a range of predatory lending practices by mortgage lenders. Some were misrepresenting the terms of loans, making loans without regard to consumers’ ability to repay, making loans with deceptive “teaser” rates that later ballooned astronomically, packing loans with undisclosed charges and fees, or even paying illegal kickbacks. These and other practices, we noticed, were having a devastating effect on home buyers. In addition, the widespread nature of these practices, if left unchecked, threatened our financial markets."

Even though predatory lending was becoming a national problem, the Bush administration looked the other way and did nothing to protect American homeowners. In fact, the
government chose instead to align itself with the banks that were victimizing consumers.

Spitzer and his counterparts began investigating large mortgage companies like Countrywide. It became clear that there was a crime going on, and it was massive and institutional, not just individual. The Wall Street Journal reported that many of the biggest firms knew they were vulnerable to law suits and prosecution and began to hire specialized counsel. "Perhaps an even better signal that governmental investigations are on the way -- kind of like the swallows returning to San Juan Capistrano -- is the formation of practice specialty groups at major law firms to "help" clients deal with the turmoil. A post on the Wall Street Journal Law Blog notes that firms like Paul Hastings, Patterson Belknap, and Pillsbury Winthrop have assembled teams of lawyers to provide assistance, including members of the white collar crime departments. If the firms smell an opportunity, don't be surprised to see this area develop over the next few months with a range of internal investigations that may well bring criminal behavior to the surface."

Journalists in other countries saw this problem before Americans. Diane Francis wrote in Canada's Financial Post: "The subprime mortgage and asset-backed paper scandals constitute one of the biggest frauds ever perpetrated. They have resulted in mass foreclosures, writedowns, bankruptcies, firings and billions lost. The US $ 10-trillion US home-lending sector was, and perhaps still is, rotten."

**There were Many Complicit Parties**

Of course there were crooked mortgage lenders, but it was Wall Street's securitization of these mortgages that exported the fraud worldwide in the form of sliced and diced bundles of mortgages sold in CDO's and Structured Finance vehicles. At the bottom was a corrupt system that handed out mortgage broker licenses like driver's licenses, and then handed out mortgages like candy at Halloween. In between were crooked appraisers and organized crime. The stories are now seeping out. (This must be ironic to readers in an emerging economy like India which is often denounced as corrupt by bigger economic powers who are finally being exposed for their own corrupt practices).

So far, there have been few indictments, and the fear is that the small fish will face the media firing squads not the big names like former Treasury Secretary Robert Rubin or his successor Hank Paulson, or regulators including former Fed Chairman Alan Greenspan who enabled and encouraged the housing bubble.

**Notes the New Statesman:**

"It is far too early to tell who might come to symbolize the meltdown of 2008, although there has been no shortage of ire directed at executives of AIG over lavish corporate retreats, along with former Lehman CEO Richard Fuld, whose company is under investigation by prosecutors in three locations."

The first Wall Street figures to be charged in the subprime mortgage fallout worked as hedge fund managers for Bear Stearns. They were arrested in June, accused of misleading investors about the subprime mortgage crisis." But why stop there? Prosecutors hear the outcry. They realize that investigations and prosecutions are essential as deterrent.

I asked Bill Bamber, a former Bear Stearns Managing
Director and author of a book called Bear Trap about his firm’s collapse. His response: There’s obviously an element of fraud, you’re hearing about a mortgage being sold more than one time into a securitization pool. Which is obviously fraud at the front end of the food chain so to speak. Also what you have is also a problem at the rating agencies, the question that has started to come out of the congressional hearings is, “what did they know did they know they had a real model problem or not? And when you have ineffective government, almost a pseudo-monopoly in terms of S&P and Moodys in terms of the rating business, in the US, there’s a tremendous amount of trust. And if that trust was misplaced then there’s going to be serious consequences.”

What needs indicting, as I argue in my book Plunder, is the system as well as its mechanics. We need to look closely at the cabal of firms that profited, the regulators who enabled them and the media that was bought out and sold out.

Let’s jail the guilty but also totally reform the system, because even now, the shady wheeler dealers are hard at work. Everyone is decrying greed; no one is stopping it.

How did it Start?
The Subprime Scandal
The financial crisis has its origins in a related scandal that mushroomed into a much bigger problem. It started with pervasive predatory lending practices which were “hidden in full sight.”

If there’s a word that is universally invoked in the world of finance, it’s “transparency.” The word comes to us from the 16th century with the connotation of “shining through,” The idea is simple. Transparency is about being able to see what is going on and to have key practices disclosed. Without that, it is believed, financial markets can’t function because of a lack of trust and clear rules that all the players adhere to. It is a market fundamental, a primary rule of principle.

Or So You Would Think
When it began, subprime lending was even not a term that most people outside the financial markets understood. (By 2007, the American Dialect Society would call it the most used term of the year.) The Wikipedia would describe it this way:

“Subprime lending, also called B-paper, near-prime, or second chance lending, is the practice of making loans to borrowers who do not qualify for the best market interest rates because of their deficient credit history. The phrase also refers to paper taken on property that cannot be sold on the primary market, including loans on certain types of investment properties and certain types of self-employed individuals. Subprime lending is risky for both lenders and borrowers due to the combination of high interest rates, poor credit history, and adverse financial situations usually associated with subprime applicants.”

In early February 2008, almost a decade after the birth of what would become the subprime industry, the Securities and Exchange Commission, the nominal regulators of financial markets, found the courage to admit that they didn’t really know what was going on in their multi-billion-dollar securities market.

They Announced an Investigation
One of their “enforcers” explained: “The big question is, who knew what when, and what did they disclose to the marketplace?” These were the words of Cheryl Scarboro, an associate director in the SEC’s enforcement division in charge of the subprime working group. This working group, composed of
one hundred lawyers, which seems to have only begun working after the scandal erupted, is investigating how banks, credit rating firms, and lenders valued and disclosed complex mortgage-backed securities.

Reuters reported they were looking into three areas: “the securitization process, the origination process and the retail area. Insider trading, which is one of the SEC’s highest priorities, is also a key area.”

Finally in December 2008, the SEC sent a letter to the CEOs of Wall Street firms reminding them of their obligations - a good sentiment but a bit late:

As SEC Chairman Cox noted recently, “Experience has taught us again and again that giving short shrift to regulatory compliance subjects a company’s investors, employees, management, directors, and every other stakeholder to unacceptable risks...”

Bear in mind that they are not operating in the interests of borrowers who were victimized by deceptive loans, but inquiring whether shareholders – i.e., investors – were kept in the dark through inadequate disclosures.

Their scope is narrow: “We do have to work very hard at bringing the right cases,” says SEC enforcement division chief Linda Chatman Thompson. “We work on the most ‘impactful’ cases. At the end of the day we have to be about deterrence.”

Deterrence? That was a concept born in the nuclear age to prevent/deter war. How it’s relevant after the collapse of the industry itself, was not addressed. What is there now to deter?

This SEC group was reportedly “talking with” but not coordinating with oversight bodies like the Federal Reserve, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, and Office of Thrift Supervision. Is it significant that the FBI, which also announced its own investigation into criminal conduct by mortgage firms, is not on this list!

If the regulators who should be in the know about these practices are not, it’s not surprising that most of the media and the public share this plight.

The whole area is murky. Even George Miller, the Executive Director of the industry’s own trade association and lobby group the American Securitization Forum, told CNBC as this investigation was announced, that one of the reforms his organization was advocating was “taking steps to enhance where necessary the transparency in the marketplace.” Note the qualifying phrase “where necessary.”

While reporting from the Forum’s meeting in Las Vegas, CNBC’s correspondent joked they had “gambled away our economy.” Ha, ha. The Forum has not always been a joke. When the Treasury Department announced, with great fanfare, a program to help distressed homeowners in December 2007, it was widely reported that this industry group had actually written it. The plan offered no help to families facing foreclosure.

They also played a very powerful role in holding off government scrutiny. They were the influential behind-the-scenes players rationalizing the industry and its exotic derivative financial instruments. Their website, which lists their impressive membership list of big banks and funds, describes its work this way: “The American Securitization Forum (ASF) is a broadly-based professional forum through which participants in the US securitization market can advocate their common interests on important legal, regulatory and market practice issues.”

According to the New York Times (NYT), the Forum’s Las Vegas meeting could be considered a “predator’s ball.” The newspaper did not remind readers that 16 years earlier this same phraseology was used widely about an earlier scandal on Wall Street. This account was published on August 15, 1991:

They call it the Creditors’ Ball: a hundred or so bankruptcy lawyers, bankers and investors, sipping cocktails and feasting on shrimp in the Hamptons in an unabashed celebration of the impoverished 1990’s.

This party of the well-paid, the well-connected, and the well-coiffed is quickly becoming the social event of the bankruptcy set, just as the Predators’ Ball was a highlight of Wall Street’s social calendar. That Beverly Hills extravaganza, sponsored by Drexel Burnham Lambert Inc., ended with the brokerage’s downfall in 1990.

So much for lessons being learned.

The Importance of Disclosure

At least now, the industry’s public face and the regulators have come around to agreeing with a growing army of critics that
inadequate disclosure was at the root of the problem, i.e., a lack of transparency.

And not only in the housing industry!

Well-known banks had also been admitting a little, while hiding a lot. When the finance ministers from the Group of the seven top industrialized countries met in Tokyo on February 9, 2008, they issued a call to banks to fully disclose their losses from the subprime meltdown. The German Minister Peer Steinbruck said that these write-offs could reach a whopping $400 billion, four times previous estimates.

It must be noted that just a month earlier, in late December, Wall Street firms paid out more record bonuses to the bankers who had made them a vast fortune.

**Why the Secrecy, Why the Lack of Disclosure?**

A top-level corporate reputation consultant, who asked to remain anonymous but who has worked on the issue, summed it up for me in one word: greed. "They were making so much money that they didn't have time for due diligence or transparency. It was just pouring in."

Yet, oddly enough, one of the industry’s big traders was still not remorseful. “We need to step back and take a breather,” John Devaney told the New York Times. “I don’t think there is anything fundamentally wrong.”

No one asked him about the findings of the Senate’s Joint Economic Committee:

- Approximately $71 billion in housing wealth will be directly destroyed through the process of foreclosures.

- More than $32 billion in housing wealth will be indirectly destroyed by the spillover effect of foreclosures, which reduce the value of neighboring properties.

- States and local governments will lose more than $917 million in property tax revenue as a result of the destruction of housing wealth caused by subprime foreclosures.

- No one thought about that at the beginning of the subprime boom either.

**How Did This Crisis Emerge Undetected?**

Fraud is just one of the unresolved issues of the US financial crisis. Another involves the role of the media and the regulators who seem, in retrospect, to have been asleep at the switch.

The question many are now asking is this: "How Did We Miss Signs of an Impending Economic Crisis?"

That question again? It was asked about 9/11 in connection with the US government ignoring warning after warning about likely terrorist attacks. The CIA raised it again about its own ostrich-like behavior in the run-up to the war on Iraq.

Now it’s being asked by the New York Times about the failure to anticipate and potentially pre-empt the subprime mortgage crisis, which has escalated into a deeper meltdown in global financial markets leading to layoffs and serious fall-off in economic growth.

Did this “just happen,” like a hurricane appearing one morning out of blue skies?

Of course not! The signs were there for all who wanted to see them, and warnings were plentiful even as they were ignored. It’s odd how on the front page of its widely read Sunday edition, the “newspaper of record” could splash a story on how the media and the markets looked the other way as massive deals were being financed by securities cobbled together from subprime loans backed with no assets. Why were the signs missed, asked the Times? Unlike the CIA, the Times did not assess its own reporting and its role in all of this. A few days later, the newspaper’s business columnist showed that, in fact, many did know and tried to raise the alarm.

This revelation seems to be an example of the front pages not knowing what the business pages had reported. The Times columnist reminded readers that Ben Bernanke, Chairman of the Federal Reserve Bank who had just pumped billions of dollars in the markets to keep them liquid and then followed up with a cut in the discount rate, was asked about these issues two years earlier:

- It came in November 2005, toward the end of his all-day Senate confirmation hearing, when Senator Paul Sarbanes brought up the mortgage business.

- Mr. Sarbanes, the ranking Democrat on the Banking Committee then, pointed out that the number of people taking out adjustable rate mortgages soared in 2004. “Are you concerned about the potential for a bubble in the housing market?” the senator asked Mr. Bernanke. “And specifically, does the drastic increase in the use of risky financing schemes, including interest-only and even negative amortization..."
mortgages, concern you?”

Mr. Bernanke replied that the Fed was reviewing its guidelines for these loans and planned to issue new ones soon. The guidelines, he added, “would have on the margin some beneficial effects in reducing speculative activity in some local markets.” At no point, though, did Mr. Bernanke suggest that he was concerned.

And what about the larger media? Where was their concern? Back in the spring of 2006, I published an article in Nieman Reports, the journalism review published at Harvard University and read by top editors. I specifically lambasted the lack of reporting on the issue. It was titled “Investigating the Nation’s Exploding Credit Squeeze.”

Its thesis: Questions of and by whom and for whom need more and better investigation, as well as a look at who are the losers and who are the winners.

The article in a magazine widely read by newspaper editors suggested some concrete approaches media outlets could take based on my own experience inside big media organizations:

- Report more regularly on these credit issues; billions of dollars are involved, not to mention millions of lives.
- Identify the key corporate institutions and contrast the compensation of their executives with the financial circumstances of their customers.
- Shine a spotlight on how special interests and lobbyists for financial institutions contribute to members of Congress and other politicians, across party lines, to ensure their desired policies and regulations.
- Investigate political influence affected by campaign contributions. Some reporting about this took place during the bankruptcy debate, but there has been little follow-up.
- Examine the influence credit card firms have on media companies through their extensive advertising.
- Take a hard look at the predatory practices in poor neighborhoods – and crimes committed against poor and working class people, who are least able to defend themselves. Legal service lawyers tell me that they are overwhelmed by the scale of mortgage scams involving homes whose value have been artificially inflated.
- Focus attention on what consumers can do to fight back. Robert Manning, author of Credit Card Nation, explains: “If ten percent of American credit cardholders withheld their
monthly payments, it would bring the financial services industry to a standstill. At a larger issue, what we have to do is to get people involved at the state level, get their state attorney generals involved, aggressively filing class action lawsuits and then putting pressure on key legislators to say, ‘This is unacceptable that they’re not representing and balancing the issues of commerce with consumers. The balance is tilted dramatically against the average American.’

The response was tepid. I followed up by organizing a Media For Democracy online e-mail campaign. (Media For Democracy is an advocacy effort tied to Mediachannel.org, the media issues website I edit.) Media For Democracy members sent tens of thousand of requests to media outlets urging that the issue be given more coverage. This was well before the market meltdown. The appeal read in part:

We are dismayed by the superficial reporting we have seen on the debt crisis in America. The press has been asleep at the switch in reporting on this story, often showing more compassion for wealthy businessmen than abused consumers.

We believe that our media outlets have a responsibility to offer more context, background and information about how this debt crisis occurred and what we can do about it.

What was the Media’s Response?
Not much. Most responses came in the form of yada-yada-yada form letters as in “Thank You For Writing to the Today Show.” Responding to public concerns and suggestions are not high on the media agenda.

The media has still not given us a reason for burying the story. It’s hard not to wonder if their disinterest has something to do with advertising. Mortgage lenders have spent more than $3 billion on TV advertising, radio, and print since 2000. Much of it is deceptive and misleading, say experts – the industry denies it – yet media outlets have not challenged their accuracy.

Is it any surprise that this industry has received so little scrutiny from another industry benefiting by its largesse? Eventually, on the Iraq War, some media outlets admitted they practiced poor journalism even as many of their mea-culpas did not basically change their narratives. Why not on this issue? The only media controversy I saw revolved around whether Jim Cramer of CNBC and TheStreet.com was right to demand that the Federal Reserve Bank cut interest rates. His TV commentary on the issue was a screaming rant, the type of approach he takes on his TV show Mad Money. The commentary later had more than a million views on YouTube.com.

When the Fed later did cut its discount rate, Cramer claimed credit but then, later in the same broadcast, had second thoughts, admitting that the Bank did not follow his advice. Cramer has yet to scream about justice for those tricked into signing up for subprime loans. (When the iTulip.com website, which critiques shallow financial journalism, mocked the Cramer commentary, Cramer’s TheStreet.com went berserk, demanding that You Tube take it down and threatened to sue. It appears that this TV bully and critic is really very thin-skinned when he is criticized.) To be fair to Cramer, he can be a very astute critic as he is in the pages of Lapham’s Quarterly where he denounces “the damn bankerman who broke us. No, there won’t be a police officer to investigate, and the government, at least this federal government won’t save us.... Get ready, many more dollars will soon vanish before you discover you’ve been robbed.”

Other media critics have been scathing about the dereliction of duty that is so obvious here. Dean Starkman of the Columbia Journalism Review was contemptuous: “What’s wrong? Why ask us? This kind of after-the-fact financial reporting I equate with a National Transportation Safety Board investigation – kicking through smoldering wreckage after the plane has already crashed. There’s nothing intrinsically wrong with this kind of reporting. It just feels a little late. Also, I always find it disingenuous to talk about napping watchdogs, as in the headline above, when the Journal and the rest of the business press themselves slept on the job and had to scramble to catch up to the corporate scandals earlier in the decade.”

The problem with media coverage of business and economics is not just spin or bias. Some of the reporting is quite good. What is often missing are the references to deeper structural problems that lead to economic pain and disparities.

Ongoing reporting gravitates toward offering the most upbeat interpretations of government reports, almost as if they have been spun. Consider this story carried by the Associated Press and run in the New York Times on February
"After years of denial and spin about the financial condition of U.S. households and consumers, you might think the newswires and salesmen on cable would be buzzing with the key findings in Wednesday's Bureau of Labor Statistics report on U.S. Hours worked, real compensation, output and productivity. You would be wrong."

Or this story with the headline, “Productivity Growth Slows and the Costs of Labor Rise,” ran in the New York Times the same day:

Worker productivity, a crucial factor in rising living standards, slowed sharply in the last quarter of 2007 while wage pressure increased.

The Labor Department reported Wednesday that productivity, the amount of output for each hour of work, increased at an annual pace of 1.8 percent from October through December, down from a 6 percent pace in the July-September period. The slowdown reflected an overall weakening in economic activity.

Labor costs rose by 2.1 percent, after having fallen by 1.9 percent in the third quarter and 1.1 percent in the second quarter.

Charles McMillion analyzed this story for the Campaign for America’s Future.

This is a very clear example of how the media spin the news every day to hide economic troubles and mislead those who believe they are following economic conditions. All the major media spun this story in almost exactly the same way as the AP, with the key findings either not mentioned at all or they are relegated to an afterthought as space permits.

The key finding in that report is that the total number of hours worked (and paid) in non-farm businesses during the fourth quarter of 2007 fell at an annual rate of 1.5 percent. Indeed, the total number of hours worked in the fourth quarter was less than in the fourth quarter of 2006. The report shows total non-farm jobs also falling at a 0.5 percent annualized rate in Q4 and rising by only 0.4 percent year over year.

Furthermore, after adjusting for the increased costs of gasoline, health care, etc., real average (not median) salary and benefit compensation for all U.S. workers fell at an annualized rate of 0.3 percent in the fourth quarter and by 0.3 percent year over year. Since total hours worked fell even with meager year over year job growth, this means that average real weekly and monthly hours paid per job were reduced along with the decline in real compensation per hour. With lavish soak-the-customers-and shareholders bonuses on Wall Street lifting average compensation, the median decline in compensation was surely far worse.

Unfortunately this kind of coverage is not an anomaly but part of a pattern.

When the focus is just on the ups and downs of markets, we tend to see a sanitized world of men in ties, computers, and experts. When we go out into the streets, we see something very different.

In an essay on economic trends called “A ‘Slow Motion Train Wreck’” that quoted my own views, writer/economist Stephen Lendman notes that “the problem is deep, structural and aided by stripped away regulatory protections giving predatory lenders and Wall Street schemers free reign to target unsuspecting victims.”

He ticks off some of the major trends in our economy that are rarely cited:

• Soaring consumer debt;
• Record high federal budget and current account deficits;
• An off-the-charts national debt, far higher than the fictitious reported number;
• A high and rising level of personal bankruptcies and mortgage loan delinquencies and defaults;
• An enormous government debt service obligation we’re taxed to pay for;
• The systematic loss of manufacturing and other high-paying jobs to low-wage countries;
• A secular declining economy, 84% service-based, and mostly composed of low-wage, low or no-benefit, non-unionized jobs;
• An unprecedented wealth gap disparity;
• Growing rates of poverty in the richest country in the world;
• A decline of essential social services.

Now parts of this story are being covered but often it is the wrong story. The reporting tends to focus far more on panicky markets than on victims of predatory lending and the people of the world who are coping with the consequences of irresponsibility in high places on Wall Street and in Washington. (This article represents the personal views of the author. It was written months before the disclosure of the Bernard Madoff’s $50 Billion dollar ponzi scheme that bilked investors worldwide.)
The current turmoil in the global financial market and its origin in US financial markets from where it spread has made it imperative that we need to question, once again, the validity and relevance of the neo-liberal theory and policies relating to the financial sector which in our judgement are responsible for such outcomes.

We try in the following pages, to interpret the current global crisis. This is done by identifying the two special aspects which in our judgement, explain its origin, the spread as well as intensity. We then look into the dominant precepts behind, an uncritical acceptance of which seem to have led to policies responsible for much of the current malaise in the financial sector. These relate to the mainstream or neo-liberal economic doctrines to achieve what in related literature is viewed as “efficient” financial markets. We then interpret the unfolding of various bankruptcies and bailouts in the US financial sector which have come out in public domain. Finally we pay attention to the actual and potential threats for the onset of a similar crisis as seem to prevail upon developing countries including India.
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Regional trade xxx more than

Former Professor,
Jawaharlal Nehru University (JNU) and Currently Visiting Professor, Institute for Studies in Industrial Development (ISID) and Jamia Millia Islamia, New Delhi

Sunanda Sen
What Triggers a Financial Crisis? Some Theoretical Concerns:

To get at the background of the US (and currently global) financial crisis one needs to address issues which include, first, the prevalence of high stakes in financial markets with uncertainty. In such situations the risks (as are involved in holding financial assets) often turn out to be disproportionately high when one compares those to what eventually comes out as their realized returns. Transactions as above have been identified in the literature as ‘ponzi’ deals, which, as pointed out by the post-Keynesian economist Hyman Minsky1 in 1986, are both unsustainable and hazardous as compared to acts of simple hedging (or even speculation) on asset prices.

With ponzi deals as above the high returns offered by borrowers to entice new investors to lend and invest, often fail to be realised in the market. To avoid an impending default and an interruption of business, it not only becomes necessary to continue with new investments but also that such investments be adequate to compensate the losses already incurred on previous investments. However, since confidence on financial assets acquired by lenders on the basis of these transactions gradually tends to be eroded, such dealings come to a grinding halt, leading to big holes in the balance sheets of the concerned parties.

Ponzi finance as above is very different from hedge finance which to some extent keeps the business going as long as hedging offsets the losses with possible gains. Even speculative finance, which dwells on more risk than under hedging, can be sustained until it becomes ponzi, with borrowings at high rates no longer generating compensating returns, a situation which has clearly plagued the US financial markets.

A second factor which similarly contributed to trigger the global financial crisis relates to financial innovations which go with de-regulation in financial markets. By generating derivative instruments which aim to protect asset values in uncertain markets, these innovations also make it possible to invest and acquire financial assets much more easily. For example, with ‘futures’, a typical derivative product which arranges for a contract in the security exchanges for sale and purchase of a financial asset in some future date, the deal can work to the convenience of both buyers and sellers by insuring against uncertainties in the market; while dispensing with cash transactions at the time of the contract. Thus the buyer contracting a ‘long’ (buying) position deposits only a fraction of the contracted price as ‘margin’, with the security exchange. Innovations and instruments as above have opened up vast potentials for an expansion in financial market transactions which today are no more constrained by availabilities of bank credit. However, transactions as above and the agents involved can remain in business as long as the hedging works to minimise the risk under uncertainty and the risk-adjusted returns offered to those with long (buy) positions are realised by those who hold the short (sell) positions on assets. These may not materialise in a typical ‘ponzi’ situation, for reasons mentioned above.

It now remains to be seen as to how aspects as above are handled in mainstream theory and policy with their strong advocacy for wide-ranging de-regulations in financial markets. By postulating rational expectations and access to full information on part of all agents in the market; uncertainty, in these theories, does not get in the way of achieving efficiency as long as markets are left free. Accordingly speculation (under uncertainty) is reduced to arbitrage (in point of space)
and hedging (in point of time). Under such circumstances the market is supposed to take care of uncertainty-related concerns by enabling the use of financial derivatives. From this angle security markets would perform at their best when no restraints remain on trading, in spot markets and in those for derivatives. In case banks as lenders are wary of potential defaults by borrowers due to incomplete and/or asymmetric information in the market, they may even resort to credit rationing, as held in the literature. But both borrowers as well as lenders are still viewed as rational beings who decide freely on their lending or borrowing activities in the market. It is not difficult to see that positions as above, emanating from advanced countries, have continued to dominate policies in financial markets and financial institutions.

Despite the continuing dominance of the mainstream doctrines on policy, the magnitude and the intensity of the latest problems in global financial markets seem to have jolted a bit the entrenched positions held by establishment, a fact borne out in terms of the efforts to bend the standard rules of monetarism and free market norms under capitalism. Otherwise how can one interpret the huge bail-out packages from the state in a country (or countries) which till recently had pledged to remain as ardent advocates of free-market capitalism?

Turbulence in Financial Markets- The Sub-prime Loan Market Crisis in US
Back in the 1970s, the US economy was subject an unprecedented wave of credit squeeze as Alan Greenspan, the Fed Chairman launched a series of monetarist restraints on credit in a bid to contain inflation. Reacting to these, financial innovations led way in devising alternate channels of credit creation beyond the usual banking orbits. By this, a large number of US firms were able to access short-term credit by using, as collaterals, securitised assets which in the market were treated like commercial papers. As the wave of securitisation (of assets) caught on, new forms of financial intermediation followed with investment banks re-packaging these securities which were marketed easily to other banks or non-bank financial units including other investment banks as well. It is important here to point out that since these transactions were outside the orbit of conventional banking channels, the Fed had no regulatory power over those. Instead these deals were subject to the jurisdictions of the Securities and Exchange Commission (SEC) of USA. One witnessed, as a consequence, a 50% decline in the proportion of US financial assets as were held by banks between 1950 and 1990. Credit and transactions related to securities were thus made easy along the non-banking channels, with rates charged on loans at much lower spreads as compared to those along conventional banking channels. Transactions as above facilitated the churning of multiple asset-backed securities (ABS), generated on the basis of the original (or the underlying) asset, while propping up multiple counterparties which held those assets. Leveraging played a major role in the creation of these debt financed assets, which continued as long as there was trust and confidence in the uncertain markets on these newly created financial assets.

Mortgages on property opened up new profit opportunities for the financial sector in the US economy around late 1980s. By creating a market for housing which targeted the section of US citizens so far financially excluded on grounds of race and/or income, it became an opportune moment for banks and other non-bank intermediaries to venture out for good business. Incidentally the potential house-owners who were targeted were so-far excluded from the financial markets by a 50% decline in the proportion of US financial assets as were held by banks between 1950 and 1990. Credit and transactions related to securities were thus made easy along the non-banking channels, with rates charged on loans at much lower spreads as compared to those along conventional banking channels. Transactions as above facilitated the churning of multiple asset-backed securities (ABS), generated on the basis of the original (or the underlying) asset, while propping up multiple counterparties which held those assets. Leveraging played a major role in the creation of these debt financed assets, which continued as long as there was trust and confidence in the uncertain markets on these newly created financial assets.

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banks which followed credit-rationing which ruled out such loans. Possibilities as above to securitize the mortgaged assets opened up new channels of investments, for the broker-mortgage firms, the issuers and insurers of asset based securities (ABS), investment banks who readily purchased and repackaged the ABS, and other financial institutions. Each, by acquiring an asset, were able to leverage by obtaining credit against the latter.

As the process continued, a large number of people with low incomes were now endowed with a mortgaged property and a liability to pay monthly instalments, usually to the broker-mortgager cum bank which organised the deal. These assets were backed by loans which later were discovered as ‘sub-prime’, with the mortgaged collaterals subject to valuation in a sliding market, loans at interest rates higher than the ruling rate in the market, and with little accountability of the borrowers, many of whom were not bankable in terms of the conventional practices followed earlier. The euphoria, fed initially by the rising property prices on one hand and the eagerness on part of the financial community to profit by using the securitisation route on the other (which temporarily shifted the risk to counterparties), did work as long as it lasted. All this business, led by investment banks, as we have mentioned above, was outside the purview of the Fed, while the SEC did not find any reason to interfere.

To follow the sequence as led to the recent sub-prime crisis of the US we provide below a rough sketch of the possible links in the system:

The above scheme of sub-prime loans which prompted the upswing in the asset market eventually failed to work. As mentioned earlier, the high property prices of mid-1990s made possible for banks to advance loans against mortgaged houses at high interest rates to low income borrowers who had very little credentials in the financial market. Repackaging of these to back securities (which exchanged hands to generate further assets and credit opportunities) finally proved to as an Achille’s heel by impairing the credentials of the entire financial system in USA. Use of futures and other derivatives (swaps, options etc) expanded the scale of operations by making it possible to bid on positions in the security market with small margins of the final transaction in cash until full payment was due when the contract matured.

To recapitulate the sequence as above, it may be worth to follow the following four stages of the upswing in the financial market and the subsequent three stages of the reversal:

**The Build up of the Boom**
1. Loans advanced by banks, via broker-dealers of mortgages, to borrowers in housing markets at sub-prime rates. Borrowers committed to regular instalments to parties as above.
2. Mortgaged assets get repackaged by issuers of securities as Collateralised Debt Obligations (CDOs) which are the Asset Based Securities (ABSs or Mortgage Backed Securities) sold to investment banks which sell these to other financial institutions.
3. Market prices of these financial assets determine the returns to the investor.

**The Approach to the Crash**
1. Drop in property prices, house-owners fail to service debt, announce foreclosure of the mortgage deal.
2. Issuers of ABS and investment banks face losses due to...
non-payment by borrowers, facing losses which are aggravated by sharp declines in ABS prices in the market.

3. Losses for other FIs who hold such assets as above.

The sequence is also captured by the following formulation:

\[ q = f(A, r) \]

where \( f_A \) and \( f_r \) are positive as long as \( \partial q/\partial A \) and \( \partial q/\partial r \) are both positive.

Thus \( dq = f_A A + f_r r < 0 \) when \( \partial A \) and \( \partial r \) are both negative, which, as mentioned above, is likely in the downturn.

Symbols used include:

- \( q \): average return on ABS
- \( A \): average market value of ABS
- \( r \): the initial rate of average down-payments on mortgaged houses

To follow the sequence in reality, a major financial crisis in the US first hit the hedge fund Long term Capital Management (LTCM) in September 1998 when it was rescued by the Fed which injected $3.6bn to help out its excessive leverage ratio. A sense of doubts and failing trusts continued and intensified over the next decade until it reached a climax by the third quarter of 2008 when two major investment banks (Fannie Mae and Fredie Mac) were taken over by the Treasury and another major investment bank AIG was recapitalised by the Treasury with an injection of $85bn against 80% equity stake with AIG, all happening in the first two weeks of September 2008. The AIG deal was to protect the biggest insurance agency and investment bank in the country which by this time owned a trillion dollar assets spread over 130 countries and a $441bn exposure to credit default swaps.

Loans by the Treasury to AIG was supposed to carry a rate of interest of 11.5%, to be paid back by selling its assets within two years. In between another big investment bank Lehman Brothers went bankrupt on September 12th. By 11th September, funds injected by the Fed in the financial market, was around $900bn a sum which has kept on rising by each day as the market fell further. The latest move by the Treasury to pump in a huge sum of $700bn and its ratification by the US legislators and even the rate cuts by most central banks in OECD is yet to bring a reversal of the downswing in asset valuations and a general recessionary trend in the global economy. Steep rise in call money rates for inter-bank lending and sharp fall in yield on US Treasury bonds, considered so long as safe investments, are aspects which speak for themselves. In all, the story reflects a scene of systemic crisis with greed and miscalculation as is typical when it ends with a ponzi strategy.

The crisis has already spread to the real sector, not just by cracking the housing bubble but with problems faced by auto and other major industries. This was far from a surprise, given the large exposure which the real sector in recent times had to the booming financial sector, both by holding the financial assets which till recently were attractive in terms of high returns and also by sharing the prosperity with a booming financial sector. Financial crisis in the US economy has also cast a shadow to other advanced countries across the atlantic, concerns on which are evident in the agenda laid out for the recent meetings of the EU in Europe and England. Currently the fear of job cuts and production losses dominate the official
policies and concerns expressed from different quarters, not only in advanced countries but also in developing countries which today are closely linked with the rest of world.

How does it Affect the Indian Economy?
As with other developing countries which today are closely integrated with overseas markets, India at the moment faces a considerable risk of a severe downturn as a consequence of the global financial crisis. Despite the large size of the country, both in terms of the geographical spread and population which provides the potential for a large home market, India’s reliance on overseas markets have recently risen considerably. The reasons include at least four factors which include, first the free play of FII investors since 1993 when India’s stock markets were thrown open to such short term investments. Speculatory flows as above have been responsible for phenomenal expansions in the country’s stock markets, with capitalisation as well as P/E ratios moving up to unprecedented levels. Second, there has been an extensive use of derivatives, on a legal basis in security exchanges and as OTCs. This has led to rapid increases in their use, especially after 1992 when much of these were legalised. Derivative trading in the future market has been at least six times the turnovers in spot trading at the National Stock Exchange till the meltdown started in these markets. Third, foreign presence in the capital market has been prominent, especially with FII inflows in the secondary markets for stocks, which not only contributed to the rising turnovers but also to vulnerability in terms of sudden flight of capital. The rising level of official reserves, to the extent propped up by these inflows, are already facing a depletion. These have also affected the exchange rate of the rupee, currently heading a downward spin, despite efforts on part of the monetary authorities to manage the rate. Fifth, with both banks and corporates having a considerable exposure in the global equity market it remains one of the imponderables as to how much the balance sheet of these financial and industrial units would be damaged by the global financial melt-down. As rently estimated by the author, for corporate units as a whole 40% of their portfolio consists of short term assets. Finally, with the onset of recessionary forces in the real sector of the advanced nations, export markets will be generally hard hit for countries like India. Of late, advanced areas have been absorbing 40% of India’s merchandise exports. A drop in the latter, along with a decline in other exports (with another 30% used to be absorbed by developing countries) would cause serious crises, both in foreign exchange earnings and in jobs related to the labour-intensive export industries. In addition, jobs and services as are related to the outsourcing by foreign companies and the Business Processing Organisations (BPOs) would get serious jolt.

One ought to feel positive about the economy with the confidence and positive thinking on the part of policy makers in India, currently devising ways to avoid the contagion effects on the domestic economy. It may not be as simple and easy, however, for the country to come out unscathed in the current global scenario which has been described as financial tsunami! It is even less likely that world’s financial markets and its economies will be immune to such shocks in future if the prevailing norms of de-regulated finance remain unchanged. After all even a top billionaire like Warren Buffet was convinced to make a statement in 2002 that “...Derivatives are like financial weapons of mass destruction, carrying dangers which now latent, are potentially lethal”!

Endnotes and Additional Thinking
1 Hyman. P. Minsky, Stabilizing an Unstable Economy New Haven, Yale University Press 1986
2 See for an elaboration and a critique, Sunanda Sen, Global Finance at Risk: On Real Stagnation and Instability Palgrave Macmillan 2003 and OUP 2004
6 ibid
7 This aspect has been discussed in my article “ Labour in De-regulated Financial Markets” in Philip Arestis and Luiz DePaula (ed) Global finance and Emerging Markets Elgar 2008
8 www.berhshirehathway.com

(The views expressed in the write-up are personal and do not reflect the official policy or position of the organisation.)
“Causes of the World Financial Crisis and A New Paradigm in Global Economic Relationship”

Dang T. Tran

Chair and Professor of Economics, California State University, Los Angeles, U.S.A.

Mortgage-backed Securities and Derivatives

Since the late 1990s investment banks in Wall Street in the US invented new financial instruments called collateralized debt obligation (CDOs) and credit default swaps (CDS). A CDS is an insurance contract in which a bank (or another financial institution) assumes the risk of the loan originated from another bank to a company. The lending bank pays a small insurance premium to the insuring bank. When the borrowing company defaults on the loan, the lending bank will receive compensation for the loss.

A CDO is an investment-grade security backed by a pool of bonds, loans and other assets. Mortgage-backed derivatives are more complex than ordinary CDOs because the former are not only debts based on other debts but they grow exponentially by repackaging and reselling. For example, banks commonly package groups of home mortgages together and sell this combined debt as residential mortgage-backed securities (RMBS). The values of the derivatives are estimated by complex formulas worked out by physicists in investment banks such as J.P. Morgan. Banks in Japan and China are major purchasers. Unfortunately, each time debt is repacked and resold it grows, in some cases exponentially creating an enormous, global pyramid of debt thousands of times greater than the value of the underlying assets. But the values of the derivatives do not appear in the balance sheet; they are off-balance sheet items. Because of different but moving maturity dates in the same bundles of home mortgages when the ownerships of individual components change hands, it is
difficult to ascertain their values. It is alleged that Chairman of the US Federal Reserve System, Ben Bernanke and Warren Buffett did not understand them. It is no wonder that nobody knows the exact values of these derivatives. Estimates range from $35 trillion to $1000 trillion worldwide. Probably the figure lies somewhere between the two numbers. One figure offered by Economic Intelligence Report is around $345 trillion.

Hedge funds, brokerages, and banks borrowed money to buy these risky derivatives with the hope of magnifying returns. Herd like behavior is common among hedge fund investors, which amplifies the momentum of price changes. The fever of bidding the prices of derivatives sent home prices up, one feeding the other. This was fueled by easy money and low interest rates. Case-Shiller Home Price Index shows a continuous year-to-year increase in national average home prices from 1993 to 2005 with the highest 16% jump in 2005 from the previous year.

But home prices could not go up beyond the supporting income. In 1997, a median house price was roughly five times a homebuyer’s income. By 2007, the former was about ten times that of the latter. For instance, the historic mean expenditure on housing in the Los Angeles County (LAC) have been 36% of income compared with the recommended ratio of 28% for a comfortable living. Yet, a typical LAC family must spend 49% of their income to afford a median-priced home. In order to return to its historic mean, home prices must fall by 60% from the 2006 high. Thus, at some point in 2006, the ever-rising home price became unsustainable and started to fall.

First, the fall occurred with the sub-prime home loan market where many home buyers bought homes without being qualified. The home price decline is the key factor that’s driving home owners into foreclosure and mortgage lenders into bankruptcy. Since 2006 there were 17 rate hikes which strangled millions of American homeowners. Up to two trillion US dollars in adjustable rate mortgages (ARMs) had to be set higher by 40%, leading to skyrocketing defaults and foreclosures.

Then it spread to the prime home loan market. Foreclosures are at or near record levels in October 2008, constituting half of all home sales in Southern California. At the same time, the September 2008 median home price in the same area dropped by 41 percent from the peak $505,000 median reached in spring and summer of 2007 (Data Quick).

The U.S. real estate boom was made possible by multiplication of mortgage-backed derivatives. Their values are determined by fluctuations in the underlying values of the mortgages which depend on housing prices and on whether the homeowners keep paying the mortgages. When housing prices fall, homeowners may incur negative equity and would rather abandon the houses and let them go to foreclosures. There are now 12 million homes whose values drop below the homeowners’ loans.

The values of derivatives nosedived with falling housing price and mounting foreclosures. The institutions which bought the derivatives with high margins (borrowed money called leverage) such as mutual funds had to unload their
assets to meet margin calls. Leverage is the debt-to-equity ratio. Before 1990, this used to be between five and ten times. But after 1990, it started ballooning to up to 50 times, for instance Merrill Lynch was more than 40 times, Goldman Sachs was 28 times, and Lehman Brothers was 30 times when it failed. The process of deleveraging is a natural way of solving the excessive leveraging.

The need to raise cash to meet margin calls and shareholders’ redemption led to near collapse of the stock markets with the Dow Jones Industrial Average Index fell by 40% in three months. Major mortgage lenders such as Freddie Mac, Fannie Mae, Washington Mutual, and Wachovia became insolvent, so did the well-known derivative dealers on Wall Street such as Bear Stearns, Merryl Lynch, and Lehman Brothers.

**New Banking Structure and Hedge Funds**

The new banking structure enabled the merging between commercial and investment banks through the repealing of Glass-Steagall Act in 1999. This act was passed in 1935 after the Great Depression in response to the failure of thousands of commercial banks due to their using customers’ deposits to invest in risky assets such as real estate and corporate stocks. The Glass-Steagall Act separated investment banks from commercial banks. Essentially, the former could not accept deposits and the latter could not invest in corporate stocks and bonds. Since 1999, commercial banks have been able to acquire risky assets such as home loans and securitize them into derivatives which can be broken down or chopped off into smaller pieces to be sold in the market. In addition, credit default swaps (CDSs) mentioned above mushroomed exponentially into trillions of dollars beyond any bailout effort to rescue insurance companies.

The financial sector in the US has expanded dramatically in recent years. Over the past 60 years, the value added of the US financial sector has grown from 2.3% to 7.7% of GDP.
assets used to be five percent of the total assets in the economy. Now their share is 25%. The stock market valuation of US financial companies as percent of that of non-financials jumped from seven percent in 1979 to 29% in 2004, a four fold increase. The ratio of aggregate profits of financial corporations to those of non-financials rose from 20% in the 1970s and 1980s to 50% after 2000.¹

There are 9,000 hedge funds worldwide with their assets growing from $221 billion in 1999 to $1,223 billion in 2006. They are responsible for 25-50% of the turnover on many financial markets.² Before this global financial crisis, there have been many spectacular failure of hedge funds such as Long-Term Capital Management (LTCM) in 1998 and Amaranth in 2006. W. White, Head of the Monetary and Economics Department of the Bank for International Settlements (BIS) noted in 2004 that “Increase risk taking on the part of private sector participants in financial markets has been facilitated by financial market deregulation and technical change.”³

Financial Times of London reported that European Central Bank warned of hedge funds threat to stability.⁴ It was reported that German Chancellor Angela Merkel had proposed that hedge fund regulation be put on the agenda for next G8 meeting. It seems clear that the new financial structure with its attending innovations needs new kind of supervision by the government. However, the pricing of derivatives is so complex that the government personnel were not able to understand them much, less to supervise. In addition, the private rating agencies such as Moody and Standard and Poor failed in their responsibility to properly issue their rating of the degree of risk that these financial institutions have undertaken.

Information Problem and Market Self-regulation
At this juncture, it is useful to make some digression as to why laws, regulations, and ratings are important in preventing the breakdown of the credit market. If there were laws and regulations as to how the derivatives should appear in the balance sheets which should be published every quarter, then the shareholders as well as the public will know about the problem. The market and the supervising agencies can then react accordingly. Similarly, the rating agencies can provide appropriate signals in their ratings as to how much risk the commercial, investment banks, mutual funds, and hedge funds have assumed in issuing the derivatives and CDSs. When these institutions fail in their function, it constitutes an information problem in providing the knowledge of attributes about the offending agents in the markets. Knowledge of attributes is essential for maintaining market efficiency and preventing the collapse of the market, in this case the credit market.

Mr. Alan Greenspan, former Chairman of the Fed, testified that he was shocked at the magnitude of the crisis because he had believed that the banks were able to self-regulate. Self-regulation normally does not occur at the individual firm levels because of human weakness. Self-interest which forms the basis of market activity could go into excess by what we call greed. This can be seen by the fact that banks lent to homebuyers beyond their ability to pay and issued derivatives and CDSs to some amounts beyond anyone’s imagination. These excess-
es can be regulated by the market with the condition that there is no information problem mentioned above. If the information about the home-lending practices by banks and the way the derivatives were created and priced were known, the credit bubble would not have been so big because the market would punish those offending agents early in their game and prevent them from carrying out their excesses. The punishment will be in the form of falling stock prices of the institutions concerned, forcing them to correct their behavior. This is self-regulation at the market level. Only when there is no information about what the financial institutions are doing that lead to the failure of the market to regulate their participants.

It is not that nobody knew about the impending bubble. Edward M. Gramlich, a Federal Reserve governor, unsuccessfully pushed Alan Greenspan to crack down on irrational lending before the mortgage boom. But his warning was ignored by those who believed in the industry’s self-regulation. In addition, it had been well known among several reputed financial advisors in the US that the sub-prime loans were building up with the help of anomalous lending practices by the banks. Besides informing their newsletter subscribers, they did warn the financial authorities in their press conferences and formal letters, but nobody listened.

When the credit bubble finally bursted and some information about the magnitude of loans and derivatives was released, the stock market reacted violently against the offenders causing their stock prices to fall by 80-90%, leading them into bankruptcy (Citigroup, Bear Sterns, Lehman Bros., Merrill Lynch), or being taken over by the government (Indy Mac), or bought out by other institutions (Washington Mutual, Wachovia). Some of them had to be rescued by the government (Citigroup, Goldman Sachs).

**Economic Consequences of the Financial Meltdown**

After the turbulent episode of reckless risk-taking and leveraging with the disastrous consequences, banks turned to opposite direction of risk-aversion and deleveraging to protect themselves. This created a worldwide credit squeeze. It was extremely difficult to borrow money to buy homes or do business. This condition has serious effects on emerging/developing (periphery) countries because it was the center (deepest capital markets) that provides the liquidity to finance their trades. With their stock markets on a downward spiral following the similar path that the US stock markets, they have no where to turn to raise their funds. The reason why the US dollar gaining in value against most other currencies for the last three months is money has been flowing back to the US, resulting in lack of liquidity in the rest of the world. In addition, their major export markets are drying up as the more developed nations enter into recessions, cutting back on consumption.

As the US economy went into recession coupled with lowest
confidence level by consumers, consumption is going to decrease sharply, which will drastically lower imports. There are widespread corporate bankruptcies and lay-off of workers. Since the beginning of this year, two million jobs have been lost. Unemployment in the US is expected to rise to eight percent from 6.5%. An economic contagion across countries and markets are undergoing. Bank of England estimated that worldwide loss due to the credit crisis amounted to $2.8 trillion. A global recession is in progress. This spells trouble for emerging countries which rely on the US markets for their exports. Stock markets all over the world fell in tandem with those in the US. The emerging nations are in worse shape than the US because they rely too much on the foreign markets for their growth. Among the suffering countries are China and India. The Chinese government bailout plan of $586 billion did not seem to stop the downside. One reason why the Chinese bailout package will not work is the Chinese consumers save too much of their income. Their saving rate is estimated between 40 to 50%, which means that if this habit continues their domestic market will not be able to support the economic growth of 11%, only about seven percent or even five percent per year. Nearly 1,000,000 Chinese factories are expected to be shut down this year (2008). As one financial blog put it, “Factory bosses are jumping over walls and fleeing China and their debts. More than one million people have lost their jobs over the last few months in one province of the country alone.” China’s real estate bubble is about to burst early next year. In Beijing alone, housing sales have plunged by 70 percent. Together with plunging equity prices, this will create a large negative wealth effect on an already insufficient domestic consumption.

Will the Bailout Work?
The next question is: will the rescue package of $700 billion by the US Treasury Department and the massive liquidity injections by the US Federal Reserve work? The original intention of the Treasury bailout were to infuse capital into the failing institutions, to lift up the price of derivatives by helping homeowners to pay mortgages to prevent them from foreclosures, and to facilitate the take over of weaker institutions by the stronger ones. The week before the Federal Reserve pumped an unprecedented $1 trillion into the economy, followed by the pledge of the chiefs of the central banks of the UK, Germany and other leading nations, to help to any banks in trouble. In our estimation, the problem is too big for the government to rescue. As of the first quarter of 2008, there were 1,479 banks and 158 thrifts at risk of failure with $3.2 trillion in assets, 41 times the figures estimated by the FDIC; $14.8 trillion in residential and commercial mortgages, $20.4 trillion in consumer and corporate debt, plus $2.7 trillion in municipal debts outstanding; $180.3 trillion in derivatives, of which JPMorgan Chase alone held $90 trillion, almost half of the total US market share; and $465 billion in credit exposure to derivatives, up 159% from one year earlier.6

What the US and European governments are doing in their rescue effort is to save indiscriminately all banks and financial institutions. What we learn from the explosion of the Challenger Spacecraft is to not mix poor quality products with the good ones. This is the O-Ring theory based on the fact that a poor 50 cents O-ring was responsible for the disaster. Based on the theory, the positive assortative matching production function is derived with the result that if, in one group, workers with high skills work together, and, in another group, workers with low skills work together, total output will be higher than if high-skill workers work with low-skill workers in only one group. Because of its externality, this O-ring effect can work
across firms as well. A firm producing an input for another firm but if its product is of poor quality it will lower the quality of the product of the second firm. We have seen General Motors and Ford many years ago combining low quality components with good ones in their cars thereby causing frequent breakdowns.

In the application of the O-ring theory into the financial system, it becomes clear that saving a poor institution will have negative effect on the efficiency of the whole system. It is quite reasonable for the government to rescue the system from collapsing but, at the same time, it has to do so in the most efficient way possible. Saving an institution with amount of derivatives that could sink other institutions is simply inefficient and unreasonable. The government should not try to do the impossible because by doing that it would eventually lose its credibility. Once credibility is gone, the government’s actions will be ineffective and they would not be able to control events.

**A New Paradigm in Global Relationship**

The American as well as worldwide booms in the past 17 years had been driven by American consumers who spent more than they earned. It was helped by easy money (in particular by Alan Greenspan nicknamed “Easy Al”). The consumers used the cheap money to buy homes and durable goods without stopping. The creators of mortgage-backed securities thought that this trend of living beyond the means would go on forever. They were partly right because the US was the only country that can go on satisfying its consumers’ appetite and incurring perennial trade deficits and budget deficits because it possessed a prime reserve, funding currency needed by everybody. It was a convenient way to provide liquidity to finance world trade. Much of the budget deficits were covered by foreign bond-buyers and of trade deficits by foreign investment in the US. The US incurred debt to foster economic development in the rest of the world. During this process, the US has become the largest debtor nation on earth. Yet, it is in the world’s interest to keep the locomotive of the world economy running by supporting the American consumption binge because nobody else is able to do so. But no country can go on consuming beyond its production forever. By nature, there must be a limit to anything created.

The banks attempted to test the limit by encouraging unqualified home buyers to buy homes they could not afford. And they failed, pulling down other institutions like a house of cards, creating a worldwide recession. But to save is not a bad idea for Americans. Just as the slogan used by marketers to entice consumers to buy, “you have to spend in order to save,” now we might as well say the reverse “you have to save in order to spend.” To save means to invest, another way of spending. So, in order to ensure global economic stability, Americans must be shocked back to reason and to save. But the other side of the equation requires that emerging economies must also increase their consumption. This is because their saving rates range between 30 to 50% of their incomes. The emerging economies must break the habit of high saving that was required in the first phase of economic growth. Now when one cannot expect the others to keep bearing the “burden” of consumption alone to propel one’s growth which is harmful to all, one has to start to enjoy it oneself since it would be beneficial to all. The emerging economies must be shocked into boosting domestic consumption and investment. Thus, this would be a new paradigm for the world economy: Americans are now becoming savers again just as people in emerging economies are becoming consumers in their domestic economies. In this new setup, balance and sanity will be restored to the world and any rescue plan to prevent the new relationship between the USA and the rest of the world from returning to equilibrium and rationality will eventually fail. 

**Endnotes and Additional Thinking**

1 Andrew Glyn, Capitalism Unleashed, Oxford University Press, 2006, p. 52.
2 ibid, p. 185.
4 June 2nd, 2006.
5 Patricia Sullivan, Washington Post, Thursday, September 6th, 2007; Page B07.
6 Figures come from Martin D. Weiss, Why Financial Collapses Are Unavoidable And Government Actions May Be Backfiring, Open Letter to Dominique Strauss-Kahn, Managing Director of The International Monetary Fund, October 13th, 2008.

(The views expressed in the write-up are personal and do not reflect the official policy or position of the organisation.)
ANALYZING THE MELTDOWN: WHAT WENT WRONG?
have you ever heard the story of some body trying to elongate the economic cycle longer than its natural course by using some forceful measures? And, in the process, causing the cracks in the walls of world’s financial architecture? The most sensational part is that the measures which were taken to avoid hard landing, ironically, resulted into crash landing!

When the fuel in the economy is running out, the ‘pilot’ fearing a hard landing has “experimented” a prolonged journey on borrowed fuel (instead of searching for tried and tested soft landing methods). In one of the most defining moments in the financial history of the world, the pilot has ‘strategized’ that only way to avoid risk is ‘to take bigger risk’! However, eventually by the time the fuel completely dried up even to borrow, the flight completely out of fuel had a severe crash landing which resulted into irreparable cracks in the walls of flight and casualties all over the place.

And, another interesting aspect of this story is, the pilot who made such a costly “experiment” is neither novice nor inexperienced. In fact, he is the most experienced pilots of the world. Yes, this was true. These were the scenes from the drama titled ‘Wall Street’, the name of the flight is rich ‘US economy’ and name of the pilot is the then Fed Reserve Chairman ‘Alan Greenspan’. (Of course, Alan Greenspan is quick enough to blame the President Bush’s government as the reason for such an “experiment” in his recent autobiography ‘The Age of Turbulence’ by mentioning Bush has replaced the Policy with Politics. However, this blame game is a different story altogether).

A Bit of History
In 2000, at the fag end of the tenure of Bill Clinton as US President, the United States was at its best in terms of Budget surplus with an enviable figure of US $ 1.4 Trillion, besides all impressive economic indicators, keeping to its reputation of ‘The Economic Super Power’. The next president Bush has adopted US in its best shape possible.

Take an interesting note here: during the election battle between Bush and Al Gore in 2000 for presidential race, the key topic of debate between them was “How are they going to spend Budget Surplus?” This underlines how good the situation was! (To put the things in perspective, just differentiate this with the recent debate between Obama and McCain in their recent election battle wherein the key topic of discussion is “How are they going to handle Budget Deficit?”). One of the election promises made by Bush was he will make tax cuts using the Budget Surplus. And, Bush won the election as US President.

Up and till then, the situation was pretty normal. However, then two key developments took place in US: One is, bursting of Dot-com bubble in the fag end of 2000. Second is, collapse of World Trade Towers of US in September 2001. These two developments have resulted in many IT start-ups (who until
then enjoying Millions of dollars of valuations) go belly up overnight, severe loss of jobs and a brief recessionary period in US. Amidst of all these, in the urgency of showing the mighty power of US military, Bush has launched War on Afghanistan.

Heavy tax cuts, job losses and Afghanistan war have really put enormous pressure on the already deteriorating US economy with recession. They started using red ink to indicate budget from the erstwhile black ink, i.e. the Budget Surplus has turned into Budget Deficit. Alan Greenspan has feared a hard landing of US economy at this stage.

As per general commonsense (of course, which is not quite common), the cycles bound to happen in any economy and the role of regulator / central banker is to moderate its pace. The regulator can neither create nor stop a cycle. However, Alan Greenspan has tried to “experiment” to avoid this economic cycle by a significant monetary relaxation with an orientation of special focus on fund flow into real estate. The economic growth with real estate oriented model is a tested model of growth. However, in my opinion, Alan Greenspan has misjudged the suitability of this method to US due to two specific inherent characteristics of US economic system: One is, overspending of Citizens and second is, Over-leveraging of corporate.

Overspending of US citizens: The term ‘saving’ is alien for US citizens. They simply can’t understand what does that mean. The household savings rate of US is -0.5% (Just see that in the comparison of China’s +32% and India’s +29%). The behaviour of US citizens can be compared to the lavish son of a rich father. You can’t expect him to be rational in his spending habits. That’s what exactly happened with the present generation of US. Thanks to the wealth accumulated by the past generations of US, the present generation of US got carried away under the myth of being citizens of “Super rich America”. For an irrational spender, the biggest weapon is ‘Credit Card’. And backed with liberal financing facilities provided by the US banks and financial institutions, they never found the necessity of controlling their ‘temptation’ of heavy spending.

Overleveraging of US corporate: Another area where US had missed the plot was insufficient regulatory control mechanism regarding the leveraging aspects of their giant banking and financial institutions, under the myth that “they are too big to fail”. Expecting greedy capitalistic organisations to be self-regulatory mechanisms is suicidal. However, that’s what exactly miscalculated by Alan Greenspan and the SEC Chairman Christopher Cox.

How ‘Real Estate Driven Growth Model’ has Backfired?

Essentially, these two inherent characteristics of US have proven that the ‘real estate driven growth model’, as adopted by Alan Greenspan at such a critical juncture of US financial history, a flawed model. The model proposed by Alan Greenspan essentially liberalizes the lending standards to real estate borrowers. His idea was this model will enable relatively free movement of cash in the economic system from the banking institutions to real estate borrowers and hence, activating the economic system to avoid the recession.

However, the original idea as conceived by Alan Greenspan in this model has been ‘misused’ by the greedy banks and financial institutions in the urgency of earning extra yield on the loans given to borrowers with relatively sub-standard credit ratings, without giving due significance to their discipline of lending standards. Broadly, three kinds of borrowers emerged in this real estate loan mania in US.

- One is, “Prime borrowers” with best credit ratings possible,
- Second is, “Alternative A (Alt-A) borrowers” where documents / proof of credit worthiness missing (the creditworthiness of this class is somewhere between Prime and Sub-Prime)
- Third is, “Sub-Prime borrowers” with weak credit ratings

Understandably, the interest that can be charged from
Sub-prime borrowers is higher than that from Alt-A borrowers. Similarly, the interest that can be charged from Prime borrowers is the lowest amongst three as they enjoy best of the credit ratings. Thanks to the Alan Greenspan’s liberalized real estate growth model, so called ‘self-regulated’ banking institutions have taken full advantage of the situation to increase their lending to Sub-prime clients to earn extra yield on their lending.

The result was aggressive lending by banks to home loan borrowers, defying time-tested, conservative and prudent norms of ensuring that the loan amount did not exceed the value of the asset being purchased. The US borrowers especially with weak credit ratings who were denied loans earlier have been granted with real estate loans now.

Besides that, there was born the concept of “home equity”, when if you asked for a $1 million loan to buy a house, US banks lent $1.2 million in the belief that real estate prices will only go up and never come down. (In contrast, in India or in all other countries in the world, banks lend only about 80-85 percent of the value of the asset, and the borrower has to pay the balance). Greenspan’s thinking was that lenders would use the extra funds to spend on other items of consumption and recession would be beaten.

Not only that, in their bid to capture higher market share, banks lent even to people with doubtful creditworthiness. As all sections of people are granted loan facility, this has increased the demand for real estate multi-fold in US. The real estate prices started soaring. (If some of you can recall, this was the time when you would have heard that one of your friends who went to US has purchased a house in California or Florida within one year of going to US!). These soaring real estate prices have attracted more and more investors (typical ‘herd mentality’) to purchase real estate, increasing the demand for more and more loans from the banking institutions. The capitalistic banking institutions kept on lending with out any question. The vicious cycle has formed in no time.

More loans leading to more real estate prices, which is attracting more demand from investors, who are demanding more loans. All this mania has resulted in US real estate prices to go up by three times in four year period during 2001 to 2005. The US regulator, be it Fed or SEC, should have acted at this stage moderating the whole cycle. But didn’t (probably they don’t want to be called as ‘party spoilers’).

If you think this vicious cycle was the real cause of concern, then hold your breath, this vicious cycle has developed two more deadly evils.

One is, the lavish US citizens started to take mortgage on their ‘appreciated’ real estate assets to satisfy their heavy spending habits. The mortgage demands in US economy have soared. This has made US economy an ‘Asset Based Consumption’ driven economy instead of ‘Income Based Consumption’ (unlike in India). The heavy spending habits, especially to buy low cost Chinese goods, have resulted in moving US wealth to China in bundles and bundles every day, weakening US economy day by day.

Besides this, as the real estate party kept on continuing, the banking institutions kept on lending to their countrymen for their ever increasing demand for real estate loans and mortgage loans without any second thought, they found themselves short of fund availability. This has pushed the adrenaline-driven CEOs of giant US banking institutions to stretch their balance sheets to take advantage of real estate boom by making some fundamental basis errors (in bull markets, rationality gets replaced with adrenaline) such as stretching Debt-Equity ratios of these institutions to impractical unheard of levels, creating huge Asset Liability mismatch and covering up such weaknesses with ‘Financial Innovation and Engineering’. Debt-Equity Ratios Stretched

Just to illustrate, in normal manufacturing and other businesses, the prudent debt to equity ratio is usually in the range of 1.33-2 to 1 (remember the recommendations from RBI’s Narasimham committee report!). This means, out of the total capital invested by a business, if one dollar is the promoter’s equity, borrowed funds invested in the business is $1.33 to $2. But in the banking industry, the debt-equity ratio is always much higher because the deposits of banks are considered as debts of the bank.

Commercial banks, however, despite their high debt-equity ratio are highly regulated as they take deposits from the public and have to follow strict lending, provisioning and capital norms. Investment banks, such as Goldman Sachs, for example, are, however, very lightly regulated and do not have to
follow these prudential lending and capital norms. Just before Goldman Sachs got into trouble couple of months ago, it had debts of about $1.04 trillion against its own equity capital of only $40 billion. This means it had a debt to equity ratio of 24.7:1.

To simplify the explanation, let us say its debt-equity ratio was 24:1. That means of every $25 it was investing or lending, one dollar was its own money and balance $24 was borrowed money.

In this situation, even if it incurs a loss of four percent on its loans or investments, the bank runs up a loss of one dollar, which is four percent of $25 originally invested.

This in turn means the entire equity capital of the bank is wiped out and it has to file for bankruptcy because losses have to be borne by the owner of equity capital. Borrowed funds have to be returned to borrowers.

It is very usual for any bank to make a mistake in lending or investment decisions to the extent of four percent. In the real estate boom of 2002-06, banks had lent an imprudent share to Alt A mortgages and Sub-prime borrowers. Running up a four percent or more non-performing assets was just waiting to happen. When it happened, Goldman Sachs as also all the other investment banks which had equally high debt to equity leveraging found their capital eroding too fast for their comfort.

For example, after the crisis broke, US investor and one of world’s richest men Warren Buffet and others stepped in and pumped in about $7.5 billion equity into Goldman Sachs and brought down its leveraging to 20.8:1. In good times, however, even a four percent return on their capital, that means a return of one dollar on the $25 invested would translate into a 100 percent return on the banks’ own equity capital of one dollar.

The problem with the European banks was they too had big exposures in the US market during the real estate bull phase and they too did not follow prudent loan to deposit ratios. Loan-deposit ratio explains how much was loans lent by the banks as a percentage to their deposit base.

A prudent loan-deposit norm for commercial banks is around 80 percent. That means they lend 80 percent of their deposits and keep the balance 20 percent to service depositors.

UK based Northern Rock, the first bank in the world to be hit by the Sub-prime crisis and nationalised in 2007 had a loan-deposit ratio of 215 percent. That means, when they have a deposit base of $1, they have lent $2.15 to their customers indicating that difference of $1.15 was borrowed by these banks to lend further. (Meaning these banks were doing more of a ‘money-lending’ business under the nomenclature of ‘bank’).

Most of the other banks hit also have excessive loan-deposit ratios of around 160 percent so that when faced with troubled assets they are no more able to service depositors.

**Asset Liability Mismatch**

Another significant mismatch that has developed alongside the stretched Debt-Equity ratios in the financial operations of banks and financial institutions was “Asset Liability Mismatch”. It’s commonsense to understand that you should never finance the long term assets with short term finance. The CEOs of US and European banking institutions have again missed such an obvious point in the urgency of taking advantage of real estate boom.

Besides stretching the Debt-Equity ratios, they started financing the real estate loans to their clients using six monthly revolving credits. To illustrate, let’s say some bank is giving a real estate loan for 20 year period to a borrower and bank will get repaid the same in EMIs over that period of 20 years. US banks have financed such real estate loan using a six month revolving credit wherein banks will need to repay to their lenders that amount in the next six months. How can you repay something in six months when you are supposed to get back that amount in EMIs over 20 year period? Hence, the banks started to revolve that credit every six months, meaning they will repay that amount after six months by using a fresh borrowing. In effect, they have to revolve that amount 40 times (that is two times a year, for 20 years stretch) before they get their money back from their borrowers. Even if there is slight tightness in the credit market and the bank couldn’t able to revolve that credit even once out of such 40 times, that bank stands bankrupt under cash crunch. That’s what exactly happened with UK based Northern Rock.

**Financial ‘Innovation’**

Under the mission to prove computer models can think better than human mind, the banks and financial institutions started

Probably the Third World War would have done much lower destruction than derivatives!
to deploy billions of dollars of leveraged money using complicated computer models into newly invented financial jargon such as Credit Default Swaps, Collateralized Debt Obligations, etc. The financial world started to hear the terms like ‘financial engineering’. The trick here is financial professional can’t execute something without the assistance of technical professional. And, technical professional can’t understand the risk involved in the finance. However, till the time things went well, both financial professionals and software engineers have married their ‘acumen’ to create financial engineering. As rightly said by Stephan Roach, the then Global Equity Research Head of Morgan Stanley with more than 30 years of experience, that he couldn’t able to make out head or tail of many financial instruments being discussed in one of the dinner meetings which are proposed by financial engineers aged 25 years. Even the fact that the experience of Stephan Roach is more than the age of the new breed of financial engineers couldn’t help him.

The idea behind the latest concepts is that these traders supported with complicated computer models are better than the crowd and hence, can afford to take extra bit of risk in terms of extra leverage to maximize the return on equity because they are controlled under so-called ‘risk-management’ models. Just to put the things in perspective, the very concept of ‘Credit Default Swap’ (CDS) was coined at the end of year 2000. The size of the market in 2001 was $600 Billion. By the year end of 2007, the CDS market size has grown 100 times to $65 trillion, that is two times that of world’s GDP and is four times bigger than US GDP.

And, one more market titled ‘Collateralized Debt Obligations’ (CDO) market based on CDS market has also grown to $40 trillion during the same period, aggregating the total of CDO & CDS market sizes to $105 Trillion. That is, a good 3.5 times that of the world’s GDP. Hang on, don’t just raise your eye brows, there is not even an official ‘clearing house’ to clear the trades of these markets. That’s right – no transparency, no clearing house. God, save us! (by this stage, markets are driven more by hope and prayers than the rationality).

All these excesses of Debt-Equity ratio, financial engineering ensured huge movement of money in the overall financial system of world resulting in huge rallies in equity, bond, currency and commodity markets across the globe during 2004-2007. In its own right, this is a rare phenomenon – asset classes of all nature across the globe appreciating! The fuel for this was coming from the leverage created out of US. This has made some of the professionals working in these giant banks and financial institutions such as Bear Stearns, Lehman Brothers, Morgan Stanley, Merrill Lynch, Goldman Sachs, AIG enormously rich in terms of hefty salaries, bonuses, ESOPs, etc. In the peak of the cycle towards the end of 2007, some of them became rich enough to buy even small islands in Bahamas, owning yachts, private jets, costly accommodations, luxury travelling, costly cars, etc. (that’s right, ‘signs of excesses’!)

Everything was going well. However, the party has to end somewhere. And, somebody has to pay the party bill, that too with real money and not out of leveraged amount. What has started as ‘financial innovation’ was about to give signs of ‘financial destruction’.

**Party Ended**

During June–July 2007, the initial signs of US real estate market correction started showing. By December, 2007 the correction in US real estate market has become severe. The US real estate market, mother and fuel of all bull markets across the asset classes all over the world for initial part of this decade, started to show signs of cracks. The hell broke loose. What has happened since then is historic. Let whatever happen from hereon, whatever had happened during 2008 is truly dramatic. If somebody writes a book on “100 years History of Wall Street” any time from hereon, the year 2008 will definitely deserves to occupy the entire centre spread. In just a matter of one calendar year, the world has seen the demise of Bear Stearns, Lehman Brothers, takeover of Merrill Lynch, nationalization of Freddie Mae, Fannie Mac and AIG. Further, special package support to iconic companies such as Goldman Sachs, Morgan Stanley, Citi, etc. Just to put the things in perspective, the balance sheet totals of some of these companies is as follows:

- **AIG**: US$ 1 trillion
- **Lehman Brothers**: US$ 675 billion
- **Fannie Mae, Freddie Mac**: US$ 1.8 trillion
- **Merrill Lynch**: US$ 1.02 trillion

By 2007, the CDS market size has grown 100 times to $65 trillion, twice that of world’s GDP.
Goldman Sachs : US$ 1.08 trillion  
Citi : US$ 2 trillion  
The aggregate of balance sheet totals of top 10 financial institutions in US works out to US$ 20 trillion as against the size of US GDP of US$ 14 trillion! This indicates how much leverage was flowing in the system and how much ‘paper money’ is created out of financial engineering. 

The collapse of these ‘too big to fail’ organisations have resulted in mass wealth destruction across the financial markets, be it in equity, bond, currency, commodity markets across the globe. The destruction is as high as 60%-90% in all markets. (That is, if your return is 0% this year, you can proudly say ‘I have outperformed’ the market). Warren Buffet’s view that ‘Derivatives are weapons of mass destruction’ was proved literally. Probably the Third World War would have done much lower destruction than the modern day Derivatives!

The youngsters in the colleges must be wondering what they should take inspiration from! Gone were the days when a father inspires his son saying that ‘you should work for Citibank or Goldman Sachs in New York one day’! What should MBA colleges base their case studies on! For which companies a young management graduate should dream for in his campus interviews! Yes, let’s accept it, the world has changed forever! Few eternal optimists may be of the opinion that this is a cyclical bear market in a structural bull market (that is, like any other normal bear market). However, considering the gravity of the situation, this time there are enough indications that this may be a structural bear market. This time the downward cycle is so strong involving all the asset classes, while coming down it has damaged the walls of the ‘World’s Financial Architecture’ as defined in “Bretton Woods” agreement after Second World War.

After Second World War, when the entire world’s financial system was scattered, the leaders of the all nations have met in a hotel named “Bretton Woods” in UK to decide the nuances and dynamics of the world’s financial architecture, wherein it is decided that ‘Gold Standard’ (that is the amount of Gold balances that each country possesses) becomes the base for determining respective currency values of each nation in the world.

Now, with the present day financial innovation and over leverage, it seems current day financial institutions have broken that World’s Financial Architecture. So much for ‘financial innovation’!

**Mending the Recovery**

It’s a Jillion dollar (that is, thousand trillion dollars) question! It is the question which is going to define the dynamics, structure and lives of the people who are associated with financial system of the world. By no stretch of imagination, it’s going to be easy. It took so much intelligence, innovation to create this problem. Then, it’s bound to take much more intelligence to fix the problem. Needless to say, it’s going to be very painful transformation.

It demands a quick response from the leaders of the world may be to mend the existing structure or recreate a new structure. The flaws of Bretton Woods agreement are obvious now. The areas of mending the existing structure range in various areas such as the interest rate arbitrage existing between various countries, currency rate arbitrage, revamping of accounting standards, overhauling of credit rating system, bringing transparency into derivative structures, etc.

On top of that, this brings to the notice the critical need of educating our youth regarding the proper financial discipline and ensuring their proper understanding of basics and fundamentals of financial concepts. History paves the way for future. It’s our duty to take the hard lessons from history and plan for prosperous future for us and next generations. In 2008, we became part of the history and we should make sure we won’t become history!

**References and Additional Thinking**

- Age of Turbulence by Alan Greenspan  
- Speeches by Alan Greenspan  
- Speeches by Christopher Cox  
- Financials of Goldman Sachs  
- Financials of Bear Stearns  
- Financials of Lehman Brothers  
- Financials of Merrill Lynch  
- Financials of Freddie Mae, Fannie Mac  
- Financials of AIG  
- Financials of Citi  
- Bailout package as announced by Ben Bernanke, Henry Paulson

*The views expressed in the write-up are personal and do not reflect the official policy or position of the organisation.*
Saskia Sassen
Robert S. Lynd Professor of Sociology and Member, The Committee on Global Thought, Columbia University
A BAD IDEA: Using a Financial Solution to the Financial Crisis

Traditional banking is about selling money you have. Finance, unlike traditional banking, is about the money that is NOT there. Thus finance is getting from whatever amount of money you have (ten thousand or ten billion) to its doubling, tripling. This means that pumping taxpayers' money into the financial system is giving finance more grist for its mill: leveraging.

We have had five bailouts since the 1980s, the decade when the new financial phase took off. Everytime taxpayers' money was used to pump liquidity into the financial system, finance used it to leverage. That is what finance does. We can't hold it against finance. But we can choose a non-financial solution to the crisis.

It is almost irrational to give finance the instruments to do more of what has brought us at the brink. The prior bailouts each contributed one more element to the unsustainable leveraging we have now reached. The high level of financializing of our economy is reflected in the relation of financial assets (which is to say, debt) to GDP. Before the crisis it had reached 450% to GDP, according to the recently released McKinsey report.

The financial deepening of economies has become one of the major dynamics characterizing advanced economies. The ratio of global financial assets to global gross domestic product was nearly 350 percent in 2006, before the devaluations of the current crisis. More generally, the number of countries where financial assets exceed the value of their gross national product more than doubled from thirty-three in 1990 to seventy-two in 2006. Securitizing a broad range of types of debt is a key vehicle for this financial deepening. Government and corporate debt have been subjected to securitization for several decades, with variable degrees of success. The extension of securitization into consumer debt, including mortgages, took off in the 1980s in the U.S. Thus mortgage securitizing is not new; indeed, the first mortgage-backed security was invented in 1977, though not necessarily widely used at the time.

The decisive crisis that brought the system to the threshold of a global depression is the credit-default swaps crisis—the outstanding US$ 55 trillion credit default swaps for which there is no money. To this we might add the US$ 640 trillion in outstanding derivatives worldwide. The complexity of this inverted financial pyramid is almost impenetrable. An example is the incapacity of the Treasury to estimate the cost of rescuing AIG—first estimated at US$ 40 billion by its management, it wound up at $121 billion. Unwinding the credit insurance on Lehman cost far more than the Treasury had estimated, reaching $ 360 billion.

Yet another indication of this irrationality comes from the participation of the Federal Reserve in this financial “solution”: The Fed is now heavily leveraged in terms of the vast amount of money it has either already extended or committed through a range of facilities. It looks like a hedge fund, and a very speculative one at that. This puts the federal guarantee system at risk— for instance, at the limit it would undermines
the capacity of the government to guarantee people’s bank deposits.

The Fed has lent $1.5 trillion in taxpayers' money to banks, including Citigroup and Goldman Sachs. This does not include the $700 billion bailout authorized by Congress. As collateral, the Fed is accepting a bunch of securities -- but it is not telling the public what these securities are that we the taxpayers now own in return for that US$ 1.5 trillion it has lent.

And these $1.5 trillion are only the tip of the iceberg. Right now, Bloomberg News best estimate is that $7.7 trillion of taxpayers’ money has been committed to the banking and financial system. This potential debt is equivalent to half the 2007 US GDP. That is not good. Further, the taxpayers did not authorize this; through our legislators we authorized the Treasury to spend $700 billion. On top of it, neither the Fed nor the Treasury are informing the public where it is all going. Legislators have made some noises. But there should have been a roar.

Bloomberg News took the plunge on November 26 and sued the government: it asked a US court to force the Federal Reserve to disclose information about the securities the Fed is accepting on behalf of American taxpayers (us!) as collateral for $1.5 trillion of loans to banks and firms. That is a good move. It demands some accountability from the Fed: we the taxpayers are entitled to know what we are getting for our bundle of “loans.”

The IMF recently produced some interesting data showing the extent to which financial leveraging has caused the greater acuteness of the current crisis compared with the other three major crises since the 1980s.

Figure 1, shows that financial leveraging added another 20% to the underlying banking crisis, thereby bringing the current financial crisis up to an equivalent of 40% of global GDP, compared to earlier crises, which rarely went beyond 20%.

The IMF data also show the extent to which Asia is in a very different position than the US and Europe. Its emergent crisis is economic rather than financial. But given interlinked global markets, a crisis made largely in the US and to a lesser extent in the EU, is arriving in Asia. The stock markets declines are to be distinguished from the leveraging that has fed our crisis. Stock market declines indicate the shrinking resources available to meet all these outstanding amounts.

What would happen if the solution to the financial crisis would emphasize growing the economy -- making sure that a wide and diverse array of (especially) small- and medium-sized firms are put into fast-track activity. This would raise the demand for workers,
especially since a large share of small firms is labor-intensive and small to medium firms account for the largest share of employment in most economies. This would in turn raise household demand which would feed back into all kinds of economic sectors. And so on…

So, what would be the mechanisms, the conduits, for transferring tax payers’ money into small and medium sized firms that could bring about economic growth, rather than merely being a transfer of money? This will vary across national economies. But let me suggest that in most economies, doing infrastructural work is not a bad starting point. And I am not thinking of building huge dams and major new bridges. That is mostly work that only a few large global engineering firms are able to do. There is so much more people-oriented infrastructural work that needs to be done: building and/or repairing the basic infrastructure of large stretches of cities and towns, cleaning up toxic fields, expanding public transport systems, just to mention a few.

Once a government has decided to put billions into an economy as an emergency measure, it can begin to work on such needs, needs which cannot easily be met through market mechanisms. As these projects get under way, they activate market mechanisms directly (increases in demand for inputs from other firms, increases in labor demand and hence in consumer demand, which in turn further feeds demand from firms for more inputs and more workers. This is a very indirect process for growing an economy. Indeed, quite a few more financial firms would have gone down, and credit would be tighter for a while if the US government had decided to put that vast amount of money into the rebuilding of infrastructure, from small to large-scale labor intensive projects. But in the long run, we would be in the business of economic growth rather than financial leveraging.

The US government has resisted putting money into the economy even where it is urgently needed – such as strengthening the 700 bridges that are known to have a faulty design and are likely to collapse sooner or later, causing potentially large-scale injury and death. These are the bridges that have the same flawed design as the Minneapolis Bridge that collapsed. Yet the US government has not addressed this, has not even started. And now it has decided to inject trillions of dollars into the financial system. Imagine the multiplier effects across small and medium enterprises and households of that kind of money input. Obama’s proposal to spend $2 trillion in the real economy cannot start soon enough. Our households in the US do not need more credit -- they need incomes. The longer we allow the Fed and the Treasury to handle the crisis their way, the deeper they sink the country and the more difficult Obama’s rescue plan becomes.

Endnotes and Additional Thinking

1 This is a revised version of the piece originally posted on www.Huffington Post.com


(The views expressed in the write-up are personal and do not reflect the official policy or position of the organisation.)
MENDING THE MELTDOWN: ENGINEERING
Introduction
The seizing of money flows was caused by the exponential growth in debt, itself caused by compounding interest on money supplies based on debt. Recovery requires replacing debt money with government issued legal tender, denominating money in work time hours and percents of hours, and setting reasonable limits to income. Then we can pay attention to the real economy.

Engineering recovery requires a clear picture of a properly functioning economy. I offer that picture here as a simple diagram of two equal flows; goods and services moving clockwise and money moving counter clockwise.

The flows can continue as long as they are equal. Substitute countries for people and the same property holds for trade relationships among countries. You can think of many reasons why the flows could be unequal. Keep in mind that unequal flows are problems to be solved. It is precisely persistent inequality in the flow of money that has caused the current
“meltdown.”

Kahlil Gibran, in his 1923 classic, The Prophet, expressed the nature of the relationships among people cooperating in equitable flows of goods, services, and money as follows.

And a merchant said,
Speak to us of Buying and Selling.
And he answered and said:
To you the earth yields her fruit,
And you shall not want
If you but know how to fill your hands.
It is in exchanging the gifts of the earth
That you shall find abundance and be satisfied.
Yet unless the exchange be in love and kindly justice,
It will but lead some to greed and others to hunger.
Spaceship Earth cannot sustain a human population in peace and happiness where some want while others waste.

We are told that the credit market crisis was caused by the inability of people buying homes to pay their mortgages. Those mortgages then became “toxic” assets. The United States Federal Government was then panicked by banking interests to borrow $700 billion to “bail out” the banks. So, they presumably would have money to lend. We were told that this action was needed “by the end of the week” or the financial system would seize completely. The Federal government had a much more sensible alternative that would have cost it nothing; namely, to change the way that interest is charged on mortgages.

Today interest is charged at an annual rate on a declining balance. Table 1, shows how this is done for a mortgage of $100,000 at 6.5 percent interest. The monthly payment in the example is $632.07. Of the first monthly payment, $541.67 goes to interest and $90.40 pays principal; of the second monthly payment, $541.18 goes to interest, so 49 percents more, $90.89, pays principal. The portion that goes to interest...
gradually gets smaller and the portion that goes to principal gradually gets larger until the last payment 30 years later when $3.39 goes to interest and $626.46 pays off the principal.

After 30 years, total interest paid is $127,542.98, 127.6 percent of the loan, not 6.5 percent. Suppose instead that 6.5 percent was calculated once and the charge distributed over the life of the loan as shown in Table 2. Look at the difference this simple change in math makes to the debtor’s ability to pay and the speed with which the mortgage is paid off. Each month $600 pays down the principal and the bank receives $39.16 to cover its costs, essentially book keeping. The cost to the homebuyer is repaying the loan plus $6,500 and the mortgage is paid off in 14 years.

There is nothing sacred or eternal about how interest rates are now calculated. You can see how the way it is done now causes debtor distress, not only for those with “sub-prime” mortgages, but all those with mortgages. Foreclosures would become rare and people could stay in their homes with money available for all those other things they must now give up like home maintenance, children’s education, health care, etc.

This simple change that would have cost the government nothing was not made because private lenders control the money supply of the United States and of all other countries, as far as I know, is itself borrowed into circulation. The result is exponentially increasing total debt by the mathematics of compounding interest.

### The Money Origination Problem

A borrowed money supply requires that interest be paid to keep the money in circulation. However, interest can only be paid with borrowed principal, so interest paid must be re-borrowed back into circulation. Consequently, debt grows by compounding interest, that is, exponentially, explosively, astronomically. The process is relentless and explains why there are periodic booms and busts. When debt increases, the economy booms; when interest is paid and/or, ironically, when debt is paid down, the economy busts. Interest in 2008 on US credit market debt requires an increase in total credit of $4 trillion. Next year it will be more.

The First Congressman from Georgia, James Jackson, warned the First Congress in 1790 not to base the new nation’s money supply on borrowing. In his 9th February 1790 speech to Congress, he said:

“Let us take warning by the errors of Europe and guard against the introduction of a system followed by calamities so universal. Though our present debt be but a few

### Table 1. Home Finance as Done Now

<table>
<thead>
<tr>
<th>Date</th>
<th>Payment</th>
<th>Interest</th>
<th>Principal</th>
<th>Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loan Date</td>
<td>$100,000.00</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Month 1</td>
<td>$632.07</td>
<td>$541.67</td>
<td>$90.40</td>
<td>$99,909.60</td>
</tr>
<tr>
<td>Month 2</td>
<td>$632.07</td>
<td>$541.18</td>
<td>$90.89</td>
<td>$99,818.71</td>
</tr>
<tr>
<td>Month 3</td>
<td>$632.07</td>
<td>$540.68</td>
<td>$91.39</td>
<td>$99,727.32</td>
</tr>
<tr>
<td>30 years later</td>
<td>...</td>
<td>...</td>
<td>...</td>
<td>...</td>
</tr>
<tr>
<td>Month 360</td>
<td>$629.41</td>
<td>$3.39</td>
<td>$626.46</td>
<td>0</td>
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</table>

### After 30 Years

<table>
<thead>
<tr>
<th>Amount of Loan</th>
<th>$100,000.00</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amount of Interest</td>
<td>$127,542.98</td>
</tr>
<tr>
<td>Total Payments</td>
<td>$227,542.98</td>
</tr>
</tbody>
</table>

When debt increases, the economy booms and ironically, when it is paid down, the economy busts.

### Table 2. The Way It Can Be Done

<table>
<thead>
<tr>
<th>Date</th>
<th>Payment</th>
<th>Interest</th>
<th>Principal</th>
<th>Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loan Date</td>
<td>$100,000.00</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Month 1</td>
<td>$639.16</td>
<td>$39.16</td>
<td>$600.00</td>
<td>$99,400.00</td>
</tr>
<tr>
<td>Month 2</td>
<td>$639.16</td>
<td>$39.16</td>
<td>$600.00</td>
<td>$98,800.00</td>
</tr>
<tr>
<td>Month 3</td>
<td>$639.16</td>
<td>$39.16</td>
<td>$600.00</td>
<td>$98,200.00</td>
</tr>
<tr>
<td>14 years later</td>
<td>...</td>
<td>...</td>
<td>...</td>
<td>...</td>
</tr>
<tr>
<td>Month 167</td>
<td>$400.00</td>
<td>0</td>
<td>$400.00</td>
<td>0</td>
</tr>
</tbody>
</table>

### After 30 Years

<table>
<thead>
<tr>
<th>Amount of Loan</th>
<th>$100,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Service charges</td>
<td>$6,500</td>
</tr>
<tr>
<td>Total Payments</td>
<td>$106,500</td>
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</table>

His warning was ignored and United States public and private debt grew as he predicted from $75 million in 1790 to $50 trillion by 2008 (Blain, 1987). The seizing of credit markets is not due to a shortage of credit; it is due to a shortage of borrowers. Jackson warned that a borrowed money supply, “must hereafter settle upon our posterity a burden which they can neither bear nor relieve themselves from.” Although the Reserve Bank of India is fully government owned, the government apparently follows the same practice as in the United States; namely, borrowing instead of issuing money. If the central government of India issued instead of borrowed money, it would not have a debt of Rs 1,15,000,00 crore (The Economic Times, 22nd November 2008). Some say...
the ratio of debt to GDP is what matters. In 1984 the total
debt, not just government debt, to GDP ratio in the United
States was 2.34 (Statistical Abstract, 1986). In 2007 it was 3.57.
Debt growth is following its own mathematical imperative.
India’s debt to GDP ratio can be expected to follow the same
path as that of the United States. India has the advantage of
being at an earlier stage of the exponential growth process.

With money that originates as debt, debt can never be paid
down because that reduces the money supply. US President
Andrew Jackson reduced federal debt by 1836 to $38,000, not
millions but thousands. A deep depression followed in 1837.
Historian Gibbons wrote
at the time that the banks
were full of money but
none was in circulation
(Gibbons, 1970). The
world now finds itself in a
similar situation. The process can be stopped by doing what
many people think is already done, namely, by the government
issuing money.

**Table 3. Private and Government Finance**

<table>
<thead>
<tr>
<th>Private Finance</th>
<th>Government Finance</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Creates debt.</td>
<td>Creates legal tender.</td>
</tr>
<tr>
<td>2 Credit supply is temporary, exist only as long as</td>
<td>Money supply is permanent, debt-free and interest-free.</td>
</tr>
<tr>
<td>debt and interest continue to be paid and re-</td>
<td></td>
</tr>
<tr>
<td>borrowed.</td>
<td></td>
</tr>
<tr>
<td>3 For profit, requires charges above cost.</td>
<td>Tax supported, can operate at cost.</td>
</tr>
<tr>
<td>4 Governed by the wealthy.</td>
<td>Governed by elected representatives.</td>
</tr>
</tbody>
</table>

**Government Can Pay Money Into Circulation, Debt Free and Interest Free**

When government issues money, it enters the economy
debt-free and interest-free. As such it can move private
interest rates down near zero, with borrowers paying no more
than a small fee to cover actual bank book-keeping and
overhead expenses. Debtors could then pay down debt as
debt-free money replaced debt burdened money (Chart 3).
The action would be similar to exchanging the blood of a
patient from a supply that is unhealthy to one that is healthy.
The Constitution for the Federation of Earth, under which

The Provisional World Parliament operates, is ahead of the world in providing that money
is paid into circulation (http://www.radford.edu/~gmartin/).

Government could add money to finance new projects where needed, for example, to pay
people to build needed infrastructure. Money is a book-keeping entry. There should never be a shortage of money when every-
thing else is present; an unmet need, materials, and labor. The issue of money is the
essence of modern government. Borrowing is completely unnecessary. The government that borrows
surrenders its sovereignty to its creditors. The banker, Mayer
Amschel Rothschild (1743-1812) is reputed to have said in
1790, “Let me issue and control the money supply of a nation
and I care not who makes its laws.”

Money is the life blood of economic exchange, a public
utility, as essential to the health of an economy as the blood
that courses through our veins and the air that we breathe are
to the health of our bodies. At present, only coins are paid into
circulation debt-free and interest-free. It is time that every
nation have a money supply that is permanent, debt-free,
interest-free, and directly
governed by elected representatives. A respon-
sible recovery and a
healthy economy require it.

**Inflation**

When government origination of money is suggested, the first
thing many people think of is inflation. Doctors would never
give a patient a blood transfusion if a similar reaction occurred
every time someone needed blood. Enough money is the goal,
nor too little nor too much. The problem of inflation has
not been solved because it is not properly understood.

The capitalist theory of money says that inflation is caused
by “too much money chasing too few goods.” The fear of
inflation comes up when there is talk of raising wages of the
lowest paid workers; it does not come up when top manage-
ment executives receive huge salaries. That alone tells us that
the “quantity theory of money” is mistaken.

The quantity theory of money says that inflation depends on
the quantity of money. It says nothing of the quantity on
money. Does the accuracy of the length measured by a meter stick depend on the quantity of meter sticks? Not at all. Measured length depends on the quantities on the meter stick. So it needs to be with money. The numbers on national currencies need to be defined in terms of a “known quantity.”

India shares with every other country that its currency is a word, “Rupee,” without a definition. People think they know the value of their national currency because they judge its value inductively by the many prices they see on goods and services. Their judgements change when prices change. Inflation becomes part of their judgement. The absence of a definition of the meaning of the name on a currency is clear when we look at a foreign one. Where on an Argentina peso does it say what “peso” means? No wonder that the value of currencies is thought to depend on trial and error, supply and demand, invisible market forces.

Economists long ago stopped looking for a money unit comparable to units of the metric system, considering such a unit “unimaginable,” “unthinkable,” even “absurd” (Timberlake, 1965:16). Nonetheless, the unit exists. It has been operating unrecognized, much like gravity before humans knew of its existence, since the International Monetary Fund (IMF) began publishing the necessary data in 1950.

Monthly, on its country pages, the IMF publishes currency exchange rates (line ae), employment (line 67e), and Gross Domestic Product (GDP) in national currency (line 99b).

The actual value of any nation’s money is then its GDP divided by the hours of work that produced it. The actual price of those goods and services, as Adam Smith explained in his 1776 classic, is the labor required to produce them; money is their nominal price (Smith, 1976:47-51). The actual value of any nation’s money is then its GDP divided by the hours of work that produced it.

Chart 4. Currency Exchange Rates and Gross Domestic Product per Hour of work for 95 Countries Circa 2007

![Chart](image-url)
**Chart 5. Exchange Rate Inequity Between India and Bangladesh**

\[
\frac{\text{GDP}}{\text{Hours}} = \text{GDP per hour of work}
\]

I estimate hours by employment times 2000 for 40 hours per week for 50 weeks. Data in the October 2008 issue of International Financial Statistics, shows India’s price level in 2007, apparently for only the formal economy given employment of 27 million, was 866 Rupees per hour.

\[
\text{Rs. 47131.5 billion} / (27.206 \text{ million workers} \times 2000) = 866 \text{ Rupees per hour of work.}
\]

Logarithms, of GDPs per hour of work and IMF exchange rates for 95 countries for the latest year correlate a strong \( r = .83 \) (Chart 4). Strong correlations, at times over .90 of a possible 1.00, have existed all the years that the IMF has published the data (Blain, 1996).

The center “line of best fit” represents equal work time. Countries below the line are developed countries. Their currencies are overvalued; their exchange rates are too low. Countries above the line are less developed countries. Their currencies are undervalued; their currency exchange rates are too high. We can see this difference by converting currency exchanges rates to minutes of work.

\[
\text{Exchange Rate} \times \frac{60}{\text{GDP per hours}} = \text{Exchange Rate in minutes}
\]

Multiplying by 60 changes the result from hours to minutes (Table 4).

Deviations from equal work time are “invisible” causes of unequal trade. For example, India’s currency exchange rate in 2007 was equivalent to 2.7 minutes of work, just under three minutes. Bangladesh’s currency exchange rate was equivalent to 95 minutes, more than an hour and a half. At those rates, trade between India and Bangladesh was hugely unequal, but invisible with currency exchange rates expressed in Rupees, Taka, and Dollars (Chart 5).

All nations today suffer invisible trade imbalances. Converting all currency exchange rates to work time exposes them. Accurate measurement is as essential to trade relationships as it is to safe air travel.

Measurement is one of mankind’s oldest and most practical activities. It is, in fact, an essential tool for survival – it is often said that what can’t be measured can’t be managed (Joseph, 2005).

**Money Can be Denominated in Hours and Percents of Hours**

People automatically associate time with money. We waste time and money. We spend time and money. We invest time and money. We save time and money. We work by the hour, the day, the month, and the year. We pay taxes, dividends, and interest at certain times. Every aspect of economies is
Table 4. Currency Exchange Rates in Minutes for 95 Countries Circa 2007 page 1 of 3

<table>
<thead>
<tr>
<th>Country</th>
<th>Currency</th>
<th>Latest Year</th>
<th>IMF Ex. Rate (line ae)</th>
<th>GDP (line 99b)</th>
<th>Employed (line 67e)</th>
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## Table 4. Currency Exchange Rates in Minutes for 95 Countries Circa 2007 page 2 of 3

<table>
<thead>
<tr>
<th>Country</th>
<th>Currency</th>
<th>Latest Year</th>
<th>IMF Ex. Rate (line ae)</th>
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Table 4. Currency Exchange Rates in Minutes for 95 Countries Circa 2007 page 3 of 3

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<th>Year</th>
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organized by time, except money. It is time to bring the discipline of time to money.

The Provisional World Parliament adopted an hour of work as the world money unit in 2004 at its Eighth Session in Lucknow, India. The Provisional World Parliament is charged with solving problems from a global perspective, which would explain why it is ahead of the rest of the world both in how money should enter economies and in how money should be denominated.

Movement to currencies denominated in work time can be done in two steps the way Europe adopted the Euro. In that case, the economic crisis of the 1970s led to plans for a single European currency. In 1991 with the Maastricht Treaty, the 15 members of the European Union agreed to set up a single currency. First, they launched the Euro on 1st January 1999 as an electronic currency used only by banks, foreign exchange dealers, big firms and stock markets. This allowed them to “get their bearings,” to decide on a reasonable exchange rate for their own currency and the new Euro. Then on 1st January 2002, three years later, they replaced the old national currencies with Euros. Unfortunately, Europe missed the opportunity to denominate the Euro in Hours, so the Euro behaves in the same unstable way as all other national currencies.

Any nation, without a treaty, can begin immediately to calculate the work time equivalent of all their prices by dividing them by their Gross Domestic Product per hour of work. India, for example, can maintain prices in both Rupees and Hours, thereby, without changing anything else, therefore without risk or disruption to its existing economy, India can see the work time equivalent of all factors in its economy. It would be like pilots of aircraft seeing their correct altitudes for the first time. The ensuing conversations would prompt reasonable men and women to make adjustments to improve the equitability of goods and money flows domestically and internationally. It could mark a bright new dawn for economic relations. The Provisional World Parliament is also ahead of the world in recognizing the need to set lower and upper limits to income in its World Legislative Act 22, the Equity Act, passed in Lucknow, India in 2004. It provides that the highest wage be no more than four times the minimum wage (Almand, 2005:25).

Income limits are important as debt is paid because ownership of those debts is concentrated in relative few hands. All natural phenomena have natural limits. People can eat only so much food, wear only so much clothing, occupy only so many places, yet we have allowed people to accumulate unlimited amounts of money. Capitalism as we know it encourages hoarding money. The hoards have become astronomical and continue to grow. No wonder money flows are seizing. Whatever the reasons for unequal incomes, they should be temporary and moderate, if goods and money flows are to be sustainable so that we can enjoy the fruits of the earth, as Kahlil Gibran wrote, “in love and kindly justice.”

Endnotes
1 Some local currencies like Ithaca Hours have hours on them.
2 Without logarithms, the correlation is almost perfect because the very large GDPs per hour suppress the smaller ones into the equivalent of a single point.
3 http://news.bbc.co.uk/hi/english/static/in_depth/business/2001/euro_cash/history/1.stm

References and Additional Thinking

(The views expressed in the write-up are personal and do not reflect the official policy or position of the organisation.)
The global credit crisis suggests that it is time to reflect on the past ten years of financial market development in India. What went wrong? What could have been done differently? And most importantly: What should India do today to make finance safe for the next generation?

As several commentators have pointed out, one of the central causes of the global financial crisis is complex financial innovation. Let me explain that briefly.

Credit, Risk and Derivatives

We are dealing with three things: credit, risk and derivatives. Credit and risk require no in-depth explanation – they are the bread and butter of financial markets. Finance is all about lending and borrowing money or other assets, and risk is inherent to such business.

Derivatives are a tad more complex. On the basic level they are straightforward: Financial derivatives are contracts that allow parties to trade risks that derive from some underlying assets. An agricultural producer can, for example, buy a futures contract in wheat or coffee, whereby he locks into a specific sale price in the future, thereby eliminating the risk of price changes during the production period. Another well-known derivative is the stock option, which is often used as an incentive device for top employees.

However, derivatives can do more than that, as recent decades have shown. One of the remarkable features of derivatives is their sheer speed of development. Until the 1970s, few people had ever heard about derivatives; economic curricula only mentioned them in the context of agriculture. Then with the revolution of information technology and financial deregulation, banks began to produce a widening array of financial innovations, starting from futures and options in the 1980s, going on to interest rate swaps and mortgage-backed securities in the 1990s increasingly complex derivatives, and expanding to a
FINANCIAL INNOVATION: Making Markets Safe for the Next Generation

Oskari Juurikkala
Research Fellow, Institute of Economic Affairs (UK)

range of credit derivatives after year 2000.

In India, derivatives entered the scene quite lately, which means that the speed of change has been even more stunning. Until the 1990s, financial market rules were very restrictive and protective, for both good and ill. Then, stock markets began to be developed and rules were systematically liberalized. In 1999 some exchange-traded derivatives were permitted under the amended Securities Contract Regulation Act. Most importantly, over-the-counter (OTC) derivatives were allowed insofar as authorized by the Reserve Bank of India (RBI). OTC derivatives are increasingly complex derivative contracts made between banks and businesses, investment funds, insurance funds etc.

Growth Pains
The depth of the current financial crisis must not blind us from the fact that there have been repeated difficulties with derivatives in the past. They enable companies to leverage their risks and investments to such an extent that it can be difficult to control and supervise them. Numerous employees have been tempted to gamble with dubious derivatives in the hope of larger personal gains and bonuses, knowing that the downside risk will be borne by the employer. The legendary case of an escalating gamble for life was that of Nick Leeson of Barings in 1995. The gamble failed, and the venerable British bank went bankrupt.

Often top management really does not understand the true nature of the risks that are being taken, until losses have realized themselves. This has been true of all derivatives debacles from Barings to Orange County to Metallgesellschaft to David Askin and beyond. Yet a particularly interesting case was the 1998 drama of Long Term Capital Management (LTCM): the spectacular hedge fund was supposed to be engaged in a low-risk arbitrage strategy, until the unexpected default of Russian government bonds created a domino effect which destroyed the portfolio of LTCM and nearly brought down several US banks with it.

What is worse, all of the past seems like a walk in the park in comparison to the ongoing crisis. What made the present crisis so special?

Complex Gamble with Credit Risk
Perhaps the main problem was that no one really understood what they were doing. To say that may sound silly or even arrogant, yet it seems to be an accurate description of the reality.

Credit derivatives are perhaps the most fiendishly complex derivatives ever conceived. They became a big market just a couple of years ago, and have grown to a truly global trade. Their key idea is simple: to allow lenders (for example, banks) to transfer their credit risks (for example, default of mortgages or corporations) to outside investors. Thus banks can do more business.

It can be very profitable to banks to do this. But why would anyone participate? Because that can be profitable too, as long as it works. Credit derivatives such as credit default swaps (CDS) can provide participating investors with inordinately large returns to their investment. That in turns means that a lot of people will be interested.

The trouble is that, it may not work out as planned. What happened during the last couple of years was the typical artificial boom: too much money flowing into certain invest-
ments, causing a lot of credit and risk. The housing markets around the world have been hot for many years in a row, with many people getting mortgages on flimsy grounds and hoping that prices would go up indefinitely.

The imprudent behavior of house buyers was one thing. The other thing was the conduct of the lenders, who neglected ordinary risk measures, as the idea was to sell the risks to someone else. The latter – hedge funds, pension funds and so on – seemingly did not always quite grasp what they entered into; perhaps the coupon just looked too yummy to say no to. Credit risk rating agencies had their role in the story too, as they gave too good marks to products bearing seeds of destruction.

It all started as an attractive new trade in which many people wanted to participate, but it grew into a global house of cards that was hard to sustain. Somewhere down the line, US consumers had not enough money to maintain their excessive living and spending habits, so that an increasing number of mortgagees defaulted on their loans. This caused a downward spiral, in which foreclosures and sales shot the property market down, thereby eroding collateral value and reinforcing the negative cycle.

India’s Trial by Fire

India’s derivative market has unfortunately not been free of similar setbacks, especially with OTC derivatives. At present, the permitted OTC instruments include different types of rupee interest rates derivatives and foreign currency derivatives such as forwards, swaps and options. Importantly, corporations are only permitted to engage in derivatives transactions for the purpose of hedging, not speculation.

Since then, the market for OTC derivatives has exploded in India. The amount of reported OTC derivatives has grown dramatically between 2004 and 2007 (refer Graph 1). Of course, the notional amount figures do not signify the actual

![Graph 1: OTC Derivatives in India](image-url)
value at risk in these deals; they only give a sense of the size of the market.

Before any financial derivatives were permitted in India, the topic attracted heated debate. The advocates of derivatives submitted that financial innovation enables better risk management and lower transaction costs. The critics argued that derivatives might be used to circumvent regulations and to engage in speculative gambling. There is evidence to suggest that, unfortunately, both sides have been right: although derivatives can have various valuable uses, their abuse seems to have been equally common.

The RBI guidelines prohibit speculation with financial derivatives, but it is debatable how effective the rules have been. In early 2008, Indian courts witnessed a flood of litigation concerning complex deals with foreign currency exchange rates. Numerous industrial companies had lost significant sums of money after placing complex bets on such future exchange rates as between the US dollar and the Swiss franc. Large losses have also been experienced with credit linked notes and currency options.4

The companies have sued various banks, accusing them of mis-selling complex financial instruments. Some commentators have argued that the deals were dubious from the outset and involved high risks of loss to the companies. According to an Ernst & Young survey, an increasing number of Indian corporate treasuries were involved in derivatives transactions, and at least 35 percent of the respondents were not just managing risks but had resorted to "opportunistic hedging," i.e. speculation.5

Credit Derivatives in India

Unfortunately, problems do not end with speculation by industrial companies: it is the banks themselves who are likely to suffer the most, in India as elsewhere. Although the present RBI guidelines do not permit the issuance of credit derivatives, it seems that the law only prohibits them in the local currency. One of the largest derivatives players in India, the ICICI Bank announced in early March mark-to-market losses of Rs264 million on credit derivatives. Given that the financial crisis has gone much worse since then, the current losses must be significantly higher.

The risks are very real. According to a statement made by finance minister P. Chidambaram, Indian banks had a total derivatives exposure of over Rs127 trillion, which is more than three times India’s trillion-dollar GDP. Although that is not a direct estimate of the amount of money at risk in these deals, it means that Indian banks are fully participating in the global derivatives gamble. Moreover, it seems that the figure does not include exposure to equity derivatives or collateralized debt obligations (CDOs).6

The RBI governor Y.V. Reddy said in April 2008 that although the situation is problematic, there is are no systemic risks. However, it is difficult to say how such statements should be viewed: the deepening of the problem in the USA and Europe – contrary to optimistic statements made by central bank leaders in early 2008 – shows that either no one really knew how serious the problem was, or someone was simply dishonest.

In light of all this, it is all the more surprising that the RBI has recently said to be planning to introduce credit default swaps (CDS) in 2009.7 It is precisely those fiendishly complex deals that are at the heart of the global credit crisis.

Unfortunately, the RBI is able to permit them without any additional legislation, simply by issuing new guidelines under the Reserve Bank of India Act.

It is said that the plan is to create exchange-traded CDSs, not an OTC market, to encourage transparency. However, one must realize that transparency is not all it takes to make the products safe. The problem of leverage is not confined to OTC derivatives, but is present in exchange-traded derivatives too, as several cases such as Barings and Long-Term Capital Management demonstrate.

Moreover, options and futures can, at least in theory, be valued quite easily without sophisticated models and large amounts of data. CDSs are an entirely different kettle of fish: as recent events demonstrate, even the most skilled and sophisticated risk management institutions have shown themselves incapable of making the right judgments. Introducing such deals on the exchanges could well attract an even larger number of speculative gamblers.
The Need to Regulate Derivatives
Some reasons were mentioned earlier as to why derivatives are so problematic: high leverage and complexity. But there are also other reasons why legislators – and the general public – should take derivatives seriously. One is that they are often employed to deliberately circumvent regulations, such as investment restrictions of investment funds.8

Such restrictions are often imposed by companies and financial institutions to control their risk exposures in accordance with the nature of their business and the needs of their clients. Other times investment restrictions are imposed by public authorities, pension funds being a good example. The experience of past months shows the importance of such restrictions: The safety of pension wealth is of paramount importance to dignified living in old age, but most pension savers have neither the skill nor the incentive to actively monitor their fund policies closely enough.

This was witnessed in the USA with numerous infamous cases appearing in mid-1990s. The most significant of them was the loss of USD1.69 billion by Orange County on highly leveraged derivatives investments. As investor George Soros put it: “Some of these instruments appear to be specifically designed to enable institutional investors to take gambles which they would otherwise not be permitted to take. There are so many of them, and some of them are so esoteric, that the risks involved may not be properly understood even by the most sophisticated of investors.”9

Unfortunately laws and regulations were not updated to deal with the problem, as events in 2007-08 have revealed. Law professor and former investment banker Frank Partnoy has argued that regulators were over several years pressurized by banking interest groups to adopt lax rules which paved the way for the present crisis. He summarizes it thus:

“There were numerous instances of the differential treatment of derivatives and equivalent financial instruments: stock options were accounted for differently than other compensation expenses, prepaid swaps and other off-balance-sheet deals were recorded differently than loans, over-the-counter derivatives were exempt from securities rules applicable to economically similar deals, and swaps were regulated differently than equivalent securities. The result was a split between perceived costs (the numbers reported on corporate financial statements) and economic reality (the number reported in incomplete or misleading footnotes, or not reported at all).” 10

In Search of Better Ways
Given the complexity of the problem, there are no obvious solutions to it. Perhaps the biggest difficulty is a surprising one: many uses of derivatives are legitimate, indeed very valuable. If used properly, they enable cost-efficient risk management, which in turn facilitates productive business and lowers financing costs. Paradoxically, this makes it difficult to decide where and how to draw the line, and regulators and legislators are understandably reluctant to impose overly restrictive rules. Unfortunately, the true risks are often learnt when it is too late.

Yet many things can be done, and on several levels. To start with, one should not underestimate the importance of education. I do not mean only education in the technicalities of financial derivatives, but also the cultivation of high moral standards as something essential for profitable long-term business. This must be coupled with credible corporate ethical standards. As an increasing number of companies get into trouble after some money-hungry employees pushed it all beyond the limit, one should build competitive advantage by creating a corporate culture of honesty and integrity.

Another important consideration is incentive systems. A common feature among various derivatives debacles is that employee-level remuneration has been geared towards bonuses on short-term gains. Top managers and shareholders must become more aware of the dangers of creating strong profit incentives without making employees share in the risks.

But individual and company-level improvements must be matched with legal and regulatory reform. Past experience suggests that regulators have treated the issue all too lightly. In the years and events leading to the present crisis, numerous illegalities have arguably been committed, and lawsuits are beginning to pile up. But as far as past history is concerned, most individuals committing such illegalities have either gone scot-free or received a mere slap on the cheek. Punishing corporations alone may not be wise, because the ones to suffer
are the shareholders of the company, and they normally have little ability to control the dubious practices of individual employees.

It will be interesting to see how courts and regulators in India will deal with the issue. At the moment it seems that Indian courts are unlikely to challenge the validity of the derivatives contracts. But it must be noted that the cases are likely to be decided on the basis of fact and evidence, and assessing such evidence is easier said than done.

To avoid the evasion of regulations by further innovation it may be advisable to move from clear but narrow rules to broader standards in financial markets regulation. However, the formulation of broad standards must also take into account the problem of enforcement. A related issue is this: Why were the RBI guidelines so ineffectual? What sanctions, if any, will be imposed on the banks and corporations involved in these deals? It is possible, even in theory, for a regulator or a court of law to tell whether a specific transaction was permitted or not? These questions imply a lesson: it is useless to confine the derivatives market to “hedging” unless there is a clear definition of what that means and third parties have access to necessary information to judge the matter.

Finally, it may be necessary that wider social circles become interested in and active about the regulation of financial derivatives. The problem of “regulatory capture” is widespread in financial markets, as the wider public has little interest in the matter and the only ones who truly understand what is going on are the bankers themselves. Such a situation makes it easy for bankers to control legislation and regulation.

Conclusion
As the problems are mounting up, we must take a deep breath and start thinking about the more distant future. One thing is to try and stop the escalation of the ongoing crisis, but a more important thing is to prevent such crises in the future.

There are signs to suggest that the deregulation wave will be reversed in India. RBI Governor D Subbarao wondered in a recent speech whether OTC derivatives and structured products were such a good idea after all. India's Chief Economic Advisor Arvind Virmani also proposed that it might be wiser only to permit exchange-traded derivatives.

It will be interesting to see what decisions India’s legislative and regulatory bodies will take in the coming months and years. It has been proposed by some that perhaps India was not ready for these complex financial instruments. That may be true; but one wonders whether any country was ready. In assessing the alternatives for the future, we should not get carried away by novelty and neglect the hidden beauty of simplicity. India has a long and bright future ahead, and it should not stumble into short-term attractions that benefit a small circle alone and not the entire nation.

Endnotes and Additional Thinking
4 See e.g. "Why Indian companies' love affair with derivatives soured," Mint, April 16th 2008.
5 "FX deals cast pall over fledgling India derivatives," Reuters, April 11, 2008.
7 "Credit default swaps likely by next year," Mint, November 19th 2008.
9 Testimony to the United States House of Representatives Committee on Banking, Finance and Urban Affairs, 13th April, 1994.
10 Frank Partnoy, Infectious Greed (Henry Holt, New York, 2003), page 405.
12 Frank Partnoy, “Financial Derivatives and the Costs of Regulatory Arbitrage.”

(The views expressed in the write-up are personal and do not reflect the official policy or position of the organisation.)
FINANCIAL CRISIS: BUYING TIME THROUGH EXPANSION OF DEPOSIT INSURANCE ARRANGEMENTS

SEBASTIAN SCHICH
Principal Economist, Division for Financial Market Affairs, Directorate for Financial and Enterprise Affairs, OECD, Paris

Deposit Insurance in the Spotlight
In India, the Deposit Insurance and Credit Guarantee Corporation (DICGC), a wholly-owned subsidiary of the Reserve Bank of India, administers the country’s compulsory deposit insurance scheme. During the current financial crisis, a discussion has set in about a possible upward revision of the ceiling of coverage provided under the scheme per depositor and per bank. Broadly similar discussions have taken place in OECD member countries. The present note reviews selected actions taken by OECD governments in this context in the Fall of 2008 and places them in the wider context of government provision of the financial safety net.

Whenever a crisis hits, interest on the part of market participants, the general public and policymakers in guarantee arrangements rises. Government provision of a safety net for banks and, often, other types of financial institutions is a key element of the policy responses in this context. In the process, a typical policy response involves the expansion of existing and introduction of new guarantees. The current financial crisis is no exception in that respect.

Financial Safety Net Elements
A proper financial safety net is necessary to reduce the risk of severe financial crises. Without an appropriate financial safety net, even simple rumours of problems regarding solvency or liquidity of a financial institution have the potential to become self-fulfilling and turn into a full-blown financial crisis. By contrast, with an appropriate financial safety net in place, confidence tends to be greater and financial crises less likely than otherwise.
There is no generally accepted definition of the key elements of the financial safety nets. A narrow definition is that they are composed of deposit insurance and a lender of last resort function, although a more widely accepted one is that they include (at least) three elements, the prudential regulatory and supervisory framework, the lender of last resort function, and the deposit insurance system. An expanded definition may also include financial institutions’ failure resolution mechanisms. There exist numerous interactions between the different elements of financial safety nets.

**Trade-Off Facing Each Element of the Safety Net**

Each of the different elements highlighted in the figure is facing a similar trade-off. On the one hand, these elements are designed to reduce the disruptions in the financial system stemming from bank failures. On the other hand, they have to be designed in a way that they reduce ex ante moral hazard risk that otherwise can result in the same fragility that the financial safety net is supposed to minimise.

While each of the different elements faces a similar tradeoff, each element has a different objective function. The latter may conflict with each other, and this situation has implications for the institutional sharing of responsibilities.

A wide set of different institutions are involved in the provision of the various elements of the financial safety net. Besides the prudential authorities – regulators and supervisors – monetary and fiscal authorities play an important role and there are also specialized agencies providing deposit insurance and these agencies may have additional special...
responsibilities in a crisis situation, including in relation to bank failure resolution. The monetary authority, whatever its involvement in prudential responsibilities (and there is a renewed discussion about the extent of that involvement), plays a crucial role within the financial safety net because of its role as “lender of last resort”. The fiscal authority is involved in the financial safety net either directly or indirectly because of its role as “solvency provider of last resort” but also because of its political responsibility for the use of taxpayer money.

Policy Actions in OECD Countries in the Fall 2008
When distrust among banks accelerated and spread to the wider public during Fall 2008, governments took a number of radical policy actions related to financial safety nets, several of which related to deposit insurance arrangements. In this context, it is helpful to remember that a report by the FSF Working Group on Deposit Insurance concluded in 2001 that, at the level of each country, a well-established mechanism needs to exist in all key areas constituting the financial safety net. The report stressed that if a country has established a well-developed mechanism in only some but not all of these areas, it is still likely to face difficulties in finding effective solutions for preventing or resolving serious problems in its banking system.

According to many observers, the episode involving Northern Rock in the United Kingdom testifies to the importance of that advice. The deposit insurance mechanism turned out to be a weak element in the country’s financial safety net. In particular, because of the inadequacy of the deposit insurance system, the situation at Northern Rock triggered fear of contagion with systemic implications. Be that as it may, many of the issues related to deposit insurance that were highlighted by this episode were not specific to the United Kingdom. They were relevant for the systems in place or (under study) in other countries as well. This suggestion has been underscored by the large number of policy measures taken in October 2008, which included the following:

- In many of the jurisdictions where such arrangements had already existed, some design aspects were changed. Perhaps most notably among such changes, the levels of maximum deposit insurance coverage have been increased, at least on a temporary basis.
- Policy makers in some countries made statements that suggested either explicitly or implicitly that deposit insurance coverage would be unlimited. Also, coverage of guarantee arrangements was also extended in some cases to bank liabilities that were not traditionally covered by such arrangements.

Such measures were part of a wider set of measures aimed at restoring confidence. The expansion of the scope of deposit guarantee arrangements reduces the threat of bank failures by raising the likelihood that depositors and creditors continue to provide a stable source of financing for banks. They are thus helpful in averting a further loss of confidence and, hence, these actions buy valuable time. There are nonetheless potential costs associated with these measures.

Potential Costs Associated With Expansions of Insurance Coverage
Moral Hazard
First, any guarantee can give rise to moral hazard. Clearly, in the midst of a crisis, one should not be overly concerned with moral hazard, as the immediate task is to restore confidence and guarantees can be helpful in that respect. Nonetheless, market discipline needs to be allowed to operate, among other things because it can help reduce the final costs of a financial crisis.

To allow for a greater role for market discipline it is important to specify when the extra deposit insurance coverage will end, and this timeline needs to be credible. For the announced transition to more limited guarantees to be credible, the root causes of the problems need to be effectively addressed. Absent such a credible “exit strategy”, government guarantees once implemented can be difficult to withdraw, as the experience of Japan during its last financial crisis has illustrated.

In Japan, initial policy responses to the banking crisis in the early 1990s was forbearance, provision of emergency
liquidity, assistance to encourage mergers of failed institutions, and strengthening of deposit protection (CRS Report for Congress, “The US Financial Crisis: Lessons From Japan,” 2008), while monetary and fiscal policy measures were limited. The failure of measures to rescue the banking system and address the root causes of the problem of non-performing loans led to a substantial swing in sentiment from excessive risk appetite to extreme risk aversion. It took an extraordinary long time for the recovery of the banking sector to take place and this observation can be explained also by the stringent conditions applied for the assistance in the earlier support packages. Since banks were unwilling to accept the conditions, they side-stepped government support and tried to bolster their balance sheets by cuts in lending. As a result, Japan suffered an extended period of negative or weakly positive growth, which in turn complicated recapitalisation of the Japanese banking sector.

The Deposit Insurance Act was revised in 1996 to temporarily lift the deposit insurance coverage limit of Yen ten million (about USD 95,000) per person per bank, so as to insure all deposits without limit. The limit was supposed to be reinstated in April 2001, but its reinsertion was then postponed to April 2002, and even then only gradually lifted; first or time deposits at that date and subsequently, in April 2005, for ordinary deposits (with the exception of payment and settlement deposits).

On a more fundamental level, it is not clear however to what extent government guarantees can ever effectively be considered one-off propositions. If a government guarantee is extended during one crisis, there may be a general perception that one will always be made available during crisis situations.

Issues Raised by the Coexistence of Different Levels of Protection
Second, the coexistence of different levels of depositor protection can give rise to unfair competitive advantages; these could be vis-à-vis other forms of savings (e.g. close substitutes to bank deposits) or vis-à-vis other deposit-taking institutions that do not enjoy the guarantee. The latter could be based in the same country or in other countries. In this context, authorities also need to clarify international arrangements for coordinating the deposit insurance of cross-border institutions. At a minimum, information-sharing arrangements and mechanisms for rapid cooperation need to be improved, although the experience related to Iceland suggests that ex-ante agreements on burden-sharing between different countries involved may be necessary. Ultimately, as regards the design of national systems, authorities may need to agree on a set of international principles for deposit insurance systems that includes a set of common objectives and main features while recognizing that there may be differences in the design of systems reflecting varia-
tions in the structure of banking sectors.

**Funding Issues**

Third, when the extent of ex-ante funding is inadequate, the difficult issue arises as to how funds should be collected in the wake of bank failures, without reinforcing banking sector pressures. Indeed, efforts to raise additional funding during a crisis would be confronted with the risk of reinforcing (downward) cyclical developments.

Also, in this context, governments need to carefully evaluate their capacity to provide for the implicit or explicit guarantee that they have announced, so as to ensure that the announced guarantees are credible. For example, in the case of some countries, the assets of the largest bank or banks could exceed the country’s gross domestic product by quite a large margin, thus potentially putting into question the capacity of the national government to provide for the announced guarantee of bank deposits (or other types of liabilities).

**Considerations Regarding the Limits of the Safety Nets**

Once the financial turbulence abates, a thorough analysis of the costs and benefits of the recent changes to the financial safety net, including those related to deposit insurance arrangements needs to be undertaken. In this context, it is interesting to note that some countries did not modify their deposit insurance arrangements, thus leaving more room for private efforts. Arguably, confirming the outer limits to the financial safety net during a crisis, rather than changing them, would be expected to raise the credibility of such limits.

**Difficulties in Determining the Tolerated Risk Level for the Financial System**

The difficulty of fixing these limits reflects the difficulty in determining the tolerated level of risk for the financial system. The financial system is not totally failure-free nor is it designed to be. For one, as a general rule, there is a natural limit to how safe any type of system can be. The financial system is no exception in that respect. Perhaps more importantly, some measure of risk-taking in financial markets is necessary for innovation and growth to occur. That process necessarily means that some bets will turn out to be poor ones, but that is how the system is meant to work in channel-
long run.

One needs to make a conscious decision as to how to balance out financial system efficiency with the likelihood and severity of “accidents”. Incidence of bank failures differs across OECD countries and this observation may reflect differences in the tolerated risk level. For example, in the United States, banks do actually fail, even if the failure of large entities is rare. There have only been two years since 1934 when no banks failed in that country (that is, in 2005 and 2006). At the peak of the Savings & Loans crisis, more than 1,000 banks failed in 1988 and 1989. Since the beginning of this year, and unlike in previous years, several banks have failed. In most European countries, by contrast, policy authorities appear to have been reluctant or unwilling to close even small (insolvent) banks.

What makes it difficult to determine the tolerated risk level is the complexity of the financial system. This complexity appears to have important implications for the “accident” rate. In particular, one hypothesis in this context is that the financial system may be very efficient and stable most of the time, but that it exhibits excessive instability once thrown out of balance. Due to the non-linear feedback mechanisms in complex interconnected financial system segments, even the materialization of small risks can throw the system out of balance: Several amplifiers exist, the joint effect of which can lead to large effects of initially small triggering events.

The experience with the recent financial turbulence seems to testify to the relevance of the assessment. The US sub-prime mortgage debt market was small compared to the US mortgage market let alone as a share of the US or even global financial market. Developments in the subprime market seemed to have had outsized effects on the broader financial markets, a development that can however be explained ex post by the existence of a large number of mutually reinforcing sources of downward dynamics (e.g. including erosion of confidence, market value accounting, need for deleveraging, etc.).

**Conclusion**

As part of the emergency measures taken by many OECD governments in the Fall 2008, retail deposit insurance in a number of OECD countries has been expanded beyond normal limits. In some jurisdictions, such measures have even involved the introduction of blanket guarantees. Any guarantee can give rise to moral hazard, and blanket guarantees are arguably most likely to give rise to moral hazard.

Clearly, in the midst of a crisis, one should not be overly concerned with moral hazard, as the immediate task is to restore confidence, and guarantees can be helpful in that respect. Nonetheless, market discipline needs to be allowed to operate, among other things because it can help reduce the final costs of a financial crisis. It is widely recognised that these measures should only be of a temporary nature and that credible timeline for reinstatement of more limited insurance is specified. For such timelines to be credible, “exit strategies” must be defined that involve actions that effectively address the root causes of the lack of confidence among the wider public vis-à-vis banks and among the banks. Absent such strategies, government guarantees, once extended, are difficult to withdraw. But the longer they last, the more likely are behavioural changes that would raise the ultimate costs of crisis resolution.

Also, on a more fundamental level, it is not clear however to what extent government guarantees can be fully withdrawn, under all circumstances. If a government guarantee is extended during one crisis, there may be a general perception that one will always be made available during crisis situations. 

**Endnotes and Additional Thinking**


(The views expressed in the write-up are personal and do not necessarily reflect the official policy or position of the organisation).
Global Financial Crisis and Key Risks: Diagnosis and Policy Responses

Pramod Kumar Yadav
Fellow Programme in Management (FPM), Public Systems, IIM-Ahmedabad
Introduction

Theory of financial economics had been on the lookout for a theoretical paradigm that in all the possible likelihood was robust enough to describe the behavior of financial markets with a fair degree of accuracy. This sense of urgency for such a quest merged financial economics with the age old theory of probability. This was accomplished by some of the last century’s most distinguished and influential financial economists like Fischer Black, Myron Scholes, and Robert Merton. The trio using probability theory came up with the idea of pricing options, one of the most popular derivative contracts in financial markets. This changed the very perception of the financial world and opened whole new areas of research in the arena of financial innovations. These financial innovations created a great sense of euphoria in the name of financial instruments being capable of measuring risks and effectively pricing those risks. The positive sentiments were further bolstered by the successful application of these innovations which helped financial markets take a leap in last few decades. These innovations were hugely capitalized by investment banks all over the world. There were some failures as well, albeit of very small magnitudes. The market was perceived as the best cure of all the financial problems, be it inflation, interest rates, or exchange rates. The American and European banks innovated instruments such as inflation protected securities, exchange rate protected securities, a whole many variety of option and future contracts, and various other hedging instruments. The underlying principle behind such financial sophistication was that it was possible to effectively measure risks in financial markets. This growth in financial markets was in tandem with the sustained global economic boom in last two decades. The global economic history suggests that there had never been a long period of economic boom with such an unprecedented and fairly uniform geographical spread. Another significant development was that the global economy somehow got very well correlated and interconnected with American economy leading to various market and non-market distortions globally, appearing at time to time. The coupled growth and innovations in financial markets and economic boom led to the formation of economic bubble of an enormous size. Economists could not establish a consensus about the time and severity of the bubble burst. The man made bubble got the whole world in party mode and nobody wanted to spoil his party. In due course, the bubble got monstrously bigger and its capacity to shake the world also became alarmingly high. The bubble crossed its threshold in summer of 2007 when many leading American and European banks got severely hit by a collapse in the value of mortgage-backed securities which were packaged for consumers with a very low degree of credit ratings and in some cases none whatsoever. The phenomenon known as sub-prime crisis pierced the bubble first and the bubble headed down to a fast and dangerous burst. Some of the evidences of bubble burst are following:

1. Several major financial institutions such as Lehman Brothers (filed for bankruptcy on September 15th leading to the global turmoil since then), Bear Sterns (taken over by J P Morgan), and insurance giant AIG have financially failed.
2. Various stock markets (From New York to India and London to Hong Kong) have fallen dramatically, especially in the week after the bailout plan was passed.
3. Spreads on a variety of different types of loans over comparable US Treasury securities have widened dramatically. Cost of short term borrowing credit rose strenuously and liquidity dried up.
4. More and more financial institutions, insurance companies, investment banks are reporting severe losses at unprecedented rates.

Slicing and Dicing the Current Financial Chaos

The structure of the financial world has evolved over the years. Right since its early days to early 80s, the share of non-broker dealer sector of the market, mainly commercial, households, and non-financial corporations, in total asset moved in unison with the share of broker dealer based investment banks. In early 80s, the share of broker dealer segment of the market started accelerating and ended up taking over almost two third of the total assets in early 2008. Such a dramatic increase was partially attributed to the growing financial innovations, conducive but flawed regulatory responses, and a rapid increase of market based mortgages. Banks (commercial) were major holder of mortgages up until early 80s. However, the share of market based mortgages took off in early 80s by structuring various
types of financial instruments such as mortgage based securities, asset based securities, and institutionalization of government sponsored enterprises like Fannie and Freddie.

Conventionally, commercial banks engaged into the practice of holding loans on their balance sheets. Mid 80s onwards, the innovative financial structuring paradigm led the major investment banks dominated mortgage market to origination and distribution based model of mortgage system. The idea behind such mortgage market was to offload the risks to other parties. Banks repackaged loans and passed it on to other financial investors by using complex structured products, commonly known as Collateralized Default Obligations (CDOs). This was accomplished by clubbing various diversified mortgage portfolios, loans, corporate bonds, and other credits into a basket and then selling the slices of the basket to investors at differential prices.

Another related issue was the liquidity mismatch for the banks. A typical bank would hold long term mortgages and long term firm loans as the long term assets. The liability side of the balance sheet would show that the assets can be financed either by expensive equity and long term financing or cheap short term funding by commercial papers and repo. Short term funding was cheaper mainly owing to investor’s expectation of inflation and holding risks, rat race among investment banks, increasing popularity of structured products, and lower mortgage interest rates-hitting 45 years low in June 2003. A majority of investment banks and financial institutions started long term financing by cheap short term funding and hence suffered from extreme leverage. The mortgage origination volume increased rapidly from $800 billion in 1996 to a humongous level of $ 3.9 trillion in 2003 (S&P/Case-Schiler index, 2007). The banks started rolling over the short term funding liquidity every day. This led to dangerous issues of maturity mismatch. Apparently this mismatch, knowingly or unknowingly, remained unnoticed by banks and financial institutions until the subprime crisis hit.

To exacerbate the situation further, rating agencies started giving too high ratings (AAA,AA,.) to the holding institutions by incorrectly extrapolating housing prices, systematic risks and correlations, and too much dependence upon leverage capital ratio. Such high ratings certainly suggest some kind of non-transparent and unfair innovative incentive mechanisms designed between the institutions and credit rating agencies.

Accommodative and political economy based regulatory system in US delightfully came up with the proposal of making houses affordable to even lower income borrowers with a poor credit or none at all in some cases. The holdings of Fannie and Freddie to low and middle income borrower went up to 56% in 2004 in comparison to 50% in 2000. Traditional full asset and income documentation based fixed mortgage started getting replaced by low-documentation adjustable mortgage rate based loans with a belief that house prices could only rise and the borrower could thus refinance his loan using the increased value of the house. The housing prices in US rose close to about 100% between 1996 and 2006. Lowering house prices in early 2007 led to subprime mortgage defaults which triggered the liquidity crunch.

The rising popularity of structured products thus cheap credit together with easy loan availability led to housing market crisis which further amplified into the burst of the big financial bubble created over the last two decade. The shock originating from faulty design of housing market propagated through almost all the possible segments of financial markets and it amplified into a full blown financial crisis with asset and market liquidity crunches.

What Happened When the Crisis Hit

When housing prices started heading downwards and the subprime crisis hit, the liquidity from the market got dried up. The financial institutions that have either originated subprime loans or have bought subprime asset-backed securities faced a dramatic increase in subprime and Alt-A mortgage defaults. Short term funding in the form of repo and asset backed commercial paper was no longer cheap. Rolling over of daily liquidity became almost impossible as the spread between margins and haircuts increasingly expanded. The money market participants were no more willing to lend to each other. This setback brought the rating agencies back to their senses and they started downgrading the asset backed securities and financial entities. Most of the quantitative hedge funds started vanishing from the market. Major investment banks started writing off the mortgage and asset backed securities from their books. Mortgage delinquency rates continued heading northwards since January and early February 2008. Since the invest-
ment banks and financial institutions engaged with each other in the transactions of structured credit products and offloading the risks to other parties purely on over the counter (OTC) market, it also gave rise to the problem of externality and an excessive counterparty credit risk.

**Impact of Financial Crisis on India**

There is a strong palpitation among industry practitioners and policy makers about the impact of global financial turmoil on India, especially considering the increasing integration of Indian economy and its financial markets with the rest of the world. The key risks for India can be expected to arise chiefly from the potential reversal of foreign capital flows and foreign contagion in medium term. The adverse effects in India have so far been limited to equities market mainly because of reverse flow of equity portfolios and its volatility, domestic forex markets, and liquidity conditions. It is believed that the dried up global market liquidity will not exert adverse macro effects on India in very near term given the overall strength of domestic demand, predominant domestic financing, and healthy status of balance sheets of Indian corporate sector.

However increasing integration of Indian financial sector with upbeat global markets motivated and incentivized the ambitious Indian global firms to raise debt in global markets as it was cheaper to raise funds in global markets during pre-crisis period. Once the crisis hit, the borrowing costs for Indian firms increased dramatically as global liquidity dry-up together with rise in credit risks spiraled up the rates. Consequently the Indian firms raising debt in global market became dollar deficits. With no other option left, these firms raised short term debt in Indian money market, converted them back into dollar, and used the proceeds to pay back external dollar obligations. The short term debt raise in money market pushed the domestic interest rate up and conversion of rupee into dollar exerted downward pressure on the rupee exchange rate. This tightened the Indian money market. The overall rise in debt service reduced the margin and stock prices plummeted.

Domestic financial markets in India have been efficiently channeling domestic savings into a large part of domestic investments. The domestic firms in presence of strong liquidity conditions put their money in mutual funds for various monetary advantages. Post-crisis, when liquidity conditions became poor, the domestics firms started pulling out their money from the mutual funds to meet their own financing needs. This created a severe setback for real estate companies and non banking financial corporations as their primary sources of funding were the mutual funds. The lowering in the asset value of the mutual funds together with further redemption and fairly high degree of illiquidity and non-tradability of instruments holdings by mutual funds caused mutual funds to go to domestic short term money market and sell holdings of bonds and shares. This resulted into lowering of bond and stock prices. This also shows that the global financial crisis has created significant ripples in Indian financial sector.

The real estate sector, the most dependent sector on external financing, was already facing difficulty in arranging finances due to economic slowdown and correction in prices. The liquidity problem causing redemption from mutual funds further exacerbated the financing difficulties for the real estate sector. The easy and cheap credit available to real estate sector in the past would not be possible in the future. This would get more severe considering the likely fall in sticky prices of real estate and acute liquidity stress. The Indian firms that produce globally traded products will suffer from drop in revenues as global demand will go down.

The disturbing events of global financial markets in Septem-
October 2008 have affected asset prices in India significantly. Since the time period from September 2008 up until now is very short and market data are not available, realistic and quantitative impact assessment of the crisis on India is not feasible. However, the above analysis suggests with a fair degree of accuracy that asset prices and financials of many firms will experience negative shocks in near future. When such shocks happen, the financial health of the company would become supremely weak. Given the lack of flexibility to reduce the workforce or financial capacity to change the production processes in short term, firms must have access to finances (debt or equity) in order to keep operating. This requires a robust financial system that is capable of providing debt and equity to firms in future, and hence the necessary short term liquidity.

Policy Responses and Future Directions
The Reserve Bank of India (RBI) has been coming up with several policy measures to mitigate the impact of financial turmoil on India. Some of the main instruments to manage liquidity and maintain monetary stability have been market stabilization scheme, liquidity adjustment facility, some changes in cash reserve ratio, and statutory liquidity ratio. A flexible use of a combination of these instruments has managed to provide healthy short term liquidity by absorbing adverse market and economic conditions. However such short term liquidity based measures should not be seen as a permanent panacea for the financial crisis. A dynamic policy regime needs to be established in order to combat the impact of the crisis in near to medium term. Some of the recommendations are following:

- Since the demand for rupee has gone up, a substantial amount of liquidity should be injected into the market. Therefore the rupee liquidity should be raised substantially. This can be accomplished by variety of ways; the two main being further cuts in CRR and SLR.
- As previously mentioned, a lot of Indian firms had to convert rupee into dollar to meet their obligations. This suggests fairly high dollar illiquidity. If we want our globally dispersed firms to operate in global markets, we need to increase the dollar liquidity. This could be materialized in the form of currency swaps.
- India needs to maintain its fiscal health in future. This is crucial because giant real estate firms in India that have been borrowing at 35 odd % per year are likely to indulge in distress sales in near future. Having gone through the large expansion plans, the corporate sector in India may face competitions from other countries. This is likely to result into decline in aggregate Indian corporate profits. If this becomes the case in future, government may have to come forward to rescue these two sectors.

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GLOBAL FINANCIAL "FIXES":
A POLITICAL ECONOMY PERSPECTIVE

Meenakshi Rishi
Associate Professor of Economics,
Albers School of Business & Economics,
Seattle University, U.S.A

Kathryn Burruss
Student,
Albers School of Business & Economics,
Seattle University, U.S.A

Introduction
The G-20 Summit, which ended on November 15, 2008, detailed the ways in which nations must come together and collaborate in order to mend the current financial meltdown. The summit—coined “Bretton Woods II”—proposed a reform agenda that mixes broad principles with specific steps to be undertaken before their next meeting on April 30, 2009. In general, the proposals boil down to three specific areas. The first is the realization that the financial crisis has now firmly gripped the real economy in the form of a pervasive global recession. Policymakers agree that only a concerted use of fiscal and monetary policies on a global scale will help cushion the spread of the global downturn.

Second, the G-20 has pledged to address issues pertaining to financial regulation by bolstering monitoring of banks, non bank financial entities, and credit-rating agencies and proposing new rules pertaining to global supervision of global financial institutions.

Third, the G-20 has recognized that worldwide macroeconomic imbalances, viz., where excess savings on the part of a few nations finance excess spending on the part of others need to be corrected to avoid further vulnerabilities in the international economy.

It is the opinion of this article, that the G-20 agenda is not entirely comprehensive, as it fails to acknowledge the political economy of the current financial crisis—in particular, the conflicting goals between states and markets. The article contends that since the relationship between state interests and global markets is thorny, no simple band-aid fix will lead to a sustainable solution. The limitations of global “fixing” notwithstanding, the article does propose some specific mends for the financial meltdown and highlights the importance of emerging economies in this regard.

The International Political Economy of Global Finance
International political economy focuses on the complex relationship between states, markets, and societies. States, markets, and society seek different goals, employ different means, and reflect different values. These differences in the “rules of the game” often result in sharp tensions and conflicts within and between these entities and can complicate multilateral negotiations. The July 2008 breakdown of the Doha Trade Round in a sense reflects the stalemate generated by the tussle between national and global interests.

Viewed in this lens, the current global financial system is a product of the inherent tension between states that want to regulate financial flows and capital markets that thrive on cross
border flows of money. While the past two decades have seen the rise of a more market-oriented financial structure, the inherent instability of financial flows has at the same time, generated enthusiasm for the insulation of national economies from the vagaries of such flows. Such considerations have resulted in haphazard rules and regulations and in some sense created the global crisis that we are in at this juncture. Consider, for instance the issue of financial regulation. While states welcome inflows of capital they also want to have the independence of regulating their own financial institutions. Thus, national self interest stands in the way of adopting and accepting some sort of global regulation that is so vital for the continued resilience of global finance.

From a political economy perspective, Basel 1 and Basel 2 exemplify the classic conflict between national and global interests. In 1988, Basel 1 was proposed by the Bank for International Settlements (BIS) as a global regulatory mechanism to help banks define “core capital” requirements. Tarullo (2008) has noted how the Basel talks themselves were examples of deal-making by nation-states to garner better advantages for their own banks. At any rate, the simple rules of Basel 1 soon gave way in the late 1990s to Basel 2 that subjected banks to minimum capital requirements based on assessments of the “riskiness” of their assets. Risk assessment was deemed to be in banks’ own purview and banks hugely relied on credit rating agencies and on their own models to estimate risk and minimum capital requirements. We now know that this approach to risk management was woefully inadequate and banks simply did not have a sufficient cushion in the wake of a liquidity crunch.

Complicating the matter was the role of banking regulators. Under the previous global rules, bank regulation was left to national regulators who largely believed in a micro-prudential approach - dealing with one bank at a time, under the assump-
tion that if each one was healthy, the system would be safe. This assumption has obviously been found to be false, as the inadequate supervision that resulted from this micro-management has managed to spill out of the US sub-prime mortgage market to banks in industrialized countries as well as in emerging markets.

Recent academic and political conversations on the topic of reform have recommended the need for broad based financial supervision, macro-prudential standards that focus on the strength of the entire banking system (not just individual banks), and international regulators that advise financial firms on risk and leveraging. In this context, British P.M., Gordon Brown has suggested a “college of supervisors,” while the EU has proposed a school of regulators to watch over the biggest financial entities—banks, as well as non-bank financial firms and hedge funds. But, the reality of the situations is that while nations display no qualms in converging to international accounting standards, they are not quite ready to accept an international financial watchdog. Quite simply, no government wants to give up national sovereignty in favor of monitoring by a global regulator.

Indeed, the implementation of credible financial reform crucially hinges on recognizing the politics of the process and confronting the classic dilemma- should nation states sacrifice sovereignty and focus instead on the enforcement of the new international rules of engagement? This is a serious question that demands serious thought- a luxury few nation states have at the present time. Similarly, once the global economy recovers, there is a possibility states will revert to supporting national interests over global safety. Under this uncertain backdrop, the G-20 Summit, and the goals they laid out are somewhat hyperbolic, especially concerning the “fixing” of the financial market. These limitations notwithstanding, this article proposes some specific and modest reforms for mending the current crisis in global finance.

**Specific Areas of Reform**

(i) Expanding the Role of Governments- Better governmental regulation is needed, not necessarily more governmental regulation. Governments must harness the power of market discipline to boost stability. To do this, they will have to demand transparency and promote standardization and exchange based trading. Given the loss of confidence in the performance of credit rating agencies, Governments must be given legal authority to monitor the operations of such outfits.

As global finance is inextricably interconnected, emerging economy governments must collaborate with those in industrial economies. A political economic view suggests that an innate reaction to financial crisis is for a nation to turn its markets inward and institute protectionist policies. However, it is a shortsighted approach—market connectivity brought about the crisis, and only global collaboration will help alleviate the problem. Simultaneously, all governments must deal with the solvency of banks, the ability of banks to fund themselves in illiquid markets, and the health of the real economy. For this reason, multilateralism and not unilateralism is the key to any policy redesign.

(ii) Back to Basics for Banks- The current financial crisis is the swift kick that the financial markets and regulators needed to wake up and re-examine the mess they have created. From here, a number of reforms must be made to avoid future crisis and create a sound global financial system. In the area of banking regulation, some progress is already underway as the FASB has closed the loophole that allowed banks to transfer securitized debt obligations off their balance sheets.

At this point, and forward, banks must learn to separate investment banking from commercial banking and take a broader view of the risks they incur by operating as investment banks. Further, banks need higher capital standards; they need to prepare for crises by building reserves and buffers while the times are good, so that they can be less affected when the going gets rough. It has been in the nature of banks’ risk models to realize a crisis at the moment when the crisis hits, which is hardly effective. Banks should be required to adopt international accounting rules and utilize fair value accounting for financial assets and liabilities. The use of fair value accounting, as instructed by a recent BIS proposal, will help banks build their buffer, as it will increase the amount of liquidity by reducing asymmetric information about opaque assets and liabilities. Banks should also disclose and/or recognize off-balance sheet risks on their balance sheets as this will reinforce market discipline. Yes, all these recommendations
will limit the size and capacity of banks, but safer finance, not bigger finance, is the key to reengineering global banking institutions.

The murkiness and complexity of financial instruments has been a serious problem punctuating the current crisis. Banks should take a long hard look at the costs of non-transparency and non-disclosure. Transparency and information sharing will help deter dangerous financial moves and help banks become more balanced across regions in the way they lend and operate.

(iii) The Role of Central Banks- Central banks are the guardians of financial solidity and they strive for price stability via monetary policy. They have held an almost mystical presence through the last decades as they have been observed to respond to financial need at exactly the right moments. However, central banks do bear some of the responsibility for the current crisis as they did not adequately monitor the asset price bubble that was generated by the combination of loose monetary policies and risky financial maneuvers of the global financial firms. Central banks simply must do a better job of monitoring and creating a soft landing for untenable asset price bubbles.

Central banks have often seen providing liquidity and macroeconomic stabilization as separate tasks, as liquidity is a short-term crisis and macro stabilization a medium term goal, but in the face of the current crisis, the two tasks will have to be addressed at once, as a continuation of locked credit markets will have even broader negative economic effects. If central banks held a precarious balance before, the current crisis will be, by far, the most daunting. The balance that they will have to find in monetary policy is increasingly narrow—if policy is too tight it will further exacerbate the recession, but if it is too loose price instability and inflation could worsen.

Central banks need to be more aware of bank activities in order to clear the loopholes that were precursors to the current crisis. Central banks need to educate themselves with the plethora of innovations being offered by financial institutions and understand how they would affect the economy. For this matter, all financial institutions, not just central banks, will need to make it a priority to forecast how financial market movements will correlate with the economy and become better educated on recent financial sector advancements. In this way, financial institutions can stay ahead of potential problems.

(iv) Mending Global Imbalances - One cannot deny the importance of global imbalances in the current financial
conundrum. It is no mystery that the asset bubble in the US was fueled by the giant pool of emerging market savings that originated in the aftermath of the Asian crisis. Emerging economies learned two important lessons from the Asian crisis that began in 1997—one, that reversal of short-term capital can wreak havoc on countries with less than adequate amount of foreign-exchange reserves; and two, that the IMF can only be used as a last resort. As is evident from Table 1, emerging economies responded accordingly by running current account surpluses and by amassing foreign exchange reserve cushions. At the same time, industrial countries were building quite an appetite for spending because their deficits were being financed by emerging market surpluses.

This global macroeconomic imbalance must be addressed as part of any credible policy. The persistence of such unevenness can compromise the vulnerability of the international currency and financial system. But, here again, the tussle between pursuing national self interest and a desire for global balance is undeniable. On the one hand, global financial stability demands that all countries strive for “balance” in their Balance of Payments. On the other hand, how can global policy makers dictate such a rule to emerging economies with current account surpluses or to spend-thrift economies like US and UK with persistent current account deficits?

Many commentators in the G-20 summit feel that international financial institutions can play an important role in correcting global imbalances. As detailed in the G-20 Summit Statement of November 15, 2008, the collaboration between international financial institutions bodies will be fundamental in constructing feasible recommendations.

While it is not a matter of dispute that nations must work together to ensure that international financial institutions have sufficient resources to provide aid, the credibility of some of these institutions is at stake. In particular, the IMF’s policies have come under severe criticism in the aftermath of the Asian crisis. Needless to say, the IMF will need to reevaluate its policies and criteria for lending. Flexibility should be the key in determining lending, as the institution needs to be responsive to the full range of financial and economic crises. Further, the current architecture of the IMF, the World Bank, and other institutions should be reviewed so that these bodies appropriately reflect the current global economic realities. Accordingly, the IMF may have to reconsider the constitution of its board and start by admitting more emerging economies to the same. Mr. Taro Aso, Prime Minister of Japan, has also demanded a greater role for emerging markets in the Financial Stability Forum—an assembly of financial supervisory authorities and central bankers of various countries.

Although the need for change in the IMF (and World Bank) is broadly accepted, specific changes have yet to be implemented. The clash of national interests makes any kind of consensus difficult to achieve.

**Table 1: Emerging Markets Economic Indicators, October 2008**

<table>
<thead>
<tr>
<th>Country</th>
<th>Exchange Rate</th>
<th>Current account, % of GDP</th>
<th>Foreign exchange reserves, $bn</th>
<th>Foreign assets as % of liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Brazil</td>
<td>-24.8</td>
<td>-1.6</td>
<td>206</td>
<td>51</td>
</tr>
<tr>
<td>China</td>
<td>6.9</td>
<td>8.5</td>
<td>1,906</td>
<td>363</td>
</tr>
<tr>
<td>India</td>
<td>-20.1</td>
<td>-2.9</td>
<td>283</td>
<td>na</td>
</tr>
<tr>
<td>Russia</td>
<td>-8.7</td>
<td>6.2</td>
<td>542</td>
<td>56</td>
</tr>
<tr>
<td>South Africa</td>
<td>-38.7</td>
<td>-7.7</td>
<td>31</td>
<td>128</td>
</tr>
<tr>
<td>South Korea</td>
<td>-31.3</td>
<td>-3.3</td>
<td>240</td>
<td>41</td>
</tr>
<tr>
<td>Hungary</td>
<td>-19.2</td>
<td>-5.9</td>
<td>25</td>
<td>49</td>
</tr>
</tbody>
</table>

From: The Economist, October 25, 2008
half of the total increase in import volumes, and one third of global trade since 2000. It is worth noting that currently emerging economy central banks hold over $5 trillion in reserves, a five time increase from 2000. But, it is apparent that even with a comfortable reserve position, emerging economies are not immune to crises in advanced economies. At the same time, emerging economies have momentum in their favor and the global macroeconomic outlook will be increasingly influenced by production, consumption, savings, and investment decisions made in these economies.

What about specific policy responses to the current crisis? One must note that there are large variances in the domestic financial development of emerging economies; therefore strategies will need to be structured on an individual basis. Already several large emerging economies are calling for a concerted fiscal stimulus plan to limit the progress of the crisis. China was the first to adopt a fiscal route to growth in November 2008 and India released the specifics of its stimulus package a month later, on December 7th, 2008.

Especially important will be the role that China plays in reengineering currency, banking and governmental policies. From any perspective, without China’s involvement a mending of the global economy is unthinkable. China accounts for one quarter of the global growth of the last five years and is a leader in intraregional trade. China holds $2 trillion in foreign currency savings, and its financial prowess and leadership will be fundamental to the recapitalization of Western financial markets. The Chinese economy might be able to stave off the recession faced by advanced economies, due to robust export-led growth, solid investment, and capital accumulation. In the last few years, China has loosely aligned its currency to the dollar, which has rendered its currency cheap and forced rival exporters to keep their exchange rates low as well. Surpluses accrued from this manipulation of exchange rates, helped contribute to the global imbalances discussed above. Although, there is a global need for China to reconsider its currency policy, the state of China will probably not move to reform its policies unless it has a greater stake in global policymaking. The political economy of this situation is obvious — in order for China to change policy, there must be an outside incentive. This could be a larger role in the IMF, or a more explicitly recognized position.

What about other emerging economies? As emerging economies hold a prominent position, they need to be asking how to maximize gains and minimize costs, as to avoid the mistakes made by advanced economies. India, in particular needs to rein in its budget deficits as it can lead to vulnerabilities and compromise financial stability. The Baltic region’s greatest obstacles are internal corruption and incompetent politics. In Latin America, policymakers must make sure that the benefits of growth are more widely distributed. Not only will this be socially beneficial, but also it will help with the sustainability of these economies, as there will be a broader support base for reforms and stable growth momentum.

Conclusion
There is no denying that a financial and economic crisis has hit the globe, but what silver lining can we glean from the situation? The slowing growth of emerging economies and the recession in the advanced economies is a call to a refocusing and a re-envisioning of how the global economy operates. This article has attempted to integrate considerations of international political economy in the complex tapestry that characterizes the current state of global finance. The crisis is a call for the modification of unbridled growth, risky financial moves and deregulation in the financial sector. It is also an appeal for policymakers to understand the tensions between national sovereignty and global financial markets. Interdependence and globalization have only resulted in exacerbating the tussles between states and market and without an appreciation of these complexities; no mending agenda will be sustainable.

Endnotes and Additional Thinking
2 Statement from G-20 Summit, NYTimes.com, pg. 3.
3 The Economist, October 25th-31st, pg 88.; Statement from G-20 Summit, NYTimes.com, pg. 4
5 The Economist, October 12th 2008, A monetary malaise, pg 22

(The views expressed in the write-up are personal and do not reflect the official policy or position of the organisation.)
A Proposal To Stop The Fear-Fear Spiral
Introduction

The “financial market tsunami” that rocked the world had its origin in the US housing market, and resulted from indiscriminate and excessive lending on one hand, and excessive leveraging among financial institutions on the other hand. Earlier on, the US housing market boom was driven by indiscriminate and excessive lending rather than by low interest rates. The indiscriminate and excessive lending reflected a moral hazard problem, as lenders believed that they shifted their risks to others or had protection against default through the widespread use of credit default swaps. Through securitization, mortgage lending institutions easily obtained more money to lend to homebuyers, as a result of which many of them became overly leveraged and thus more and more vulnerable.

In point of fact, in the absence of excessive lending, really destructive bubbles could never form. If homebuyers had meager incomes, their limited ability to bid for homes means that homes could never be priced beyond their reach. The US housing bubble was in part a result of domestic politics that favored making mortgage borrowing available to those who could not afford it, and in part a result of a form of moral hazard: some financial institutions believe their lending is sheltered by Credit Default Swaps, so that they can lend indiscriminately, and mortgage brokers have little concern with repayment, since their immediate concern is to earn a commission.

The reversal of US housing prices since 2006 was not unexpected, even though the extent of the decline was. Just as the housing bubble was caused by policy that mistakenly favored homeownership and ignored the dire consequences of excessive leveraging, so its collapse was triggered by excessive interest rate raises against a backdrop of dangerous leveraging.

The Fear Fear Spiral

In the beginning, the declines in home prices were relatively mild, and the economy held up quite well, benefiting from a weak dollar that helped US exports surge providing impetus to the economy. But as home prices fell more and more, the effects on lending institutions began to show, and the Fed waited far too long before it began to reduce interest rates. As the damage spread, fear began to grow, and it was the collapse of Lehman Brothers in mid 2007 that served as the
last straw, and the financial tsunami grew into an unstoppable force.

The collapse in confidence led to a virtual freeze in credit markets. The so called TED spread, namely the spread between three-month U.S. Treasury Bill yield and LIBOR, rose to well over 400 basis points on October 10, 2008, well over the long term average of around 30 basis points, and the financial markets were seized with fear. Home price collapse accelerated, consumer confidence plummeted, the ISM indices dropped to a frighteningly low level of 39, and world financial markets suffered the worst month of decline not seen in decades. This happened notwithstanding the most aggressive injection of liquidity by the central banks of the world and the passing of the unprecedented bailout package that in the end exceeded 800 billion dollars.

What made matters much worse at this time was the dramatic rise in the exchange value of the US dollar and the even more dramatic surge of the Yen. Exports-dependent Japan was hardest hit. A 91 Yen to the Dollar exchange rate, particularly when the Dollar itself had surged against a basket of currencies, would wipe out the profits of all major manufacturers in Japan. The Nikkei collapsed, and the Hang Seng Index in Hong Kong followed. In China, which itself was hard hit by the strength of the RMB, stock indices broke through all barriers and collapsed. Major declines across the world fed a “fear fear spiral”, and housing markets across the world went down, threatening the health of banks and other financial institutions, whose balance sheets continue to deteriorate with every percentage point decline in the housing markets. Banks feared the worst and would not lend to other banks. The inter-bank market was totally frozen. As they stopped to lend, borrowers were caught in a credit crunch. It is imperative to stop the fear-fear spiral.

Two Measures to Deal with the Crisis

With coordinated interest rate cuts around the world and many rounds of liquidity injection into the banking system, finally the credit markets began to warm up in the second half of October 2008. Stock markets around the world started a healthy rebound in the last week of October. If they continue to rise, then there is a good chance that the vicious circle between the financial market and the real sector would be broken. But I would argue that two measures would ensure that the vicious circle be broken, and thus that the ensuing recession be short and mild rather than a prolonged deep recession which many analysts are now predicting.

A Buy-Back Program

Presently, housing prices in the United States are no longer out of line with long term trends of per capita GDP and are still slipping largely because of a lack of confidence. These prices under normal times should be able to hold, and the contraction in new housing supply over most of the last year is also contributing to a new equilibrium. Holding prices at today's levels will, moreover, be sustainable over the longer run. Indeed, if the price level is creeping up over the longer term, holding nominal housing prices at today's levels will still allow real prices to adjust.

More specifically, I propose that the US and the UK government, as well as any other country caught in a similar situation, to announce a buy-back plan from existing homeowners for homes at a "fair price as of October 2008" (or any other suitable "cut-off date," as this will be called). This fair price is calculated in the first instance as the original purchase plus or minus a percentage reflecting the change in the regional housing price index from the original purchase date to the cut-off date, but it will be fine-tuned upward or downward through an on-site appraisal.

Once this announcement is made, home-sellers will think twice before selling while potential home buyers will re-emerge, since there is no more fear that housing prices will continue to spiral downwards. As housing prices stop falling, the financial health of financial institutions will be secured. There will be an end to the rising defaults which are now haunting the financial markets. The stock market will surely rebound, and confidence will gradually revive. The strong wealth effect that this brings back to the economy means that consumption, factory orders, and employment will revive.

The government will sell any units purchased at a price
What made matters much worse was the dramatic rise in the exchange value of the US dollar higher than the acquisition price. This means that there will be no net cost to taxpayers, and indeed there is a potential for capital gain for the government.

To limit the scale of the offer, it is proposed that the offer be for homes priced at or lower than the median price. While the offer is thus limited to the lower half of the housing market, other properties will also benefit because of spill over effect. The offer may also be made to financial institutions that have foreclosed the properties and this will help improve their liquidity.

The proposed measures are effective in restoring confidence and they are consistent with human psychology.

**Judicious Intervention in Currency Markets**

It is comforting to see that sanity appeared to return to currency markets in the first week of November. Apparently the central banks had coordinated their efforts in intervening in the currency markets. The Yen fell back to 99 Yen to the Dollar, while the US dollar fell back to a level that is more consistent with the economic fundamentals of the economy. In December 2008 the Yen surged again, this time against a much weakened US dollar.

There is evidence that an excessively strong US dollar was very much behind the Asian Financial Crisis. Indeed, the real purchasing power of the US dollar rose 15% from 1995 to 1998, which really hurt those economies that had their currencies closely tied to the US dollar. It should be noted that both a freely floating exchange rate regime and a pegged exchange rate regime could be inconsistent with healthy economic growth. A floating Yen, such as the Yen in October 2008, could become excessively strong. A pegged Peso could also become excessively strong, as in the case of Argentina peso crisis from 1999-2002. The Peso was excessively strong because it was tied to a strong currency at the time. Judicious intervention is necessary.

**The Future**

Over the longer run, of course, it will be necessary for the financial institutions to be judicious in the extension of loans to home-buyers, and for the regulators to ensure that no market players are excessively leveraged, and that key decision makers must not be in positions of conflicts of interest. For example, rating agencies are likely to be biased if they have business ties with the very companies whose securities are being rated. Regulators should also ensure that key decision makers in the market place are not biased by any conflicts of interest. They also must ensure transparency of costs and risks, because market participants need to be informed before markets can operate efficiently.

Much reform will be needed over the longer term, and the world’s financial market will be different. The more immediate task now, however, is to stop the slippage of the US housing market. Without this, mortgage rates will continue to stay high to reflect the cost of fear, and this will continue to weigh down the housing market and the global economy.

*The views expressed in the write-up are personal and do not reflect the official policy or position of the organisation.*
Restructuring a Financial Collapse to Full and Equal Rights for All
Poverty, war, and economic collapses are caused by “Plunder by Trade” within external commerce and, within internal economies of wealthy nations, by “Property Rights Law, as Applied to Nature’s Resources and Technologies, Denying Others Their Rightful Share of What Nature Offers to All For Free.” These are socially-produced, not labor-produced, values and thus properly belong to the citizenry in roughly equal shares.

Property rights within monopolized Land were addressed deeply by Henry George and the other primary monopoly, banks/money, has been with us for at least three millennia. Secondary monopolies, established by those same property rights laws, were studied deeply, in their early stages, by John Stuart Mill, Alfred Marshall, Thorstein Veblen, Ralph Borsodi, Stuart Chase and others.

Along came the Great Depression, World War II, and the Cold War, and those views on property rights disappeared from the university system. Even though the concepts you read here were not taken from any standard teachings of today, they do have the solid academic base just described. Such easily-understood economics were pushed out of the social mind during the Cold War hysteria.

The developing world now understands “Plunder by Trade” and are correcting those economic imbalances. So, we are concentrating here on “property rights law, as applied to nature’s resources and technologies.” Since it is the key to restructuring all other sectors of the economy, we will start with how to eliminate the monopolization of banking and money and we will be using the American economy as an example.

Money and banking are social technologies understood for millennia. The only tangible values (meaning they were labor created) within modern fractional reserve banking is brick, mortar and furniture. As there are few tangible values to own and modern banking is only a social technology without the tangible values of precious metals once used, this crucial social tool should be socially owned and operated.

With $7 trillion pledged by the Treasury and Federal Reserves pouring into the American banking system to stem the current (2008-09) collapse, those banks are—by current bankruptcy law—already socially owned. It is only necessary to declare it so by Congressional action or Presidential decree. Since the Federal Reserve has the power to create money and distribute it directly to those socially-owned member banks, they cannot go broke. Depositors of the remaining sound banks will flee to the security of those socially-owned banks, who, due to operating at 1/3 the cost of a monopolized banking system, are paying higher interest on deposits and charging lower interest on loans. As depositors flee to that security and higher profits, the banks from which they are fleeing will turn in their keys and the entire banking structure will be socially owned. The banking structure will then be in place to stop this financial collapse in its tracks and restructure to full and equal rights for all with no poverty and a quality life
for every world citizen.

The first order of business for President Barak Obama and the frightened Congress would be legislating “the right for every head of household—husbands, wives, or singles—with
tout a job and without other income or resources to apply to
their bank or credit union for a monthly subsistence based on
single households receiving 75% that of married couples and
an allowance for each dependent.” Those funds circulating will
replace the massive sums of money being destroyed by today’s
(2008-09) collapsing values.

This is what Treasury Secretary Hank Paulson and Federal
Reserve Chairman Ben Bernake are attempting to do with
their pledged $7 trillion but they are pouring that money at the
ethereal world of high finance which created this crisis instead
of at the real economy and that money is being destroyed
faster than it is being created. Where those polices may fail,
pointing that money at the real economy, as we are suggesting,
will succeed if it is honestly applied.

Banks will put the applicant’s electronic transfer number on
those applications. That
form will include
testimony, under oath,
that they have no
income or resources.
Upon signing, and on
the 1st of each month
thereafter until receiving their first full paycheck, subsistence
funds will be computer-deposited into those accounts. Heads
of family will walk out with funds in that secure bank to cover
food, fiber, and shelter for that month and each month
thereafter until they are again employed.

With this break from unequal property rights laws as applied
to nature’s resources and technologies, all Americans are now
fed, clothed, and housed. The worst aspects of the crisis, a cold
and hungry citizenry, are taken care of as the flow of money
keeps the economy going.

With money flows across national borders controlled
through countries and regions issuing new currencies spend-
able only within their borders and the currency of a world
central bank handling trades between nations and regions (a
dual currency structure), any shortage of circulating money for
subsistence payments’ and continued funding or repairing of
economic infrastructure can, up to the level of a balanced
money supply, be created.

As a nation or region can safely create its own money if
spendable only within its borders, negotiations will be ongoing
with other countries on establishing that crucial dual currency
trading structure worldwide. Currencies within each country
or economically viable region are then controllable by man-
dated fractional reserves controlling the velocity, and thus the
supply, of money. A 30% increase in reserve deposits beyond a
targeted level will require mandated reserves be increased
from a mandated three percent to possibly four percent (or
10% increased to 13%) to maintain a stable money supply.
When the crisis is over, surplus money will be drained back out
of the system.

As collapsed monopoly values based on unequal property
rights law can quickly rebuild, governments must move quickly
to restructure those laws. A single payer health care bill (one is
ready to be introduced to Congress, November 2008) would
pass and, with health care now a human right, medical costs
will start dropping towards its proper level of 50% of today’s
monopoly costs.

That drop in costs,
already in effect in
countries with single
payer health care,
exposes over 50% the
health costs in America
as wasted within the
superstructure of monopolized health care. A monopoly
marketing right has been replaced by a social right with its
already proven efficiencies.

As they are a necessity, insurance on homes, cars, business-
es, etc, should be a social right. The human right to a secure
retirement (social security) operates on only half of one
percent of premiums paid (payroll deductions). With that
insight into the monopoly costs of marketing rights for
insurance, Congress passes legislation for all except life
insurance to become a social right.

Insurance costs immediately drop from the current 50% of
premiums to six percent. The disappearance of insurance
offices from every community, even as all are better insured,
exposes the superstructure of the former insurance monopoly.
Those now-unemployed insurance workers will draw subsis-
tence payments until the economy is fully restructured and
everybody employed.

The genie will be out of the bottle and it cannot be put back.

Developing world now understands
‘Plunder by Trade’ and are correcting
those economic imbalances
The advantages and efficiencies of a socially-owned banking system, universal health care, and a secure retirement as social and human rights would be so obvious that the citizenry will be looking forward to a continued restructuring to full and equal rights. With the citizenry now understanding and intending to restructure the unequal property rights laws that created their poverty and this crisis, any monopoly values still standing will collapse.

That new social understanding is Henry George’s key concept, “Human labor did not produce land (resources), nature offers it to all for free, and a rightful share for each can be had through socially-collected resource (land) rents returned to all citizens through funding essential services.”

All taxes disappear and the citizenry are quintuply repaid as those funds (bank profits, created money, and resource rents) finance governments, build and maintain economic infrastructure (water and sewer systems, roads, railroads, electricity, communications superhighways, and all other natural monopolies), provide universal health care and retirement and, in an emergency such as the current worldwide economic collapse, finance any social need.

With these quintuple gains understood by the awakened citizenry, society collecting all resource rents and expending it on social needs will pass by law or referendum. The mother of all monopolies (land [resources]) and its sister primary monopoly (banking) will have been eliminated. All would be receiving their share of the wealth produced by nature (banking is a very natural social technology), and, for the first time in history, an honest capitalist society will have been established.

As the above is taking place, accountants will be assessing the value of all property before and after the financial collapse. The price mechanisms of capitalism had measured those values but the illegitimate monopoly-created values and the 60% of the current blocs of capital created to buy and sell them will have disappeared and only labor created tangible values (closely matching use values) remain. Protection of honestly-earned savings mixed with those collapsed monopoly values requires reduction in debts at the same ratio as the rationalization (collapse) of monopoly values.

Under these inclusive principles, land values will be zero but the use values will be more valuable than ever. The renewed titles to land (resources) will require paying resource rents to society. With property reassessment ongoing, this alert president proceeds to clear up titles to all property and, with the greatest good for the greatest number in mind, restore the financial health of the nation.

With current collapsed values calculated, the previous owners will have first rights. The land under all homes, all farms, all mines, and all industries will be debt free but the owners must now pay monthly resource rents to society. Considering these rent payers, which will be everybody, are quintuply repaid as those funds come right back to them as addressed above, socially-collected resource rents and bank profits is by far the most efficient social structure.

As land now has no sale value, those lands will incur no purchase costs but its ownership will, since rental values must be paid, require productive use. The property owners have all rights to that land as before except the right to collect a private tax, the land rent.
Loans against nature’s wealth (land, resources) must be erased from the records and that against structures revalued to current values. Registered owners, including former owners of foreclosed properties, will have first rights. Acceptance of that debt-free title obligates owners to pay monthly resource rent to society. If 50% of loan values were backed by the land before the crisis, that 50% loan value is erased and the remaining 50% revalued. If homes and structures, separate from the land, were half paid for before the collapse, the remaining loan would be discounted to 50% those structure’s current value. Autos, boats, and other loans would be similarly restructured. Paid-for real-estate would not be affected except that landowners monthly rent to themselves (socially collected) would, when all efficiencies were factored in, be quintuply compensated as addressed above.

Productive resources and personally operated businesses would be entitled to protection and support from the socially-owned banking system in the same manner as these suggestions for protection of titles to homes. Assuming a rental home had been repossessed, those renting would be first in line to purchase those homes and financing would be available. This socially-owned banking system, being not-for-profit and not bankruptable due to its money being spendable only within the nation’s borders, has replaced trillions of dollars in uncollectable debts on homes with collectable debts at the same debt-equity level as before the collapse.

Protecting the rights of all while stabilizing a severe crisis is not viable under private banking and restructuring an economy is equally impossible. Protecting borrowers would be in direct conflict with current property rights and private banks’ maximization of monopoly profits. In contrast, when stabilizing a crisis such as we face today, a socially-owned bank can erase all debt that is necessary.

With the citizenry understanding the monopoly system they previously were unaware existed, and with property rights secure, this is the time to tackle the doubling of consumer costs due to patent monopolies. Explanations to the citizenry on how consumer prices are at least twice that necessary due to the monopoly structure of patent laws will make those patent property rights changes imperative. Whether by Congressional action or referendum, those patent laws will change to paying inventors well and placing patents in the public domain.

When that law is fully in place, 85% of the activity of casinos known as stock markets—where those unearned monopoly profits were collected—will disappear and consumer product costs will drop by half or more. The resources and talented labor previously battling over who shall claim the
enormous wealth produced by technology will be available for truly productive use.

Now fully understanding the efficiencies of technology denied us by the monopolization processes, it will be recognized that the citizenry of the world can be educated right at home over communications superhighways at five percent the cost of brick and mortar schools. That base is already laid, Internet2—in use for 10 years—is 100 to 1,000 times more powerful than Internet1. Once that efficient education system is in place, working hours must be reduced to absorb the labor force that once cared for brick and mortar schools.

Among the large numbers of unemployed will be people well qualified to calculate the number of productive jobs in a fully rationalized, efficient, economy. We will assume their calculations will match ours, two to three days work per week for each employable citizen. From that calculation, Congress would pass and a President would sign, or a voter referendum would mandate, a reduction of the work week by that amount. A productive job for each is now guaranteed.

Subsistence payments continuing as wages during the first one to two months, or more, of an employment-learning period will readjust the workforce smoothly. Highly skilled jobs, pilots, railroad engineers, etc, will take substantially longer. A few skills, such as scientists, may take years to rebalance the workforce but that and a stable money supply can be seamlessly accomplished. This planned rebalancing will take a little time, but very little compared to the current ad hoc, unplanned, highly inefficient rebalancing of economies.

Current patents will be in force for up to twenty years. Transferring technology to undeveloped regions in trade for access to those resources as we speak. All will recognize that unequal property rights (monopolization patterned after aristocratic law) had effectively collapsed and they will adjust their property rights accordingly. Most important, the developing world will realize that they collecting the resource rents (in part the unearned profits of “plunder by trade”) will both reclaim their right to those resources and provide the money to build industry and infrastructure.

Values of corporations are primarily capitalized values of wealth appropriated through exclusive title to nature’s resources and technologies, the monopolization process. These are all big boys fully believing in the system they had created and which had now crashed. As those monopoly values had been appropriated from productive labor over the years and those unequal property rights — now proven as a system of theft—have been abandoned, nothing is owed there. The economic collapse plus the loss of monopoly values will drop the value of most corporations below their debt values (values collapsed 89% in the Great Depression).

As the original private banks will have been holders of 1st mortgages, they, now socially-owned, will own most of those corporations and the elimination of patent monopolization will collapse stock values to tangible (labor created) values. This thesis retains private property and free enterprise. Distributing shares to labor and management within those corporations as loans at market-value, and with those loans to be repaid along with the principles of the subchapters “Accumulation of Capital under Henry George’s inclusive property rights ” and “Investment and Job Opportunities” in Economic Democracy: A Grand Strategy for World Peace and Prosperity (by this author) that would be resolved equitably. With its own workers and managers the new owners, along the lines of those subchapters, those industries would be operated efficiently.

A department within the socially-owned banking system of each economically viable-region or nation (currencies viable only within those borders through a dual currency world structure) would fund those major industries and businesses.
The financing of worker-owned businesses and cooperatives would be the economic ideal of labor employing capital. Since this banking system has the power to direct socially-created money to areas in need while simultaneously holding required reserves high enough to destroy surplus buying power and maintain a steady money supply, and with each industry or business responsible for their debts, funding would not be a problem. Loans to cover expansions and new enterprises would be available at interest rates high enough to cover risk.

The many sub-divisions of financial empires within the ethereal world above the real economy will have collapsed when the economy crashed. The socially-owned banking system will keep the real economy operating. The many methods of intercepting wealth within the vapory ethereal world of high finance will have withered on the vine. GDP now measures only economic activity in the real economy as compared to 60% of its current measurement being the trading of monopoly values.

A great hue and cry will go up that these huge blocks of unearned capital are necessary to operate an efficient economy. That warning will be muffled as the mighty engine of Henry-George-capitalism doubles the efficiency of the economy. Once full and equal rights are established a slim, trim, “real” economy will replace the highly-inefficient ethereal economy which had evolved into a crazy quilt of methods to intercept the wealth produced by productive labor transposing resources that nature offers to us all for free into industrial capital and consumer products. Once restructured, each of those best and brightest who once owned and operated those niches within a monopolized economy will be guaranteed a “productive” job. There will be no need to carve out an unproductive survival territory or financial empire.

Those who see new opportunities will have access to investment capital through loan officers trained and experienced in financing promising new endeavors. Socially-owned risk capital charging high enough interest to pay for that risk would be paid from cash flow and those entrepreneurs, no longer monopolists, would retain the honest capitalized values of their successes.

Eliminate the waste of labor and resources operating the superstructure of those monopolies permits lowering employed time outside the home to two to three days per week.

But the gains can be even greater yet. Social decisions to reject corporate control of food supplies would permit societies to establish permaculture. This is happening. Faced with massive famine, Malawi rejected cheap imported food, funded local agriculture, and is now a food exporter. So how to be food-self-sufficient is well understood. Hemp and other fiber plants from which clothes are woven are highly prolific. So, clothing self-sufficiency can be established as a part of permaculture. Rammed earth, adobe, brick, straw bale, and other efficient homes that remain structurally sound for centuries are also built from local materials. Those locally-produced essentials of a secure society — food, fiber, and shelter — ex-
pose the waste within monopoly capitalist societies.

Notice how cheap the above essentials of a secure society can be. But there is a secondary waste based on the well-understood freedom to travel in a modern economy. Not only is transportation unnecessarily expensive, one must be entertained and cared for at each stop within those travels.

A three wheeled, 300 miles per gallon, gas-electric runabout, 20% the weight of today's automobiles (http://www.popularmechanics.com/automotive/new_cars/4237853.html), will be for sale as we go to press. Beyond the computer everything in that car was on the shelf for sale 40 years ago. So it is possible to commute cheaply without environmental damage. Instead, automobile industries are collapsing specifically because they were trying to retain the $8,000, profits on large, gas guzzling, automobiles. That little, 300 mpg runabout (no gas used in local commutes) has been ignored because it would earn a mass produced profit of less than $500.

At http://www.storyofstuff.com/, we learn that all above one percent of what we purchase ends up in the trash within six months. That conspicuous consumption and planned obsolescence disappears when each are equally paid for equally productive labor and the appropriation of massive wealth through the monopoly structure is eliminated. Not only would honestly earned income not permit one to buy $60,000 — ten mile per gallon — automobiles, those who did would be ridiculed.

Labor outside the home in a fully efficient and honest economy need to be no more than two to three days per week. You can calculate this yourself by analyzing the labor value of production and distribution of every product and service a family consumes.

What will people do with that spare time? Seamstresses would spring up in every community producing beautiful and stylish unique clothes at a very low price as opposed to the current, conspicuous consumption, extremely high priced, in style, mass produced, clothes. Cheap mass production would remain firmly in place but artists of all kinds would surface and cheaply provide the community and the world with style, paintings, carvings, and artwork of all kinds. Local appliance and automobile repairmen will do most, but not all, repairs on those essentials at a fraction the cost of an uptown repair shop. Carpenters will build beautiful furniture in their shop behind the house. Teams of home builders will build homes.

Remember, each of these will have rights to employment outside the home two to three days per week which will provide them a quality life. Yet most community production will be done very cheaply and those extra earnings will provide the skilled and ambitious with a even higher standard of living. Compare that with the current impossibility of selling one's artistic creations within today's monopolized markets. Of course, the most talented and persistent will give up their job, do what they enjoy full time, and make very good money.

Summary: Abandon monopolization of nature's resources and technologies which she offers to us all for free, pay those rental values to oneself through socially-collected resource rents and socially-owned bank profits funding governments, roads, railroads, water and sewer systems, communications, electric systems, education, any natural monopoly (infrastructure), health care, and retirement, and we all have full and equal rights with a quality life while employed outside the home only two to three days per week.

Today's economic structure, touted as efficient and productive, is nothing more than aristocratic monopoly law hiding under the beautiful words capitalism, peace, freedom, rights, etc. If the serfs of the Middle Ages had won those struggles and established a cooperative economic structure instead of a monopoly structure, production would have doubled, in a few years it would have doubled again, and again and again. If those same people had been cooperative instead of warlike slave masters, they would have told the natives they met as they explored the world that, “We will teach you to read and write, teach you how to smelt iron, build ships, and teach you all other technologies of a modern society.” Those already cooperatively cultured people would have soon equaled their teachers and the world would have been fully developed a hundred years ago and all without war and poverty. If these cooperative, efficient social strategies were put in place worldwide restructuring from this financial collapse, poverty could be eliminated in ten years and a quality life could be had by each citizen of this world in two generations, fifty years.

(The views expressed in the write-up are personal. * This book (2009 edition) was written to explain how to stop the current worldwide financial/economic collapse in its tracks, and then restructure to a quality life for all citizens of this world. That restructuring eliminates the 50% plus of current economic activity that is pure waste, thus alleviating global warming.)
Storm clouds are gathering as policy makers and opinion leaders awaken to the fact that we are facing the most grimly serious economic crisis in the world history. De-leveraging, caused by collapsing debt, is occurring at such a rapid pace and massive extent that even the world’s leading central banks, including the US Federal Reserve, the European Central Bank, and the Bank of England, are threatened by credit losses so large that at some point in the not-too-distant future even their substantial balance sheets...
– not to mention access to “capital” aka taxpayer funds - could become overwhelmed.1 And the fallout effects of this meltdown have only just begun.

Thus, as one investment advisor wrote in a recent e-letter:

“The real news is this: The planet is being remade. Entire nations are withering, entire neighborhoods are dying, and for millions of people left behind, the future will not exist in any meaningful way... Please understand, I am no pessimist. For every householder trapped in a suddenly insupportable monthly mortgage payment, in a dying neighborhood, in a shrinking economy, stuck with a portfolio of wildly overvalued stocks...There is another householder living debt-free in a burgeoning township, in a booming economy, sporting a portfolio bulging with stocks picked up for pennies on the dollar, who eagerly anticipates a living standard rising higher and higher, borne upward on a fabulous tide of wealth”.2

Investment opportunities notwithstanding, drastic corrective measures are clearly called for, given the sheer magnitude of the crisis. But so long as we remain wedded to the current monetary system we will collectively be forced to participate in a level and scale of human calamity never before seen or imagined. None of us will escape unscathed or untouched.

Moreover, any corrective measures devised within the current context will necessarily be more – far more - of the same patchwork of plans targeted at select groups and industries. The debt burden will explode and consume ever more of us as escalating numbers of “have-nots” are forced into an increasingly desperate, potentially violent battle for survival against the “haves”.

All this is predictable because continual transfer of wealth upwards into fewer and fewer hands is an unavoidable, mathematical certainty of the current monetary system. Thus, the practice of “picking up” assets for a “dime on a dollar” during downturns in the credit cycle has - for countless centuries - been a time-honored tradition among the more financially able.

Said credit cycle is in fact an integral feature of the current financial/monetary system and a principal means by which wealth is continuously transferred. Ominously, one proposed component of the patchwork of plans will only serve to reinforce and protect this and future credit cycles, calling as it does for the creation of a new global regulatory regime.

As two critics recently described it, this regulatory regime “will separate the largest banks, global by nature, from the rest thus creating an elite group of financial institutions with oligo political power at the top of the global financial pyramid. These banks will be so large and so "systemically important"... that they will never be allowed to fail; they will control all global finance. The very situation [means that] the privatization of profits and the socialization of risks will become a defining feature of the new system. As the G20 have stressed, these mega-banks will continue to operate within a system "grounded in a commitment to free market principles" and thereby able to speculate freely so as to amass even greater fortunes for the financial elite while the risks they take will be borne by us, the ordinary people. The new system will have moral hazard built into it”.3

Moral hazard notwithstanding, calls for a new regulatory regime - which depends on ever greater levels of taxpayer support and transfer to citizens of risk taken on as a result of the investment strategies of the financial elite - is little more than a desperate attempt to prolong a failing system. Just as importantly, the whole endeavor will only prolong - and exponentially magnify - the misery of larger and larger portions of humanity.

As recent events show, the financial system remains precariously on life support despite the trillions in taxpayer dollars so far committed to its rescue. Even worse, said financial system is dragging the real economy - where ordinary people live and work - down with it. Most troubling of all is that there is no satisfactory way of putting Humpty Dumpty together again, because “ultimately, 'all the king's horses and king's men' cannot prevent the de-leveraging of the financial system under way. . . The extent of de-leveraging is substantial and likely to take time. [And] As each of the global economy's credit creation engines breaks down and systemic leverage reduces, money becomes scarce . . .” 4

Simply put, we operate under a monetary system that requires constant expansion of credit. We now face the
prospect of total collapse because the monetary liquidity provided by credit is freezing up. No one wants to lend because no one can afford to lend – there is simply too much bad debt which still needs to be written off. This is why governments have been so recently generous with taxpayer funds.

Unmentioned is the fact that credit is the “lifeblood of the economy” for the simple reason that money is created when banks extend credit through what are loosely termed loanable funds, also known as reserves, created via government debt paid for by taxpayers. In short and because money is created as credit (or debt), collapsing debt leads to credit contractions which then leads to a collapsing money supply.

It is, and always has been, money scarcity - not credit scarcity - which poses such an incredibly serious threat to the real economy and the ordinary people who work there.

During downturns in the credit cycle, it is a shortage of money in the real economy that forces businesses to tighten their belts or go bankrupt, leading to elimination of worker benefits, reduced wages and fewer jobs. In turn, production drops and normal access to food and other necessities of life declines. If the producers have been especially productive during the preceding upturn, the markets will be overloaded with goods too few can afford to buy, forcing prices to nosedive, often below the cost of production. And a vicious, downward cycle, once set in motion, can all too easily get out of control as more and more money evaporates from the real economy.

Yet in a bitter sort of irony, the productive capacities of the people has not radically changed. It is rather the reduced amount of available money which produces real, and often unspeakable, hardship for untold millions. The entire situation brings to mind an observation made by commentator James Crowther of the Great Depression: “Breadlines knee deep in wheat are surely the handiwork of foolish men”.5

Injecting sufficient liquidity into the national system will allow it, eventually at least, to create more money (as loans) but the resultant runaway inflation will have a similar effect as a shortage of money. Thus the enormity of the current credit crisis carries with it the very real possibility of massive, perhaps uncontrollable civil unrest which could in turn threaten the very nature of civilization itself.

Unfortunately for ordinary people, the rapid decoupling of the real economy from the financial economy now underway means that the old stand-by approaches, including mammoth liquidity injections and new regulations, are not nearly enough to prevent the inevitable descent into the mass economic destruction of real economies around the world.

The fact is that “[w]hen a long-dominant paradigm fails in its prescriptions, and it calls for more of its failed prescriptions to solve its failures, its circularity becomes terminal. What is not recognized is the underlying principle of the escalating failures: that financial crises always follow from money-value delinked from real value, which has many names but no understanding of what it is. Value is what serves life itself, and the global market paradigm has no place in its metric for the life factor at any level.”6

The financial economy is not the same as the real economy - and making money is not the same as earning it. Real value is in the earning, not the making, of money. The financial economy allows money to be created (made) as credit (or debt).

Money-value is built when interest and other fees are charged for the creation and use of this credit/money. These charges are made each and every time credit is extended or a loan is taken out, and they accumulate exponentially over time through the laws of compounding interest. Because all those fees and charges are not created as “money” they are essentially unpayable - unless more debt is incurred in order to pay said charges.

The system is inherently unstable because of the need to increase the money supply at ever faster rates as more and more money goes to pay the accumulating interest charges rather than for needed good and services. Constant expansion of both credit and markets is required or the system will face certain collapse. Paradoxically, the more an economy expands, the more it automatically goes into ever greater debt to the financial system. Market cycles must occur in order to keep inflation of wages and prices within a mathematically feasible range.

In this system, economic expansion is not simply a luxury
but an imperative. One must always “[b]ear in mind that the meaning of ‘discounted cash flow’, which is the moving line and reference body of global market value, means that what is today $100 in real terms is the same as $100 + compound interest in one year ($110), two years ($121), or 20 years from now as the starting base from which every "worthwhile enterprise" is calculated. The system is a horizonlessly expanding money-demand machine engineering all that lives to extract more money value from it.”

In essence the current money creation process turns money (or currency) into a commodity - rather than allowing it to serve simply as a medium of exchange - by allowing it to “make a gain out of itself” through the application of interest charges and assorted fees. Yet, as Aristotle himself asserted long ago, “money was intended to be used in exchange, but not to increase at interest. ... Wherefore of all modes of getting wealth this is the most unnatural.”

The real economy is where money is earned, and shortages of money for the real economy have always existed - even in good times - in those monetary systems where credit has served as money. We only need to look at money supply versus debt to understand the problem.

In the US for example, the money supply has increased dramatically since 1980, going from less than $2 trillion in 1980 to an estimated $14 trillion in 2008. Far outstripping the money supply however is debt. In 1980, total public and private debt totaled roughly $5 trillion, with about $1 trillion of that representing public debt. Today public and private debt totals roughly $50 trillion, with over $10 trillion of that representing public debt.

Significantly, this situation exists for the undisputed “economic/financial powerhouse of the world”, one that has long been blessed with workers and businesses that are among the most productive the world has ever seen. Yet more and more of their productivity, and their wealth, is in a very real sense extracted from them in order to pay the interest on their private and public debt. The consequences are everywhere, as businesses, governments and individuals struggle to do what it takes to stay ahead of bankruptcy.

Tragically and for countless centuries, much of the world has been laboring ceaselessly under the tyranny of financial systems which are allowed to make - and profit from – debt-based, commodity money. Sadly, none of this has been necessary - once you recognize that monetary systems are nothing more than giant book keeping systems. You can make them as simple or complex as you like, but they are book keeping systems nonetheless.

So it is that we can say that “the [most recent housing] boom was in fact engineered through the injection of massive amounts of "liquidity" [i.e. Credit serving as money] into the system. This money needed a home. It was this need that drove the demand for 'risk'... [But] 'risk' would be better termed as money needing a home that pays as much as possible in return. ...[The newly developed investment vehicles] created the illusion of low risk high paying investments coupled with low capital requirements. ... It was the Fed that fueled the fire....”

In short, today's meltdown was both predicted (by Warren Buffet and many others) and predictable, with ample historical precedent to serve as a guide as to both cause and effect. It was the direct result of the bursting of a massive, global speculative bubble made possible through a wide array of easy money (i.e. credit) policies, primarily promoted by the US which then led to a veritable explosion of highly privileged, highly leveraged, non-transparent, “off balance sheet” debt.

This debt was in fact credit, serving as money, looking for a place to go for the highest return – and it found it primarily in the form of increasingly complex and risky derivatives instruments, now known as “bad assets”. So it is that, “as every student of economic history knows, depressions, ever since the South Sea bubble, originate in excesses in the financial economy, and go on to ruin the real economy.”

Years before the current crisis, economist John Kenneth Galbraith was able to vividly describe the predictable scenario: “Whatever the pace of the preceding [speculative] build-up,
whether slow or rapid, the resulting fall is always abrupt. Thus the likeliness to the ripsaw blade or the breaking surf.’11

Galbraith's survey of financial panics included the South Sea Bubble of 1720 (known as one of history's worst financial bubbles and now dubbed the “Enron of England”), the Great Depression of 1929 (which some experts say made the creation of a global monetary system imperative), and a sizable list of smaller, more isolated panics which occurred in the United States from 1819 forward. None of these matched the kind of devastation unleashed upon the world by the first – and so far the worst – global financial collapse which occurred after the world’s biggest banks went under as a result of the bursting of a worldwide speculative bubble that peaked in 1345.

Some rather disturbing parallels to today’s crisis might be gleaned from that 1345 crisis. The following excerpts from an article titled “How Venice Rigged the First, And Worst, Global Financial Collapse” shed some light on some of those parallels by providing a brief glimpse into why and how this collapse occurred – together with some of the results, which included a dramatic, worldwide drop in population due to famine and disease brought about by a severe shortage of money (or rather credit serving as money) and subsequent reduced access to food and other essentials of life:

[This 1345 collapse] was more than a bank crash—it was a financial disintegration [in which] all credit vanished together, most trade and exchange stopped, and a catastrophic drop of the world’s population by famine and disease loomed. [It was] the result of thirty to forty years of disastrous financial practices, by which the banks built up huge fictitious financial bubbles, parasitizing production and real trade in goods. These speculative cancers destroyed the real wealth they were monopolizing, and caused these banks to be effectively bankrupt long before they finally went under. . .

. . . Since in Fourteenth-century Europe, important commodities like food, wool, clothing, salt, iron, etc., were produced only under royal license and taxation, bank control of royal revenue led to, first, private monopolization of some of these commodities, and second, the banks’ “privatization” and control of the functions of royal govern-

The current crisis promises to be no less dire than that of 1345 and in fact has the potential to become much worse. Surely, the time has come to break free from the clutches of a monetary system which mathematically guarantees the continuous transfer of wealth upwards and which must periodically collapse once irrational exhuberance has forced debt, including carrying charges, beyond the mathematical capacity of the system.

The task of course will not be easy, or it would have been accomplished long ago. And because certain entrenched powers are likely to resist - even resorting to force and all kinds of subterfuge if needed to be in order to retain the status quo - all options need to be left on the table. These options might include the temporary use of barter between nations and within communities, until such time as a new, unpegged, debt “free” national currency gains the trust and respect of allied nations. “Free trade” agreements would need to be canceled and bilateral agreements used instead. Local scrip, and community currencies, operating alongside bartering and the national currency, could help facilitate exchange of goods and services at least at the local level until such a time as the money supply can be correctly managed.

In tandem with these activities, governments need to begin issuing their own debt “free” money, which should be used first to retire the public debt. Public projects could be drawn
up as well, for public approval, including perhaps a one-time, emergency dividend for citizens. An appropriate amount of debt “free” money would be issued to support those projects.

As in the current system, the principle of extinguishment would be employed to manage the flow of money in and out of the system, but because interest fees and other charges will not be attached to this money, both public and private debt would decrease substantially – and real wealth would explode. Public debt would eventually disappear altogether. As nations are newly empowered with the ability to create their own wealth and sustain themselves, borrowing from the IMF or any bank would become a thing of the past.

Importantly and because money is power, the monetary system eventually adopted needs to be fully transparent, with its money flow formulas and rules and principles codified into law. It also needs to include a mechanism by which local communities and their local governmental bodies would retain a reasonable portion of the money creation power.

In the case of the Public Credit Money System, both adopted rules and the money flow formulas employed would require no more than a 5th grade education to understand. In addition, money creation power could be exercised by local citizens each time they authorize their local officials to borrow interest free money from the national monetary authority. The national government would have no say in these projects - it would only issue, in the form of a loan, the interest free money requested. Local projects might include roads, bridges, water systems, market facilities or whatever other asset or service it is that the local citizenry deems important enough to borrow interest free money. This money (and the loan attached to it) would be extinguished as the approved local taxes or other fees are sent to the national monetary authority. At the end of the specified time period the local citizenry would own, control and benefit from the authorized project in question. No longer would officials be compelled to sell off local assets to the highest corporate bidder and public/private partnerships would take on a whole different meaning and format.

Such a system would not require endless expansion and growth. Instead, excess waste and destruction of resources would become a thing of the past as individuals become vested in their communities and their collective and individual futures. We can no longer afford to simply sit by and wait for a miracle, particularly one formulated for us by the very people responsible for current - and past - crises. But, with sufficient courage, patience and resolve – together with a clear grasp of monetary systems – those of us concerned about the future of humanity and the planet can create a miracle. It's time to not only mend this meltdown but engineer a true and permanent recovery.

Endnotes and Additional Thinking

4 ibid.
7 ibid.
9 Davies and Hunt, “Sleepwalking Our Way to Hell”.

(The views expressed in the write-up are personal. He is also the creator and manager of the related website: http://thetwofacesofmoney.com/ which includes recent reviews.)
END OF GLOBALIZATION AND THE EMERGENCE OF A NEW WORLD ORDER
The recent happenings in the global financial markets, with its epicentre at the US, provide us the context to understand the text. First the context.

For long globalisation has been virtually an un-critiqued idea especially amongst intellectuals, media and the polity. No wonder, when confronted to explain the idea, those who parroted the same several times a day, were found to be at their incoherent best.

But the idea that drives the concept of globalisation is definitely not an innocent one. What else would explain the marketing of the same with missionary zeal by the proponents of this idea, all across the world? In fact, there have been several waves of globalisation – read homogenisation of the world - that has been attempted in the history of mankind. And at-least, there are three prominent attempts after Christ.

The first attempt to globalise was in the first millennium after Christ through religious interventions with the army and commerce playing a distant secondary role. The second attempt in the second millennium was through the army, with both religion and commerce playing a supplementary yet purposeful role.

The third wave of globalisation, coinciding with the end of the last millennium and the beginning of the third, has been through commerce, which has emerged as the chief drive of the modern day globalisation. And in this wave both the army and the religion have played an influential supplementary role. Crucially, the thin dividing lines between the three are increasingly getting blurred in this wave of globalisation.

What is Best for the West is Best for the Rest

The experience of the past two decades or so of this latest wave of globalisation indicates that it is premised on the assumption that what is “Best” for the “West” is assumed to be “Best” for the “Rest.” In effect, what we are witnessing is not a globalised West – read America - but the world that is getting increasingly Americanised.

But that is not all. Even in the case of commerce – the chief drive of modern day globalisation – global economy is being confronted by an enormous challenge by what is innocently termed as global imbalance. And this requires no great seer to either explain or understand the issue on hand.

In fact, this imbalance is a direct consequence of intense interaction between the profligate and the prudent, between savers and spenders, exporters and importers, between the reckless and the cautious and between countries that have a strong currency and those who have a weak currency. Yet we talk of a globalised world, a global order and a global way of doing things? How silly we could get?

Experience of the past decade or so point out to the fact that, there is a distinct dichotomy in the approach to national economics by the Asian countries (that are prudent) with the Anglo-Saxon world lead by the US, which are reckless. But what makes the US and others in the Anglo-Saxon world to be reckless in their spending, in direct contrast to their Asian counterparts, is something that is beyond the radar of any meaningful debate even at the global level.

Family Values and Economics – the Emerging Frontiers of Economics

And the answer to this is the diminishing family values in the West. Naturally, this has turned everyone in these countries into a reckless consumer. It is this breakdown of the institution of family that has atomised the society leading to this consumption binge that is having a profound impact on both the national as well as global economies.

Nevertheless, it was this mindless consumption that acted as an engine of global growth for the past several years. In the process it ushered in great amount of prosperity at the macro level, never mind the imbalance associated with it. Consequently, any one who questioned the intrinsic instability of this model was branded as Neanderthal, primordial or even insane. That explains why globalisation remained mostly un-critiqued.

Be that as it may, as brilliantly articulated by eminent finance professional, Mr. S Gurumurthy, the Western societies have been built on atomised individuals that lead to gargantuan consumption on one hand and the collapse of the family on the other. Consequently, the West had no other option but to nationalise the responsibility of a traditional family through the social security net of their respective governments. In the process, this burden pauperised the State. The result - privati-
sation of the very functions of the government as it could no longer effectively carry on its primary activities.

That in turn has lead to the corporates taking over the function of government under the privatisation programme. Consequently, corporates began to act as a surrogate for both the government and the family resulting in “corporatising” of the markets and then globalising these corporates. In effect, globalising is an agenda of a few corporates.

In the process, the markets mechanism as conceived by Adam Smith was suspended and the invisible hand as conceived by him, chopped. And when corporates too failed as it has happened recently one wonders what’s next.

In contrast, Asian countries being rooted in the traditional family values have been parsimonious in their consumption and hence enjoy a far higher rate of savings which fuels their domestic investment. This correlation between family and national savings is the emerging frontiers economics in the ruins of globalisation. Importantly, economists may now well understand that while Asian countries may not be engines of global growth caused by reckless consumption, they are surely not the cause of global instability either. At best they can be guilt of producing more, saving more and exporting more!

Turning Economics on its Head

Let me put the entire issue in the present context. The whole of Asia exports to the West, notably the US. But being conservative societies, they are unable to absorb their export surplus – read savings. The net result – they park their export surplus into those very countries that import from them in the first place. In effect, they finance the West to import from these very countries, which produces them in the first place!

This one-way export of savings remains at the core of the present wave of globalisation. In the process it is capital from the “poor” developing Asian countries that is flowing uphill into the developed “rich” West. Surely, economics has been turned on its head when it is the poor who lend and the rich who borrow!

Yet, those who swear by globalisation failed to demonstrate as to how a model that is created by the West for itself and becomes dysfunctional even in the West; can claim it to be a functional success elsewhere. At best it can be an experiment of the West attempted on the Rest.

It may be noted that the internal imbalance within the US economy as explained above manifests as the global imbalance. It is this lack of family values that leads to internal deficits within the US. And to fund this deficit the world has been sucked into the vortex called globalisation. Experts are slowly coming to the view that it is the internal imbalance within the US that remains at the root of this global imbalance. Remember, whenever the US is involved, it is always global, be it terrorism or economics.

Time to Rethink is Now

Now to the text on hand. Obviously, we need to have quick rethink on the issues concerning globalisation. Obviously the intent of globalisation to homogenise and standardise the
world through commerce and finance with a view to dominate others has surely fallen flat. Globalisation can at best mean as the Rig Veda tells us the culmination of all noble thoughts. This can happen only by understanding the plurality of the world as it stands, not by ridiculing and by imposing oneself on others. What is interesting here is to note whether it is the Dollar or the Western concepts (which in hindsight seems to be a cross between skulduggery and buffoonery) Viz. accounting standards, corporate governance or risk management systems, which remained un-critiqued till date and yet served as a model for the rest of the world to emulate stands cruelly exposed. But what are the lessons to the finance professionals from the collapse of the global model? The answer to this requires some understanding of the systemic issues involved in global financial architecture. Hence a brief reference to the functioning of the same.

Global Finance – A Cross between Crooks and Buffoons

Naturally, the recent events in the financial markets across the globe has left most completely flummoxed. What makes the developments in the US financial markets over the past fortnight extremely painful, is the fact that it has comprehensively exploded our collective belief in the ability of the US to regulate its gargantuan financial markets by itself. At this point in time, experts have come to a view that this is by far the worst financial crisis to have visited the US since the Great Depression of the 1930’s. Consider This:

• Experts predict that this financial crisis will result in a loss of at least USD one trillion and could probably end up at a far higher figure of USD two trillion. The resultant crisis, when it is full blown, is expected to severely hit the financial and banking sectors. The worrying part is that experts predict that this crisis will last several years leading to a severe and persistent liquidity and credit crunch.
• Contrary to the popular belief that the losses are limited only to sub-prime assets, the fact of the matter is that this crisis is spreading from sub-prime to prime mortgages, home equity loans; to commercial real estate; to unsecured consumer credit (credit cards, student loans, auto loans); to leveraged loans that financed reckless debt-laden Leveraged Buy Outs; to municipal bonds; to industrial and commercial loans; to corporate bonds; to the derivative markets whose risk are indeterminate at any point of time and where counterparty risk – and the collapse of many counterparties – could well lead to a systemic collapse of all markets.

The Shortcomings of the US Regulation

In fact, it is not the failure of the US financial markets that has caught analysts by surprise. Rather, it is the failure of the US regulatory mechanism that was touted as infallible till the other day and that is effectively the model for regulators across the globe to this day, which has caught analysts by surprise. It is rosogullas of Kolkata will not contain Kolkata within it! Likewise, there is hardly anything Federal about the US Federal Reserve mechanism. It may be recalled that the Federal Reserve System was formed in 1913 by an act of the Congress to serve as the central bank of US. Interestingly, the System consists of a seven member Board of Governors and twelve Reserve Banks located in major cities throughout the United States.

In effect the US Federal Reserve system is a cartel of these twelve major banks. I have in one of my previous columns titled “Who cares for the dollar? Not the Fed, surely!” pointed out to the fact that the ownership of these twelve banks remains a secret even to this day. And to this extent the working of the US Fed as a government agency suspect.

The seven members of the Board of Governors are appointed by the President and confirmed by the Senate to serve 14-year terms of office. Further, in making appointments, the President is directed by law to select a “fair representation of the financial, agricultural, industrial, and commercial interests and geographical divisions of the country.” These aspects of selection are intended to ensure representation of regional interests and the interests of various sectors of the public.
The primary responsibility of the seven Board members is the formulation of monetary policy. The seven Board members constitute a majority of the 12-member Federal Open Market Committee (FOMC), the group that makes the key decisions affecting the cost and availability of money and credit in the economy. And the decision of this group makes or breaks our fortune across the globe.

The other five members of the FOMC are Reserve Bank presidents of the twelve banks that form a part of the syndicate, one of whom necessarily is the president of the Federal Reserve Bank of New York. This is where things get interesting. A bit of search on the web about the president and CEO of the now bankrupt financial giant Lehman Brothers Richard Fuld (not pronounced as fooled) throws up something very obnoxious. Readers may be aghast to know that Fuld was (he resigned after Lehman Brothers went belly up) in the Board of Governors as the Federal Reserve Bank of New York as the elected representative of the “member banks to represent the public.” Or was it to represent the interests of Lehman Brothers? It is akin to an industrialist of a quoted company in India sitting on the board of SEBI. If the distinction between the regulator and the regulated get blurred, such disasters are bound to happen.

But where are the Chinese Walls?

Obviously, that makes the claim of independence in the functioning of the US federal System entirely hollow. Remember, one of the five outsiders in the FOMC is the president of the Federal Reserve Bank of New York!

And being in the Board of the New York Fed, the extent of influence Fuld wielded on the US Fed through the president of the Federal Reserve of New York is anybody’s guess. But the result is there for all to see. It would take a complete suspension of one’s sense of disbelief to come to any other conclusion.

And it is not the US Fed alone that is at fault. Rather this – collusion between the regulator and the regulated - seems to be a pandemic amongst the regulators in the US.

Experts have been repeatedly pointing to the prevalence of collusion between the players and the market regulator by tolerating massive “creative accounting” and other forms of “window dressing of the balance sheet.” Obviously, this is to prevent firms from recognising and reporting their true losses. This obfuscation of truth by the regulators is with an avowed objective of avoiding a financial meltdown. But in the process most of these earnings reports are not worth the paper they are written off.

Further, most financial institutions, thanks to the lax supervision even to this date by the regulators are without any let or fear manipulating the value of illiquid assets in total disregard of accounting Standards. In effect, the SEC, the Fed and other regulators are encouraging massive amounts of fudging. Auditors, especially the bigger ones with brand names have a sordid track record of playing ball on such issues. Naturally, the triumvirate of the management, regulators and auditors – the key players in any financial oversee mechanism collude, there is very little that one can do.

With the auditors, regulators and the regulated having a convergence of purpose, it does not take a seer to say that the global system is entirely in the hands of crooks. Fuld’s presence in the Board of New York Fed has effectively ensured that such manipulation needs not to be done second hand through others. Rather it seems, it was done first hand. Crucially, it had the sanctity of the laws and regulations in US.

Further, contrary to the popular belief that the financial markets have become more transparent, in real life it has become exactly the opposite – it has become more opaque. Experts opine that the reason for the same is the development of new financial instruments notably exotic derivative instruments, which are both hard to value and price. No wonder auditors in the West have become a laughing stock as they themselves could not value these instruments and find out the risks associated with these.

It may be noted that many of these instruments are illiquid and are purchased over the counter rather than in an exchange. The value of such OTC derivatives which involves banks as one of the party to the transaction exceeds USD 600 trillions – yes 600 trillions - as on date! (The worldwide figure including exchange-traded derivatives exceeds USD 3000 trillions!)
And the response to all this skulduggery in the financial markets is to unleash newer accounting standards and issue fresh disclosure norms. Cancer cannot be cured by applying pain balms! Neither can there be a substitute for ethics and discipline. Consequently, there is very little information about such instruments, their ultimate beneficiaries, the exact nature of risk they hedge and its possible negative impact on the beneficiary. All these issues are waiting to explode and they will shortly.

And as these instruments mature, one is constrained to say that what happened last week would be like a trailer of a horror movie. The main picture, one has to warn, would be scarier, deadlier and of course far more painful than the trailer. To conclude, US financial system and by extension the global financial system is a creation of bad laws, regulators who are out of sync with the developments (especially in case of creation of newer instruments) in the markets, auditors who even before you wink are ready to sign on the dotted lines and corporates whose ethics are suspect.

In short, global financial architecture and the regulatory mechanism that goes with it are entirely dominated by crooks. Strangely this was accepted by the others, especially in countries like India as infallible and as a model worth emulating. Naturally, that reduces us to the level of buffoons. In effect, global finance is a cross between crooks and buffoons. To me, accounting standards, audit standards, SOX compliance, prudential norms, corporate governance, peer review, valuations, fair market accounting, guidance et al seem to be a cruel joke. The latest financial crisis has clearly demonstrated that none of these regulation works. Yet it is this suspect ideas that are being introduced into the country.

Let Us Introspect…

Obviously, the fall of the West, notably the US calls for greater introspection. Communism with all its internal contradiction and monstrous manifestation was bound to fail. Reckless capitalism too is taking the titanic route. Is there a third way? Is there an alternative the Western model of Communism and Capitalism? Or were all these an aberration with the Asian economic model rooted in family values the only way?

It is here that one hastens to add eastern civilisations, notably India, Japan and China, have survived for over several millenniums. Their very survival over a period of time makes them a global model and worthy of emulation. But it is the intellectuals in the East who have by accepting everything from the West who have let down by the East and also the rest. And that includes the finance professional fraternity.

It is time that we reversed this colossal mistake by studying our own models and have faith in ourselves to devise a far superior model for the world. The changing dynamics of the global order make it imperative. The time to revisit all these models and to devise a new one is compelling like never before. In short, it is a sub-prime crisis caused by a sub-prime financial system caused by a sub-prime economic model caused by a sub-prime habit caused by a sub-prime culture. The fact of the matter is that all these needs to be cleansed. The billion-rupee question is – are we ready to shoulder this responsibility? If we do not seize this opportunity we will be condemned to another round of world order, designed by the West, for the West but controlling rest.

We must not be condemned to another round of world order, designed by the West, for the West but controlling rest.
Where Do We Go From Here?

The Next Phase of Globalization
The economic news from the United States in the Fall of 2008 could not be more grim. The contagion that began with collateralized bonds built upon questionable housing mortgage loans insured through dubious credit default swaps has now spread throughout the major pillars of the nation’s economy. Major Banks in crisis are now joined by the auto industry, the retail industry, and other consumer related businesses preparing to endure what would appear to be a deep and protracted recession. This has spread far beyond the borders of the United States to adversely impact world economies from Europe to Asia. Confidence in this environment is in short supply.

Many articles have begun to appear suggesting that the freewheeling market oriented capitalism that has been the order of the day for the last twenty five years needs to be rethought with more regulatory controls. Some have suggested that the imperative for globalization of markets may need to be reined in to deal with new economic realities.

The world has weathered periods of economic crisis before. The Asian financial crisis of 1997-98 threatened global markets around the world and was contained only through massive infusions of capital from the IMF, world banks and the US taxpayer. The economic slowdown of 2001 that began with the failure of high technology based firms, and accelerated after the 9/11 terrorist bombing, was short lived but significant in the movement of economic creation to the emerging countries like China and India among others. Going further back, the long grinding recession of 1978-1982 slowly ended as the information technology boom created new wealth and opened global markets.

So, how will the world pull out of this present economic meltdown? What is on the horizon that could possibly enable global economies to reverse course, climb back, and perhaps surpass the current level of development? Will it be technology related in the development of alternative energy and transport functions? Will it be in the development of new financial instruments that can put global markets back upon sound footing? Will it be in the internal economic development of China with its immense financial reserves finally put to positive use? Will it be in a reduction of tensions between “have” and “have not” nations creating global instability? Will it be in a combination of these things or in some heretofore unknown “next big thing” that injects global economies with stimulating new investment? I would suggest that some of the answers to the above questions will be generational.

**Toward a New Era of Globalization**

The election of Barack Obama as President of the United States may be looked back in years to come much like the fall of the Berlin Wall in 1989; as a metaphor for a profound shift in thinking. The fall of the Wall presaged the beginning of an age of aggressive globalization that altered static thinking in a range of areas from global capital markets to new uses of technology that brought the world closer together. President-elect Obama’s election may do the same for the world’s young people; particularly the skilled and talented middle level managers that have been stymied in their progression to decision making positions by a generation that still runs most of the world’s business and political institutions. The new generation will move globalization into venues not imagined by individuals over 50 (of which I am one). More skilled at networking, possessing a better feel for technology, and less constrained by the fights and strictures used in the past, may very well be the solution to our current economic problems.

Some have suggested that the imperative for globalization of markets may need to be reined in to deal with new economic realities.
of another era, this new generation of skilled and talented young people will begin to make its impact felt on all aspects of the global economy.

The new era of globalization will not necessarily be one where individuals travel the globe in search of new markets. If anything, markets will become increasingly local, yet guided by global conventions. This world will communicate with one another across and within cultures threaded together. Through this, a new and very different world economy will emerge. The new economy will move too fast for static measurements in exports and imports. Rather companies will grow from thousands of different places, (often from points not previously considered hospitable to market capitalism), and will not so much challenge the old structure as supplant them. Capitalism will re-form itself around smaller enterprises that rise out of the firms that created the first era of globalization. Prevailing business models will be reconfigured for a connected environment where an interchange of ideas, trends, discussions are swiftly injected into points near and far. Because you will need an education to part of this world, the new era of globalization will belong to those with the specific skill sets that enable them to take full advantage of this connectivity.

The leading edge of this new economic vision is most likely in India. I say “most likely” because I believe it can also arise in Japan, and pockets of Europe and the United States. These new economic pioneers have in many cases been trained and worked for some of the major firms in the world. In many cases they will stay there and rebuild firms from within. Old thinking will give way to new thinking and firms will be reconstituted to meet the needs of this new generation. Because the firms will grow in different ways, we will have to value them differently. The binding ties created through education, cross-cultural communication and global work will alter thinking: slowly at first and with greater speed as growth occurs.

A new and better world economy will arise from the current crisis. It will be built differently, without the reliance on an American consumer and fossil fuels from Muslimocracies to move it forward. It may at last long address the bottom of the pyramid; individuals crushed at the bottom without hope or promise. It will not be easy. There are bound to be hiccups along the way. But the foundations of the new era of globalization will be built upon far more solid ground than the previous one. I believe.

(The views expressed in the write-up are personal and do not reflect the official policy or position of the organisation.)
RECOVERING THE JEWEL OF THE BRITISH EMPIRE: THE TRIUMPHS AND CHALLENGES OF THE PEOPLE’S MOVEMENT THAT TOOK BACK INDIA

Ellen Hodgson Brown J. D.

Los Angeles, California, USA, Author of ‘Web of Debt’
In the nineteenth century, India was called the jewel in the crown of the British Empire and was the very symbol of imperialism. The country celebrated its freedom in 1947, after Mahatma Gandhi unleashed the collective power of the Indian people and helped bring about the country’s independence by leading a mass non-violent resistance movement against the British. Today India and China together are called the twin engines of economic growth for the twenty-first century. Combined, they represent two-fifths of the world’s population. But while India is politically independent, it has continually had to battle the entrenched moneyed interests, which have fought to recover their lost dominance by other means. What they could not keep by force, the neo-colonial powers have sought to regain by economic coercion.

According to a PBS documentary called “Commanding Heights,” in the 1950s India was a Mecca for economists, who poured in from all over the world to advise the Indian government on how to set up the model economy. Their advice was generally that it should have a state-led model of industrial growth, in which the public or government sector would occupy the “commanding heights” of the economy. This was during a time when people had not yet lost their faith in the ability of governments to make good economic decisions. Gandhi’s economic ideal was a simple India of self-sufficient villages; but Pandit Nehru, the country’s first prime minister, wanted to industrialize and combine British parliamentary democracy with Soviet-style central planning.
In the prototype that resulted, all areas of heavy industry – steel, coal, machine tools, capital goods – were government-owned; but India added a democratically-elected government with a Parliament and a prime minister. At that time (in the 1950s and 60s), the country became the model of economic development for newly independent nations everywhere, the leader for the Third World in planning, government ownership, and control.1

Helping to shape the economics of Nehru and his successor Indira Gandhi in the 1960s was American economist John Kenneth Galbraith, who was appointed ambassador to India by President John F. Kennedy. Galbraith believed that the government had an active role to play in stimulating the economy through public spending. He wrote and advised on public sector institutions and recommended the nationalization of banks, airlines and other industries. India’s banks were nationalized in 1969.

Disillusionment with the promise of Indian independence set in, however, as the private interests that had controlled colonial India continued to pull the strings of the new Indian State. In 1973, the country had a positive trade balance; but that was before OPEC entered into an agreement to sell oil only in US dollars. In 1974, the price of oil suddenly quadrupled. India had total foreign exchange reserves of only $629 million to pay an annual oil import bill of $1.241 million, almost double its available reserves. It therefore had to get US dollars, and to do that it had to incur foreign debt and divert farming and other industry to products that would sell on foreign markets. In 1977, Indira Gandhi was forced into elections, in which key issues were the IMF and the domestic “austerity” measures the IMF invariably imposed in return for international loans. Indira was pushed out and was replaced with a regime friendlier to the globalist agenda. William Engdahl writes, “the heavy hand of Henry Kissinger was present . . . in close coordination with the British.”2

India’s later economic history was detailed in a 2005 article by a non-partisan research group in Mumbai, India, called the Research Unit for Political Economy (R.U.P.E.). It stated that India’s development was supposed to have been carried out free of powerful foreign and domestic private interests; but the economy wound up tailored to those very interests, which the authors described darkly as “large domestic and foreign capitalists; landlords and other feudal sections; big traders and other parasitic forces.” The government embarked on a policy of engaging in investment by expanding external and internal debt. Loan money was accepted from the IMF even when there was no immediate compulsion to do it. Annual economic growth increased, but it was largely growth in the “unproductive” industries of finance and defense. External debt ballooned from $19 billion in 1980, to $37 billion in 1985, to $84 billion in 1990, culminating in a balance of payments crisis in 1990-91 and a crippling IMF “structural adjustment” loan. After 1995, the policies advocated by the World Bank were reinforced by the stringent requirements of the newly-formed World Trade Organization. According to the R.U.P.E. group:

For the people at large the development of events has been devastating. The relative stability of certain sections – middle peasants, organised sector workers, educated employees and teachers – evaporated; and those whose existence was already precarious plummeted. It took time for people to arrive at the perception that what was happening was not merely a series of individual tragedies, but a broader social calamity linked to official policy. As they did so, they expressed their anger in whatever way they could, generally by throwing out whichever party was in power . . . .

Yet the [new government] follows, indeed must follow, broadly the same policies as its predecessor. Any attempt to slow the pace is met with rebukes and pressure from imperialist countries and the domestic corporate sector. Indeed, there is no longer any need for them to intervene explicitly. With the last 14 years of financial liberalisation, the country is now enormously vulnerable to volatile capital flows. This fact alone would rule out any serious populist exercise: for the resources required would have to be gathered either from increased taxation or from fiscal deficits, either of which would alienate foreign speculators and could precipitate a sudden outflow of capital.3

Miracles for Investors, Poverty for Workers

Like other Third World countries, India has been caught in
the trap of accepting foreign loans and investment, making it vulnerable to sudden capital flows, subjecting it to the whims and wishes of foreign financial powers. Countries that have been lured into this trap have wound up seeking financial assistance from the IMF, which has then imposed “austerity policies” as a condition of debt relief. These austerities include the elimination of food program subsidies, reduction of wages, increases in corporate profits, and privatization of public industry. All sorts of public assets go on the block – power companies, ports, airlines, railways, even social-welfare services. Canadian critic Wayne Ellwood writes of this “privatization trap”: 

Dozens of countries and scores of public enterprises around the world have been caught up in this frenzy, many with little choice. . . [C]ountries forced to the wall by debt have been pushed into the privatization trap by a combination of coercion and blackmail. . . How much latitude do poor nations have to reject or shape adjustment policies? Virtually none. The right of governments . . . to make sovereign decisions on behalf of their citizens – the bottom line of democracy – is simply jettisoned. In theory, these structural adjustment programs also benefit local populations by enhancing the efficiency of local production, something that supposedly happens as a result of exposure to international competition in investment and trade. But their real effect has been simply to impose enormous hardships on the people. Food and transportation subsidies, public sector layoffs, curbs on government spending, and higher interest and tax rates all hit the poor disproportionately hard. Helen Caldicott, M. D., co-founder of Physicians for Social Responsibility, writes:

Women tend to bear the brunt of these IMF policies, for they spend more and more of their day digging in the fields by hand to increase the production of luxury crops, with no machinery or modern equipment. It becomes their lot to help reduce the foreign debt, even though they never benefited from the loans in the first place. . . Most of the profits from commodity sales in the Third World go to retailers, middlemen, and shareholders in the First World. . . UNICEF estimates that half a million children die each year because of the debt crisis.  

Countries have been declared “economic miracles” even when their poverty levels have increased. The “miracle” is achieved through a change in statistical measures. The old measure, called the gross national product or GNP, attributed profits to the country that received the money. The GNP included the gross domestic product or GDP (the total value of the output, income and expenditure produced within a country’s physical borders) plus income earned from investment or work abroad. The new statistical measure looks simply at GDP. Profits are attributed to the
country where the factories, mines, or financial institutions are located, even if the profits do not benefit the country but go to wealthy owners abroad.7

In 1980, median income in the richest ten percent of countries was 77 times greater than in the poorest ten percent. By 1999, that gap had grown to 122 times greater. In December 2006, the United Nations released a report titled “World Distribution of Household Wealth,” which concluded that 50 percent of the world’s population now owns only one percent of its wealth. The richest one percent own 40 percent of all global assets, with the 37 million people making up that one percent all having a net worth of $500,000 or more. The richest ten percent of adults own 85 percent of global wealth. Under current conditions, the debts of the poorer nations can never be repaid but will just continue to grow. Today more money is flowing back to the First World in the form of debt service than is flowing out in the form of loans. By 2001, enough money had flowed back from the Third World to First World banks to pay the principal due on the original loans six times over. But interest consumed so much of those payments that the total debt actually quadrupled during the same period.8

China and India: Ahead of the Pack
The statistics for most Third World countries are dismal, but India has done better than most. China is politically still
Communist and therefore part of the “Second World,” but it too has had serious struggles with poverty. Advocates of the free-market approach have relied largely on data from China and India to show that the approach is working to reduce poverty, but as Christian Weller and Adam Hersh wryly observed in a 2002 editorial:

[T]o use India and China as poster children for the IMF/World Bank brand of liberalization is laughable. Both nations have sheltered their currencies from global speculative pressures (a serious sin, according to the IMF). Both have been highly protectionist (India has been a leader of the bloc of developing nations resisting WTO pressures for laissez-faire openness). And both have relied heavily on state-led development and have opened to foreign capital only with negotiated conditions.9

The declines in poverty in China and India occurred largely before the big strides in foreign trade and investment of the 1990s. Something else has contributed to their economic resilience, and one likely contributor is that both countries have succeeded in protecting their currencies from speculators. Both were largely insulated from the Asian crisis of the 1990s by their governments’ refusal to open the national currency to foreign speculation. In India, as in China, private banking has made some inroads; but in 2006, 80 percent of India’s banks were still owned by the government.10 Public bank ownership has served India well in the credit crisis of 2008, which it has largely escaped. Government ownership has not made India’s public sector banks inefficient or uncompetitive. A 2001 study of consumer satisfaction found that the State Bank of India ranked highest in all areas scored, beating both domestic and foreign private banks and financing institutions. A 2007 study also found that India’s public sector banks were faring better than its domestic private sector banks.11

A Country of Many States and Disparities
Differing assessments of how India is faring may be explained by the fact that it is a very large country divided into many states, with economic policies that differ. In a June 2005 article in the London Observer, Greg Palast noted that in those Indian states where globalist free trade policies have been imposed, workers have been reduced to sweatshop conditions due to murderous competition between workers without union protection. But these are not the states where Microsoft and Oracle are finding their highly-skilled computer talent. In those states, says Palast, the socialist welfare model is alive and thriving:

The computer wizards of Bangalore (in Karnataka state) and Kerala are the products of fully funded state education systems where, unlike the USA, no child is left behind. A huge apparatus of state-owned or state-controlled industries, redistributionist tax systems, subsidies of necessities from electricity to food, tight government regulation and affirmative action programs for the lower castes are what has created these comfortable refuges for Oracle and Microsoft. . . . What made this all possible was not capitalist competitive drive (there was no corporate “entrepreneur” in sight), but the state’s investment in universal education and the village’s commitment to development of opportunity, not for a lucky few, but for the entire community. The village was 100% literate, 100% unionized, and 100% committed to sharing resources through a sophisticated credit union finance system.12

Conditions are much different in the state of Andhra Pradesh, where farming has been the target of a “poverty eradication” program of the British government. Andhra Pradesh has the highest number of farmer suicides in India. These tragedies have generally followed the amassing of unrepayable debts for expensive seeds and chemicals for export crops that did not produce the promised returns. An April 2005 article in the British journal Sustainable Economics traced the problem to a project called “Vision 2020”:

[T]he UK’s Department for International Development (DFID) and World Bank were financing a project, Vision 2020 [which] aimed to transform the state to an export-led, corporate controlled, industrial agriculture model that was thought likely to displace up to 20 million people from the land by 2020. There were no ideas or planning for what such displaced millions were to do and despite these fundamental and profound upheavals in the food system, there had been little or no involvement of small farmers and rural people in
shaping this policy.

Vision 2020 was backed by a loan from the World Bank and was to receive £100 million of UK aid, 60% of all DFID’s aid budget to India. There were about 3,000 farmer suicides in Andhra Pradesh in the 4 years prior to the May 2004 election and since the election there have been 1,300 further suicides.13

A later report put the number of farmer suicides between 1997 and 2005 at 150,000.14 India’s farmers, who make up 70 percent of the population, voted out the existing coalition government in May 2004; but the new ruling party, the United Progressive Alliance (UPA), has also had to take its marching orders from the World Bank, the World Trade Organization (WTO) and multinational corporations. The Sustainable Economics article noted that laws and policies have been pushed through the legislature that threaten to rob the poor of their seeds, their food, their health and their livelihoods, including:

• A patent ordinance that introduces product patents on seeds and medicines, putting them beyond people’s reach. Prices increase 10- to 100-fold under patent monopolies. Since India is also the source of low-cost generic medicines for Africa, the introduction of patent monopolies in India is likely to increase debt and poverty globally.
• New policies for water privatization have been introduced, including privatization of Delhi’s water supply, pushing water tariffs up by 10 to 15 times. The policies threaten to deprive the poor of their fundamental right to water, diverting scarce incomes to pay water bills that are ten times higher than needed to cover the cost of operations and maintenance.
• The removal of regulations on prices and volumes, allowing giant corporations to set up private markets, destroying local markets and local production. India produces thousands of crops on millions of farms, while agribusiness trades in only a handful of commodities. Their new central role in much less regulated Indian markets is likely to result in destruction of diversity and displacement of small producers and traders. India’s poor, however, have not taken all this lying down. Following Gandhi’s example of mass non-cooperation with oppressive British laws, they organized a nation-wide movement against the patent ordinance. Communities created “freedom zones” to protect themselves from corporate invasion in areas such as genetically modified seeds, pesticides, unfair contracts, and monopolistic markets. The grassroots movement called for a rethinking of GATT (the General Agreement on Tariffs and Trade), which led to the creation of the WTO in 1995. The WTO requires the laws of every member to conform to its own and has the power to enforce compliance by imposing sanctions.15

The Credit Crisis, Local and International

A key factor in the protracted crisis in agriculture has been the drying up of credit since the 90s, for small farms and businesses. A key factor in the protracted crisis in Indian agriculture has been the drying up of credit since the 1990s, particularly for owners of small farms and businesses. After India’s nationalization in 1969, banks extended credit to
many sections of the population that were formerly considered “unbankable,” particularly farmers and small business owners; but by 2007, 90 percent of farmers still remained outside the bank network, and for those farmers and small businessmen who could get credit, interest rates were about double those for large-scale industries.16

Again, this was largely due to policies imposed from abroad. A major factor contributing to the decline in bank credit to the small business sector was the “Basel norm” imposed on commercial banks in the 1980s by the Bank for International Settlements (BIS), the “central bankers’ bank” in Basel, Switzerland. The BIS set capital adequacy standards under which loans to private borrowers are “risk-weighted,” with the degree of risk determined by private rating agencies. Since small business owners cannot afford the agencies’ fees, banks assign 100 percent risk to their loans. The banks then resist extending credit to these “high-risk” borrowers because more capital is required to cover the loans. When the conscience of the nation was aroused by a spate of suicides among Indian farmers, the UPA government, lamenting the neglect of farmers by commercial banks, established a policy of ending the “financial exclusion” of the weak; but this step had little real effect on lending practices, due largely to the strictures imposed from abroad.

The neoliberal agenda of “free trade” and privatization has made significant inroads since the early 1990s, with neoliberals routinely decrying the fact that India’s public sector banks are oriented more toward serving the customer than turning a profit. But studies showed that Indian public sector banks were out-performing private sector banks even before the current credit crisis, which has hit the most aggressive private international banks particularly hard. Customers are now fleeing to the safety of India’s public sector banks, which have emerged largely unscathed from the credit debacle.17 The public sector banks have been credited with keeping the country’s financial industry robust at a time when the U.S. market is experiencing its worst financial crisis since the 1930s. India’s state-led, populist-oriented democratic model may yet have a chance to prove its mettle as against the Western neoliberal model, demonstrating that service to the public is not incompatible with efficiency, profitability and growth.

Endnotes and Additional Thinking
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15 C. Lucas, et al., op. cit.
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(The views expressed in the write-up are personal and do not reflect the official policy or position of the organisation.)
India’s Trade Engagements With Africa: A Comparison With China

Kaushal K Vidyarthee
Wolfson College, University of Oxford, U.K
Introduction
Over the last decade, India and China have established themselves as an increasingly influential players across Africa. Subsequently, many recent studies have examined the impact on sub-Saharan Africa (SSA) of Chinese and Indian ascendancy with the goal of formulating strategies for poor countries to maximize the benefits and minimize the costs of engagement (Evans et al. 2006; Goldstein 2006; Kaplinsky et al. 2006; Broadman 2007). However, India’s engagement with Africa has been analysed in quite limited way and almost negligible at policy level. After the recent first India-Africa Forum Summit in April 2008, a lot of enthusiasm has been shown by the government towards reaching out to Africa. My concern here what the level of engagements is so far, how much we can do and where we stand in comparison to China’s engagement with Africa. Thus, this paper uses the opportunity to explore this issue through the lens of economic and political relations in last decade and to analyse the differences between ‘Sino-Africa’ and ‘Indo-Africa’ trade relations.

India and China have similar comparative advantage over Africa, but there are noteworthy differences in their relations with Africa- in terms of policy approaches, trade structure, and regional preferences. China’s contribution to global output is almost treble to that of India hence Indian engagement with Africa has smaller implications when compared to Chinese (Mwega 2006). The process of economic evolution in India and its growth rate has been different from China which had led to some of these differences. Moreover, although Indian connection to Africa has been far stronger to Chinese in the past; China has pursued more globally oriented foreign policies pertaining to export-import structures and its growth and composition. The argument being that the foreign policy of a country is coloured by the concept of economic diplomacy in today’s world. Especially when the trade and FDI expansion are linked to the aid flows. This paper critically reviews the growth and composition of exports and imports structure of Sino-Africa and Indo-Africa engagements in an empirical and descriptive way. What sectors and commodities are being preferred over what and which region is gaining or losing in terms of trade; and their respective reasons are focused here.

‘Indo-Africa’ and ‘Sino-Africa’ Engagements in Perspectives
Nature and Scope of Engagement
India’s trade with Africa was estimated at $16.3 billion during April-January 2006-07 with exports rising 53 % to $ 6.6 billion while imports during the period almost doubled to $ 9.7 billion (Sidhharth 2007). Trade between China and Africa in 2006 totaled more than $ 50 billion, with Chinese companies importing oil from Angola and Sudan, timber from Central Africa, and copper from Zambia (Zafar 2007). SSA is comparatively disadvantaged in manufacturing industries, espe-
impact on their engagements with Africa.

India’s Import from Africa

Broadman (2007) points out that during 1990-2004, India’s import from Africa has risen at an annual average growth rate of 14 %. Between 1997 and 2005, it got doubled. It was predominantly mineral fuel/lubricants (55.1 %) in 1997 but by 2005, the commodities in SITC9, which includes Gold, became very prominent as it accounted for two-fifth of total imports. However, it is notable that during 1997-2005, the import volume for commodities in SITC 9 got more than twelve-fold increase; machinery and transport equipment sector has had a seven-fold increase, while the import volume of mineral fuel/lubricants reduced to its one-fifth. It is evident that India’s import composition has changed dramatically over the last decade. Growing economy and ever-enlarging gold-consuming class has dictated the import structure. South Africa, the largest gold producer, accounted for 68 % of India’s total import from Africa in 2004 (Broadman 2007).

China’s Import from Africa

The growth rate of China’s import from SSA was 20 % annually between 1990-2004 and it rose to 48 % annually between 1999 and 2004 (Broadman 2007). China’s imports from Africa are predominantly primary products, oil and metal products driven by its need to secure natural resources. Mineral fuels and lubricants accounted for 24.9 % of total exports in 1996, rising to 70.9 % in 2005. Mineral and crude materials’ (SITC 2) combined share increased from 75.2 % in 1996 to 86.8 % in 2005 (Table 1). By 2005, China had overtaken the UK as Africa’s third most important trading partner (after the US and France) (Tull 2006). China’s growing demand for commodity imports has led to an expansion of commodity exports from some African economies. The share of five families of commodities (oil, iron ore, cotton, diamonds and logs) in China’s total import from Africa grew from less than 50 % to more than 80 % between 1995 and 2005 (Figure 1). China imports African manufactured products mostly from South Africa. (Kaplinsky et al. 2006).

India’s Export to Africa

India’s export to Africa had 182 % increment from 0.95 billion dollar in 1997 to 2.7 billion dollar in 2005. Manufacturing goods (40 %) is not a predominant sector in 2005 as it was in 1997; it is more diversified into chemical products, machinery/ transport equipment, food and livestock etc. Unlike import situation in the same period, every single sector has observed positive growth; however their trade-deficit has kept looming.

China’s Export to Africa

There has also been a tremendous increase in China’s export to Africa from US $ 895 million in 1996 to US $ 9.42 billion in 2005, a 712 % increase. China offers low-priced imports such as textiles and clothing, electronic devices, machines and so on. Manufactured imports (SITC 5-8) accounted for more than 90 % in 1996 and 2005.

China’s export (i.e. manufactured products) to Africa mainly goes to seven countries-Sudan, Ghana, Tanzania, Nigeria,
Ethiopia, Kenya and Uganda, where it accounts for five to fifteen - of their imports (Kaplinsky et al. 2006). China is likely to continue exporting manufacturing goods, machinery and transport equipment and other manufactured article as in 1996 and 2005, it accounted for 80.9 % and 89.8 % of total exports respectively.

The stylized facts reveal an interesting story about the changing trade patterns of Sino-African and Indo-African engagements. First, there has been a dramatic increase in direct trade between China and Africa outsmarting the direct trade between India and Africa. India’s import from Africa only about doubled over 1997-2005 as compared to China’s more than ten-fold increase. Second, during the same period, Chinese trade deficits with Africa observed more than seventy fold increase while India’s trade deficits has seen a very moderate overall growth of 24 % (Table 1).

Third, China surpasses India in importing mineral fuels and metals from Africa and export cheap consumer and capital goods. Fourth, it should be noted that the Sino-Africa and Indo-Africa trade pattern differ significantly only in its import composition as that gold dominates India’s import while oil and metals dominates China’s. Finally, China’s imports are concentrated among a small number of natural resource economies lacking product diversification in their export structure. More than 75 % of China’s trade takes place with four countries—South Africa, Sudan, Angola, and Nigeria.

India’s trade engagement is even more skewed towards very few countries as South Africa accounts for more than two third of import as well as export.

Process of Economic Evolution in India and China

The stark emerging differences between Sino-Africa and Indo-Africa engagements in last decade have two determinants- economic policy and foreign policy. In 1978, the economic reforms of Deng Xiao-Ping set China on a path of economic liberalisation and accelerated growth (Toye 2007). Reforms in India can be also dated back to the 1980s with a shift in the national government’s attitude to favour private sector business, and the abating influence of the state, but the real reforms came up following India’s 1991 balance of payments crisis, when India was forced to liberalise its economy. China emulated highly successful East Asian experience by implementation of various reforms including the removal of trade barriers, adoption of competitive exchange rates and the creation of Economic Processing Zones (EPZs). China saw a decline of weighted tariffs from 32.2 % in 1992 to 4.9 % in 2005 while trade weighted import tariffs fell from 27.9 % in 1992 to 13.4 % in 2005 in India (Mwega 2006). Unlike China, most of the SEZs in India are still in their stage of infancy.

In contrast to China, India’s development has been characterized by a lower saving rate, limited inflows of FDI and poor

### Table 1: Sino-Africa and Indo-Africa Trade Pattern

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<tr>
<td>China’s Import From SSA</td>
<td>1576</td>
<td>Crude materials, Mineral fuel</td>
<td>Angola, South Africa and Sudan</td>
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<tr>
<td>India’s Import from SSA</td>
<td>96</td>
<td>Commodities in SITC 9 (Gold)</td>
<td>South Africa</td>
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<td>China’s Export to SSA</td>
<td>953</td>
<td>Manufactured goods, Machinery/transport equipment</td>
<td>Sudan, Ghana and Tanzania</td>
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<tr>
<td>India’s Export To SSA</td>
<td>182</td>
<td>Manufactured goods, Machinery/transport equipment</td>
<td>South Africa</td>
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<td>Trade Deficit -China</td>
<td>7080</td>
<td>In case of China, Trade deficit rose from 224 million US $ to 16 Billion US $, while in case of India it rose from 1.13 Billion to 1.41 Billion US $</td>
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<td>Trade Deficit -India</td>
<td>24</td>
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Source: Adapted from (Kaplinsky et al. 2006; Mwega 2006; Zafar 2007)
infrastructure. This has limited India’s ability to compete in the export market for the manufactured goods. In addition, one of the key differences in India’s growth process has been the failure of manufacturing industry, and boom in the services sector. While Africa is still not benefiting significantly from booming service sector in India, China is promoting its competitive sectors (manufacturing and construction) very vehemently. Command based authoritarian system of governance in China provided an incremental edge to its non-disruptive reforms than to democratic system of governance and decentralised planning mechanism in India (Deshpande et al. 2002). Africa responded more favourably to China’s economic evolution process and its rapid growth pushed by rapid industrialization than to India’s economic process which faced emergence of the service sector as a driving force of economic growth.

Foreign Policies and Politics of Trade of India and China
The formal links between China and SSA go back to the Bandung Conference in 1955. Until the mid-1990s, link was directed by aid towards Liberation Movements and to further the desire to politically isolate Taiwan. But since the mid 90s, aid appears to be increasingly directed towards broader strategic objectives, and in particular towards the development of linkages with the resource-rich SSA economies (Kaplinsky et al. 2006). Tull (2006) argues that since 1990s China has pursued a more active foreign policy, extending especially to closer ties with the non-Western, especially African states -given their numerical strength. Besides this, China fears for its ascendancy as a global political power in the context of US hegemony (Zafar 2007). In 1998, a White Paper of the Chinese Ministry of Defence proclaimed energy security as an integral part of China’s overall security resulting in stepped-up efforts to expand its oil imports and to diversify its oil suppliers, increased oil imports from Africa, and augmentation of its African suppliers. China’s global economic, foreign and security policies have become clearly inter-twinned. (Mwega 2006).

Aid and FDI are being packaged with the trade deals by China to bind strategic allies more closely and to secure supplies of materials for their ever-expanding economy.
Chinese FDI in Africa grew from $20 million in 1998 to $6 billion in 2005 and it is largely related to resource extraction and low-cost infrastructure construction involving Chinese labour. Chinese aid to Africa has increased from $107 million in 1998 to $2.7 billion in 2004 (Toye 2007). Moreover, China has also cancelled bilateral debts for 31 African countries totalling $1.27 billion in 2004. In 2006, Chinese government passed a policy to encourage and support investment in Africa, including provision of preferential loans and buyer credits (PRC 2006). China has therefore become a major player in the field of infrastructure and construction activities (ranging from stadiums in West Africa to Presidential Palaces in Kinshasa) and small scale entrepreneurial investments. Many of these projects are not commercial and are financed by ‘tied aid’ (Kaplinsky et al. 2006). Chinese enterprises currently number more than 700, operate in 50 countries and employ close to 80,000 Chinese workers (Zafar 2007).

China-Africa Co-operation Forum was established in 2000 to bolster the trade and economic relations between them. By 2005, China had bilateral trade and investment agreements with 75% of African countries and it has embassies in all African countries, except six, that have established diplomatic relations with Taiwan (Mwega 2006). The third meeting of forum ‘China-Africa Summit’ was held in early November 2006 in Beijing and involved 48 African presidents and heads of government. China’s distinctive approach involves a combination of aggressive diplomacy and the cultivation of friendly ties with a no-strings attached financial and technical assistance package. China’s pledge of non interference in countries’ internal affairs and lack of lending conditions on governance or fiscal management have elicited positive reactions from several governments (Zafar 2007). Moreover, there are various other mutually advantageous interactions such as promotion of democracy is not an objective of China’s foreign policy (Tull 2006).

India has a long history of trade and investment with modern-day Africa, particularly in East Africa, where there are significant expatriate Indian communities. The current scale and pace of India’s trade and investment flows with Africa is unprecedented even though it constitutes a very small part in comparison to China and the world economy. Even today, tariff levels of India on African products are higher than China. After long dormant of 45 years (since Jawaharlal Nehru’s last visit), higher level delegates including Prime Minister of India made a visit to two countries - South Africa and Nigeria in mid 2007 for bilateral engagements and negotiations (Dutta-Ray 2007). Unlike China, India has not pursued any aggressive policy to engage with Africa for its energy security even though India too needs oil, uranium and raw materials. India is still trying to enter into infrastructure development like road, railways construction and telecom in Africa.

Currently India does not have any policy like China’s Africa Policy to promote and engage vehemently and strategically with Africa. The Trade & Economic Relations Committee (TERC) of India is discussing ways to increase India’s trade engagement with African countries and decided to club Africa with the progress on India-US economic dialogue. Even though India enjoys the advantage of a large expatriate business community throughout Africa, especially in South Africa, Kenya and Tanzania; and it can offer Africans a mix of
growth economics and political freedoms, due to lack of targeted policy it has lagged behind the Sino-African engagements (Dutta-Ray 2007). It can be concluded that there is a gap between China’s and India’s foreign and strategic policies, which clearly explains the differences in Sino-China and Indo-Africa engagements.

Conclusion
There are noteworthy differences between India’s and China’s relations with Africa. Sino-Africa engagement outsmarts Indo-Africa engagements in terms of trade growth and trade deficits. During 1997-2005, India’s import from Africa only about doubled as compared to China’s more than ten-fold increase; and Chinese trade deficits with Sub-Saharan Africa observed more than seventy fold increase while India’s trade deficits has seen a very moderate overall growth of 24%. The Sino-Africa and Indo-Africa trade pattern differ significantly in its import composition as gold dominates India’s import while oil and metals dominate China’s. India’s trade engagement is highly skewed in term of regional linkages in Africa. On economic side, the differences in China’s and India’s processes of economic evolution in last decade mirrored in their trade engagements. First, India liberalized its economy after a gap of decade in comparison to China. Second, the gap between India and China’s growth rate in last two decades impacted their trade orientation and resource needs. Third, the growth has been led by different sectors in both countries. China’s emerging manufacturing sector and its need of primary commodity and oil boosted Sino-Africa trade while India’s booming sectors (services, IT) did not cater to African needs. Fourth, Indian SEZs are in their stage of infancy in comparison to China’s EPZs/SEZs.

On political side, China has pursued more globally oriented foreign policy than India even though India’s has enjoyed stronger linkage with Africa in past. China proclaimed energy security as an integral part of China’s overall security and looked towards better tie-up with Africa for the same and India lagged behind here. Unlike India, China offers African countries a series of package deals with trade comprising FDI and aid. As a result, Chinese FDI and aid is growing at high rate in comparison to India, consequently boosting better trade engagements. India also lacks in terms of integrated and aggressive policy like China’s Africa policy which also explains the differences in their trade engagement with Africa. Thus, it can be concluded that the gap between China’s and India’s trade engagements is explained by their differences in their economic processes and political policies.

Endnote
1 SITC is acronym for ‘Standard International Trade Classification’, used in UNCTAD Database.

References and Additional Thinking

(The views expressed in the write-up are personal and do not reflect the official policy or position of the organisation.)
India and Japan: Entering a New Era of Economic Relationship
Amit Singh  
Consultant, ICRIER, New Delhi

In recent years, India’s image at the popular level in Japan has changed considerably — from that of a poverty-stricken third world country to a modernizing nation with world class IT-enabled services and strength in many other commercial areas from biotechnology and medical science to financial services and pharmaceuticals. Prime Minister Yoshiro Mori’s visit to India in August 2000 was the beginning of a new era of India-Japan relations, which set the precedent for visits to India by his successors Mr. Junichiro Koizumi and Shinzo Abe. Since then, the two countries sought to strengthen bilateral ties through new initiatives and programmes ranging from economic and cultural linkages to defence and security. The year 2007 was celebrated as the Year of Friendship between India and Japan, which marked the 50th anniversary of the Cultural Agreement, concluded between them in 1957. Japan gives 30 per cent of its foreign aid to India and is, even in this period of global economic turmoil, committing more than US $4 billion to the Delhi-Mumbai Industrial Corridor (DMIC). Indian Prime Minister Dr. Manmohan Singh described DMIC as an "industrial artery", which covers almost 1,500 km between New Delhi and Mumbai. DMIC—the country’s most ambitious development project ever— is going to be one of the kernels of co-operation between India and Japan. The two recent mega deals between Indian and Japanese companies, namely, Daiichi-Ranbaxy merger (US $4.6 billion) and the acquisition of 26 per cent stakes (US $2.7 billion) in TATA Teleservices by Japanese mobile giant NTT DoCoMo, are clear instances of the growing economic ties between the two countries.

However, some areas of bilateral relationship are still weak and in some areas ties are still slow to develop. Commercial relations, for example, remain less than satisfactory. Two-way trade between India and Japan (US $ Million 10,177 for 2007-08) has risen in the last five years, but still remains considerably low when compared with China-Japan (US $ Million 2,37,193) or even India-China trade figures (US $ Million 37,931 in 2007-08). Similarly, Japan’s foreign direct investment in India for April-June, 2008 (US $ Million 333) is less than compared to its investment in smaller Asian countries such as Vietnam (US $ Million 411), not to mention China (US $ Million 1899). While India’s trade with the rest of the globe has risen over the last few years, trade with Japan has not kept pace with the growth in India’s overall trade. This indicates that India has looked at other markets for trade expansion and has not focused on Japan (due to either lack of market access in Japan or barriers to Indian exports to Japan).

Japan’s FDI in India (2008) is even lesser than its investment in smaller Asian economies like Vietnam

The new ideas and plans to strengthen the bilateral relationship included having a free trade agreement (FTA) between the two countries. During the visit of Japan’s Prime Minister Koizumi to India in April 2005, the two counties agreed to set up a Joint Study Group (JSG) for such FTA by June 2005. The JSG in its report in 2006 recommended that the two countries launch inter-governmental negotiations to develop a Comprehensive Economic Partnership Agreement (CEPA). India and Japan launched negotiations for a Comprehensive Economic Partnership Agreement (CEPA) in January 2007.

Being a comprehensive Agreement India-Japan CEPA covers trade in goods and services, investment flows, trade promotion and measures for promoting economic cooperation in identified sectors. After ten rounds of negotiations, a number of issues in the proposed India-Japan CEPA are yet to be resolved, including items in the negative list of products to be protected from tariff-cuts and quality control norms for import of farm goods. Tariffs (import duties) on most goods in Japan are already low at present. Thus a critical determinant in greater market access for Indian products in the Japanese market would be the reduction of existing non-tariff barriers (NTBs). India has raised concerns over Japanese technical barriers to trade (TBT) and their stringent sanitary and phytosanitary (SPS) measures, which act as NTBs to Indian export items. In the last round of talks held in October 2008, Japan and India successfully finalized the text for SPS measures and TBTs—a first for any developing country involved in bilateral talks with Japan. Though the text includes a special article on ‘generic medicine’, it mostly pertains to only exchange of information; whereas India’s...
interests are more in streamlining the entire export process in Japan. In goods sector, Japan’s interest lies in automobile and chemicals, while these are the areas in which Indian industry is seeking total protection. India, on the other hand, is keen on expeditious implementation of quality control norms in Japan. Indian industry feels that the implementation process of SPS norms in Japan is so long that in case of mangoes, it took 15 years for India to get clearance. Indian industry have sought immediate tariff elimination by Japan for certain products of export interest to India, like leather, footwear, textiles, marine and animal products on which Japan is having very high level of tariffs. Further, export of Indian agricultural goods, chemicals and pharmaceuticals face various NTBs in Japan. In its CEPA with Japan, India should aggressively push the case of the pharmaceutical sector as well as that of chemicals, biotech and cosmetics sectors ensuring that Japan agrees to open up its market for these products. Indian pharmaceutical companies have not been able to tap the Japanese market to its full potential due to the country’s stringent SPS, TBT and environmental norms. Japan provides the world’s second largest drug market. At the moment it takes an Indian pharmaceutical exporter 5-7 years to start exporting from the date of application. Japan is not agreeing a mutual recognition agreement (MRA) in pharmaceutical sector, which would enable both the countries to identify the testing procedures and standards used in the other country for their goods. India’s demand is to have standards uniform to those set by US Food and Drug Administration (FDA), but Japan contends that these are not enough and is resolute pushing for its own set of testing measures. Exporters also face difficulties in understanding guidelines and regulations, since they are mostly in the Japanese language. Rules of origin, which lay down how much of an imported input should be allowed in a product being traded under the CEPA, is another contentious area. Japan wants the norm to be more relaxed for certain products like textiles. India favours stronger norms as it wants to prohibit third-party goods from coming into the country’s market at concessional import duties allowed under the CEPA.

In services, the major hurdle lies in the area of mutual recognition agreements wherein both parties accept foreign professionals with degrees and diplomas offered in their home country. Computer-related and IT services; accounting, auditing, and book keeping services; architectural services; engineering services; medical and dental services; advertising services, and services for telecommunication and audio-visual communication are of particular interest to India in this context. As such a mutually agreed MRA is desirable for clinching the deal in terms of services. India has also requested Japan to open up trade in healthcare and banking services, which Japan is not ready to do. Moreover, a 15 per cent withholding tax — a share of the payment withheld by the paying party on account of taxes — levied by Japanese authorities is also a major hurdle discouraging Indian professionals from working in Japan, and needs to be sorted out.

A recent CII study highlights that trade between India and Japan has the potential to double in the next two years if issues like trade facilitation and non-tariff barriers are addressed amicably. The study calls for greater focus on agricultural exports to Japan, since Japan’s self-sufficiency rate in food production is about 40%. The share of agricultural items in India’s exports to Japan has seen a decline by about 22% in the last 10 years, although the processed food exports increased by four percent during this period. Currently major Indian exports to Japan like agricultural goods, pharmaceuticals, chemicals face various NTBs. On services trade, the study calls for relaxation of visa norms especially for Indian medical/Para-medical workers and engineers. Japan has liberalized entry of nurses to Philippines and Indonesia as part of its free trade deals. The study calls for liberalization of trade in services within Mode-IV (cross-border movement of professionals) in the India-Japan CEPA.

Trade between the two countries was worth US $7.5 billion in 2007, and the CII has long estimated that it could get doubled in the next two years. It says the figures could be US $15 billion by 2010. Indeed the bilateral trade has more than doubled since 2002-03. The trade balance which currently favours Japan may get narrowed with the CEPA, which is expected to raise India’s exports. However, CII has warned that this jump in commerce is predicated on the completion of trade facilitation and elimination of NTBs. To that might be
added what Japan feels are abysmal roads and freight carriage systems. That is the best reason to see how, by helping India with ODA or investment in infrastructure, Japan is also helping her own self. Interest of that sort gave a fillip to the bilateral relationship between the two countries. In 2007-08 Japan embarked 225 billion Yen (Rs. 8582 Crore) for India to undertake nine new infrastructure projects. They include the Kolkata Metro Project, Tamil Nadu Urban Infrastructure Project, Haryana Transmission System Project and UP Forestry and Poverty Alleviation Project. The Japanese Government has also provided funds for Water Supply and Sewerage Project in Goa and the Maharashtra Transmission System Project. India-Japan cooperation for key infrastructure projects in India like dedicated freight corridor (DFC), the Delhi-Mumbai Industrial Corridor (DMIC), a Metro System for Chennai, apart from numerous other social and infrastructure investments spread over the current fiscal, is going to act as the founding stone for the new era of trade and economic relations under the Comprehensive Economic Partnership Agreement (CEPA) between the two countries.

After clinching the FTA with ASEAN and sorting out all outstanding issues with South Korea for a CEPA, India is keen to conclude the CEPA with Japan. The relationship between the two countries would grow further if they can finalize this proposed CEPA. It is expected that such an Agreement would help the two countries increase their share of Asia’s economic output in the coming years. However, if the current global financial crisis continued to affect the global economy for long, it would most likely impact the increasing economic relationship between India and Japan. How much the present crisis affects the India-Japan comprehensive economic relations remains an open question. Nonetheless, the CEPA between the two large economies of Asia may evolve an understanding between them for the early conclusion of the WTO’s Doha Round negotiations, which is vital for the maintenance and development of the international trade system.

**Endnotes and Additional Thinking**
1. Source: Export Import Data Bank, DGFT, Ministry of Commerce & Industry, India.
2. Source: JETRO
3. ‘India-Japan CEPA Negotiations: A CII Perspective’.

(The views expressed in the write-up are personal and do not reflect the official policy or position of the organisation.)
All Moscow was burnt down, you know, by a penny candle,” says a character in Ivan Turgenev’s 1861 novel, Fathers and Sons. He could well have been speaking about the current global financial meltdown, which was sparked by default on a few housing mortgage payments in the United States, which went on to engulf the mighty investment banks on Wall Street and then spread rapidly to financial centers around the world. Sixty trillion dollars of wealth have been destroyed by a mere $50 billion loss on subprime loans.1

If that were not enough, the financial meltdown is now pushing the world economy into recession. The US, the European Union and Japan are already in it, and other advanced economies are slowing to a standstill. Recovery is not projected until 2010.

The rescue efforts by the US and other G-7 authorities aim mainly to stabilize the banking and financial system, less to restore economic growth. So far this year upwards of 8 trillion dollars has been allocated for bank bailouts, while the amounts for fiscal stimuli are much less: $168 billion in the US, $257 billion in the European Union and $251 billion in Japan.2 The incoming US Administration has pledged to shift the focus from bailout to jobs – which could mean a substantial fiscal stimulus of $400 to $600 billion -- but that will have to wait till next year.

The only good news is that developing countries continue to grow in spite of the financial turmoil and economic downturn in the developed economies. To be sure, developing countries are subject to downward pressures as demand for exports...
weakens, credit tightens and investment slows. But many developing countries, including in Africa, are continuing to grow, albeit at a slower rate, through South-South trade and investment. Can this growth be sustained? Can developing countries be a new engine of growth?

De-Linking: Myth or Reality?
Although most economists would say that developing countries cannot “de-link” from their traditional trading partners or from global financial markets, there is one who argues otherwise. “The answer is in the affirmative,” says a Princeton University Economics Professor and Nobel Prize winner. His name is Sir Arthur Lewis. He came from the Caribbean island of Saint Lucia. He spoke 29 years ago:

“For the past hundred years the rate of growth of output in the developing world has depended on the rate of growth of output in the developed world. When the developed grow fast the developing grow fast, and when the developed slow down, the developing slow down. Is this linkage inevitable? The developing countries can solve the problem only by accelerating sharply their trade with each other. ”

When Sir Arthur Lewis delivered his Nobel laureate lecture in December 1979, the world economy was in a recession since 1974. Our present crisis is more serious and more global but, at the same time, the developing countries are more dominant players. His argument carries more force today, at least let’s hope so.

Today, developing countries contribute 30% to world output and 40% to world trade, some 10% points higher than in 1979. However, Arthur Lewis based his argument on the potential for developing countries to trade with each other: the potential for their inter-trade to take up the slack in declining import demand and slowing growth in developed countries. This potential has increased greatly in the intervening years.

South-South trade has been expanding faster than North-South trade for more than a decade. Their inter-trade was about 20% of their exports in the 1970s; it is now about 50%. Today, developing countries export about as much to each other as they do to developed countries. And, it is not all raw materials and natural resources. It is also agricultural products, chemicals, metals, mechanical and electronic appliances and vehicles.

Also, expanding inter-trade has been accompanied by investment. South-South Foreign Direct Investment (FDI) tripled in the past decade. Today, there are some 20,000 transnational corporations based in developing countries, making up a fourth of all multinationals worldwide. The 100 largest multinationals from developing countries had $570 billion of foreign assets in 2006.4

Developing countries tend to trade and invest within their regions. Trade flows among Asian countries are particularly dynamic, growing twice as rapidly as their trade with developed countries. But, equally, inter-regional flows have grown rapidly, particularly between Asia and Africa, and Asia and Latin America. South-South FDI is a particularly important source of capital for the smaller and weaker economies: it is underpinning near six percent growth in Sub-Saharan Africa in 2009.

A number of countries in all developing regions rank as emerging markets. Their capital markets have performed well. Even after the recent turbulence, their equity prices in early October 2008 were still well above their 2003 level. South-South cross-border investment has helped insulate the emerging market economies from the financial crisis in the North.5

So, can developing countries “de-link” and be a new engine of growth? The IMF says growth in 2009 will come mostly from emerging market economies.6 That is a good news indeed, and a vindication of Sir Arthur Lewis: at least one third of the world economy -- the developing world -- will continue to grow.
in spite of the downturn in the developed economies.

But can it be sustained? On one hand, the gains to date were helped by the robust world economic environment of recent years. Per capita income grew by more than three per cent in over 100 countries in 2007. But the global environment will be more of a drag than a boost in 2009. On the other hand, much of the recent expansion in investment and trade was led by developing countries. The current upturn in global FDI demand was led by them in 2004, even as FDI into developed economies was still declining. If they have done it before, they can lead again.

Much depends on the global policy response. The arrangements being put in place among the G-7 central banks to replenish the international credit markets need to extend to developing countries. The IMF will disburse financing with streamlined conditionality to countries in difficulty. The World Bank will triple lending to developing countries and expedite grants to the poorest countries. The policy forum has broadened from the G-7 to the G-20. Hopefully, such actions and others’ will limit the collateral damage of the financial crisis on developing countries.

**South-South Policy Response**

“The real problem is whether developing countries will persist in rapid growth despite the slowdown of the developed countries,” argues Arthur Lewis. And, for that, the solution is for developing countries to shift to more balanced growth paths, relying more on internal demand to sustain growth. He reasoned as follows: “It is not possible for all developing countries to make this switch and neither is it necessary; for if leading developing countries grow fast and import heavily they will substitute to some extent for the former rapid growth of developed countries.”

Indeed, several developing countries with adequate reserve positions – like Brazil, China, India and Nigeria – have leeway to take proactive measures to sustain their growth. China has already announced $586 billion of investments in infrastructure and social welfare over the next two years to stimulate internal demand. India has announced a $4 billion stimulus. A number of additional countries – as in South East Asia - have economies capable of self-sustaining growth and generating trade for others. “If they are specially linked to each other by preferential trade and currency arrangements,” said Arthur Lewis, “one may even speak of the creation of a new centre consisting of former peripheral nations that have built a new engine of growth together.”

This could happen now. Asian countries are pursuing anew the establishment of an $80 billion fund to restore liquidity in their financial markets. Their joint fund will supplement foreign reserves and enhance the currency swap arrangements instituted under the Chiang Mai initiative of 2000.

In Africa, Chinese state banks and African banks have developed a $6 billion joint fund to invest in the continent, which includes not only South Africa, Egypt, and other North African countries, but also, what the IMF calls, a “second generation” of emerging markets in sub-Saharan Africa: Botswana, Ghana, Kenya, Mozambique, Nigeria, Tanzania, Uganda and Zambia.

In Latin America - Argentina, Bolivia, Brazil, Ecuador, Paraguay, Uruguay and Venezuela agreed last year to create a Bank of the South -- Banco del Sur -- with up to $7 billion in initial capital. This initiative has fresh urgency.

Additionally, at the national level, India and China can fast track their existing bilateral investment funds – announced at $5 billion each – to be quick disbursing for Asian-African trade and investment.

At the 2006 Sino-Africa summit for 50 African leaders, China proposed a doubling of trade between China and Africa to $100 billion by 2010, and pledged to double aid by 2009. Subsequently, in 2007, China initiated the China-Africa Development Fund to support Chinese equity and quasi-equity investment in African agriculture, manufacture, energy, transportation, telecommunications, urban infrastructure and natural resource exploration. The initial plan called for a start-up capital of one billion dollars, to be increased over three phases to five billion dollars. This schedule should be fast tracked, and the Sino-Africa summit should be reconvened to generate the political consensus to make it possible.

In April 2008 India hosted its Summit for 14 African leaders and offered $5 billion in financial credit and $500 million in development grants to Africa and preferential market access for all exports from least developed countries. These pledges
need to be fast tracked. Doing so, will sustain India's internal growth by facilitating domestic demand for food, energy and natural resources, as well as its exports, more than half of which are destined to Africa and other developing regions. Indian firms are also active investors and contractors in Africa. South-South is a win-win for India.

Japan, too, established a $2.5 billion bilateral investment fund for Africa but, unlike China and India, has had limited success in seeing its companies invest in Africa. The fund should be re-oriented towards supporting triangular South-South investment in which Japanese companies are encouraged to partner with other Asian firms which have been successful in investing in a business environment similar to their own in earlier years.

In West Asia and the Arabian Gulf, there is increasing focus within the region and in other developing regions. Their sovereign wealth funds -- which have considerable assets exposed to the financial turmoil in developed countries -- have begun to diversify their portfolios and are increasingly investing in the developing world at attractive risk-adjusted returns. Their direct investments are currently about $10.5 billion, mainly in Asia but also some in Africa and Latin America. There is considerable potential to expand such investments in the developing world (where the rate of return is above 10%), and diversify risks at the same time.

On the trade front, 26 African countries have just agreed to consolidate into one free trade zone their three trade blocs -- Southern African Development Community (SADC), the East African Community (EAC) and the Common Market for Eastern and Southern Africa (COMESA). This agreement will facilitate intra-regional trade and promote investment in infrastructure and energy projects which are a focus of developing country transnational firms.

Generally, tariffs among developing countries are relatively high; however, where these tariffs have been reduced, trade among countries has expanded rapidly. Trade among the 43 developing countries in the Generalized System of Trade Preferences expanded by 50% in 2000-2005, faster than the 39% growth of their trade with the rest of the world. The scheme should be broadened and enlarged: it includes Brazil, India, Mexico and other large and dynamic developing economies but China and South Africa and several West and Central Asian economies are not members and they should all be invited to join.

The South Summits (in 2000 and 2005) recognized the need for platforms to better identify business opportunities and networks to promote public-private partnerships, and it is timely that Qatar will host the first South-South Trade and Investment Fair in Doha in 2009.

**South-South Benefits All**

Sustaining South-South growth in the current global meltdown is in the interest of all countries. Developed countries have a commitment to aid the poorest and will benefit from their growth and development. Arthur Lewis concluded his Nobel lecture by noting that “dependence is mutual,” and that developing countries, by their prosperity, can help a little to sustain prosperity in developed countries. “What we all really need is that world trade recapture its growth rate of eight per cent per year.”

Moscow, of course, was reconstructed. The unfortunate disaster provided the authorities an opportunity to plan a new city, which they did. Hopefully, our present crisis will yield a new financial system, more transparent and better regulated, with a revamped IMF but more broadly reliant on regional institutions. Developing countries -- the new engine of growth -- should fully participate in the re-design.

**Endnotes and Additional Thinking**

1 A full accounting of this still unfolding crisis awaits future economic historians.

2 These numbers, which are still accumulating, are as of November 2008.


5 International Monetary Fund, Global Financial Stability Report (October 2008).

6 International Monetary Fund, World Economic Outlook (October 2008).

7 See, for instance, the Statement issued by the Board of the South Centre, Revamping the Global Financial Architecture (29th October 2008; http://www.SouthCentre.org).

(The views expressed in the write-up are personal and do not reflect the official policy or position of the organisation.)
In recent years, the depth and breadth of the domestic foreign exchange market have improved markedly. It is noteworthy that the increase in foreign exchange market turnover in India between April 2004 and April 2007 has been the highest amongst the 54 countries covered in the latest Triennial Central Bank Survey of Foreign Exchange and Derivatives Market Activity conducted by the Bank for International Settlements (BIS). According to the survey, daily average turnover in India has jumped almost 5-fold from US $ 7 billion in April 2004 to US $ 34 billion in April 2007; global turnover over the same period has risen by only 66 per cent from US $ 2.4 trillion to US $ 4.0 trillion. Reflecting these trends, the share of India in global foreign exchange market turnover has trebled from 0.3 per cent in April 2004 to 0.9 per cent in April 2007, though the share as such appears miniscule.

The Indian volumes have thus grown rapidly and the diversity of market participants widened. The development of the foreign exchange market has been spurred earlier than the initiation of the financial sector reforms. Following the balance of payments crisis in 1991, the foreign exchange market received a shot in the arm, which in turn supported the growth of the foreign exchange market. The nature of trading shows that it has been concen-
trated in the onshore markets and there is a thriving non-de-
leveraged forward market. Also, the ratio of turnover to trade
flows remains much higher than the other emerging market
economies implying that the capital flows play a dominant
role in increasing the turnover.

Brief Background
The foreign exchange market in India started in earnest
about three decades ago when in 1978 the government al-
lowed banks to trade in foreign exchange with one another.
However, it was in the 1990s that the Indian foreign ex-
change market witnessed far reaching changes along with the
shifts in the currency regime. The rupee exchange rate that
was pegged earlier was floated partially in March 1992 and
fully in March 1993. The unification of the exchange rate was
instrumental in developing a market-determined exchange
rate of the rupee and an important step in the progress to-
wards current account convertibility.

A further impetus to the development was provided with
the setting up of an Expert
Group on Foreign Exchange
Markets in India (Chair-
mans: Shri O P Sodhani),
which submitted its report in
June 1995. The Group made
various recommendations for
deepening and widening of the Indian foreign exchange mar-
tet such as, freedom to cancel and rebook forward contracts
of any tenor, delegation of powers to the authorized dealers
(ADs) for grant of permission to corporates to hedge their
exposure to commodity exchanges/markets and extension of
the trading hours of the inter-bank foreign exchange market
- all of which were implemented. Consequently, beginning
from January 1996, wide ranging reforms have been under-
taken in the Indian foreign exchange market. After almost a
decade, on the recommendation of the committee on Future
Capital Account Convertibility (Chairman: S. S. Tarapore)
an Internal Technical Group on the Foreign Exchange Mar-
tet was constituted in January 2007 to undertake a compre-
prehensive review of the measures initiated by the Reserve Bank
of India (RBI) and identify areas for further liberalisation
and relaxation of restrictions in a medium term framework.

The momentous developments over the past few years
have been reflected in the enhanced risk-bearing capacity
of banks along with rising foreign exchange trading volumes
and finer margins. The foreign exchange market has ac-
quired depth (Reddy, 2005).

Factors Contributing to the Forex Market Growth
Apart from the liberalized regulatory regime, the growth
in the foreign exchange turnover has been attributed to in-
creased trade in financial assets globally [Galati and Heath
(2007)]. Investors with longer-term investment horizons
continued to diversify their portfolios by investing in foreign
bonds and equities. At the same time, leveraged investors,
with relatively short investment horizons, were attracted to
foreign exchange markets by the potential returns on carry
trades. An increase in high frequency, algorithmic trading,
mostly by banks, has also contributed to increased turnover,
particularly in the spot market.

Further, the portfolio inflows from abroad into the domes-
tic equity markets have also made a large contribution to the
foreign exchange turnover as there has been a region-wide
rally in equity markets and substantial purchases were
made by the non-residents in
2007.

In addition, arising out of
the stop and go policy of the
RBI on the exchange rate
of the rupee, there has been a sharp rise in volatility in the
exchange rate movements, which has increased the arbitrage
opportunity as well as hedging demands. Also, the measures
undertaken by the RBI to ensure more conducive environ-
ment for the foreign exchange market transactions for small
and medium enterprises had resulted in sharp increases in
the derivatives positions undertaken by these enterprises.
The estimated total exposure of the banks to the exotic
derivatives was of a mind-boggling nature of $ 3.16 trillion
as on December 31st, 2007. A number of companies have
reported losses for a few quarters in their balance sheets and
they have also been engaged in dispute with banks which
have opened up a Pandora’s box. In this respect, it is worth
noting the observations presented in the Report on Currency
and Finance 2004-05 (pp 178):

“greater liberalization enjoins upon banks to act more re-
responsibly so as to instill confidence in corporate entities un-
dertaking derivatives transactions. Following the instances of
some international banks encountering compensation claims owing to slackness on their part, there is need for all banks in India to introduce a customer suitability and appropriateness policy. The “appropriateness standard” ensures that banks use the same principle for taking credit decisions in respect of complex derivative transactions, as they do for non-derivative transactions”.

**Foreign Exchange Market Turnover**
The turnover in the foreign exchange market has increased rapidly from at $13,06,037 million in 1997-98 to $123,70,933 million in 2007-08, a jump to a 10 fold over the period of 12 years.

Also, the turnover as a multiple of overall balance of payments (BOP) has increased from 3.7 to 9.0 during the 12-year period. With the deepening of the foreign exchange market and increased turnover, income of commercial banks through treasury operations has increased considerably. Profit from foreign exchange transactions has accounted for more than 20 per cent of total profits of the

---

**Table 1: India’s Overall Balance of Payments in USD Million**

<table>
<thead>
<tr>
<th>Year</th>
<th>Current Account</th>
<th>Capital Account</th>
<th>Overall Balance</th>
<th>Turnover</th>
<th>Ratio Of Turnover To Overall BOP</th>
<th>Ratio Of Turnover To Capital Account</th>
</tr>
</thead>
<tbody>
<tr>
<td>1997-98</td>
<td>123347</td>
<td>68740</td>
<td>192253</td>
<td>1306037</td>
<td>6.8</td>
<td>5.6</td>
</tr>
<tr>
<td>1998-99</td>
<td>124174</td>
<td>59907</td>
<td>184258</td>
<td>1327730</td>
<td>7.2</td>
<td>10.6</td>
</tr>
<tr>
<td>1999-00</td>
<td>140406</td>
<td>70618</td>
<td>211680</td>
<td>1178098</td>
<td>5.6</td>
<td>10.7</td>
</tr>
<tr>
<td>2000-01</td>
<td>158104</td>
<td>99412</td>
<td>257821</td>
<td>1434248</td>
<td>5.6</td>
<td>8.4</td>
</tr>
<tr>
<td>2001-02</td>
<td>159480</td>
<td>77963</td>
<td>237637</td>
<td>1487359</td>
<td>6.3</td>
<td>9.1</td>
</tr>
<tr>
<td>2002-03</td>
<td>185053</td>
<td>81896</td>
<td>267149</td>
<td>1584863</td>
<td>5.9</td>
<td>9.3</td>
</tr>
<tr>
<td>2003-04</td>
<td>225503</td>
<td>135034</td>
<td>361139</td>
<td>2139800</td>
<td>5.9</td>
<td>8.6</td>
</tr>
<tr>
<td>2004-05</td>
<td>311948</td>
<td>169056</td>
<td>481611</td>
<td>2892119</td>
<td>6.0</td>
<td>9.5</td>
</tr>
<tr>
<td>2005-06 PR</td>
<td>404078</td>
<td>260106</td>
<td>665022</td>
<td>4415303</td>
<td>6.6</td>
<td>9.3</td>
</tr>
<tr>
<td>2006-07 P</td>
<td>502115</td>
<td>409858</td>
<td>913244</td>
<td>6570825</td>
<td>7.2</td>
<td>10.9</td>
</tr>
<tr>
<td>2007-08 P</td>
<td>624839</td>
<td>749449</td>
<td>1375824</td>
<td>12370933</td>
<td>9.0</td>
<td>13.1</td>
</tr>
</tbody>
</table>

PR-Partially Revised, P-Provisional.

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**Table 2: Ratio of Current and Capital Account Flows to Turnover**

<table>
<thead>
<tr>
<th>Year</th>
<th>Ratio Of Turnover To Current Account</th>
<th>Ratio Of Turnover To Capital Account</th>
<th>Ratio Of Turnover To Overall BOP</th>
<th>Year</th>
<th>Ratio Of Turnover To Current Account</th>
<th>Ratio Of Turnover To Capital Account</th>
<th>Ratio Of Turnover To Overall BOP</th>
</tr>
</thead>
<tbody>
<tr>
<td>1997-98</td>
<td>10.59</td>
<td>19</td>
<td>6.8</td>
<td>2002-03</td>
<td>8.56</td>
<td>19.35</td>
<td>5.9</td>
</tr>
<tr>
<td>1998-99</td>
<td>10.69</td>
<td>22.16</td>
<td>7.2</td>
<td>2003-04</td>
<td>9.49</td>
<td>15.85</td>
<td>5.9</td>
</tr>
<tr>
<td>1999-00</td>
<td>8.39</td>
<td>16.68</td>
<td>5.6</td>
<td>2004-05</td>
<td>9.27</td>
<td>17.11</td>
<td>6.0</td>
</tr>
<tr>
<td>2001-02</td>
<td>9.33</td>
<td>19.08</td>
<td>6.3</td>
<td>2006-07 P</td>
<td>13.09</td>
<td>16.03</td>
<td>7.2</td>
</tr>
<tr>
<td>2007-08 P</td>
<td></td>
<td></td>
<td></td>
<td>2007-08 P</td>
<td>19.8</td>
<td>16.51</td>
<td>9.0</td>
</tr>
</tbody>
</table>

scheduled commercial banks during 2004-05 and 2005-06. As per the RBI’s Report on Currency and Finance (2005-06), the bank group-wise distribution of the turnover (as a proportion of the total turnover for the respective year) reveals that foreign banks account for the largest share in total turnover, though their share declined from 59 per cent in 1996-97 to 42 per cent during 2005-06. The shares of public and private sector banks have increased correspondingly. The turnovers of some of the new private sector banks, in particular, have increased sharply during this period.

### Ratio of Forex Turnover to Flows

As shown in the data set presented in Table 1, the capital account transactions have always lagged behind current account transactions, but the gaps have steadily fallen and finally in 2007-08, the capital account transactions have overtaken the current account transactions. The ratio of forex turnover to capital and current flows shows that the significance of capital flows has increased more than the current account flows. The ratio of turnover to current account flows has increased from 5.58 in 1996-97 to 19.80 in 2007-08 while during the same period for capital flows, it has increased from 10.70 to 16.51, as in 2007-08. Capital flows have exceeded the current account flows.

As per a study of BIS, the ratio of foreign exchange turnover to trade flows has been plotted for several countries. Table 3 has been constructed using the figures in a Graph contained in the relevant BIS article (Working Paper No. 252). It shows that the ratio is the highest for New Zealand at 250 and the lowest for China at 5. The forex turnover of China has increased more than sevenfold, from $2 billion in 2004 to $15 billion in 2007, but the trade flows of China have been much more robust. In the case of most of the emerging markets, the ratio has been below 15. Only, South Korea, India, Singapore and Hong Kong are enjoying above the Asian average (Table 3).

#### The Share of Interbank Turnover

The share of interbank turnover has declined, while that of merchant transactions has increased over the years. Nevertheless, interbank operations continue to dominate the market. The merchant segment of the spot market is generally dominated by the government of India and select large public sector units, such as Indian Oil Corporation (IOC) and the foreign institutional investors (FIIs) The increases in the transac-

### Table 3: Ratio of Foreign Exchange Turnover to Trade Flows

<table>
<thead>
<tr>
<th>Country</th>
<th>Ratio</th>
<th>Country</th>
<th>Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>New Zealand</td>
<td>250</td>
<td>Europe</td>
<td>35</td>
</tr>
<tr>
<td>United States Of America</td>
<td>195</td>
<td>Hong Kong</td>
<td>35</td>
</tr>
<tr>
<td>Australia</td>
<td>170</td>
<td>Singapore</td>
<td>20</td>
</tr>
<tr>
<td>Japan</td>
<td>100</td>
<td>India</td>
<td>19</td>
</tr>
<tr>
<td>Great Britain</td>
<td>80</td>
<td>South Korean Won</td>
<td>18</td>
</tr>
<tr>
<td>Canada</td>
<td>40</td>
<td>Thailand</td>
<td>6</td>
</tr>
<tr>
<td>Asian Average (ex-Japan)</td>
<td>15</td>
<td>China</td>
<td>5</td>
</tr>
</tbody>
</table>

Note: Average daily turnover in April 2007 divided by average daily gross trade flows in 2006. Source: BIS working paper no.252; pp 19.

### Table 4: Share of Merchant and Interbank Turnover

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Merchant</td>
<td>209924</td>
<td>252684</td>
<td>250826</td>
<td>281231</td>
<td>272386</td>
<td>329220</td>
</tr>
<tr>
<td>(16)</td>
<td>(19)</td>
<td>(21)</td>
<td>(20)</td>
<td>(18)</td>
<td>(21)</td>
<td></td>
</tr>
<tr>
<td>Interbank</td>
<td>1096113</td>
<td>1075046</td>
<td>927273</td>
<td>1153017</td>
<td>1214973</td>
<td>1255643</td>
</tr>
<tr>
<td>(84)</td>
<td>(81)</td>
<td>(79)</td>
<td>(80)</td>
<td>(82)</td>
<td>(79)</td>
<td></td>
</tr>
<tr>
<td>Merchant</td>
<td>494769</td>
<td>704355</td>
<td>1221064</td>
<td>1797606</td>
<td>3760847</td>
<td></td>
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<tr>
<td>(23)</td>
<td>(24)</td>
<td>(28)</td>
<td>(27)</td>
<td>(30)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interbank</td>
<td>1645031</td>
<td>2187584</td>
<td>3194238</td>
<td>4773218</td>
<td>8609278</td>
<td></td>
</tr>
<tr>
<td>(77)</td>
<td>(76)</td>
<td>(72)</td>
<td>(73)</td>
<td>(70)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Diversification of the Turnover

The turnover in domestic market has diversified considerably over the years. The turnover now includes ‘new’ as well as ‘traditional’ foreign exchange instruments. The traditional instruments include the spot, outright forwards and foreign exchange swaps. The new over the counter (OTC) instruments include currency swaps and options, which have also, began gaining significance in recent years (Table 5).

Non-Delivered Forward Market

The non-delivered forward (NDF) market in Indian rupee has been in existence for over the last ten years reflecting onshore exchange controls and regulations. NDFs are synthetic foreign currency forward contracts traded over the counter outside the direct jurisdiction of the respective national authorities of restricted currencies. The demand for NDFs arise principally out of regulatory and liquidity constraints which face the underlying currencies. These derivatives allow multinational corporations, portfolio investors, hedge funds and proprietary foreign exchange accounts of commercial and investment banks to hedge or take speculative positions in local currencies. The pricing is influenced by a combination of factors such as interest rate differential between the two currencies, supply and demand, future spot expectations, foreign exchange regime and central bank policies. The settlement is not by delivering the underlying pair of currencies but by making a net payment in a convertible currency, generally the US dollar.

The liquidity in the rupee NDF market has improved since the late 1990’s as foreign residents who had genuine exposure to the Indian rupee but were unable to adequately hedge their exposure in the domestic market due to prevailing controls participated in the NDF market. However, with the gradual relaxation of exchange controls, reasonable hedging facilities are available to offshore non-residents who have

Table 5: Outstanding Derivatives: Notional Principal (Amount in Rs Billion)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreign Exchange Contracts (outstandings)</td>
<td>13013</td>
<td>17285</td>
<td>29254</td>
<td>37625</td>
</tr>
<tr>
<td>Forward Forex Contracts</td>
<td>12487</td>
<td>15286</td>
<td>24653</td>
<td>32044</td>
</tr>
<tr>
<td>Currency options purchased</td>
<td>526</td>
<td>1998</td>
<td>4601</td>
<td>5581</td>
</tr>
<tr>
<td>Futures</td>
<td>732</td>
<td>1430</td>
<td>2290</td>
<td>2068</td>
</tr>
<tr>
<td>Interest Rate Related Contracts</td>
<td>13119</td>
<td>21842</td>
<td>41958</td>
<td>54998</td>
</tr>
<tr>
<td>Of Which: Single Currency Interest Rate Swaps</td>
<td>12817</td>
<td>21530</td>
<td>41597</td>
<td>54590</td>
</tr>
<tr>
<td>Total Contracts/ Derivatives</td>
<td>26864</td>
<td>40557</td>
<td>73502</td>
<td>94691</td>
</tr>
</tbody>
</table>

Note: Data pertains to scheduled commercial banks.
Source: Rakesh Mohan’s speech

Table 6: Turnover of Asian Currencies in Tokyo

<table>
<thead>
<tr>
<th>Currencies*</th>
<th>Total</th>
<th>Spot</th>
<th>FX Swaps</th>
<th>Deliverable</th>
<th>Non-deliverable</th>
</tr>
</thead>
<tbody>
<tr>
<td>CNY</td>
<td>6959</td>
<td>179</td>
<td>10</td>
<td>9</td>
<td>6761</td>
</tr>
<tr>
<td>HKD</td>
<td>96044</td>
<td>25742</td>
<td>63615</td>
<td>6687</td>
<td>1185</td>
</tr>
<tr>
<td>IDR</td>
<td>1718</td>
<td>277</td>
<td>178</td>
<td>78</td>
<td>1185</td>
</tr>
<tr>
<td>INR</td>
<td>10662</td>
<td>1682</td>
<td>65</td>
<td>230</td>
<td>8685</td>
</tr>
<tr>
<td>KRW</td>
<td>30768</td>
<td>3693</td>
<td>934</td>
<td>767</td>
<td>25374</td>
</tr>
<tr>
<td>MYR</td>
<td>4463</td>
<td>1147</td>
<td>0</td>
<td>83</td>
<td>3233</td>
</tr>
<tr>
<td>PHP</td>
<td>2028</td>
<td>150</td>
<td>7</td>
<td>21</td>
<td>1850</td>
</tr>
<tr>
<td>SGD</td>
<td>22824</td>
<td>10932</td>
<td>9202</td>
<td>2690</td>
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<tr>
<td>THB</td>
<td>3628</td>
<td>1289</td>
<td>1675</td>
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<tr>
<td>TWD</td>
<td>9503</td>
<td>1931</td>
<td>14</td>
<td>313</td>
<td>7245</td>
</tr>
</tbody>
</table>

Source: Tokyo Foreign Exchange Market Committee (2007)
Table 7: Transactions of Asian and Other Emerging Currencies (Daily Averages in Hundred Millions of USD)

<table>
<thead>
<tr>
<th>Year</th>
<th>HKD</th>
<th>SGD</th>
<th>TWD</th>
<th>KRW</th>
<th>THB</th>
<th>IDR</th>
<th>INR</th>
<th>MYR</th>
<th>PHP</th>
<th>CNY</th>
<th>BRL</th>
<th>RUB</th>
<th>ZAR</th>
</tr>
</thead>
<tbody>
<tr>
<td>April, 2008</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Spot</td>
<td>10.9</td>
<td>5.2</td>
<td>0.2</td>
<td>2.6</td>
<td>0.6</td>
<td>0</td>
<td>0.1</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>7.3</td>
</tr>
<tr>
<td>FX Swap</td>
<td>36.7</td>
<td>13.4</td>
<td>0.3</td>
<td>4.2</td>
<td>2.9</td>
<td>0.1</td>
<td>0.1</td>
<td>0.4</td>
<td>0.1</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>10.9</td>
</tr>
<tr>
<td>Forwards</td>
<td>1.2</td>
<td>1.2</td>
<td>3.9</td>
<td>4.8</td>
<td>0.1</td>
<td>1.3</td>
<td>2.6</td>
<td>2.9</td>
<td>1.2</td>
<td>4.8</td>
<td>3.0</td>
<td>2.9</td>
<td>2.9</td>
</tr>
<tr>
<td>of which NDF</td>
<td>0</td>
<td>0</td>
<td>3.9</td>
<td>4.7</td>
<td>0</td>
<td>1.3</td>
<td>2.6</td>
<td>2.8</td>
<td>1.2</td>
<td>4.8</td>
<td>2.3</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Total</td>
<td>48.8</td>
<td>19.9</td>
<td>4.4</td>
<td>11.6</td>
<td>3.6</td>
<td>1.4</td>
<td>2.8</td>
<td>3.3</td>
<td>1.3</td>
<td>5.1</td>
<td>2.4</td>
<td>0</td>
<td>21.1</td>
</tr>
</tbody>
</table>


Table 8: Extent of RBI Interventions in the Foreign Exchange Market (In USD Billion)

<table>
<thead>
<tr>
<th>Year</th>
<th>RBI’s Operations*</th>
<th>Turnover</th>
<th>Per cent (2 over 3)</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1)</td>
<td>(2)</td>
<td>(3)</td>
<td>(4)</td>
</tr>
<tr>
<td>2002-03</td>
<td>45.6</td>
<td>1560</td>
<td>2.9</td>
</tr>
<tr>
<td>2003-04</td>
<td>80.4</td>
<td>2118</td>
<td>3.8</td>
</tr>
<tr>
<td>2004-05</td>
<td>41.9</td>
<td>2892</td>
<td>1.4</td>
</tr>
<tr>
<td>2005-06</td>
<td>22.3</td>
<td>4413</td>
<td>0.5</td>
</tr>
<tr>
<td>2006-07</td>
<td>26.8</td>
<td>6571</td>
<td>0.4</td>
</tr>
<tr>
<td>2007-08</td>
<td>78.2</td>
<td>12370</td>
<td>0.6</td>
</tr>
</tbody>
</table>

* Includes spot as well as forward transactions.


exposure to the Indian rupee, especially when compared with the hedging facilities provided by some other competing Asian countries. Besides, the NDF market also derives its liquidity from (i) non-residents wishing to speculate on the Indian rupee without any exposure to the country; and (ii) arbitrageurs who try to exploit the differentials in the prices in the two markets.

With regard to the regulatory aspects on the NDF market, there are no controls on the offshore participation in the Indian rupee NDF markets. Domestic banking entities have specified open position and gap limits for their foreign exchange exposures and through these limits, domestic entities could play in the NDF markets to take advantage of any arbitrage opportunities.

As shown in Table 6, the rupee NDF market was the second largest at $ 8,685 million in April 2007; next only to the South Korean won which has the highest daily average turnover of $ 25,374 million in April 2007 (Table 6). As per the latest report of the Tokyo Foreign Exchange Market Committee for April 2008, the NDF turnover in Chinese yuan has exceeded that of South Korean won followed by Taiwanese dollar and Malaysian ringgit. The turnover in the Indian rupee has slipped to the fifth position (Table 7).

RBI Interventions in the Foreign Exchange Market

In response to the developments in the foreign exchange market, the RBI has intervened both in the spot and forward market with the purpose of modulating the currency movements and curbing volatility. The RBI’s intervention in the foreign exchange market has increased from $ 45.6 billion in 2002-03 to $ 78.2 billion in 2007-08. However, the share of RBI’s operations as a percentage of total forex turnover has increased from 2.9 per cent in 2002-03 to 3.8 per cent following the redemption of Resurgent India Bonds, but thereafter it has slipped to 0.4 per cent in 2006-07, which again rose to 0.6 per cent in 2007-08 given the sharp volatility in the exchange rate (Table 8).

References and Additional Thinking


(The views expressed in the write-up are personal and do not reflect the official policy or position of the organisation.)
DEVELOPMENT AND EXCLUSION: Concern, Analysis and Empirics from West Bengal and India

Pinaki Chakraborti
Department of Economics, Burdwan University, West Bengal

Rik Chakraborti
Department of Economics, Burdwan Raj College, Burdwan, West Bengal
Introduction
In the recent times there has been a notable resurgence of interest in development and displacement. Phenomenal increase in the literature on development and exclusion essentially reflect a collective concern for the sizable loss of human resource resulting from globalization in several third world economies.1 The necessity of integrating into the world economy not only has been realised as a final inevitability for any developing nation, the trend of integrating has itself received a boost over the last couple of decades. The consequential pace of new economic and socio-political changes in such globalising economies has effectively led to exclusions on multiple dimensions on a very large scale.2 Hence a key challenge confronting any part of the globalising third world is to moderate the magnitude of such exclusion and thereby move onto the growth and development path that ably steers the economy towards largest feasible extent of inclusive development and efficient utilisation of all resources. World Development Report (2001) strongly endorses this endeavour.

The problem of consequential exclusion in various forms is not at all a new one. It can be traced to Aristotle and even beyond, in the past. There in lies the light of optimism; human societies have been surmounting this challenge continuously along the wheels of history and survived with increasingly inclusive development, if viewed over a long time horizon. Erudite social thinkers have time and again drawn our attention to the awesome displacement that is carried with changes in technology and new innovations, all along. As we move from discovery of wheel, fire and agriculture through industrial revolution to this new globalisation of the cyberspace, we not only ride through a history of displacement and exclusions, but also experience the synergies that assimilate the contradictions of the new methods and accommodate the displaced in the mitigation drives. And such processes are strongly active within the present day socio-economic dynamics of West-Bengal as well.

The purpose here is to understand this resolving discourse of displacement. Can the struggle of West Bengal to adapt the emergence of globalization in our times strongly hope for those continuous breakthroughs that will steer the direction of economic development of the state such that the seemingly displaced or excluded people are increasingly taken care of and drawn back to the development mainstream? It is now well known that the globalisation and development discourse in West Bengal has been passing through discomforting functions.3 Sheds of pessimism and often anarchic sermons have been surfacing. It is thus imperative to understand the positive and negative forces adequately and strengthen the scope for increasing inclusion which will illuminate an optimally accommodative, inclusive path of industrialisation. West Bengal has reached a point of no return regarding industrialisation which has to be perceived accurately for attaining sustainable development that does not deny human values.

The present paper examines to what extent the temporary displacements and exclusions are indispensable and tries to highlight the underlying dynamics that are likely to set things right, given adequate and sincere attention from all concerned. And through this course, it presents a brief critique of the recent literature that appeared anxious regarding whether the present path of development through industrialisation in West Bengal is inclusive in nature or in essence exclusive. Following this, the paper suggests the policy strengths that such emerging industrial economies would need to make their growth sufficiently inclusive.

In what follows, the section II briefly sketches the West Bengal economy and her recent developments. The next section reviews critically the literature that came up recently expressing concerns on displacement and suggesting some ways out. Section IV, taking the essential lead from the literature survey, discusses the way to minimise displacement, intricately intertwined with the fundamental and perennial problem of choice that society has to solve to attain the innovative path of resolution. Section V, concludes the discussion by suggesting policy actions to deal with the inevitability of displacement toward minimising the loss of human resources. In this section, we briefly present a set of features and changes relating to the economy of West-Bengal in recent times to indicate some major issues. The economy at the time of independence earned its reputation as an industrially developed state, though the vast majority of her people were rural and had been eking out a bare survival from an
overburdened agriculture only. The asymmetries that critics often forget on West Bengal are quite a few. (a) Her forced acceptance of a huge influx of population because of partition, continuing to a small extent even today; (b) the fast fall of the old industries most of which flourished during the middle-late British period, not because of mishandling but of dying demand and hence increasingly became social liabilities; (c) reluctance of new capital to flow in because net returns to investment in some other newly industrialising states were higher since they enjoyed the late comers’ advantages not available to West Bengal.

The economy since then experienced the planned development, the emphases of which transitioned from an agriculture-industry balance through the periods of protectionist heavy industry and HYV-green-revolution drives to the current liberalisation scenarios. In course of this development the population pressure on this land nearly trebled while growth of output and new industries lagged behind with the size and hence stock of land remaining the same. The economy has become seriously land scarce resultantly.

Table 1: West Bengal: Geographical Area Sq. Km.

<table>
<thead>
<tr>
<th>Year</th>
<th>Total</th>
<th>Rural</th>
<th>Urban</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>88752</td>
<td>85427.26</td>
<td>3324</td>
</tr>
</tbody>
</table>

The share of the agricultural sector in the overall gross domestic product (GDP) in the Indian economy has been falling from 29.76 per cent during 1993-94 to 23.15 per cent during 2000-01 to 2002-03. This was mainly because of high rate of growth in services sector. Compound average growth rate of agriculture also has been falling quite fast.

Table 3: Land Utilization (’000 Hectares)

<table>
<thead>
<tr>
<th>Year</th>
<th>Report-</th>
<th>Forest</th>
<th>NAC</th>
<th>OUL</th>
<th>CF</th>
<th>NAS</th>
</tr>
</thead>
<tbody>
<tr>
<td>1980-81</td>
<td>8604.85</td>
<td>1078.12</td>
<td>1347.98</td>
<td>588.08</td>
<td>82.52</td>
<td>5508.85</td>
</tr>
<tr>
<td>1995-96</td>
<td>8694.51</td>
<td>1195.52</td>
<td>1642.37</td>
<td>174.91</td>
<td>219.78</td>
<td>5461.93</td>
</tr>
<tr>
<td>1999-00</td>
<td>8689.03</td>
<td>1191.95</td>
<td>1658.94</td>
<td>158.13</td>
<td>208.3</td>
<td>5471.71</td>
</tr>
<tr>
<td>2002-03</td>
<td>8686.64</td>
<td>1193.64</td>
<td>1633.43</td>
<td>124.13</td>
<td>381.25</td>
<td>5354.19</td>
</tr>
<tr>
<td>2004-05</td>
<td>8685.45</td>
<td>1174.77</td>
<td>1699.99</td>
<td>123.98</td>
<td>314</td>
<td>5374.71</td>
</tr>
</tbody>
</table>

NAC: Not Available for Cultivation; OUL: Other Uncultivated Land
CF: Current Fallow; NAS Net Area Sown

Given the fact that the trend in terms of sectoral division of the economy resembles more or less the Indian economy as a whole, it may be provoking to examine the causes behind the relatively much high extents of agitation being focused primarily in West Bengal and in a few other select regions rather than being a nationwide phenomenon. The tables reveal an already enormous and further increasing population pressure and moreover that in the land use pattern while agriculture stagnates, industry and other uses have failed to increase at any significantly adequate pace. This is particularly true for the period identifiable as being contemporary to the advent and progress of globalization. If we roughly associate rural with agricultural and urban with secondary and tertiary sectors, then the figures clearly reveal that the brunt of the pressure of activities has been considerably more on the rural areas. Agricultural productivity also seemingly has reached a limit in commercial crops and in food crops have increased in the post globalization period mainly because of lower cost in non-land inputs and availability of high efficiency machineries. The productivity fall because of

Table 2: Population Features of West Bengal

<table>
<thead>
<tr>
<th>Population Features</th>
<th>1991</th>
<th>2001</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>68077965</td>
<td>80176197</td>
</tr>
<tr>
<td>Rural</td>
<td>49370364</td>
<td>57748946</td>
</tr>
<tr>
<td>Urban</td>
<td>18707601</td>
<td>22427251</td>
</tr>
<tr>
<td>% Urban</td>
<td>27.48</td>
<td>27.97</td>
</tr>
<tr>
<td>Density ^</td>
<td>767</td>
<td>903</td>
</tr>
<tr>
<td>Decadal Variation</td>
<td>24.73</td>
<td>17.77</td>
</tr>
</tbody>
</table>

^ Per Sq. Km
Source: Statistical Abstract, BAES, GoWB.

Table 4: Agricultural Productivity (’000 Kgs per Hectare)

<table>
<thead>
<tr>
<th></th>
<th>1990-91</th>
<th>2001-02</th>
<th>2002-03</th>
<th>2004-05</th>
</tr>
</thead>
<tbody>
<tr>
<td>Food grains</td>
<td>146.3</td>
<td>204.1</td>
<td>200</td>
<td>208.9</td>
</tr>
<tr>
<td>Non-Food grains</td>
<td>146.9</td>
<td>175.4</td>
<td>163.4</td>
<td>166.3</td>
</tr>
</tbody>
</table>

Source: Statistical Abstract, BAES, GoWB, 2005
Table 5: Rate of Change in Agricultural Productivity

<table>
<thead>
<tr>
<th></th>
<th>90-91 to 01-02</th>
<th>2002-03</th>
<th>2004-05</th>
</tr>
</thead>
<tbody>
<tr>
<td>Food grains</td>
<td>3.39</td>
<td>-0.20</td>
<td>0.44</td>
</tr>
<tr>
<td>Non-Food grains</td>
<td>1.79</td>
<td>-0.71</td>
<td>0.18</td>
</tr>
</tbody>
</table>

Source: Statistical Abstract, BAES, GoWB, 2005

Table 6: Mode of Employment

<table>
<thead>
<tr>
<th>2001</th>
<th>Male</th>
<th>Female</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Worker (main + marginal)</td>
<td>22388044</td>
<td>7093646</td>
<td>29481690</td>
</tr>
<tr>
<td>Cultivators</td>
<td>4655210</td>
<td>998712</td>
<td>5653922</td>
</tr>
<tr>
<td>Agricultural Labourers</td>
<td>5080236</td>
<td>2282721</td>
<td>7362957</td>
</tr>
<tr>
<td>Household Industry workers</td>
<td>917180</td>
<td>1254890</td>
<td>2172070</td>
</tr>
<tr>
<td>Other workers</td>
<td>11735418</td>
<td>2557323</td>
<td>14292741</td>
</tr>
<tr>
<td>Industrial</td>
<td></td>
<td></td>
<td>9535027</td>
</tr>
<tr>
<td>Agricultural</td>
<td></td>
<td></td>
<td>35135612</td>
</tr>
</tbody>
</table>

Source: Census 2001

Table 7: Share of Worker Categories in Employment (2001)

<table>
<thead>
<tr>
<th>Category</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Worker (main + marginal)</td>
<td>100.0</td>
</tr>
<tr>
<td>Cultivators</td>
<td>19.2</td>
</tr>
<tr>
<td>Agricultural Labourers</td>
<td>25.0</td>
</tr>
<tr>
<td>Household Industry workers</td>
<td>7.4</td>
</tr>
<tr>
<td>Other workers</td>
<td>48.5</td>
</tr>
</tbody>
</table>

Source: Census of India 2001

Table 8: Percentage of Agricultural Workers to Total(Main+Marginal) Workers by Residence and Sex 1951-2001 for State / District

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>P</td>
<td>M</td>
<td>F</td>
<td>P</td>
</tr>
<tr>
<td>West Bengal</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>T</td>
<td>49.83</td>
<td>50.11</td>
<td>48.21</td>
<td>53.8</td>
</tr>
<tr>
<td>R</td>
<td>69.16</td>
<td>71.65</td>
<td>57.38</td>
<td>71.65</td>
</tr>
<tr>
<td>U</td>
<td>3.00</td>
<td>2.72</td>
<td>5.82</td>
<td>1.85</td>
</tr>
</tbody>
</table>

Source: Census of India 2001

For an enhanced comprehension let us look at some features of the employment scenario.

Clearly the West Bengal economy is still characterized by overburdened, agriculture bearing the major weight of occupational choices made by people. Given the fall in agricultural productivity it is very logical and rational that the socioeconomic inclination would be a frantic search for new industrial opportunities. It could have been an encouraging...
fact indicating labour allocation moving in favour of industries implying sizable increase in industrial employment from a comparison of increases in the percentage of agricultural worker in total worker in the table 8.

However such optimism is prevented by the fact that the percentage of the rural increased at a greater rate than the fall in the urban values. Taking the rise in the rural population both in absolute and the percentage of total, it only reflects agriculture is still taking the major brunt of population pressure, not only as a supplier of food, but also as a user of human resources in West Bengal. The facts are reciprocally matched by the table 9.

The rural values are naturally lower than the urban values in table 9. But notably both the types of percentages have shown declining trends till the Census of 1991 and only marginal rise in 2001. This may be a sign of a silver line in the later half of post liberalization-globalisation transformation. Nevertheless the figures simply call for serious attention to the feeble growth of new industries, including the small and household ones. The reason plausibly is the dearth of any significant demand pull for the existing big and small industry of the state. From this one can logically argue that had there been one or two big industrial units of products which are in high and expanding demand, things would have taken to a positive and strong turn around towards prosperity and full employment, with increasing efficiency of human resources of West Bengal. But then therein generates the most obdurate source of resistance: owing to the necessity of allocating large chunks of land to these new ventures, people owning land have been facing resulting uncertainties of all sorts on the top of slowly declining source of traditional livelihood, agriculture and for some, the loss of power. They fear the loss from all these dimensions that will result from the displacement if that occurs, and to some extent such fears are justified given the numerous repetitions of such turn of events throughout the course of history.

West Bengal has a considerable past of industries from which it tried to deviate during the post independence planned development era whereby the new displacement wave started. But this is not singular on West Bengal. Quite a few other states have had similar experiences, an exclusion process we take up below. For West Bengal this has happened many times over and the greatest extent is most prominent during the colonial era. However, in the recent times, after the heavy industry drive Second Five Year Plan onwards and its linkage effects settled down, the industrial employment situation also

Table 9: Percentage of Non Agricultural (Household Industry +Others) Workers to Total ( Main + Marginal ) Workers by Residence and Sex for State / District Percentage to Total ( Main + Marginal ) Workers

<table>
<thead>
<tr>
<th></th>
<th>1951</th>
<th>1971</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>P</td>
<td>M</td>
</tr>
<tr>
<td>T</td>
<td>50.17</td>
<td>49.89</td>
</tr>
<tr>
<td>R</td>
<td>30.84</td>
<td>28.35</td>
</tr>
<tr>
<td>U</td>
<td>97</td>
<td>97.28</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>1991</th>
<th>2001</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>P</td>
<td>M</td>
</tr>
<tr>
<td>T</td>
<td>45.75</td>
<td>47.01</td>
</tr>
<tr>
<td>R</td>
<td>29.33</td>
<td>29.08</td>
</tr>
<tr>
<td>U</td>
<td>94.34</td>
<td>94.55</td>
</tr>
</tbody>
</table>

Table 10: Average Daily Workers Employed in Registered Factories in Lakhs

<table>
<thead>
<tr>
<th>Category</th>
<th>2001</th>
<th>2003</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Food Prod &amp; bev</td>
<td>8.75</td>
<td>9.07</td>
<td>9.21</td>
</tr>
<tr>
<td>Textile</td>
<td>32.35</td>
<td>31.76</td>
<td>31.92</td>
</tr>
<tr>
<td>Tan, Leather, etc</td>
<td>1.68</td>
<td>1.58</td>
<td>1.82</td>
</tr>
<tr>
<td>Wood and cork*</td>
<td>1.17</td>
<td>1.25</td>
<td>1.25</td>
</tr>
<tr>
<td>Paper etc</td>
<td>1.43</td>
<td>1.46</td>
<td>1.46</td>
</tr>
<tr>
<td>Chemical etc</td>
<td>4.50</td>
<td>4.46</td>
<td>4.46</td>
</tr>
<tr>
<td>Rubber and plastics</td>
<td>2.73</td>
<td>2.81</td>
<td>2.88</td>
</tr>
<tr>
<td>Basic Metals</td>
<td>10.77</td>
<td>10.63</td>
<td>10.96</td>
</tr>
<tr>
<td>Metal</td>
<td>5.31</td>
<td>5.21</td>
<td>4.98</td>
</tr>
<tr>
<td>Machinery and equip</td>
<td>7.64</td>
<td>7.85</td>
<td>7.45</td>
</tr>
<tr>
<td>Medical, Optical Inst</td>
<td>0.36</td>
<td>0.35</td>
<td>0.35</td>
</tr>
<tr>
<td>Vehicles, trailers</td>
<td>1.08</td>
<td>0.84</td>
<td>0.82</td>
</tr>
<tr>
<td>Other trans equip</td>
<td>4.66</td>
<td>4.53</td>
<td>4.35</td>
</tr>
<tr>
<td>Electricity, Gas, Steam</td>
<td>2.41</td>
<td>2.32</td>
<td>2.28</td>
</tr>
<tr>
<td>Auxiliary transport</td>
<td>1.55</td>
<td>1.66</td>
<td>1.79</td>
</tr>
<tr>
<td>Computer</td>
<td>0.09</td>
<td>0.09</td>
<td>0.08</td>
</tr>
<tr>
<td>Education</td>
<td>0.09</td>
<td>0.09</td>
<td>0.09</td>
</tr>
</tbody>
</table>

Source: Calculated on data from Statistical Abstract, BAES, GoWB, 2005
shows signs of stagnation.

From the table 10, we trace a picture of growth of industrial employment mainly in the large-scale industry sector which indicates stagnation of the industries well known for their prosperity in relatively recent times. Since there have been no major labour saving innovations in those units the data no doubt imply slackening paces in terms of employment generation of these industries.

Most of these industries in terms of employment have been slowing down or even shrinking. One can imagine what confronts the old dead log industries such as Jute. As from the above description, even without going deep into the poverty scenario of the state (which of course has improved but certainly is not in any condition to generate complacency), we see that the state has been frantically in search of sustaining employment opportunities. One new ground that has been broken open is the small-scale and household industries. This has registered remarkable growth in the past, not-so-distant. But looking at the statistics on Household Industry Worker and Other Worker over the past two decades we presented, it can be said that it is also showing signs of stagnation.

In terms of a figure, industrial employment looks like the chart above. They simply represent almost zero growth period when expansionary pull of globalization is supposed to have been increasing.

Some exception may be attached to the Food and Beverages, Chemicals, Metals and Machinery and to some extent in Transport sector. But in most cases employment has fallen in comparison with 2001 level.

It will now be practical to look into some figures from other states in India. As we have done earlier in this essay, we associate agriculture with rural and nonagricultural, mainly industry activities with urban columns of data.

In most of the selected states taken employment levels are
Table 11: Enterprises and Employment Pattern of Various States in India

<table>
<thead>
<tr>
<th>State</th>
<th>Enterprises</th>
<th>Employment</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Rural</td>
<td>Urban</td>
</tr>
<tr>
<td>Bihar</td>
<td>871554</td>
<td>418053</td>
</tr>
<tr>
<td>Gujarat</td>
<td>1343290</td>
<td>1075475</td>
</tr>
<tr>
<td>Maharashtra</td>
<td>2262035</td>
<td>2112732</td>
</tr>
<tr>
<td>Orissa</td>
<td>1424534</td>
<td>366889</td>
</tr>
<tr>
<td>Punjab</td>
<td>496667</td>
<td>575505</td>
</tr>
<tr>
<td>West Bengal</td>
<td>2831128</td>
<td>1454560</td>
</tr>
</tbody>
</table>

Source: Economic Census of India 2005.

Figure 4: Number of Enterprises (Rural)

Figure 5: Number of Enterprises (Urban)

Table 12: Employment Dynamics

<table>
<thead>
<tr>
<th>State</th>
<th>Work Participation Rate</th>
<th>Rank</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bihar</td>
<td>32.16</td>
<td>33.88</td>
</tr>
<tr>
<td>Gujarat</td>
<td>40.23</td>
<td>42.1</td>
</tr>
<tr>
<td>Maharashtra</td>
<td>42.96</td>
<td>43.46</td>
</tr>
<tr>
<td>Orissa</td>
<td>37.53</td>
<td>38.88</td>
</tr>
<tr>
<td>Punjab</td>
<td>30.87</td>
<td>37.58</td>
</tr>
<tr>
<td>West Bngl</td>
<td>32.19</td>
<td>36.78</td>
</tr>
</tbody>
</table>

Figure 6: Work force Participation Rates (WPR)
lower than West Bengal.

Evidently, the Work force participation rates (WPR) are higher than West Bengal only in Gujarat and Maharashtra but the decadal growth of WPR is highest in West Bengal. Yet as in a region dominantly industrial, employment growth will mean relatively higher employment in industry, similarly with a region dominated by agriculture, and stagnant industries, rise in WPR will mean relative rise in agricultural employment. Hence, given the contemporary nature of the economy this picture actually evinces at growth primarily in agricultural labour force, which in West Bengal does imply further pressure in agriculture as compared to industrially developed states like the two we mentioned.

The economy of West Bengal has tried hard to develop on the existing industrial base but the industries inherited from the colonial period were established to serve British interests and their way of availing comparative advantage. Mostly these concentrated on traditional income inelastic activities and so failed to align with the growth of the World economy post independence. Hence new ventures were imperative and given the role of the state in India and the governments at all levels, the eventual displacements occurred under the initiatives from the state which facilitated further new activities driven by private capital in some states in the country, not all.

The reason simply is the asymmetric regional suitability to the new investments and so whatever new industrial efforts were initiated required stakes on agricultural land or alternatively clearing forest areas. The second option was evidently untenable given the long run implications in terms of infrastructure development and environmental-biodiversity costs though in certain states like Orissa, some forestry were in fact cleared to facilitate new investments.

The purpose of this section, in general is to make a quick scan of the literature controverting over the pains of industrialisation resulting from emerging capital mobility of globalisation, albeit the route taken is that of examining mainly the papers criticising recent displacements of agricultural people in West Bengal, published in a famous Indian Journal during 2007.

There are quite a few analytical works that elaborately sift through the possibilities of large scale displacement germane to the industrial development. Around the advent of industrial capitalism the initial proponents like Smith, Ricardo, Marx and also Malthus debating on technological progress through introduction of machinery. All of them suggested eventual absorption of the initially displaced through growth and prosperity to follow, though Marx was sure on the residual ‘reserve army of labour’ that was an inevitable consequence of expansion of capitalism. The discourse remained evolving since then. The evolution of industrialisation history all over the globe had to inflict displacement. Besides if one studies the industrialisation in England, America, Russia, and even Peoples Republic of China recently, one cannot possibly deny the large-scale displacement of people at some points of their economic history.

The nine world famous economists in their joint paper on the issue (Banerjee et al, 2007) have argued that one must not persuade the government to give up industrial land acquisition because of the tragic events taken place in Nandigram. Given the openness, strength of savings, infrastructural and spread the Government of West Bengal should involve in land acquisition for industrial ventures oriented to the consequent absorption of a large mass of unemployed. This of course will have to make proper compensation to the concerned people adequately and take the State credibly into industrialisation. Government must involve itself in the process to prevent unholy tie-ups likely to come up to misappropriate money and assets depriving the legitimate holder.

Fernandez (2003), recently has analysed the displacements taken place in independent India. We summarise his account first for some empirics on India in this respect. During this period, Fernandez recorded transfer of 47 lakhs acres of land and 36 lakh displaced persons of whom 20 % were of tribal origins making about a six percent of the State’s population of the weaker sections. In India as a whole according to his database an aggregate of sixty million displaced and/or Project Affected Persons have been recorded. History resembles itself in Orissa, Kerala, Andhra Pradesh, Assam, and Goa and so on. Of these displaced people, the hope of rehabilitation was realised only for 35.27% in Orissa, 28.82% in Andhra Pradesh, 13.18% in Kerala, 33.23% in Goa. For
West Bengal and Assam, according to Fernandez, rehabilitation records are weak; only nine percent and 10% respectively. Venkateswaran (2007) recorded instances of displacement where cash compensation was resorted to, like cases of POSCO in Orissa and Tata Motors in Singur and argued them to be grossly inadequate.

The question of compensation has emerged as the key issues in the recent literature on the debate. The two recent ones are Sarkar (2007) and Bhaduri (2007). The former advocates industrialisation but with adequate compensation to be determined by the market, rather than by the government and the latter rejected this path of development altogether and advocated a take off from a deficit financing of full employment by the state. But the role of the government as a player in the market is important in the present context to prevent the weak people from being robbed by the land mafia or thugs of the intruders disguised in the name of market enforced acquisition. In quite a few places in India, when government avoided its responsibility, this is what has happened, affecting the displaced even more adversely. Bhaduri’s suggestions do not seem conformable with the current economic environment, leave alone its economic consistency and viability. There are quite a few other important contributions we mentioned earlier in this paper that reflect deep concern for the displaced. It will be useful to take these two papers at deeper details.

Sarkar has examined elaborately the emergence of land appropriation for industrialisation in a number of countries and analysed the occupation dynamics tracing out from emergence of capitalism in England. He noted the eventual forcible evictions that the weak users (owners whose rights could easily be flouted) of land. He identified this with the advent of capitalism via the route along which the powerful land owners and the class/group of people thriving for profits from investment virtually coalesced to drive the weak and small land peasants away. Albeit different routes this has happened in China, India in recent times. According to him unfolding of a Lewis (1954) process unleashed expansive pulls on land which created groups of gainers and losers, perpetrators and sufferers, among whom conflicting bargaining interests emerged. Sarkar visualized a Coase theorem scenario where without government intrusion a market would have developed reducing transaction and other costs, especially in the case of West Bengal beyond 2007. Had the government let the market mechanism play its role uninterrupted by state coercion, a natural price acceptable to both the sides would result. But the state government, after reaching the limits of land redistribution through its rigorous land reforms, had no way but to attempt large scale industry as freely flowing in private capital appeared reachable.

In that context the losers appeared to resemble industrial workers affected by shut downs. Since the workers are compensated by the capitalists in such cases, Sarkar wants the Government to compensate the workers. The crux lies in the ill-defined nature of property rights of the weak peasants and that remained for more than a century which the government uses to subsidise the Tatas. A significant point made by Sarkar is the fact that in spite of remarkable land redistribution through widespread land reforms West Bengal remained poor, a basis for the argument Sarkar makes.

These observations can be put into serious question if someone is truly unbiased. West Bengal inherited an overdose of adverse and irreversible historical asymmetries, the industries of the colonists fast waning in world income, a huge overload of refugees, backbone breaking partition, and then the discriminating freight policies of the central government. The land reforms started with the background of a mammoth
world bank loan on the country which aggravated the budgetary shortages and the size of the funds to be allocated to development activities. Punjab is a different path that was not available to West Bengal.

But the major lacuna in Sarkar’s market argument lies in absence of another type of symmetry. Peasants and the capitalists are unequal and in a country where under on going reforms some commercial banks can send thugs to the defaulting debtors, one can imagine the consequences the disagreeing peasants might have to face. In fact in some of the mega-development projects in Maharashtra unverifiable information hints to such dire misfortunes to have occurred to the original holders of land. Such oppressions are also reported from Jharkhand and Chhattisgarh in the recent work of Bhaduri on the subject(2007).

In fact, the most radical reading of the discourse comes from Bhaduri (2007). Bhaduri argues that beyond the apparent, three interrelated questions center around the issue of industrialization: who is the central actor, what is the sectoral commodity composition of output from industrialization and who loses and who wins in the process.

He finds the ongoing industrialization actually to be a process of ‘internal colonisation’ ruthlessly destroying livelihood and displacing the poor from their existing agricultural base even within the orbits of existing parliamentary democracy. The evicted people often come from the tribals or dalit groups. He sited instances where consent of gram sabha for land acquisition were manufactured by police at gunpoint. To him the accumulated evidences on industrialization in different countries and political-economy systems ranging from early capitalism and centralized bureaucratic socialism to post-socialist and late capitalist experiences implied totally neglected status of distributive bearings of industrial growth. He found the ‘trickle down’ often put forward by ruling neoliberal ideology ‘dubious’ and ‘politically foolish’ as no concern or commitment on the speed of trickle down is put forward. Thus the losers are always the poor of the land-based people while the other two questions leads us to colonization by the multinationals which is kind of legitimized by the neo-liberal political system. This always goes against the poor majority a paradoxical development resulting through the means of democracy. Bhaduri’s policy suggestion is even more radical if not totally revolutionary. He wants this on going legitimization of atrocities be summarily rejected first. He advocates for launching a programme of implementing immediate full employment centered on agriculture and villages, targeting in the demand side, the domestic market only. The action has to be operationalised through searches, proposals and approvals at the effective participatory development that was intended in the 73rd and 74th Amendments of the Indian Constitution. According to him resultant dynamics of full employment will be self sustaining if properly monitored and steered. The problem of finance obviously has to be solved by considerable deficit financing initially.

This reflects lack of pragmatism, overlooking many practical hindrances too difficult to overcome. It is impossible to carry out so extensive a programme without a time consistent planning. That in turn needs and a thorough coordination among the levels of activities, right from the village to the state and central tires, which is formidable given the informational asymmetries and hiatus. Implementing the required mechanism requires extremely well maintained symmetric linkages to generate the necessary welfare effects. What will be the commodity composition of this drive, for example, and who decides, if lacking in the required information and knowledge?

Will the programme coexist with the current openness of
the economy or do we go again for protection. No new series of protection goes cohesively with the present WTO regime that India has signed into, at the time when the international relations are determined by the unipolarity of the global political economy. Viability of the entire programme is uncertain let alone the explosive inflationary spirals that may be triggered off from deficit financing of full employment. Inflation swallows the poor, not the affluent.

Bhattacharya (2007) argued that though the rumours and exaggerations colour the reports and under-reports the coercion and excesses unleashed by the BUPC (Bhumi Uchchhed Pratirodh Committee) in Nandigram, the lack of livelihood and a fear of losing them even further, in case of the SEZ coming up, are real and deep seated among the poor agricultural people. They truly lack in employment opportunities. Women are deliberately being traumatized by the opponent sides. The plight is aggravated because of the neoliberal policies at the centre which has made agriculture a loss-making proposition. As a result multidimensional fears reinforce themselves. The reports are adequate to claim that poor now are not a single homogeneous class with a single political face but there are conflicting many and it is likely that strategic coalitions have been forged among the political and survival interests leading to queer symbiotic group formations. Hence it was possible to distort the message of land acquisition proposed promising adequate compensation, into apprehensions and use that for political gains by those in the opposition.

Patnaik (2007), has blamed the false expectation of employment in the corporate industrialization that has been unleashed in the country and the left are being made scapegoat of the situation. According to him the profit seeking corporate encroachment of poor peasants economy destroys more employment than it creates and this generates a perennial sequence of falling employment, through direct and indirect adverse employment effects of corporate industrialization. The best way to industrialise, which is imperative is to ensure protection to the potential ‘dispossessed’ and minimise the effects of employment and other adversities. But that is impossible under corporate industrialisation, mainly because of its faith in private sector (through PPP) at the cost of a more effective and promising public sector in this respect. Tragedy is embedded in the paradoxical development by which a capable public sector and a strong central government promote the interest of monopolies and multinationals.

The upshot of this literature in a way reflects and examines the transition paths to industrial development that started with the famous paper of W. Arthur Lewis came out in 1954. By our practical experience we have learnt that the paths to long run improvements are neither smooth nor appear as entirely unambiguous advantages to all concerned parties. We will examine the essential upshot that follows from this literature for our own analytical argument in the next section.

All this refers to a fundamental problem of choice. The assumption of ‘no land of cocaine’ from basic economics applies here. The society has to pay a price for everything that it chooses to consume. Since all economies are limited geographies allocating resources to some use precludes these from utilised in alternative uses. Hence any new action has always two sides in effects, the gainers and the losers. The choice can be taken as an improvement if it benefits the maximum number, the majority compensating the losers in the process. Heated debates and resistances ensue when the process fails to ensure this or causes adverse apprehensions. Events in West Bengal are the signs of this only and is nothing falling from the sky for the first time in the world. Of course any violence and death in the process is unfortunate and undesirable. But history is ruthless in resolving the conflicts coming on its way and so some casualties though always extremely regrettable
are often the resultants. From a long view this is all in the process, a history of bargaining between affected sides. To advocate the solution which we think is likely to emerge, we first present the kernel derived from the supportive information presented above.

The Upshot from Theory:

(i) The actors include the entrant industry entrepreneur, the agricultural people divided into two groups, the poor and the rich, the political parties and the government.

(ii) Displacement has been widespread, in course of industrialization and development, not only in India but in most of the countries developed, not only in West Bengal but in many other states aspiring for development and increasing employment.

(iii) The process generated winners and losers, the latter in larger numbers which often include the tribals and the backward communities. Thus a Coase Theorem emerges and government could have left it alone to the emergence and working out of a market mechanism.

(iv) Even poor now have been divided between embattling political sides and hence a homogeneous poor with common class interest is a myth and not to be seen in the country.

(v) Corporate industrialization in actual effect has nothing to offer to the poor because it is them who suffer most through displacement and FDIs. And, 

(vi) The single priority should now be to deficit finance full employment. That, by its intrinsic strength of going for full employment will generate an upward spiral of output-employment in India if it aims for the domestic market exclusively (which perhaps necessarily involves a new round of protective mechanism).

The Implications of the Empirics:

(i) Industrialisation often resulted from overburdening of agriculture and massive pressure of employment demand, naturally arising out of a falling agriculture, population pressure and non growing nature of industries.

(ii) West Bengal through their successful implementation of extensive land reforms, and becoming severely land-scarce eventually in course of her development, has exhausted availing the opportunities that were there in agriculture.

(iii) The small industrial activities have not been growing much, lacking the necessary demand pull over time.

(iv) Capital internationally available now has been looking for investment outlets preferably in an economically viable area. Hence the threat to move out of troubled locations is neither empty nor incredible. There has been gainers often come from outside (Posco, TATAs etc) and sufferers from inside, the rural base.

(v) Big or small, spread of industry is a must.

Combining these two sides of the present study an interesting future seem to be unfolding for West Bengal and for the whole country may be. We cannot traverse a negative infinity to start afresh with prohibitive protection and nationalization of the financial surplus so that the inflow of corporate capital can be refused. Is there any point in retelling a known story of widespread public decision making in decisive activities, in which the world as a whole measurably failed? We have to let the refusal to corporate capital emerge, rather than be imposed. Even if a Marxist path is beneficial, it is the original Marx, (patient but sure in waiting for maturity of contradictions to be transformed through gradual stages) that should be trusted rather than asking for haste. Learning from history is a crucial element and there, one has to be thoroughly pragmatic. We have run out of our stock of time to experiment with theories of social action, and driving poverty-stricken people growing fast in size, confined to an agriculture clearly striking hard on the stubborn limits of diminishing returns.

The facts and figures cited are enough to argue that some new big industry is badly needed in the economy of West Bengal because of the fact that its agriculture is overburdened and came to the eventual unsustainability of small land holdings when subjected to further fragmentations over generations. Technological progress alone cannot pull the economy out; it requires a major breakthrough now that simultaneously will create a chain of new demand and development.

The extent of unemployment, still prevailing in the state will aggravate unless the locked gates onto the new path can be broken open. Else wise anything will be a sheer loss in terms of human resources mainly, not excluding misutilisation of other resources. Those who are choosing to remain deaf to industrialisation needs are in essence trying to move against the gravitation. Can any body ask for a society that never experienced the discovery of fire and wheel? Would remaining...
confined to bullock carts solve our needs for any length of time, and be able to create enough employment needed? Hence industrialise we must. But then, at what cost? Certainly not to be bought at pushing the value of life being driven down to near zero.

Admitting the limits of reality the process anywhere will demand that the government will be involved in bringing about the best for the two sides, the entrants and the incumbents. An optimal combination of vote-bank orientation and public well-being objectives is likely to be forged into the government which tolerantly and carefully includes the opposition. The mistake here is the losing sight of the human factors. A complex cross current of interests has led to the fatal slowdown. This definitely can be avoided in future by skimming the decision from the grass-root level. Let the participatory role of villagers in local government be invoked for a threadbare debate, taking all the costs and stakes into consideration and in which the role of the government is one of an effective whistle-blower, in the case of fowl plays. As the decision converges to a general acceptability, the government has the responsibility of implementation. Along this course, there is no scene of violence and killing. This is the way our human resources are best utilised and generate widely acceptable solutions and positive development dynamics.

For this, we need a fully functioning, responsible and mature democracy. The choice of all the resources for the future should be made through involvement of most of the people of present, and that prerequires an effective participatory process of development. Thorough involvement from the gram panchayats levels (the PRIs) in the crucial decisions is a must. That to depends on the ability for proper utilisation of the human resources of our society. That only can solve the problem of displacement and exclusion. We have to look forward to developing such a state very soon. Till then let the good sense prevail.

Endnotes

1 For an excellent survey of this literature, please see Fernandez (2003).
2 There has been considerable controversy over the displacements apprehended or actually happened in Orissa, Gujarat, Maharashtra, West Bengal in India and many other African countries as capital became almost freely mobile across regions and countries because of the conquest of globalization. For a cursory look, check on the spatial distribution of FDI ventures financed by J.P. Morgan Chase in the last decade
4 Sarkar (2007) has an endorsing discussion on this issue.

References and Additional Thinking


(* Authors are indebted to Anindya Kumar Priya for valuable assistance on Charts; they are also grateful to the participants for their incisive comments at the Felicitation Seminar, Department of Economics, Burdwan University, in March, 2007, held to honour Prof. Asit Kumar Banerjee, on his superannuation. The views expressed in the write-up are personal and do not reflect the official policy or position of the organisation.)
Faultlines & Conflict
 Ending Strategies In
 India’s Northeast
Rajesh Dev
The Backdrop
Since the nineteen nineties our perceptions, in South and South East Asia, about borders and boundaries seems to have undergone a distinct transformation. The pressures and “processes of global restructuring” have sharpened our sensitivity and “insight into the relationship between modern states and transnational linkages” and its importance in a new global political and economic architecture being restructured in a phenomenal and paradoxical fashion.

The redrawing of the traditional political boundaries of existing nation-states and depletion in their sovereign control is challenged by an apparent “hegemonisation” of autonomous social, political and economic spaces and entities. The paradoxical upshot of this phenomenon is succinctly exposed by David Ludden when he states, that “even though globalisation is deterritorialising…national territorialism is alive and well, and it may be getting stronger”. Interestingly, there is an indigenization of this process of “deterritorialisation” within national states where identities competing for autonomy often seek a “sovereign split” challenging further the political contours of existing nation-states.

Yet the most ubiquitous and consistent attempts at “shaking off the iron-grip of [multinational] nation-states” is being persistently made through pressures for transnational “market integration” because of the deliberate shift in the “global development regime”. National sovereignties are diluted by “regional blocs” that are being crafted through a renegotiated “boundary delineating technique” that uses transborder kinship relations and traditional cultural linkages and affinity as rationalising premises for enhanced economic interactions.

These global dynamics initiated ideological shifts in India’s foreign policy objectives that sought to make amends with India’s South & South East neighbours. The “Look East Policy” and the “Silk Route” became metaphors that expressed these strategic shifts grounded in a newly emerging post-cold war reality.

The LEP and the Silk Route metaphor not only coincided with India’s changing foreign policy priorities but also became the ‘missing link’ that re-established ‘traditional’ cultural links between south and south east Asia, an area often defined as “Suvarnabhumi” and “Suvarnadipa” or even “the Indian El-Dorado”. This strategic reopening was seen not only as a reinvigoration of India’s regional ties but also one that would become the Asian Gateway to Europe. The ideological formulations that structured these attempts at tweaking the “territorialized” political geography of the region have been expressed again through metaphors that call for transforming the constraints of geography into opportunity.

Incidentally this new ‘integration’ with an Asian Dream is set to unfold through a peripheral and complex region of India that shares only around 4% of its borders with India, while 96% is coterminous with its Asian neighbours. It is this reality that is currently being factored in the emerging policy initiatives adopted by the Indian state which apparently believes “that the future of Northeast [India] lies in its political integration with India and economic integration with Southeast Asia”. The LEP is projected as the backdrop for a new “phase of growth with equity” for a hitherto peripheral “frontier” called Northeast India. This region is assumed to be the most important segment to a newly emerging regional architecture.

The Regional Matrix
The “Northeast” is defined and described as a strategic borderland and is a region of India that is a crucible for conflicts emerging from mismanaged diversity. It has thus become a critical site for incessant politico-ethnographic investigation and documentation. It is a region where policy initiatives intended to moderate and negotiate diversity are also provided a locale for arranged experimentation.

In discursive practices what we find portrayed often is a “North-east” that is collectively reflected as either a “paradise unexplored” — when one needs to sell it to a modern consumer yearning with an orientalist desire; or more typically as “conflict-ridden” — when the state needs to rationalise non-democratic initiatives to apparently contain violent defiance of the state.

In both these connotations there is an implicit suggestion of an essential “core” that the “region” commonly possesses and reflects. An assumed ‘core’ having an innate, natural, uncontested and fixed content through which the “region” can be collectively represented and also reproduced.
The “paradise unexplored” metaphor evokes an exoticised mystery about the region that is both arcane and enigmatic to the so-called “mainland” and gets reflected in the seemingly “racial stereotyping” of the people from the region and especially the “exoticised vulnerability” of its women.

Contrarily, in the sense of the “conflict-ridden” connotation this incomprehensible mystery evokes a political suspicion that becomes the dominant rhetorical trope for justifying “normalising” and “controlling” efforts of a complex “periphery” by the state, where more than 120 insurgent groups are currently in operation. Many of these insurgent groups have transnational linkages not simply in terms of aid from external governments but also kin-based supports from their ethnic-kin partitioned by “territorialized spaces.” Such challenges also described as “rebellions in the ‘nation’ mode” more often than not militarised the vernacular narratives of arbitrary demarcation of borders that they argued failed to respect the coterminous permeable cultural and social spaces in the borderland region.

A “Challenged Borderland”, the region is defined exotically as a “rainbow country...extraordinarily diverse and colourful and mysterious when seen through parted clouds.” The region originally included the seven sister states of Arunachal Pradesh, Assam, Manipur, Meghalaya, Mizoram, Nagaland and Tripura, recently enhanced to eight with the inclusion of “a small and beautiful cousin...Sikkim.” Cultural and ethnic groups with relatively autonomous histories, conflicting claims and different stages of development constitute the socio-political matrix of the region. There are 160 scheduled tribes and 400 non-scheduled tribes and sub-tribes, besides a large number of non-tribal people many of whom are also indigenous.

The most dominant ethnic groups amongst them were granted statehood and autonomous institutions at various moments of post-independence history in deference to their claims of ethnic “difference”. The effective objective was to ‘recognise’ and ‘protect’ the autonomy of ‘collective life-worlds’ of many of the ethnic communities residing in the region through legal and structural mechanisms.

Surely these processes were not only oblique strategies to appropriate challenges in a peripheral border and consolidating the territorialized
borders but were “culture-protective mechanisms” for many communities. Such appropriative strategies were attempts that sought the internalisation of the limits of territorialised national boundaries in a social space hitherto marked by permeable notions of territoriality contiguity. Yet the apparent outcome of these processes is the initiation of a state of “liminality” about border and boundaries that distorts any stable notion of “sociospatial” spaces among inhabitants in

what is seen as a manifestation of a collectively shared regional selfhood.

As such, this common predicament of “collective disorder” founded on a common state of liminal affiliation with the state is customarily considered to provide the region its identifiable collective essence.

However in an undertone this erases the bewildering heterogeneity of ethno-cultural identities as well as intra-ethnic hierarchies of power within the region justifying thereby a commonly shared designation of a “region” and initiation of standardised prescriptions to surmount the purportedly collectively shared faultlines.

The Transformative Initiatives

What actually has been the attitude of the state while responding to these challenges that often interrogate its political legitimacy often through armed defiance? We have indicated already one of the most dominant strategies of the several options available with the state. This has been the ‘recognition’ and ‘institutionalisation’ of the ‘difference’ through strategies of “instituted peace” It has also pursued a strongly militaristic response to reflections of defiance and rebelliousness in the region along with anti-democratic measures of subjugation. Generality to put it in the words of Jairam Ramesh the state of India has pursued region-resuscitating initiatives through four dominant paradigms. He identifies these paradigms as structured by ‘Culture’, ‘Security’, ‘Politics’ and ‘Development’: paradigms that were arrayed in a historical continuum and evidently emphasised during a particular phase to articulate the response of the State towards the region.

But Nevertheless while it was broadly agreed that distinctiveness of the symbolic repertoires of the groups in the region had been the bases of their cultural and political claims and subsequent institutional recognition; the metanarrative that persisted was that post-partition, an operating regional economy had been “politically assassinated”. It is the resulting “development deficit” that was sought to be addressed in all political and policy responses by the state since apparently this formed the founding condition for social and political unrest. Therefore the enunciation of centralised “development” policies and institutions that rearrange the political economy in a “backward ward area full of great potentialities”. This was to eventually brace the emergence of a more stable and “developed integration” of this region.
It is this paradigm of “development” in its numerous avatars that attempted to create a standardised regional “homo economicus” that was assumed would flatten the uneven and irregular differences of identity and collective claims. In all commissioned assessments and policy initiatives the causative factors were overwhelmingly measured to be economic in nature. Yet a cumulative net devolution of 510 billion from the centre during 1991-1999 to the Northeastern states has failed in “transforming the North-east” Though it is emphasised that “more money is not the issue”, such “developmentalist” logic continues to be reified in emerging texts of assessment about the region and its challenges.

The Emerging Dilemmas
This foregoing assessment of the “Northeast” condition would remain incomplete a discussion of the dilemmas that beleaguer the region, (promises to intensify) and their implications in the search for a “transformed” northeast. The critical dialectic between democratic strategies, development paradigms and an apparently traditionally moored social order needs a more principled assessment than currently accorded. Most of the conventional descriptions overlook the contradictions and paradoxes generated by what may be referred as the “clash within” between ethnic groups generated due to a skewed format of ethnic political engineering and flawed development paradigms.

Though ‘development deficit’ (understood mostly in narrow economic terms) and its consequences continues to dominate perceptions about the conditions for crises in the region, it evidently is agreed that a large number of claims and challenges in the region "are political assertions for self-determination" though justified in templates of indigenousness and a shared cultural repertoire. Yet the game-ending strategies adopted to cauterise these conflicts and challenges reflect predictable patterns of incremental policy initiatives. These economic initiatives and political strategies have simply conversely accentuated the ‘ethnicization’ process in the region and made ethnic identity and ethnic homelands the chosen metaphors for claims-making and resolution.

In a pluri-cultural social setting that wraps dense ethnic heterogeneity with groups inhabiting coterminous social and political spaces, ethnically carved institutions provided group boundaries “formal political dimensions” resulting in power differentials between “recognised” and “yet to be recognised” ethnic groups. These formal institutionalisation of dominant ethnic identities through ethno federal states, autonomous and territorial councils have served to not only institute the primacy of ‘recognised’ ethnic groups in multiethnic settings but have also reinforced and politicised the boundary maintenance strategies by ethnic groups. To use Nagel’s expression, “the political construction of ethnicity” through these ethnically marked institutions reformats “rules for political participation and political access” along ethnic contours. Since the rules for participation and access to entitlements are often seen as being determined through an ethnic criteria, “ethnic contenders” engage in competitive confrontation for material resources with the objective being maximization of power & resources available to ones “own” group.

The institutions and procedures being crafted in the region therefore introduces “zero-sum rivalries” among the ethnic groups and actualizes possibilities of “ethnic fractionalization.”

Many economic initiatives and political strategies have conversely accentuated the ‘ethnicization’
In fact the “daily experience” \(^1\) of inter-group relations and interactions in most states of the region reveal the salience of a collective ethnic ego in structuring inter-ethnic social relations.

The logical dynamic between institutions, ethnic groups and the development imperative is manifested in the inter-ethnic conflicts and collisions in many areas of the region. Evidence of “clash within” manifested as conflicts between ethnic groups perceiving relative deprivation because of limited access to entitlements owing to ethnocentric institutions is abundant in the region. “Strategies for inclusive growth” envisioned in the Vision 2020 document does not incorporate provisions to factor the ethnic divide or dense ethnic heterogeneity either through institutional structures or through attempts in the promotion of an inclusive democratic culture that fosters tolerance and respect for plurality. The documents and policy initiatives do not adopt a nuanced view of the sociospatial overlap of ethnic groups in the region and its impact on envisioned “inclusive growth”. Any definition of inclusive growth especially for northeast India must address concerns of ethnic inequity and bridging of ethnic divide through development forms and practices that prohibits ethnic fractionalization of the economy.

Given the existing ethnic matrix in a challenged frontier it is an open-ended assumption if transborder economic linkages would neutralize ethnic assertions in economic prosperity. Apparently it seems that the fragmentation processes would magnify and the already ethnically polarized societies would possibly have to deal with exacerbated conflicts for control over markets and routes. The Kuki-Naga-Methei conflicts for control of the trade route at Moreh in Manipur suggests to such possibilities of ethnic tensions for economic supremacy. It is important not to overlook the possible impact of the link between embedded social networks and economic relations in the region.

Care should be taken to see that the “opening” would not possibly coalesce hitherto territorially fragmented ethnic-kin and renewed ‘nationalist’ claims from the region. The decentralization pressures under a globalised mechanism would possibly exacerbate contests over community rights and control over land and resources; the Lafarge case in Meghalaya is only an indicative example. Seemingly the declining political legitimacy and credibility of the institutions of the state would have to engage with newer sovereignty-corroding pressures in this traditionally embedded social setting.

In these conditions the role and reach of non-state actors along with ethnocentric entrepreneurs in almost all these states of the region would augment simultaneously with the “downsizing” of an already incomprehensible state apparatus. It may be obligatory, therefore to appreciate the material conditions and the social reality of the region while devising democratic initiatives and development paradigms for any transformation, if “northeast” is not to be simply transformed into an extractive site for a dynamic South Asian economy allowing its social chaos and economic underdevelopment to further freeze along ethnic contours. \(^\text{236}\)

### Endnotes and Additional Thinking

3 Ibid.
5 Schendel. op.cit. p.4
7 Ludden. 2006. loc.cit.
10 R.K.Dube. “Southeast Asia as the Indian El-Dorado” in India’s Interaction with Southeast Asia. G.C.Pande (ed.) op.cit. 2006 p.87
16 See www.satp.org/satporgtp/ountries/india/terroristoutfits/index.html
18 ibid.
20 ibid.
22 Schendel. op.cit. p.257
26 ibid
28 The AFSPA is one such example. See A. Bimol Akoijam “Death of Politics & Destiny of Manipur” http://www.kanglaonline.com/index.php?template=kshow&kid=1140&Idoc_Session=1613a7ae199524feab809e3e01ac7979
29 Jairam Ramesh. op.cit. 2005
30 Schendel. op.cit. p.148
31 For recent critique of the conventional notion and logic of development, see Wolfgang Sachs. The Development Dictionary. Orient Longman. 1997.
32 The formation of the North Eastern Council and the DoNER ministry are indicative institutions.
33 ibid
35 Jairam Ramesh. Loc cit.
36 NER Vision 2020 document.

(The views expressed in the write-up are personal and do not reflect the official policy or position of the organisation.)
“Volatility of Indian Stock Market and FIIs”

Krishna Reddy Chittedi
Doctoral Scholar, Center for Development Studies, Trivandrum

“Bull Markets are born on pessimism, grow on skepticism, mature on optimism and die on euphoria.”
- Sir John Templeton

Introduction
The liberalization policies initiated in India in the early 1990s brought about radical changes in the conduct of stock market. India has been in the forefront of utilizing technology to enhance its stock market performance. We saw how the market rewarded the undervalued shares and how the overvalued shares fell down to demonstrate the saying “everything which rise more than expected, has to fall. SENSEX crossed the twenty thousand mark cheering thousands of investors in the recent Bull Run. Sensex took a little over 20 years to reach the first 10,000 mark, but just a little over 20 months to double that score. The rise in global market and expectations of increased foreign portfolio investment has driven traders’ interest in the market. It is a broad based movement and the major gainers are front line stocks. On that historical date as many as 29 shares that comprise 30 share index ended higher except the Wipro Limited, which experienced a marginal decline of 0.2%. In this 10k march, not only the Nifty and the Sensex stocks the midcaps and small caps have also gained. They gained by 2.2% and 2.7% respectively during that peak. A buoyant economy provided a firm underpinning to mid-cap companies. The FIIs have broadened their investment in more than 750 stocks and in the several mid-cap companies, they are holding over 20 per cent. Institutional investors and FIIs have provided a perfect support to the rising equity values. Today, Indian stock market is largely dominated by group of FIIs that are able to move the
markets by large interventions. Aecdotas evidences of prices being manipulated to meet the bonus target of FII managers are wide spread in the financial markets.

In this context, this paper intends to analyze:

• the growth path of Sensex
• the quantum of contribution of FIIs and
• the volatility of Sensex.

BSE SENSEX
SENSEX is a basket of 30 constituent stocks representing a sample of large, liquid and representative companies. The base year of SENSEX is 1973-79 and the base value is 100. The index is widely reported in both domestic and international markets through print as well as electronic media. The Index was initially calculated based on the “Full market Capitalization” methodology but was shifted to the free-float methodology with effect from September 1, 2003. The “Free-float market Capitalization” methodology of index construction is regarded as in industry best practice globally. All major index providers like MSCI, FTSE, STOXX, S&P and Dow Jones use the Free-float methodology.

SENSEX Calculation Methodology
SENSEX is calculated using the “Free-float market capitalization” methodology. As per this methodology, as per this methodology, the level of index at any point of time reflects the Free float market value of 30 component stocks relative to a base period. The market capitalization of shares issued by the company. This market capitalization is further multiplied by the free-float factor to determine the free-float market capitalization.

The base period of Sensex is 1973-79 and the base value is 100 index points. The notation 1978-79=100 often indicates this. The calculation of SENSEX involves dividing the Free-float market capitalization of 30 companies in the Index by a number called the index divisor. The divisor is the only like to the original base period value of the SENSEX. It keeps the index comparable over time and is the adjustment point for all Index adjustments arising out of corporate acts, replacement of scrip’s etc. During market hours, prices of the index scrip’s, at which latest trades are executed, are used by the trading system to calculate SENSEX every 15 seconds and disseminated in real time.

Free-Floating Methodology
Free-float methodology refers to an index construction methodology that takes into consideration only the free-float market capitalization of a company for the purpose of index calculation and assigning weight to stocks in index. Free-float market capitalization is defined as that proportion of total shares issued by the company that are readily available for trading in the market. It generally excludes promoters holding, government holding, strategic holding and other locked-in shares that will not come to the market for trading in the normal course. In other words, the market capitalization of each company in a Free-float index is reduced to the extent of its readily available shares in the market.

Definition of Free-float
Share holdings held by investors that would not, in the normal course come into the open market for trading are treated as ‘Controlling/Strategic Holdings and hence not included in Free-float.

The Sensex Journey: The oldest stock market index in India; the BSE-Sensitive Index was first compiled in 1986. It is a basket of 30 stocks representing a sample of large, well established and financially sound companies. The components of the Sensex have been changed often to induct the leaders of the various industries. The journey of the Sensex over the years is given in the Table 2.

The 1000-Mark: The Sensex touched the four digit figure for the first time on 25th of July, 1990. Thus, it took four years to achieve this landmark. The major causes behind this achievement were good monsoon and excellent corporate results in that year.

The 2000-Mark: On January 15th, 1992 after having 538 days of trading the Sensex crossed the 2000 mark and closed at 2020 in the wake of liberal economic policy initiatives under-

Table 1. Time Frame of Various Indices-10K

<table>
<thead>
<tr>
<th>Index</th>
<th>Launched</th>
<th>Strike Date</th>
<th>Timeframe</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sensex</td>
<td>1986</td>
<td>6-2-06</td>
<td>20 Years</td>
</tr>
<tr>
<td>Karachi SE100</td>
<td>1991</td>
<td>15-3-05</td>
<td>14 Years</td>
</tr>
<tr>
<td>DJIA</td>
<td>1896</td>
<td>12-3-99</td>
<td>103 Years</td>
</tr>
<tr>
<td>Hang Seng</td>
<td>1964</td>
<td>10-12-93</td>
<td>29 Years</td>
</tr>
<tr>
<td>Nikkei 225</td>
<td>1949</td>
<td>10-1-84</td>
<td>35 Years</td>
</tr>
</tbody>
</table>

Source: Source.Econstats.com
The 3000 - Mark: The Sensex crossed the 3000 mark on 29th February 1992 followed by the market friendly budget announced by the then Finance Minister Dr. Manmohan Singh. It took only 45 days to achieve this milestone.

The 4000 - Mark: On the expectations of a liberal export import policy the Sensex crossed the 4000 mark and closed at 4091 on March 3rd in 1992. It was the period that the Harshad Mehta scam hit the market and Sensex witnessed unabated selling.

The 5000 - Mark: The crash following the Harshad Mehta scam pushed the market into a bearish phase. As the BJP led coalition won the majority in the 13th Lok Sabha election the Sensex touched the 5000 mark on 11th of October, 1999 after 7 years from the 4000 mark.

The 6000 - Mark: The magnificent performance of technology sector stocks pushed the stock markets across the globe including the Sensex to cross the all time high of 6006 in a span of 126 days in the intra-day trading, but it closed over 6000 mark only on January 2nd in 2004.

The 7000 – Mark: After the 6000 mark the burst of the internet bubble pushed the markets into a major bearish phase. Stock markets across the world experienced a massive correction. After 63 months from 6000 mark the Sensex touched the 7000 mark on June 20th, 2005 followed by the news of the settlement between the Ambani brothers.

The 8000 – Mark: On the September 2005, the Sensex crossed the 8000 mark in 78 days by the reason of huge FII inflow during 2005 and also by the participation of domestic funds in trading.

The 9000 – Mark: On November 28, 2005, the Sensex crossed the magical figure of 9000 in 78 days with market capitalization of Rs.24,05,035 crore. The main factors behind this were surging FII inflows and the strong support of local operators as well as retail investors. Year 2005 is the most important year in the stock market history. The Sensex has grown by 42.3% in 2005 alone. This is the year when crude oil, stock indices and gold touched their new highs, which never happened in the past.

The 10000 – Mark: The Sensex on 6th of February 2006, made the historical achievement by touching the life time peak of 10,003 points during mid session at the Bombay Stock Exchange on the back of frantic participation of Foreign Institutional Investors, domestic funds and retail investors.

The 11000-mark : The sensex on March 21st, 2006, crossed the magical figure of 11,000 and touched a life time peak of 11,001 points during mid-session at the Bombay Stock exchange for the first time. However, it was on March 27th, 2006 that the Sensex first closed at over 11,000 points.

The 12000-mark: The sensex on April 20, 2006, crossed the 12,000 mark and closed at a peak of 12,040 points for the first time.

The 13000-mark: The sensex on October 30th, 2006, crossed the magical figure of 13,000 and closed at 13,024.26 points, up 117.45 points or 0.9%. It took 135 days for the Sensex to move from 12,000 to 13,000 and 123 days to move from 12,500
The sensex on December 5, 2006, crossed the 14,000-mark to touch 14,028 points. It took 36 days for the Sensex to move from 13,000 to the 14,000 mark.

The Sensex on July 6, 2007, crossed the 15,000 to touch 15,005 points in afternoon trade. It took seven months for the Sensex to move from 14,000 to 15,000 points.

The Sensex scaled yet another milestone during early morning trade on September 19, 2007. Within minutes after trading began, the sensex crossed 16,000 rising by 450 points from the previous close. The 30-share Bombay stock Exchange’s sensitive index took 53 days to reach 15,000 from 16,000. Nifty also touched a new high at 4659, up 113 points.

The Sensex scaled yet another height during early morning trade on September 26, 2007. Within minutes after trading began, the sensex crossed the 17,000 mark. Some profit taking towards the end, saw the index slip into read to 16,887-down 187 points from the day’s high. The Sensex ended with a gain of 22 points at 16,921.

The 18,000-mark: To day (09.10.07) is the biggest rise in Sensex in a single day and is also the highest ever. Does this mean that every investor’s wealth has gone up significantly.

The 19,000-mark: The stock market continued its bull run, BSE 30-Share Sensitive Index (Sensex) crossed another milestone — the 19,000 mark. From the 18,000-mark, this was reached in just four trading sessions, led by metal stocks.

The 20,000-mark: India on 30.10.07 became the 20th nation in the world to have seen its stock market benchmark touch the 20,000-point milestone. Indian index Sensex breached the 20k level in intra-day trade for the first time in its over two-decades history.

“Invest early, invest regularly and invest in the long term” before entering the world of shares”. FIIs are continuously pumping their money in the Indian Stock Market as there is no tomorrow. Until December 2005, they have invested Rs. 1,75,442 crore in the Indian market since 1991. Despite they have been net sellers in three months of last 12 months, they have pumped Rs.47,181.2 crore into the Indian stock market. Major reason why Indian securities are now increasingly regarded as attractive to international investors are the relatively high returns compared with more developed global markets as well as the low correlation with world markets. The above Table.3 shows the net investment made by the FIIs.

**Foreign Institutional Investments in India**

India opened its stock market to foreign investors in September...
1992 and has, since 1993, received portfolio investment from foreigners in the form of foreign institutional investment in equities. It is possible for foreigners to trade in Indian securities without registering as an FII but such cases require approval from RBI or the FIPB (Foreign Investment Promotion Board). FII generally concentrate in secondary market. For all practical purposes, full convertibility of rupee is applicable to FII investments. Gradually, the scope of FII operations has been expanded permitting (a) additional categories of investors, (b) recognizing other instruments in which they can invest, and (c) altering the individual and aggregate FII shares in any one Indian company (Rao, et.al 1999).

Though the Sensex fall is widely attributed to FIIs pulling out, that’s not the complete explanation. While the flames of the credit crisis began to devour the developed world, the Sensex rose rapidly from 14,500 in early April 2007 to 20,000 by end December 2007. The last leg of this rise was not supported by FII buying. In fact, FIIs, who were net buyers in October 2007, turned net sellers in November and December 2007 to make up for the losses on account of the US sub-prime defaults.

Fast forward to 2008. When the Sensex began its fall in January 2008, FIIs net sold Rs 17,227 crore, but followed this up with net buying in February and March 2008, FIIs. In March 2008, there has been a net outflow of funds by FIIs of the amount Rs.1010 crore. Of the total outflow, Rs.130 crore was sold in equity and Rs.880 crore was sold in debt. During the period 2007-08 April-march, net investment by FIIs had been Rs.66,179 crore out of which Rs.53,403 crore was into equity and Rs.12,776 crore was into debt. Surprisingly, when the Sensex rebounded to 17,800 in May 2008 FIIs were net sellers. This shows that the movements of FIIs and Sensex are not directly correlated. Various extraneous factors have caused the FIIs to sell, and their selling has been absorbed by other market players (Business Line 08).

In the year 2002 the net inflows of FIIs were just Rs. 3,565.6 crore but the figure has increased more than ten times in the year 2005 as indicated by Table 3. Thus the record inflows of foreign portfolio capital, coupled with improved participation of the retail investors through mutual funds as well as through IPOs have helped this great achievement.

After scaling new heights of 20000+, sensex entered year 2008 with blushing pictures. The trade pundits, brokers and even investors predicted new heights for the year. And they felt their predictions coming true when Sensex touched the 21000 mark on 8th January, 2008. It’s interesting if one sees in terms of flows; domestic institutional investors dominate the journey from 20,000 to 21,000; FIIs were negative sellers, they sold in the cash market to the tune of USD 45 billion. So if one has to take out some pointers from this journey from 20,000 to 21,000, it is the longest journey which we have seen in the last 5,000 marks, the midcaps and small caps have been out performers and in terms of flows, it has been domestic institutional investors who have been really putting the money. The Indian market went through an impressive five-year bull market, beginning in 2003 and running until January 2008, fuelled by over $50 billion in FII inflows. Since then, India’s market sell-off has been equally intense, accompanied by higher credit costs, inflation, lower industrial production, and several high-profile earnings disappointments. Does that means that Stock market is bottoming out.

But the blushing picture soon turned murky. The skyrocketing sensex suddenly started heading south and Sensex saw the biggest absolute fall in history, shedding 2062 points intra-day. It closed at 17,605.35, down 1408.35 points or 7.4 per cent. It fell to a low of 16,951.50. Presently Sensex dancing in 9000 points, the fall was triggered as a result of weakness in global markets, but the impact of the global rout was the biggest in India. The market tumbled on account of a broad based sell-off that emerged in global equity markets. Fears over the solvency

### Table 3: FIIs Net Investment

<table>
<thead>
<tr>
<th>Year/Month</th>
<th>Equity (Rs.Crore)</th>
<th>Debt (Rs.Crore)</th>
<th>Total (Rs.Crore)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
</tr>
<tr>
<td>2004-05</td>
<td>44,123</td>
<td>1,759</td>
<td>45,882</td>
</tr>
<tr>
<td>2005-06</td>
<td>48,801</td>
<td>-7,334</td>
<td>41,467</td>
</tr>
<tr>
<td>2006-07</td>
<td>25,237</td>
<td>5,607</td>
<td>30,844</td>
</tr>
<tr>
<td>2007-08 (Apr-Mar)</td>
<td>53,403</td>
<td>12,776</td>
<td>66,179</td>
</tr>
</tbody>
</table>

Source: SEBI Bulletin - April 2008

Though the Sensex fall is widely attributed to FIIs pulling out, that is not the complete explanation.
of major Western banks rattled stocks in Asia and Europe.

After the worst January in the last 20 years for Indian equities, February turned out to be a flat month with the BSE sensex down 0.4%. India finished the month as the second worst emerging market. The underperformance can partly be ascribed to the fact that Indian markets outperformed global markets in the last two months of 2007 and hence we were seeing the lagged impact of that out performance. The US growth and the potential of the “new economy” continued to dominate investor sentiments world markets and we saw instability move up sharply across the markets. Presently, we can see market plunging after the RBI announced further hikes in Repo rate as well as CRR both increased to 9%. Also, the serial blasts at Ahmadabad and Bangalore adding to the worries and enhancing the negative sentiments. And above all we can’t see any positive trigger that can dilute the flow of negative news.

Stock Market Volatility
A study (MT Raju et al (2004)) found the mature markets to be less volatile and providing higher returns over a longer period of time. Amongst emerging markets except India and China, all other countries exhibited low returns. Harivinder Kaur’s (2004) study explains the extent and pattern of stock return volatility of the Indian most prominent spot price indices viz., BSE Sensex and S&P CNX Nifty during the year 1990-2000. It was found that the stock market volatility was the highest during 1992 and 2000, in that order. It fell sharply after 1992 until 1995, after which its started increasing again. However, the volatility of portfolio flows into India was small in comparison to other emerging markets during 1998 to 2000 (Gordan J and P Gupta (2003))

Stock market volatility plays a vital role in the economic development as well as growth. Daily volatility is calculated as a standard deviation of the natural log of daily returns on the indices for the respective months. Volatility in stock prices in India, by and large has exhibited a declining trend except over certain months. The market may have turned riskier, messy politics could resurface, and oil prices are at a new high (but at present low); but nothing seems to worry local investors, who feel the index can go up further. Understanding volatility is therefore central to risk management in an economy. Asymmetry in stock market volatility has its own significance, which implies volatility rises after negative shock than positive shock of similar magnitude. If the stock market is efficient, then the volatility of stock returns should be related to the volatility of the variables that affect asset prices.

Stock market volatility tends to be persistent; that is, periods of high volatility as well as low volatility tend to last for months. In particular, periods of high volatility tend to occur when stock prices are falling and during recessions. Stock market volatility also is positively related to volatility in economic variables, such as inflation, industrial production, and debt levels in the corporate sector (Schwert 1989).

Reasons for the Present Slowdown
1. Historic crude oil prices, high inflation rates, weak industrial production data, RBI policies, political uncertainties and obviously the sentiments of domestic as well as FIIs influenced on the sensex volatility.
2. The key benchmark indices ended lower as investors resorted to profit booking due to lack of positive triggers in the market.
3. Central banks across the globe warned that interest rates may have to rise as they look to keep inflation under control, despite the fact that economic growth is slowing in key nations such as the US and UK.
4. Investors dumped financials on concerns about the fallout from worsening global credit turmoil.
5. The global financial sector turmoil impacts sentiment in the local market and raises worries of more withdrawals by foreign funds.
6. Presently, we can see market plunging after the RBI announced further hikes in Repo rate as well as CRR both increased to 9%. Also, the serial blasts at Ahmadabad and Bangalore adding to the worries and enhancing the negative sentiments. And above all we can’t see any positive trigger that can dilute the flow of negative news.

Policy Suggestions
1. Government should set a minimum limit as well as maximum limit, within which FII invest in India, in order to avoid volatility in Indian stock market.
2. Generate new opportunities to allow more players from
Note: Daily volatility is calculated as standard deviation of natural log of daily returns on the indices for the respective months:

Source: SEBI Bulletin- April 2008

Table 4: Recent Trends in SENSEX

<table>
<thead>
<tr>
<th>From</th>
<th>Number of days</th>
<th>From</th>
<th>Number of days</th>
</tr>
</thead>
<tbody>
<tr>
<td>10000K to 11K</td>
<td>35</td>
<td>20K to 19K</td>
<td>5</td>
</tr>
<tr>
<td>11K to 12K</td>
<td>16</td>
<td>19K to 18K</td>
<td>24</td>
</tr>
<tr>
<td>12K to 13K</td>
<td>136</td>
<td>18K to 17K</td>
<td>01</td>
</tr>
<tr>
<td>13K to 14K</td>
<td>46</td>
<td>17K to 16K</td>
<td>34</td>
</tr>
<tr>
<td>14K to 15K</td>
<td>127</td>
<td>16K to 15K</td>
<td>08</td>
</tr>
<tr>
<td>15K to 16K</td>
<td>52</td>
<td>15K to 14K</td>
<td>70</td>
</tr>
<tr>
<td>16K to 17K</td>
<td>07</td>
<td>14K to 13K</td>
<td>14</td>
</tr>
<tr>
<td>17K to 18K</td>
<td>08</td>
<td>13K to 12K</td>
<td>58</td>
</tr>
<tr>
<td>18K to 19K</td>
<td>05</td>
<td>12K to 11K</td>
<td>05</td>
</tr>
<tr>
<td>19K to 20K</td>
<td>42</td>
<td>11K to 10K</td>
<td>07</td>
</tr>
</tbody>
</table>

Source: SEBI Bulletin- April 2008

Table 5: Daily Volatility - BSE SENSEX

<table>
<thead>
<tr>
<th>Month</th>
<th>BSE Sensex</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2003-04</td>
</tr>
<tr>
<td>January</td>
<td>2.05</td>
</tr>
<tr>
<td>February</td>
<td>1.50</td>
</tr>
<tr>
<td>March</td>
<td>1.45</td>
</tr>
<tr>
<td>April</td>
<td>1.30</td>
</tr>
<tr>
<td>May</td>
<td>3.81</td>
</tr>
<tr>
<td>June</td>
<td>1.36</td>
</tr>
<tr>
<td>July</td>
<td>1.06</td>
</tr>
<tr>
<td>August</td>
<td>0.92</td>
</tr>
<tr>
<td>September</td>
<td>0.73</td>
</tr>
<tr>
<td>October</td>
<td>0.90</td>
</tr>
<tr>
<td>November</td>
<td>0.69</td>
</tr>
<tr>
<td>December</td>
<td>0.77</td>
</tr>
</tbody>
</table>

Note: Daily volatility is calculated as standard deviation of natural log of daily returns on the indices for the respective months:

Source: SEBI Bulletin- April 2008

multihued countries & in this way dwindle down the risk of volatility.

3. Implementation of act is must & imperative in order to avoid from seasonal variation, rules & regulation are made, but follow up is not there.

Conclusion

The foreign portfolio flows have come to be acknowledged as one of the important source for strengthening and improving the functioning of the domestic capital markets. FII inflows are even smaller when compared to the size of our economy. Over the last decade, the FII equity flows into our country have averaged around a meager ½ percent of GDP per annum. The FII investments in Indian securities market has shown a fluctuating trend year after year. Along with the soaring Sensex in the current situation the investors should keep in mind that the factors could derail this rally like rising interest rates, high inflation fuelled by firm global crude oil prices, slow down in the economy and in corporate earnings, fluctuations in currency markets, sluggish pace of economic reforms, political instability, crash in asset prices across the board, political tension and possible terrorist attacks. The FIIs who have been so bullish in India for the last so many years might start looking at other cheaper emerging markets for better returns. It is pretty tough to predict that whether the Sensex will sustain this momentum in future or not. The investors need to be very cautious in their operations.

Endnotes

1 Business line “Why the Sensex fall is overdone” Sunday, July 27, 2008

References and Additional Thinking

• Business Line “Why the Sensex fall is overdone” Sunday, July 27, 2008
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(The views expressed in the write-up are personal and do not reflect the official policy or position of the organisation.)
RISK MANAGEMENT IN AGRICULTURE AND INDIA’S SEARCH FOR A SOLUTION
A search for high returns and the management of the concomitant risk, lie at the roots of most economic activities. Agricultural production takes place in fields that are exposed to the elements of nature. It is therefore perceived to be more vulnerable than factory based industrial production and is also considered much less controllable and predictable. Further, with the passage of time new complexities were added to this perception of agriculture, new technologies and the emergence of new crops in a given agro-climatic ambience, evolution of markets and market oligopolies and the growing importance of the sector in the political economies of the nations. While the basic nature and the cumulative complexities are enough to spark off a search for efficient and innovative risk management techniques, the growing concern about risk and the rapid development of financial instruments in the wider international market in today’s circumstances underscore the importance of delivering this crucial intermediary input i.e., risk management, to a sector that engages about half of India’s work force. We will review the developments in risk management and how far they have reached the farmers and critically appraise the success yet achieved.

The Theory Behind Risky Decisions
Risk and uncertainty both arise when any decision can have more than one outcome and not all the outcomes are favourable to the decision maker. The difference between risk and uncertainty is rather subtle and may in fact be non-existent for many practical purposes. Risk is usually associated with the measurability of the probabilities of the outcomes whereas the term uncertainty is used in a subjective any. Risk is a subject of wide connotation and significance in business and economy.

In agriculture when a farmer takes a decision to cultivate a certain crop, he makes a choice among a few viable alternatives, prepares the land accordingly, chooses whether to irrigate the crop, takes a loan to purchase different inputs and invests his time and resources on the enterprise. All the while the farmer has an objective of deriving an income that he believes is plausible. Yet, an unexpected spell of dryness, a severe storm or a flood can devastate his plans leaving him high and dry to manage his debts, family commitments and future financial needs. This is the repercussion of a crop loss.

Nilabja Ghosh
Associate Professor,
Institute of Economic Growth (IEG),
New Delhi
The loss can come from a different direction also. An unforeseen crash of price may have the same effect on the farmer, since then even a bumper production can fetch a poor income compared to what was expected. This is a serious issue in economics because of the close correspondence between price and production. Theoretically under a given demand condition, a bumper production actually tends to depress the price. Further, with markets being opened up today the prices faced by farmers are influenced by demand and supply conditions of other countries as well as our own, and with the limitation of information with which a typical farmer plans and operates, the price uncertainty is enormous today.

The literature on risk is vast and developing, with empirical techniques based on mathematical models making rapid development. The basic framework that is most popular in the literature is the expected utility theorem attributed to Morgenstern and Von Neumann and to Bernoulli. This is a very flexible model used to describe situations in which individuals choose when facing uncertain outcomes. Other approaches have been built around or are associated with this framework, such as the mean-variance theorem, mean preserving spread and the safety-first approaches attributed to some of the seminal works in Economics. Perhaps for Indian farmers, a majority of whom operate at the level of survival, the safety first could be a more realistic characterisation. Also, farmers are often not well informed nor always are they optimisers (they boundedly rational) and go by what neighbours do, what the extension agents tell them or what the commercial input sellers advise. Theory also suggests that individuals can have different attitudes to risk as reflected by the shape of their utility functions but most empirical assessment suggest that farmers work as risk averters (Binswanger, 1978, 1980).

Production Risk
Production of crops is subject to the risk of unfavourable weather conditions and pests. Indian agriculture in particular has always been seen as a gamble against an erratic monsoon, but hurricanes, tidal waves and even earthquakes are known to be common threats in both developed and developing countries. USA has encountered a number of devastating hurricanes in recent decades such as Hurricane Katrina, that had catastrophic consequences on agriculture and people. Also, it is not entirely correct to assert that agriculture in India has remained risky even while manufacturing became more and more controllable. Technological progress did reduce unpredictability even in agriculture over time even though it is still a far from any certainty. Improved seeds, controlled irrigation, chemical and biological methods of controlling weeds and pests, genetic engineering of the seed have been helping to reduce risk. Modern crop forecasting methods and early warnings enabled by development in meteorological and remote sensing methods have been aiding farmers to adopt timely actions to reduce exposures and losses to some extent. Chemical and physical testing of soil to select the appropriate technology can go a long way to make desirable production performance possible. Thus, for technology to mitigate risk, not only is it necessary to promote research on a continual basis but also to have a strong extension service system to actualise the new technological improvements and to inculcate...
good practices at the micro level. Unfortunately, both research and extension, that have largely been public responsibilities, showed poor progress in the last decades. In recent times, the private sector has also been contributing with its research outputs and its own extension but given the commercial nature of their business, their reach to the small and marginal farmers and their consideration to public and ecological concerns can be questioned.

The traditional methods of risk control dominantly involve two strategies. The first aims at risk avoidance which means leaving land fallow, shying away from promising crops or technology at the slightest risk, storing grains instead of marketing them and entering into arrangements such as share cropping and formal or informal contracts. Such methods are usually a compromise of income opportunity. The other is risk diversification, a strategy widely used in all markets that emphasise a balanced portfolio. In agriculture, unfortunately, diversifying the exposure effectively coincides with the inclusion of sturdy but less lucrative crops. Raising coarse cereals and even oilseeds in dry areas is often associated with risk mitigation and sometimes farmers also undertake non-farm economic activities for the same reason. Apart from these preventive or ‘ex-ante’ measures there are various other coping mechanisms farmers resort to (Rathore, 2004) such as selling of farm animals and land, distress migration to cities, taking up low wage off-farm work, borrowing at high interest rates from local money lenders. All these are unfavourable on welfare grounds, deleterious to human capital as they usually have a toll on nutrition, health and children’s education and they are in any case politically difficult options. A more pronounced disaster often ends up in budgetary payouts in relief, loan waiver and interest rate rescheduling and consequently in slowing down of developmental expenditures. In any case the traditional methods are hardly adequate. In Table 1, we find that in the eight years starting with 2000, as many as three years saw under-performances of our monsoon highlighting the seriousness of agricultural risk.

Table 1: Performance of Monsoon in Recent Times

<table>
<thead>
<tr>
<th>Year</th>
<th>No. of MS with deficient Rainfall</th>
<th>% Districts with Normal or Excess Rainfall</th>
<th>% Rainfall relative to LPA</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000</td>
<td>8</td>
<td>66</td>
<td>91</td>
</tr>
<tr>
<td>2001</td>
<td>5</td>
<td>68</td>
<td>91</td>
</tr>
<tr>
<td>2002</td>
<td>21</td>
<td>39</td>
<td>81</td>
</tr>
<tr>
<td>2003</td>
<td>3</td>
<td>75</td>
<td>102</td>
</tr>
<tr>
<td>2004</td>
<td>13</td>
<td>56</td>
<td>87</td>
</tr>
<tr>
<td>2005</td>
<td>4</td>
<td>72</td>
<td>99</td>
</tr>
<tr>
<td>2006</td>
<td>10</td>
<td>60</td>
<td>99</td>
</tr>
<tr>
<td>2007</td>
<td>6</td>
<td>72</td>
<td>105</td>
</tr>
</tbody>
</table>

Since 2000, as many as three years saw under-performances of our monsoon highlighting the seriousness of agricultural risk.

These farmers have to think about the survival of their families first. As a result, they often have to resort to crop diversification for managing their risk although specialisation and comparative advantage are the key elements of success in the free market. They are likely to be reluctant to invest, to try new products and technology and take up new ventures. Even if they do, failure is a distinct possibility and the loss can be devastating. There seems to be increasing evidence that they do take risk today as revealed in recent studies on farmers suicides, which showed that victim farmers had tended to move towards commercial crops, often Bt. Cotton based on credit (NIRD, 2004). An implication of concern is that the...
farmer defaults and loses his eligibility for credit subsequently. It is important to note that agricultural risk is also a risk for the banker who is not happy to lend to the farmers and especially the smaller farmers despite the stipulations on priority sector lending. This negative impact on investment can only result in poor productivity.

**Agricultural Insurance**

An awareness of the adverse consequences of risk had prompted the rulers in India in medieval times to come out with various institutionalised methods of risk management. Measures like tax remission, relief work, disaster payment and even irrigation were some of the support mechanisms that can be likened with insurance since ancient and colonial times (Mishra, 1996). In fact a formal crop insurance system also existed in the erstwhile Dewas state in Madhya Pradesh. After independence a plan for crop insurance was considered more seriously with Dr. Rajendra Prasad, the Food and Agriculture Minister making a clear declaration in the parliament, but the financial constraints of the states proved to be a solid impediment. The state appointed Expert (Dharm Narain) Committee’s negative report was another set back, so that state supported credit, extension and subsidies became instruments to push through the green revolution in the 1960’s and 70s. Unlike subsidies, insurance is a much more market based instrument and can be more in tune with today’s economy, in which risk can be purchased for a price.

Before we go further a few words can be said about the principle and evolution of crop insurance. The origin of crop insurance is traced to 1788 and a suggestion from the American scientist Benjamin Franklin at a time when France suffered a severe drought. Hail Insurance was provided in the European countries in 18th and 19th centuries but USA and Japan have the longest history of having formal programs of multiple peril insurance. In most countries crop insurance evolved in the mid 20th century. Insurance is pooling of risk organised by an outside agency so that the same loss is not likely to affict the participants similarly in the pool. In practice, pooling of risk is inhibited by two factors. First, the risk profiles of the people are not easy to decipher, leading to a typical adverse selection problem in which the pool ends up being risky as compared to the premium collected. Second and
this is especially relevant for agriculture, a single peril like a
drought can affect a large section of people, so that risk is
usually correlated. Agriculture insurance around the world is
not a success story. International experiences showed that
commercial viability has in general eluded the schemes
(Hazell, 1986, 1985). The US programme administered by the
Federal Crop Insurance Corporation is till today subsidised by
the government and the claims paid out far exceeded the
premiums received in most years of its existence. The state-
ment that crop insurance has not been commercially success-
ful worldwide can only be said with some reservation. In
some cases as in Chile and Mauritius the schemes have
proved successful for com-
mercial agriculture covering
exportable crops that require
large investment. In Japan too
the performance is fairly
reasonable though the Government has to pay for administra-
tive cost.

In India the National Agricultural Insurance Scheme
(NAIS) that is now in operation and has succeeded long years
of trial, has been generating losses in all the years of its
existence since the rabi season of 1999 and nearly all the
participating states contributed to the loss. Most notably,
Punjab has till now refrained from participating, thus helping
the risk pool to be adverse. Nevertheless participation has
grown over time (Figure 1), though
crop insurance has yet an insigni-
cant place in the economy, constitut-
ing only two percent of the gross
domestic product of agriculture, ten
percent of area cultivated and
drawing less than ten percent of the
farmers. The NAIS implemented by
the Agriculture Insurance Company
runs the scheme on an area-yield
basis to make the operation simple in
a vast country. Insurance is also
compulsory for borrowers, a step that
helps to overcome the problem of
adverse selection and acting as
collateral, insurance assures institu-
tional credit flow to agriculture. The government subsidises
the premiums paid by small farmers and also finances the
claim payments over and above the premium. While the
commercial under-performance can be excused at this
relatively initial ‘teething’ stage of the scheme, a search for
social gains also yields disappointingly weak results. Despite
our expectations, the NAIS has hardly targeted the commer-
cial crops, largely because they are charged actuarial premium
rates while foodgrains and oilseeds are charged fixed rates
that are considered affordable. The uneven playing field has
been associated with a
tendency to cover oilseeds
which are importable crops in
the country while the share of
commercial crops came down
in the time period. This is
despite the fact that more and
more crops under the last
category has been coming
under the scheme. There is also little evidence that crop yields
have shown significant improvements since the launch of
NAIS. A reasonably high share of the participation comes
from small farmers but possibly, the need for credit is the
factor that draws them. In general, less than ten percent of the
participants of NAIS are not institutional borrowers (Loanee
farmers) who may have taken insurance cover voluntarily for
its own sake. Several surveys and NSSO’s survey itself has
failed to establish that credit flow in rural sector has become
more inclusive since 2000. The performance of the area yield scheme, known for being ‘practicable’, has hardly been promising till now.

Price Risk Management

Price risk management has become a subject of intense research since the world started becoming integrated. Prior to 1990, various controls on trade served as instruments to a significant degree as also the government administered minimum support price. The Food Corporation of India and similar other para-statal boards and agencies intervened in the market to keep prices within admissible bands. For essential commodities a further complexity was added by the need to protect consumer interest that generally ran contrary to the farmer’s interest. While a price rise could be welcomed by the producer and seller of a commodity it may mean welfare loss for consumers. Although MSP is still announced regularly, globalisation has made the process difficult and inadequate and probably also unsustainable.

Hedging is a common practice in business activities by which the traders reduce their exposures to adverse price fluctuations and take counter-veiling actions in the future market. Many sophisticated financial instruments have emerged worldwide such as futures, options, swaps and bonds. Futures-trading involves obligations to sell (or buy) at a specified future date, a specified commodity and these contracts themselves can be traded in the exchange. A more preferred version is the option which gives a right rather than an obligation to sell (or buy). Both futures and options are called derivatives because their prices depend on an underlying commodity that may be an agricultural product. For most purposes, hedging involves buying or selling of a standardised futures contract against the corresponding sale or purchase of a physical commodity. The basic principle of hedging depends on the close correspondence of the spot and futures prices. Futures trading is said to be amenable for commodities that are storable, whose prices are subject to uncertainty and that are relatively free from state administration. Trading also involves the participation of speculators and arbitrageurs.

Trading in futures was not unknown in India even before its formal emergence for cotton shortly after the Chicago Board of trade was created in 1875. But futures trading always faced a cloud of suspicion in India or elsewhere (Pravaskar, 1985), and was sporadically regulated and suspended through the 20th century. Since 1950 there have been as many as five committees in India, starting with the Shroff committee that looked into the prospect of futures trading. A regulatory body known as the Forwards Markets Commission (FMC) was formed in 1952. However, in the 1960s trading in respect of most agro commodities was banned in turn as a deeply interventionary and controlled regime came into place. Informal and illegal trading however continued (Sahadevan, 2002). When the economy started reforming in the 1990s the Kabra Committee was assigned to look into the matter again and based on its recommendations suspension of trading in respect of a large number of items was lifted. Interestingly, there was an utter lack of unanimity within the Committee and Prof. Kabra, himself disagreed about the appropriateness of the items and time in nearly all cases.

In any case, futures-trading was allowed for commodities including rice, wheat and oilseeds in a three tier regulatory environment. With the state of the art information technology available and investors from different walks operating, it was hoped that the futures market would harness market informa-
adequacy and recommended expansion of its infrastructure. The Group also observed that the effective premium charges were too high and the pay-off levels started at high levels. Though the AIC’s catastrophe premium was only 2 to 3% and resultantly farmers had opted for this insurance policy against others, no farmer received a claim despite an adverse monsoon.

**Conclusion**
Risk management in agriculture therefore remains a vast and potential field of investigation. While uncertainty continues to be part and parcel of the decisions that farmers take and the impacts of such uncertainty stimulate serious political contradictions as well as national apprehension, yet the solutions at hand do not take us far. Crop insurance remains as a bundle of contradictions and its success in India is demonstrated neither by the interest shown by farmers nor by its positive effects on agriculture. The area yield insurance is only a compromise for practical purposes but the NAIS could be a starting point for many possible routes some of which are in experimental stages and are yet to prove themselves. Hedging for managing price risk has always been a victim of scepticisms, controls and prohibitions though it is a potent mechanism of integrating risk with the larger financial market in which the investors come forward to share the risk. The only experimentation in India is with futures market that has experienced only limited success. The experimentation with essential food items is still under a ban and one can hardly brush aside the questionable welfare implications. In any case, that market needs to perform much better if that is possible, to make a difference to farmers’ welfare. Meanwhile, it is important to keep in mind that technological progress through productive research and efficient extension still can serve as a valuable risk management tool. [1]

**Endnotes**
1. Formal contractual farming is also now emerging as a process to control risk while venturing into newer and commercial products and the success is yet at the stage of evaluation.

**References and Additional Thinking**
- Mishra, Pramod K (1996): Agricultural risk, insurance and income: A study of the impact and design of India’s comprehensive crop insurance scheme.
- NIRD (2004) Farmer’s suicides in Andhra Pradesh and Karnataka; Report, Hyderabad

(To express my own views is personal and do not reflect the official policy or position of the organisation.)
tion from the wider world and transmit this to the underlying market making both markets more efficient in the process. Three valuable results could be expected. Firstly hedging of price risk would be possible. The producer can sell in the futures market, thereby locking the price. Although it is unlikely that farmers in India as in most other countries would actually indulge in hedging to any significant degree, the facility will encourage traders to make purchases without fear at the time of harvest and as a result farmers would face a favourable market at this crucial time. Second is the important function of price discovery. Rather than presumptions and hearsays, the futures market and even the ready market will now provide more reliable and objective information on market and price. This is the biggest benefit that futures trade can offer to the farmers. Third is the effect of price stabilisation. It is a common knowledge the farmers, specially the small farmers who having little storage capability dispose of the product soon after harvest, often in distress. The price plummets while the farmer arranges for cash to pay debts, meet household commitments and buy inputs for the next season. A few months later, however this price is likely to rise and the farmer not only loses the opportunity but the poorer ones often buy back food at higher prices. The middlemen gain in this process. Futures trading, by bridging the time gap improves harvest time demand and narrows the inter-temporal price gap.

Doubts have surrounded all these achievements (Lingareddy, 2008). Lack of information, flow of rumours and misinformation, inadequate warehouse facilities and the dominance of speculation are some of the barriers that plagued India’s experiment so much so that it is doubtful if any benefit actually reached the farmers. More intriguingly, despite the regulation and margins in the last few years prices of essential food articles have been rising continuously creating welfare and political challenges. Whether the futures market can really be held responsible for this development is an unresolved and much debated question. Prices were rising in the international market and speculation in the wider market may have had a role besides factors like the diversion to bio-fuels. Nevertheless, the role of the domestic futures market could not be absolved. The Sen Committee appointed to investigate the matter could come out with no conclusive result nor with a specific suggestion for the withdrawal of a ban that was imposed on trading in Rice, Wheat, Urad and Tur. Prof. Sen however in his end note inferred that futures trading can ‘obviously’ affect market price since this impact is what the futures market is all about. Studies investigating the wheat trade that was permitted in 2004 and suspended on 2007 found that the futures market was possibly not performing as it should have with the cross flow of information between the markets, and there was little correlation between futures price and wheat price (Ghosh, 2007). Thus while it cannot be said with conviction that the futures price had led the market price upwards there was also little to gain from the instrument. There have been some evidence that the market integration has improved after introduction of trading and volatility has diminished in respect of a number of commodities and a rise in post harvest price of menthe oil (Vasisht and Bhardwaj, 2007, Sahadevan, 2007).

**Alternatives: Farm Income Insurance Scheme (FIIS)**

This scheme, tried out in India, promised to serve both for covering yield risk and managing price risk. The Farm income
insurance scheme (FIIS) was initiated as a Pilot scheme during the rabi season of 2003-04. The purpose was not just to protect farmers’ incomes but also to help reduce government’s expenses on the MSP programme. The FIIS operated in many ways like the NAIS, based on a homogenous area approach. Rice and wheat were the two crops covered. The scheme assured a guaranteed income based on the yield attained in the past and the MSP announced. Indemnity was paid if the actual income calculated as the product of the current yield and current market price fell short of the guaranteed income. Interestingly, in the Pilot districts where the FIIS was implemented, both MSP and NAIS for the selected crops were suspended.

The FIIS was unfortunately built on a weak theoretical foundation dominantly because income is essentially a farm level aggregate indicator as opposed to a crop level one and a crop’s viability can only determined by market forces and policy priorities. Moreover the political acceptability of the FIIS was also poor. Punjab and Haryana did not agree to join because of the MSP suspension plan. Even where implemented, due to the pressure from the farmers the MSP was restored in the harvest period. The compensatory reaction of yield with price made the income based scheme unattractive for farmers. A joint Group set up to enquire into the working of our insurance schemes described the FIIS as ‘futile and luxurious’ wastage of government money and recommended that it be wound up.

Weather Insurance
Agricultural performance is known for its sensitiveness to the weather conditions, especially the rainfall in the growing period. While several inputs and cropping practices are important for agriculture, the significance of rainfall surpasses all. In India nearly two third of the cropped area is still rainfed and many crops like cereals, oilseeds, millets largely depend on rainfall. Also irrigation of many types eventually depends on rainfall.

The main strength of the weather insurance is that the trigger event which is the adverse rainfall performance can be independently and objectively verified and measured. The Meteorological Department of India (MDI) is an independent body with its scientific expertise to generate regular rainfall data at a national scale. The scheme also has other advantages. There is no chance of moral hazard as the scheme has nothing in it to encourage negligence. The scheme has no need for information of the individual risk profiles of farmers and is extremely cost effective in that sense. In principle an unsubsidized policy can even be purchased by also a person who is not a farmer since the instrument is essentially a fair bet on rainfall performance. This also minimises the problem of adverse selection. Besides rainfall, other elements of weather such as soil moisture, sunlight and temperature can be important for agriculture. In 2003-04, nearly four million metric tonnes of wheat output was lost due to higher temperature in a critical period of cultivation and germination.

In 2003-04, nearly four million metric tonnes of wheat output was lost due to higher temperature in a critical period of cultivation. Compared to another year 1999-00 which was good in terms of the performance (76 million tones of wheat output) the average maximum temperature was more by 3 to 6°C during March at various places and the average minimum temperature was also more by 3 to 4°C compared to 1999-00.

Three Pilot Project of Weather insurance schemes in India are(1) ICICI –Lombard General Insurance Co. (introduced an insurance based on a composite rainfall index in 2003-04 in Mahboobnagar district in Andhra Pradesh for Groundnut and Castor. This was extended to other areas subsequently. A similar scheme for Oranges was also introduced in Jhalawar district in Rajasthan in 2004), (2) Agricultural Insurance Co. (AIC) (introduced the ‘Varsha Bima’ in 2004 south west monsoon period with five different options taking account of the various dimensions of rainfall failure) and (3) IFFCO-Tokio general Insurance Co. (ITGI) (had a pilot ‘Barish Bima’ in 2004 in nine districts in Andhra Pradesh, Karnataka, Gujarat and Maharashtra based on a rainfall index compensating for deficient rainfall). However, this promising scheme is not without its weakness. As in NAIS, weather conditions too exhibit wide spatial variation and the presumption of homogeneity in the area is crucial. Finally, the whole idea of the weather insurance is based on the timely availability of weather data. The joint Group had reservations on IMD’s
1.1 Introduction

A sustainable environment facilitates directly and indirectly to the strengthening of economic growth, socio-cultural demographic uplift, infrastructural buildup, positive externality generation, and improving beyond preserving levels the ‘quality of life for humans’. Further it is complementary to economic growth for long run human development objective as well, where it significantly affects human capital, its accumulation and the overall environment.

Natural disasters, especially earthquakes have affected the economic activities in Pakistan to a great extent causing instability and weakness to the economic systems and making them more vulnerable. 1935 earthquake in Quetta (Pakistan), 2001-earthquake in Gujarat (India), 2005-earthquake in Azad Kashmir and Pakistan, and again 2008-earthquake in Quetta (Pakistan) are some examples. Azad Kashmir is the Pakistani-administered part of the former princely state of Jammu and Kashmir, along with the Northern Areas of Pakistan. It covers an area of 13,300 km², with its capital at Muzaffarabad, and it has an estimated population of over three million people. The Azad Kashmir earthquake of 2005 was a major seismological disturbance that occurred at 08:50:38 Pakistan Standard Time on October 8, 2005 with the epicenter in the Pakistan-administered region of Kashmir in South Asia. It registered 7.6 on the moment magnitude scale making it a major earthquake similar in intensity to the 1935 Quetta earthquake, the 2001 Indian Gujarat (Indian or Pakistani) Earthquake, and the 1906 San Francisco earthquake. As of November 8th, 2005, the Pakistani government’s official death toll was 87,350. According to unofficial guesses, the death toll could reach over 200,000.

Azad Kashmir and North-eastern areas of N.W.F.P (N.A) in Pakistan significantly contribute to ecological balance/regulation of environment of the region by
IN PAKISTAN:
Loss of Human Capital

Dr. Syed Nisar Hussain Hamdani
Wertheim Fellow, LWP, Harvard University, USA

Imran Haq Nawaz
PhD Scholar, Pakistan Institute of Development Economics, PIDE, Islamabad
virtue of its rich forest, hub of flora and fauna (wildlife) and excess of green foliage; which provides major source of watershed, air pollution control, sufficient raining, temperature regulation, air cleanliness and eco-tourism.

The October 2005-earthquake in Kashmir caused problems in multiple dimensions. Environment, economy, wild life, physical, social, and psychological infrastructure of society etc, were all affected by the earthquake. Due to the loss in the stock of human capital and flow of the human capital from the affected areas, the optimum uses of the available resources were reduced hence degrading the economic system to less efficient system. As a result, the role of human capital for the sustainability of the economic system and environmental resources, needs to be identified and analysed.

1.2. Need for Human Capital Loss Analysis
Unfortunately, there is a little economic research literature available on the economic effects of earthquakes. Pakistan and AJK faced a huge disaster in 2005 which caused human and economic losses. Pakistan suffers from frequent earthquakes of small magnitudes because of its location on seismic belt. As mentioned above, a recent earthquake in Quetta has also caused several hundreds death, injuries, and disabilities hence causing a burden on the economy. Earlier, there was a major earthquake in Quetta, Balochistan, in 1935 when the entire city was destroyed. A number of earthquakes occurred during last three decades killing more than 100000 people while the most recent earthquake affected millions of people.

Since this is not the first and the last disaster in the country, there is a need of emergency preparedness and response for all types of disasters. This requires new planning approach and extensive applied research on the topic that may help channallizing and interlinking the state machinery, households, private sector organizations, and international support agencies in a well coordinated manner for disaster management activities. Since environment and human capital are two major affectees of such disasters, so these call for academicians and researchers’ responsiveness.

The primary objective the present paper is to initiate discussion on post-disaster situation to highlight the implications of human capital stock and flow losses while considering religious and spiritual human capital dimensions too.

2. Methodology and Data
This paper heavily draws from our earlier work (Hamdani and Shah 2006). The extended analysis done in the present paper is primarily based on primary data collected under a survey of disaster affected areas of Pakistan in June 2006, titles Divine Economics Survey – Faith and Rehabilitation Module assisted by Labor & Worklife Program Harvard University USA. Some of the tables are extracted from the author’s report “Disaster, Faith and Rehabilitation: A Post disaster Rehabilitation Analysis of Pakistan Earthquake 2005 in a Faith Perspective”. Some data were also generated from field observations by the authors during the post-earthquake period, focus group discussions and key informant interviews conducted in Azad Jammu & Kashmir and NWFP during the month of November 2005. Thirty semi-structured community level interviews of teachers, locally elected government representatives, elderly and other key informants were conducted in the affected areas Jehlum Valley, Muzaffarabad City, Garhi Habibullah, parts of Mansehra district and Abbottabad. The information was used to derive non-parametric results and preliminary findings.

3.1 Impacts of Earthquake: an Overview
Environmental sustainability, biodiversity conservation, ecological protection, development and rehabilitation have been a matter of concern in different countries of the world
since ever. Human capital loss and future development are the key agents of these ecological, socio-economic and cultural systems. Various reports indicate that about 3000 square kilometers area of AJK and NWFP has been severely affected with a loss of 84 percent houses in AJK and 36 percent in NWFP. Some estimates show that about 3.5 million people have become victim of earthquake. Some of the impact indicators are given in the following Table 1.

3.2. Human Capital Dimension

Human Capital of an individual is determined by age, education, experience and other factors. These factors also include cognitive and non-cognitive skills (Heckman 2003, Heckman and et al 2006). Some studies (Hamdani and Shah 2006, Shah 2008) suggested that religion also serves as a determinant of the human capital, religious human capital and spiritual human capital. Spiritual Human capital can be viewed as the accumulation of human capital due to spirituality related perceptions, beliefs, experiences, education, practices and the desire for the excellence.

According to the United Nations Mission Report November 2005, all major public buildings have been partially damaged or completely destroyed due to 2005 earthquake in Kashmir while substantial number of death toll contributes to a great loss of human capital since the dead people include those having variety of professional, managerial, religious, spiritual, and technical skills and experience of varying degrees. This loss of human capital has multidimensional impacts on economy, environmental sustainability and future progress in different fields. For example, since higher levels of education lead to more awareness and more effective environmental regulations (McMahon, 1997), earthquake implies a loss of environment through a loss of educated people. This role of education is recognized by World Bank (1998) that water pollution reduced significantly with reduction in population growth and increase in education.

There are other indirect channels as well where the reduction in economic well being (in our case due to the loss in stock and flow of Human Capital) would also lead to environmental degradation which is substantiated by the growth models presented by Robert Barro (1997, 2001), where one of his findings were that education permanently increases the efficiency of the labor force and this human capital also facilitates the absorption of superior technologies. The loss of infrastructural capacity and flow of potential Human capital would also impact the capacity of people to further produce and ripe the benefits of Human development.

Philippestins (2001) estimated a positive strong correlation in Natural resource abundance and Human capital and identified that excess returns from rich natural resources lead to reinvestment in higher Human capital investments. Therefore the estimate of human capital loss is necessary for future strategic policy options considered for rehabilitation and minimization of losses.

According to a UN report regarding earthquake 2005, “the earthquake’s impact on institutional capacities and loss of infrastructure in all sectors, including the public services, has reduced overall capabilities to manage waste and natural resources. This is likely to have additional negative effects on the environment in general, and also on the livelihoods and health of the affected populations. In addition to the directly affected areas, environmental impacts are likely in the lower catchments. Environmental concerns associated with the earthquake will continue to require attention and resources beyond the current relief and early recovery phase. Thus, there is an immediate need to appropriately manage forests and other environmental aspects of the Indus River watershed” (UN 2005).

The above mentioned losses in general and human capital losses in particular have long lasting implications for the economy of the affected as well as other related areas. Some of the issues are discussed below.

4.1 Discussions and Implications

The areas hit by the earthquake were not centers of agricultural or industrial activity. Moreover, ports, telecommunications, airports, power plants, oil refineries and other major economic or infrastructural units of the country are intact. And, gain in some industrial or commercial activity is also expected especially in the process of reconstruction. Despite that, the earthquake 2005 has direct implications for many aspects of life, environment and human capital being the most important among them.
Total population of AJK is over three million while close to two million resides in Muzaffarabad, Poonch, and Bagh. Almost 80% of the population in these areas was affected by 2005-earthquake. Five cities of NWFP (Pakistan) have a total population of over three million and 41% of the population was affected by 2005-earthquake while 35% of them were highly affected.

Although there has been no significant effort for scientific study of post-disaster economic evaluation, yet it is not difficult to understand that the earthquake 2005 caused huge loss of skilled manpower due to death of above one hundred thousand people and a greater number that was out of work due to injuries and disabilities or because of being homeless for many months after the earthquake. It is so also because many skilled people became unable to continue work as they lost the original working environments where they were applying their knowledge and skills prior to earthquake. An International Labor Organization (ILO) report indicated that over 1.1 million jobs were wiped off by this earthquake, which was more than 50 percent of the total employment at that time before the catastrophe. An estimated 40 to 50 percent of these people were likely to have lost their primary source of income hence this might have caused human capital implications through deterioration of survivors’ health (see UN Report 2005).

Studying loss of human capital from social development point of view is also important because it has effect on ecological system. It can lead to further reduction in the pace of education and increase in income generational activities which are natural resource dependent. Non Arid-eco system requires individual (Human capital) as well as institutional (governmental, non-governmental, community based, like minded, awareness forums, opinion leaders etc, i.e. cumulative human capital) partners at grass root level and secondary levels, but this natural disaster has severely damaged Human capital (Stock & Flow) and the infrastructural capacity for further development. In that context, the multifarious threats to the existing environment and future impacts short run operational and long run strategic policy options to minimize the expected losses.

In order to estimate how much disaster made human capital incapacitated and how would it impact the future environment, Hamdani and Shah 2006 consider the following type of skills that exist in a country. (1) Conventional skills which prevail in a country routinely, (2) Innovative skills which lead a country ahead of its counterparts, and (3) Emergency skills which enable a country to maintain a sustainable growth rate even in emergencies and natural or man-made disasters.

The same study further notes the possible skills loss is also of three types as under:

a) Permanent or complete loss if a skilled person dies or becomes disabled in a disaster.

b) Partial loss if a person is injured or disabled yet partially curable.

c) Temporary loss if a person is physically fit for using skills but either looses the required toolkits or technological infrastructure for using his/her skills or suffers from psychological shocks.

The instantaneous impact of this natural disaster is the destruction of environmental system with destruction of its components; biodiversity, forest-eco system, agro-eco system and arid and non-arid-eco system with human capital as the principle agent of these eco-systems and further debarring its rehabilitation due to the loss of human capital (stock & flow and its formation) and its contributing components (educational, community based structures etc). By its adverse impact on human capital stock, may lead to increase in poverty levels, whereas the loss of human capital flow; may push surviving human beings in perpetual poverty trap.
4.2 Loss of Human Capital Stock

Human capital stock is the accumulated form of education, skills, IQ’s, lifestyles, experiences and practices etc. According to joint WFP/UNICEF rapid emergency food security and nutrition assessment [UNWFP 2005]

‘... between 3.2 to 3.5 million people are affected. Nearly half of the population lost their houses, leaving roughly 2.5 million people homeless. But also families who haven’t lost their houses sleep outside, either because their houses are badly damaged, or out of fear of after-shocks.’

Based on certain reports as well as field observations, we find that the death of local people has caused i) intangible loss to environment in terms of innovative or indigenous ideas, concept, perception, ii) tangible loss in terms of missing routine skills from locality iii) a large number of people undergone permanent, partial or temporary loss of skills due to direct damages or displacement, or any sort of fear iv) behavioral deterioration in terms of increased dependency on forest oriented economic activity of left over people, v) increased child labor due to changed parents’ preference in crises, vi) trickle down effect of human capital loss in terms of the above mentioned losses.

One can note that the existing literature on post disasters hardly analyses the implications for and role of spiritual and religious human capital but it has been observed during the field survey that generally the data regarding the religious and spiritual personalities in almost every geographic regions and sects of different religions played tremendous role in post
disaster traumatic recovery through religious and spiritual healing. For example, the religious individuals and the organizations were first ones to establish the relief camps after the disasters such as Katrina (US) 2005, Gujarat (India) 2001, and AJK (Pak) 2005. The 2005-earthquake has caused deaths, injuries, disabilities, and other problems incapacitating to this type of human capital too.

### 4.3. Outflow of Human Capital

#### Table 3: Occupation (before EQ) - First Job and Occupation (after EQ) - First Job

<table>
<thead>
<tr>
<th>Occupation (after EQ) - first job</th>
<th>Govt. employee</th>
<th>Private Employee</th>
<th>Own business</th>
<th>Imam of mosque</th>
<th>Daily wage worker</th>
<th>Pensioner</th>
<th>House job</th>
<th>Looking for job</th>
<th>Others</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Govt. employee</td>
<td>257</td>
<td>2</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>269</td>
</tr>
<tr>
<td>Private Employee</td>
<td>5</td>
<td>88</td>
<td>3</td>
<td></td>
<td></td>
<td>3</td>
<td>11</td>
<td></td>
<td></td>
<td>113</td>
</tr>
<tr>
<td>Own business</td>
<td>1</td>
<td>2</td>
<td>79</td>
<td></td>
<td></td>
<td>2</td>
<td>1</td>
<td></td>
<td></td>
<td>92</td>
</tr>
<tr>
<td>Imam of mosque</td>
<td></td>
<td></td>
<td></td>
<td>5</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>5</td>
</tr>
<tr>
<td>Daily wage worker</td>
<td></td>
<td></td>
<td></td>
<td>1 1</td>
<td></td>
<td>19</td>
<td>1</td>
<td></td>
<td></td>
<td>25</td>
</tr>
<tr>
<td>Pensioner</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>10</td>
<td></td>
<td></td>
<td></td>
<td>10</td>
</tr>
<tr>
<td>House job</td>
<td>1</td>
<td>1</td>
<td></td>
<td>5</td>
<td></td>
<td></td>
<td>22</td>
<td></td>
<td></td>
<td>24</td>
</tr>
<tr>
<td>Looking for job</td>
<td>1</td>
<td>10</td>
<td>1</td>
<td></td>
<td>1</td>
<td>52</td>
<td></td>
<td></td>
<td></td>
<td>65</td>
</tr>
<tr>
<td>Others</td>
<td>1</td>
<td>4</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td>2</td>
<td>127</td>
<td></td>
<td>135</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>265</td>
<td>108</td>
<td>86</td>
<td>5</td>
<td>24</td>
<td>13</td>
<td>27</td>
<td>76</td>
<td>134</td>
<td>738</td>
</tr>
</tbody>
</table>


It is basically disruption, temporary or permanent in the process of flow of human capital in the form of education, IQ’s, skills, experiences and practices. People tend to choose different jobs due to the type and distribution of job and the associated cost of communication. Table 2 shows the job transition before and after 2005-earthquake. It shows a significant change in the group of people who used to work outside the affected area before the earthquake. Although, the earthquake may cause new job opportunities or the people may have decided to work locally after the earthquake due to other social reasons.

#### 4.4. Labor Migration

Table 2 describes the transition between sub-labor markets and shows significant change in the job transition in the private sector, there might be fewer jobs available in the private sector after 2005-earthquake or the workers might have availed substitute opportunities due to better job placement or any other reason.

As the determinants and magnitude of job transition on the basis of new opportunities or changed social behaviors are unknown and call for another study to find the economic
interpretations of this behavior while they are beyond the scope of present study.

Hamdani and Shah 2006 describe the process that is directly and indirectly barred or slowed down due to following devastations:

1. Loss of physical capital: This includes the losses to government and private infrastructures such as school buildings, infrastructure, electrification, furniture, laboratories etc. For example, government employees (such as civil servants, teachers, police officers and others) receive their salaries while they are unable to work because offices, schools and other workplaces are destroyed.

2. Health Facilities loss: Which will lead to a large no of weak, sick children and mothers, changes in priorities to educate girls/boy.

3. Loss of Environmental Capital: For reconstruction of large no of houses would require timber, stones etc. Similarly, loss of sanitary facilities lead to high rate of morbidity reduces growth rate of human capital. Water supply loss also leads to water born diseases and result in loss of economic growth.

4. Source of Earning Loss: It is loss of arid and non-arid agricultural fields, orchards, livestock, which leads to reduced income, increase morbidity due to less/impure foods and nutrition, more dependency alternative less productive sources.

5. Human Capital Loss: It is the loss of students, teachers, trainers, supporting staff, developed human capital.

<table>
<thead>
<tr>
<th>Table 5: Human Capital Loss (Male), Not Going to School</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>No of Persons</strong></td>
</tr>
<tr>
<td>-------------------</td>
</tr>
<tr>
<td><strong>Before Earthquake</strong></td>
</tr>
<tr>
<td>0</td>
</tr>
<tr>
<td>1</td>
</tr>
<tr>
<td>2</td>
</tr>
<tr>
<td>3</td>
</tr>
<tr>
<td>4</td>
</tr>
<tr>
<td>5</td>
</tr>
<tr>
<td>6</td>
</tr>
<tr>
<td>7</td>
</tr>
<tr>
<td><strong>Total</strong></td>
</tr>
</tbody>
</table>


<table>
<thead>
<tr>
<th>Table 6: Human Capital Loss (Female), Not Going to School</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>No of Persons</strong></td>
</tr>
<tr>
<td>-------------------</td>
</tr>
<tr>
<td><strong>Before Earthquake</strong></td>
</tr>
<tr>
<td>0</td>
</tr>
<tr>
<td>1</td>
</tr>
<tr>
<td>2</td>
</tr>
<tr>
<td>3</td>
</tr>
<tr>
<td>4</td>
</tr>
<tr>
<td>5</td>
</tr>
<tr>
<td>6</td>
</tr>
<tr>
<td>7</td>
</tr>
<tr>
<td><strong>Total</strong></td>
</tr>
</tbody>
</table>

6. Subject specific loss, e.g. loss of subject specialists, science laboratories loss that leads to loss of opportunities to study science subjects including medicine, engineering, pure sciences etc.

8. Community activist loss that is loss of native willing workers

9. Loss of Entrepreneur: That is the most precious human capital in for devolving and sustaining the productive chain ranging from local business to global economy.

The above table (4) explains the loss of human capital. Out of 764 sample households that were surveyed after 2005 earthquake at Kashmir, 112 households suffered through a loss of one family member each i.e. 14.7% of the sample, while 44 (5.8%) households faced the deaths of two family members each. There were 19 households who had at least three deaths in the family (2.4%).

4.5. Implications for Future Human Capital (FHC)

Usually, in disaster economic studies, current state of human capital is assessed and analyzed. This is perhaps because, most of the disaster studies are conducted in advanced countries where human capital is less vulnerable to physical capital.

Since disasters may have strong relationship with changes in the investment or return to physical capital and human capital, and consequently could influence economic growth, the Divine Economics Survey 2006 included the concept of Future Human Capital (FHC) also in the survey to assess the likely effect of disaster on human capital in subsequent years. The FHC was crudely defined as the state of human capital at a future date that can be estimated today on the basis of available data on human capital variables as under;

\[
FHC = (HC_t + (HC_{t+1} \times (\Psi_{t+1})))
\]

where

\[
FHC = \text{state of human capital at future date (t+1)}
\]

\[
HC = \text{conventionally defined human capital at time t}
\]

\[
\Psi = \text{quality of human capital at time t+1}
\]

\[
\Psi = (HC_t)^* (HPQ)^* (HRI)^* (HSI)
\]

*Such definitions are based on knowledge, education, skills, job experience etc.

\[
HPQ = \text{Individual’s physical and mental health index}
\]

Table 7: Persons Facing Severe Hurdles in Further Education After the EQ

<table>
<thead>
<tr>
<th>No of persons in household facing hurdles</th>
<th>Frequency</th>
<th>Percent</th>
<th>Cumulative Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>648</td>
<td>84.8</td>
<td>84.8</td>
</tr>
<tr>
<td>1</td>
<td>36</td>
<td>4.7</td>
<td>89.5</td>
</tr>
<tr>
<td>2</td>
<td>39</td>
<td>5.1</td>
<td>94.6</td>
</tr>
<tr>
<td>3</td>
<td>16</td>
<td>2.1</td>
<td>96.7</td>
</tr>
<tr>
<td>4</td>
<td>12</td>
<td>1.6</td>
<td>98.3</td>
</tr>
<tr>
<td>5</td>
<td>10</td>
<td>1.3</td>
<td>99.6</td>
</tr>
<tr>
<td>6</td>
<td>1</td>
<td>0.1</td>
<td>99.7</td>
</tr>
<tr>
<td>7</td>
<td>2</td>
<td>0.3</td>
<td>100.0</td>
</tr>
</tbody>
</table>

Source: Divine Economics Survey (2006), Religiosity & Rehabilitation Module (Assisted by LWP, Harvard University)
HRI  = Individual’s religiosity Index  
HIS  = Individual’s spirituality Index  

Table 5 and table 6 show the loss in human capital among male and female students due to not attending the school after 2005 earthquake. Blue digits in the tables represent those students who could not continue their education due to death, injuries, disability, or other reasons. The data shows that 13% of each male and female student could not continue to attend the school after the earthquake.

Figure-1 shows the total loss in human capital in the students due to not attending the school for any reason after the earthquake. It shows a substantial loss in human capital because 13% of the total school going children could not continue their school after 2005-earthquake. Also table 5 shows that almost 9% of the people could not recover from the injuries caused by the earthquake and almost 6% of them were permanently disabled. This significant disability ratio will cause increased dependency on families and it will ultimately lead to less earning hands in the long run creating a more vulnerable economic system in the affected areas of 2005-earthquake.

The individual’s conventional human capital variables shall be non-negative on future dates already obtained education, training, job experience etc. however, indices about religiosity, spirituality and physical and mental health may improve, deteriorate or remain constant in the next period. The underlying hypothesis of this interpretation is that the human capital in conventional sense together with the human capital in divine sense could lead to higher rates of economic productivity, efficiency, and growth. Particularly, if disasters serve as an impetus for improving religiosity and spirituality of the disaster victims, as have been empirically observed by Hammond (2007), then positive effect is likely on productivity and growth in subsequent years.

In table 7, the loss in the stock and flow of human capital caused by 2005- earthquake at Kashmir which created hurdles for the population in acquiring further education. For 764 sample households, the table shows simple percentages and any parametric analysis is not aimed here. The table indicates that a reasonable percentage (15.2 %) of household face severe problems in reviving educational activities of their one or more members. Out of these, about 12 percent households are those where upto three members of the household have trouble in continuing education.

The effect of disaster on allocation of time to religious and spiritual human capital accumulation (or its utilization) can be expected in almost all types of disasters because, depending on the type of people with reference to their religiosity levels,
they alter their time allocation patterns in post disaster traumatic conditions. The table-8 indicates such changes viewed in perspective of engagements after the disaster. For example, the first row data shows that if there is no death, no injury or no disability in the household as cause of disaster, the time allocated to both religious and spiritual human capital increases in post disaster situations. But if for example, two persons were injured, the time to both the activities was reduced. We can observe from column one, that in case of death of one or two household members, the time in religious and spiritual activities in post disaster situation is higher. This is exactly what happens in an Islamic society that, the family members, relatives and well wishers of the deceased person(s) use to spend time on recitation of the Holy Qur’an, repeating *darood* (salutations on the Holy Prophet and his progeny) and offering other specific spiritual recitations etc.

We can notice that If there was no death, no injury and no disability, the resumption to education took on average 63.5 days. If there was one injured/sick, then it took 79 days and if there was also a disabled, then it took 100 days. In case of two injured/sick persons with one disabled also took 120 days and with one death and two disabled at home resulted in 240 days delay in resuming education among household members.

5. Conclusion

This paper discussed some human capital related implications of any disaster such as earthquake 2005 in Pakistan. It is concluded that earthquake caused direct and indirect loss to human capital stock and outflow of human resources from disaster areas. A Divine Economics review of the situation was also undertaken to see whether or not, the religious or spiritual dimensions of human life have any relationship with post-disaster behaviors. Through simple analysis it was observed that any type of loss in physical human capital such as death, injury or sickness and disability caused by disaster has also affected the allocation of victims’ time towards accumulation or utilization of religious and spiritual human capital. For better understanding of these issues, this study suggests further research with respect to human capital in disaster affected areas. The inter-disciplinary research which integrates economics with other disciplines such as religion, spirituality, psychology, and health etc would be appropriate in exploring the post disaster economic patterns and behaviors.

### Table 9: Family Members Resume Academics After October 8 (Number of Days)

<table>
<thead>
<tr>
<th>Persons died in EQ</th>
<th>Persons Injured-sick and now recovered in EQ</th>
<th>Persons Disabled in EQ</th>
<th>Mean</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>0</td>
<td>0</td>
<td>63</td>
</tr>
<tr>
<td>1</td>
<td>0</td>
<td>1</td>
<td>79</td>
</tr>
<tr>
<td>2</td>
<td>1</td>
<td>0</td>
<td>100</td>
</tr>
<tr>
<td>1</td>
<td>0</td>
<td>1</td>
<td>95</td>
</tr>
<tr>
<td>2</td>
<td>0</td>
<td>2</td>
<td>120</td>
</tr>
</tbody>
</table>

Source: Divine Economics Survey (2006), Religiosity & Rehabilitation Module (Assisted by LWP, Harvard University)

An inter-disciplinary research which integrates economics with other disciplines is very appropriate.

References and Additional Thinking

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• www.intizar.org
• WCDR (2005), A Review of Disaster Management Policies and Systems in Pakistan, Islamabad)

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