Arthneeti

Quarterly Finance Newsletter: March 2011

The Twin Deficit Risk For Indian Economy

Private Equity: Challenges & Opportunities

Micro Finance: Key To Financial Inclusion

Interview:
Mr. Sunit Joshi
EVP-Capital Markets
SBI Capital Markets Limited

The Money Strategy
Dear Reader,

It gives us immense pleasure to publish the very first newsletter of the Finance Forum of SIMSREE. The newsletter is named as “Arthneeti” meaning “The Money Strategy”. We thank our Director, Mr. M. A. Khan and Faculty members of SIMSREE for all their support and encouragement. I congratulate the members of the SIMSREE Finance Forum for making this a reality. I would like to convey my special thanks to Mr. Sunit Joshi (Head - Capital Markets, SBI Capital Markets) & Mr. Amol Agrawal (AVP, STCI Primary Dealers) for their valuable contributions to our inaugural edition of our quarterly finance newsletter. This newsletter will be an attempt to highlight the views of Students, Faculty & Corporates in the area of finance.

Indian economy has been growing at steady rate for the past few quarters and is expected to grow at 8.5% this fiscal. The last few months have been bad for the Indian economy with scams and governance issues affecting the confidence of global investors in Indian economy. Inflation has been a great concern and balancing growth and inflation is a challenging task ahead for our FM Mr. Pranab Mukherjee. Since January 2011, the inflows have been slow due to recovery in the USA and other developed economies. But, as said by Mr. Mark Mobius, this is a short term story and India’s growth story is still intact with strong fundamentals. India’s challenges would be to control the twin deficit problem and Mr. Pranab Mukherjee has laid down the strategies to control in the 2011 Union Budget. The world economy in general has experienced uncertainty with the Middle East crisis (Libyan Crisis), high oil prices, European debt miseries. With Japan too facing turbulence after tsunami catastrophe, uncertainty across global markets looms.

In this inaugural issue, we have covered issues pertaining to Inflation Targeting, Twin Deficit problems, Private Equity Investments, Microfinance & IFRS. In addition there are other informative sections.

We do look forward to views and suggestions from the readers to help us improvise the content of the Newsletter and make it more relevant and informative.

I wish you a pleasant reading.

Gopidalai Muralidhar Rao
(Editor-In-Charge)
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Expert Talk

WHAT IS THE FUTURE OUTLOOK OF THE INDIAN EQUITY MARKETS IN THIS FISCAL YEAR?

As you know, predicting the stock markets is like crystal ball gazing, but going by the GDP growth of over 8.5 percent so far for the current year and the estimate of around 9 percent for the next financial year, the trend should be positive. India's growth story is not only intact but also robust. Inflation is a concern and this is one of the major reasons why stock markets are weak right now. As you know, stock markets really don't work on logic, but are more sentiment driven, and at present the sentiments are weak. Major reasons for our equity markets being in the present state are inflation and also governance issues, which have been cropping up for the past few months - like the CWG imbroglio, the 2G spectrum allocation controversy, the bank loans problem that surfaced in November 2010, etc. On top of this, there have been some negative global cues - the euro crisis that has gradually subsided, and now the Middle East turmoil is pushing the crude prices to higher levels. These events are affecting the markets. But let me clarify that the equity markets are not completely tanking, and the Sensex is not falling below 17,500 points. It fell below 18,000 to around 17,600, and has again bounced back. I think we will see the market range between 17,000 and 19,000 - may be for the next one month or so, unless the budget is dramatically different. Post-budget, the situation should be quite stable, and in any case, in March not much activity is expected to happen. Going forward, from June onwards, I can't say for sure, but I do foresee a bright future. Markets can't remain bleak forever; new issues have to come out and there is appetite from retail as well as institutional investors. The secondary market activity will also continue to grow. FIIs have withdrawn funds from our equity markets in January and February 2011. But unless there are great opportunities elsewhere, they will return. While the FII outflows have not been very high, this does affect the sentiments and FII inflows / outflows continue to drive the state of equity markets in India.

WHICH SECTORS, ACCORDING TO YOU, WOULD OUTPERFORM THIS YEAR?

Growth driven sectors - such as infrastructure would definitely be on a high, considering the Government's continuing thrust on building infrastructure. Pharma is a high growth sector with potential for higher returns. Even the financial services sector stocks - especially the Public Sector (PSUs) Banks, whose stocks are quoting at quite low Price to Book (P/B) Value of close to 1 or just a little above 1, have good growth potential. Ideally, these stocks should command a much higher price, as was the case until the middle of November 2010.

HOW DO YOU SEE THE IPO AND M&A SCENE DEVELOPING IN 2011?

M&As are likely to happen in sectors where there is higher competition. A couple of deals that have taken place recently include iGATE’s acquisition of Patni Computers in the IT space. We recently saw Jindal Steel picking up majority stake in Ispat. In Pharma sector, Reckitt Benckiser took over Paras Pharma. Most recently, British Petroleum has picked up 30 percent stake in Reliance Industries Ltd. The BP-RIL deal is a big positive signal for the markets - amid the generally poor performance of stock markets. So, these are positive events that have happened. The Cairn-Vedanta Deal has been stuck for the past few months because of the ONGC royalty payment issue. M&As will continue to happen, and wherever you have more competition, it is easier for the industry to consolidate - with some promoters opting to go out after making a decent return on what they had originally invested.

TALKING ABOUT THE NEXT FINANCIAL YEAR, WHAT DO YOU THINK WOULD BE THE PREFERRED INSTRUMENT FOR CORPORATES FOR FUNDRAISING? WOULD IT BE DEBT OR EQUITY?

We hope the corporate bond market picks up. Going forward, bonds should substitute loans to a greater extent. But there isn’t any substitute for equity. Because if one is setting up a large project, the lenders would provide loans to cover only a part of the project cost and the promoter has to bring in the equity. This need to raise capital would drive equity issues and the activity should pick up again in the next fiscal (2010-11). Corporate Debt (i.e. bond) market is not picking up for a few reasons: a) the investor in these instruments has no direct control and b) the instrument is not liquid. There needs to be someone who makes the market, i.e. someone buys and also sells these bonds - by offering two-way quotes. As for control, an investor in bonds is also a lender effectively, but when a bank lends by way of loan, it has greater control on the day-to-day activities of the borrower company. The bank providing loans obtains regular MIS data and documents every month, it verifies the business place or plant. But an investor in bonds has no control on the day-to-day activities of the borrower company. Although these
Companies and Pension Funds also have limitations on invest in corporate bonds. Similarly, Insurance corporate bonds are still banks. Institutions like ISSUE?

First of all, let me clarify that SEBI has not expressed any reservations or concerns on this aspect. In government mandates the issue size is usually very large and the investment bank gets good league table rankings. The disinvestment public offerings are complex transactions and also greatly improve the reputation and credentials of the merchant bankers associated with such large and prestigious transactions, which is helpful in securing other business. Also, in terms of experience, such transactions have a lot of value. A merchant banker in these issues deals with the PSU itself, the administrative ministry of the government controlling the PSU and also the Disinvestment Department. So, you are actually dealing with three different entities, whereas in most other issues in the private sector, you are dealing with only the issuer company or additionally the private equity investor. This provides the merchant banker with a different learning and perspective. In any case, who is benefitting from the low fees? Since it is the PSU concerned and the owner, i.e. the government that are benefitting, we do not see any issue with the near-zero fees. Obviously, this does not happen in the case of private sector’s public issues.

SEBI HAS RAISED CONCERNS ON IPO PRICING. THIS WAS FURTHER CORROBORATED BY A REPORT RELEASED BY CAR RATINGS. ANALYSIS OF 116 IPOS BETWEEN AUGUST 2007 AND AUGUST 2010 REVEALED THAT “ABOUT 62 PERCENT OF IPOS ARE CURRENTLY TRADING LOWER THAN THE IPO PRICE BAND”. ARE IPOS GENERALLY OVERVALUED?

SEBI Chairman did say that merchant bankers should ensure that IPOs are not overpriced. SEBI also feels that merchant bankers tend to overprice the IPOs because their fees may be linked to the total issue size. But in most cases, the fees are not necessarily linked to the issue size. Secondly, the overall issue size may be going up by only 5 to 10 percent because of the perceived higher pricing and the issue management fees could be only 1 or 2 percent of that, and I don’t think that this aspect would really have any bearing on the pricing guidance by the merchant bankers. Thirdly, the merchant bankers also have to time and again go back to their large key investors - as well as to the retail investors. If the Institutional Investors are disappointed over and over again, then the merchant bankers would face difficulty in raising capital from the markets. I do not think it is the merchant banker who overvalues the issue. Merchant banks only advise the issuing company on fixing the price band. Ideally, the price band should be arrived at as a consensus between the issuer company and the merchant bankers. The promoter naturally believes that he must get the best possible value for his company in the market. Now, the question to address is - what is the best price? Best price can differ in different markets. What was the best price in October last year may not be the best price today, when the markets are down. For instance, if in October 2010, the offer price of an IPO was Rs.100, and if today it is quoting at Rs. 90 or 80 or even 75, can we blame the decision of fixing the price at Rs. 100, taken in October 2010? The markets could as well have gone up every month and the stock could have been trading at well above the offer price now - at say Rs. 120 or even higher.

As per a recent article in Outlook PROFIT, in the IPOs managed since January 2005, SBI Capital Markets has the best performance ratio in terms of outperformers vis-à-vis underperformers at 16:15, whereas all other leading merchant banks have an adverse ratio. While we would
like to take some credit for this, the fact is that most public issues happen in buoyant market. At the time of issue, it is never in the minds of merchant bankers that the stock would not perform well post-listing. It is never the approach that once the issue is successful with the best possible pricing, the merchant bankers are not responsible for the stock’s performance. Otherwise you are not acting professionally. Also, we have to go back to the same investors time and again. We also need to stand by our reputation in the market. When the markets are doing badly, then you will find that many of the recent issues are faring poorly. In calendar year 2010 there were about 70 odd issues and I think more than 60-70 percent of these are quoting below the offer price, because the markets were doing well then and now the markets are down - especially for stocks of mid caps / small caps and a few sectors like infrastructure. It is also true that promoters, especially in bullish markets, try to sell the issues at as high a price as possible, since the general sentiments are positive. I wouldn’t even blame the promoters, because everyone wants to get the best possible price for their issue. Merchant bankers and the issuer discuss different price ranges and then a consensus is arrived and the price band is fixed. In a buoyant market, if the issue has been launched at - what is later perceived to be - a high price and is well subscribed, I think it would not be fair to blame either the issuer company or the merchant banker(s). Finally, it is a fact that, between the promoter and the merchant bankers, it is the promoter who aims to secure a higher price.

**SAIL FPO ISSUE FACED A CONTROVERSY REGARDING CONFLICT OF INTEREST FOR SOME OF THE MERCHANT BANKERS. WHAT DO YOU THINK ABOUT THIS CONTROVERSY?**

We do not think that there was any conflict of interest. In any case, the matter is now resolved and the SAIL FPO mandate is going on.

**DURING THE GLOBAL MELT-DOWN IN 2008-09, THE RATING AGENCIES WERE IN THE NEWS FOR ALL THE WRONG REASONS. DO YOU THINK RATING AGENCIES STILL HAVE CREDIBILITY IN THE MARKET?**

I would say that having ratings is much better than not having them at all. Their assessment has been wrong at times. The ratings need to be closely linked to the company’s actual performance, quarter-on-quarter sales / profit and the economic environment in general as well as the growth prospects for the company as well as the sector, etc. The rating agencies need to analyse the financial projections and accord the company the rating that it truly deserves.

**DO YOU EXPECT CONSOLIDATION IN THE MERCHANT BANKING SPACE, AFTER THE AXIS-ENAM DEAL?**

Yes, Indian merchant banking space is a little too crowded, in terms of number of players. I think the foreign banks are becoming quite strong and are looking to expanding their presence further in merchant banking here, also because there isn’t much activity happening in developed countries. So there is immense competition. There are quite a few domestic banks as well and lots of small merchant bankers have also come up. In the Axis-Enam deal, an investment bank with strong merchant banking capabilities and broking & distribution network has tied up with a large commercial bank, so that the synergies could be exploited. There could be more such deals happening in the future.

**WHAT ARE THE KEY TAKE-AWAYS FROM THE GLOBAL CRISIS FOR A FINANCE STUDENT?**

The global melt-down in 2008-09 was a great learning experience for all of us. The simple learning is - anything which looks extremely bright and rosy needs to be dealt with caution. Everything was going well in the US, when the crisis surfaced - with the real estate loans turning bad. Lack of prudence on the part of financial sector players - coupled with the relatively weak regulation - aggravated the problem. Rating agencies were also to be blamed. The culture of bonuses and performance-linked incentives also contributed to the crisis to some extent, although it would be unfair to single this out as the major factor. But greed, while it can propel growth and prosperity, has its flip side. India was fortunately not too badly affected, mainly because of our prudent banking policies & practices. As finance students, you should understand all these aspects of the global crisis, so that you can act in the right manner when you enter the industry.

**WHAT ACCORDING TO YOU, ARE THE SKILLS REQUIRED TO EXCEL IN MERCHANT BANKING CAREER?**

I think general awareness of the financial markets and knowledge of economics is very important. Domain expertise in a particular sector or capital markets can always be acquired. But if you are not aware about the developments taking place across the globe, then you will not acquire the overall perspective. You will not have the broad picture in mind while interacting with clients and other. You may do well in a niche area like regulatory or compliance, but not overall. My advice is to develop a genuine interest in the happenings in the worlds of finance, industry and economy, and read business newspapers, watch business news channels and keep updating yourself.
Goldman Sachs: World’s best M&A Adviser

Goldman Sachs, New York headquartered Investment bank has become world’s largest M&A adviser last year leaving behind Morgan Stanley headquartered in same city. Goldman Sachs has advised on 368 deals worth $553.5 billion compared to Morgan Stanley’s 393 deals worth $537.9 billion.

Facebook valuation more than Amazon

Facebook’s valuation topped Amazon.com, leaving the social networking company behind only Google among US Internet companies. Facebook is valued at $82.9 billion on secondary exchange whereas Amazon is valued at $77.2 billion. Amazon, the biggest online retailer, went public almost 14 years ago whereas Facebook is still to publish its financial results.

L&T To Split Into 9 Independent Entities

L&T has kicked off a restructuring plan that will divide the Rs. 37,000-crore engineering and infrastructure behemoth into nine virtual companies. Each of these independent companies’ will have a CEO, CFO and HR head and will manage its own profit and loss account. Each will even have its own board of directors with at least three independent directors. The L&T board has approved this restructuring, and implementation of the plan is on in full swing. The nine independent entities would be Power, hydrocarbon, machinery & product, switchgear, heavy engineering, infrastructure, building & factories, metals & minerals and electrical businesses. The restructuring is done to simplify the complex structure and is done because company could not find the successor of its current chairman AM Naik. The company has proposed the deadline year for its restructuring as 2015.

iGate acquires Patni Computers for $1.2 bn

iGate became the new owner of the Patni Computer Systems. The deal valued at $1.22 billion, is the largest acquisition of an Indian software exporter by another Indian firm. iGate is taking debt of $700 million from Royal Bank of Canada and Jefferies & Company to finance the transaction and also issuing equity of $270 million to Apax partners. iGate could make public offer of 10 million shares or increase the stock investment from Apax by another $210 million, taking it to $480 million.

China is No. 1 Economy By Purchasing Power

China overtook the US as the world’s biggest economy in terms of purchasing power. The size of China’s economy in 2010 was $14.8 trillion, compared with the US’s $14.6 trillion. In nominal terms, China’s output in 2009 was 34 trillion Yuan, or $5 trillion, at average exchange rates that year, trailing the US’s $12.9 trillion.

India’s M&A Market Jumped By 167% To $ 51 bn In 2010

The country’s M&A market saw a massive 166.5% surge in terms of deal value, amounting to $51 billion in 2010. Of this, the biggest was the over $10-billion Bharti-Zain deal. Even by number of deals done, the year saw a rise of 34.3%, with 282 M&A deals concluded during the year. India Inc’s appetite for overseas expansion continued unabated with 95 transactions through the year, worth $24.6 billion – the highest ever.

8 Indian MFs In World’s 25 Best Fund In Last Decade

Eight domestic equity mutual fund schemes, including SBI Magnum Contra, HDFC Equity and Reliance Growth, are among the 25 best performing open-ended equity
funds in the world of the last decade. The eight funds returned 31% to 38% on a compounded basis in the past decade whereas Sensex returned 17.8% on a compounded basis during the 10 years.

Real Estate: RBI Asked Banks To Put In Place An Escrow Mechanism

The Reserve Bank of India has asked banks to put in place an escrow mechanism that can ring fence their loans to real estate firms and keep a closer tab on the end use of funds. The central bank has been looking to tighten the lending norms for the real estate sector after last year’s bribery-for-loan scam involving LIC Housing Finance and some public sector banks. It also asked the banks to set up an escrow mechanism at the time of providing project loans to real estate companies. An escrow account will help in safeguarding the interests of the lender from repayment risk and in monitoring the end use of funds. An escrow account is a trust account in the borrower’s name. Payments from the customers of the borrower are deposited in this account to meet obligations, such as loan servicing. The escrow arrangement suggested by RBI will be operationised through a tripartite agreement between the developer, the banker and the homebuyer.

Government May Convert Funds In PSU Banks Into Equity

The government may convert its perpetual bonds and preference shares in state-run banks into equity, to help the lenders meet the Basel-III norms, a finance ministry official said. Banks would need Rs.6,00,000 Crore over nine years to meet the norms, according to a study by ratings agency ICRA. The Basel-III framework, which seeks to strengthen regulation, supervision and risk management in the banking sector, is to be implemented in phases beginning January 2013. The new prudential norms under Basel-III, which are yet to be finalised, will restrict Tier-I capital to common equity and retained earnings.

Rural Post Offices To Host ATMs

The government may allow post offices to set up automated teller machines, or ATMs, at rural areas, in an attempt to further strengthen the role of India Post in financial inclusion. India Post, which is working on major improvements in the payment process for social sector schemes like NREGA, will set up ATM networks in selected areas to give people access to online banking services.

NSE Appoints JM Fin To Help Cut NCDEX Stake

The National Stock Exchange (NSE), a founder shareholder of the seven-year-old National Commodity & Derivatives Exchange (NCDEX), has appointed investment banker JM Financial to bring down its excess stake in the commex to 5% by March-end. The bourse has to bring down its stake from 11.1% in keeping with a regulatory norm that restricts a single stock exchange’s holding in a commex at 5%. Forward Markets Commission (FMC), the regulator of the commodity futures market, amended the equity structure norms of commexes that had completed 5 years of operations in July 2010. Under this norm, NSE had time till December 31 2010 with the provision of an extension till March 31, 2011 to bring down the excess stake.

LSE To Buy Canada’s TMX & Create $4-trillion Bourse

The London Stock Exchange to buy Canada’s TMX to create the world’s fourth-largest bourse trading $4.1 trillion of stocks a year. The deal would create the No. 1 global centre of mining and energy stock trading and values the Toronto group at about $3.2 billion. If the combination survives likely political opposition in Canada, it will create a group with a market value of 4.3 billion pounds ($6.9 billion) based on Tuesday’s prices with LSE shareholders holding 55% and TMX shareholders getting a 6% premium.

RBI Investments In US T-Bonds Touch All-Time High At $41.1 B

The Reserve Bank of India’s investments in US treasury bonds touched an all-time high of $41.1 billion in December as returns improved. Moreover, the concerns in the euro area too mounted during the month, prompting the central bank to move to safer and liquid dollar assets. India figures among the top 20 investors in US treasury bonds.
U K Sinha Is The New SEBI Chairman

Mr. U K Sinha, the former UTI Chairman & Managing Director succeeded the SEBI chairman C B Bhave.

BP To Buy 30% In RIL Oil & Gas Blocks For $7.2 Bn

Global oil major BP will buy a 30% stake in Reliance Industries’ oil and gas blocks, including its trophy asset - the D-6 block for $7.2 billion as part of a long-term deal that involves a total investment of $20 billion, making it the biggest-ever foreign investment in India. Reliance and BP will also form an equal joint venture to supply market and trade natural gas, including LNG, which can deliver the fuel to millions of Indian homes and reduce the demand for subsidised liquefied petroleum gas.

PEs To Buy Into Hero Holding Company

Private equity firm Bain Capital and an investment arm of the government of Singapore will buy a 30% stake in Hero Investment Private Ltd (HIPL), which owns 17% of Hero Honda Motors, for 3,900 crore. The transaction, once concluded, will eventually give Bain Capital and the investment arm, GIC Singapore, an indirect holding of close to 13% in India’s largest two-wheeler company. Munjals, the family that set up Hero Honda in a joint venture with Japanese auto major Honda Motor Company 27 years ago, will buy out the foreign partner’s 26% stake at half the current market price. The Hero Group will have to pay about 3,900 crore to Honda.

Latin America: The Next Battle Ground Between The Asian Dragons And The World Power House

The $10bn package agreed with the China Development Bank was another sign of China’s surging influence in Latin America, transforming the region’s economies and undermining US dominance in its traditional “backyard.” It has lifted growth for years in commodity producers such as Brazil, Argentina, Chile and Peru with its voracious demand for raw goods such as iron ore, copper. More recently, it has followed up with a wave of investments and state-backed loans aimed at expanding its access to commodities and tapping demand from Latin America’s growing ranks of consumers. In doing so, China has emerged as an alternative source of funding for Latin American countries’ development in areas such as infrastructure and energy that were long dependent on World Bank or IMF loans that came with more strings attached. China’s growing economic stake in the region may one day raise a threat to Washington’s strategic dominance too as its deep pockets bring new friends.

Losses of Earthquake & Tsunami In Japan Reach U.S. $ 309 Billion

The Japanese government said the losses due to earthquake and tsunami that struck the country early this month could reach U.S. $ 309 billion. It is a calculation of the Cabinet Office of Japan from total devastation that occurred in infrastructure, residential buildings, and offices in Japan. A 9 magnitude earthquake and the tsunami that occurred on March 11 had destroyed the northeast region of Japan and caused thousands of people dead and triggered a nuclear crisis. The Japanese government plans to inject fresh funds into banks as loan funds for companies that are trying to rise from the devastating disaster. The funds are planned to be taken from emergency fund of U.S. $ 135 billion, which is prepared at the breaking of Lehman Brothers in 2008. In addition, Tokyo is also currently preparing soft loans amounting to U.S. $ 122 billion to help companies that were damaged by earthquake.

Global Supply Chain Take A Hit Post The Japanese Tsunami

Companies across sectors are feeling the ripple effect of the Japanese tsunami. Companies like Nokia, HTC, Nippon Steel and many more are said to have been affected from the breakdown in the supply chain.

RBI Hikes Interest Rate As Inflation Threatens Growth

India’s central bank has raised interest rates again as it
continues to fight rising prices in the country. The Reserve Bank of India raised the cost of borrowing from 6.5% to 6.75%, the eighth rise in the past year. India has come out of the global recession as one of fastest-growing economies in the world. But, rising prices of food and essential commodities have been threatening to slow down growth.

Too Much Hot Money

With slowdown in FDI by 25 per cent, India’s dependence on FII inflows, considered as ‘hot’ money for maintaining its current account, has increased this fiscal. Moreover, the gap between the foreign direct investment (FDI) and the inflows from foreign institutional investors (FIIs) mainly in the stock market has grown to USD 14 billion in 2010-11, according to the latest official data. The problem with FIIs is that they are quite fickle in nature, with the US economy showing signs of recovery and with the Indian scenario marred with inflation, the FIIs tend to move out. With a dipping FDI, an outgoing FII would surely cause some headache for the RBI, which is battling to keep the inflation under control.

Warren Buffet’s India Plans

Warren Buffett’s Berkshire Hathaway has made an entry into India through the insurance distribution business. Berkshire will directly market motor and other retail insurance products of private insurer Bajaj Allianz through a corporate agency. Berkshire India, a majority-owned unit of Berkshire Hathaway Inc has been incorporated and has received a corporate agency license from the IRDA to sell and distribute general insurance products in India through their online distribution portal.

FM Seeks Allies’ Support for Consensus on Insurance Bill

Finance minister Pranab Mukherjee is seeking support from other political parties to push through the Insurance Laws (Amendment) Bill 2008. If amended, the new law will make it possible for foreign direct investment in this sector to go up from 26% to 49%. The Bill is, however, pending to be introduced in the Parliament since 2008 as the Left, the then allies, were strongly opposing the bill. Many potential foreign investors, including legendary investor Warren Buffet, are among those waiting for the bill to be cleared to bring in investments in this sector.

New IIP Soon With 2004-2005 As Base Year

The government is all set to roll out the new Index of Industrial Production (IIP) as agencies involved in its preparation have removed the glitches that cropped up during its trial runs. The IIP measures growth in factory output, mining and electricity generation. The Central Statistics Office (CSO), which is responsible for coordination of statistical activities in the country, has given its recommendations on the new IIP to a committee of secretaries, a senior official in the ministry of statistics and programme implementation said. The new index should be out by the second week of June where we would get new growth figures from April onwards. The new index will have a base year of 2004-05 against 1993-94 for the current one. The CSO has agreed to include the unorganised sector in the new index, as suggested by a panel headed by Planning Commission member Saumitra Chaudhuri. This is expected to make the index capture factory output better and address criticism that the current index was under estimating production.

India’s core Infrastructure Industries Grew 6.8% in February 2011

India’s core infrastructure industries grew 6.8% in February from a year ago, raising prospects of overall industrial growth in the quarter ending March. The six key industries include crude oil, electricity, petroleum refining, finished steel, cement and coal - had expanded by 4.2% in February 2010. Although the growth in February was slower than the upward revised growth of 7.2% for January, it was faster than the average growth of 5.7% clocked between April 2010 and February 2011.
In mid February 2010, when the entire global economy was poised on a recovery, the International Monetary Fund suggested that Central Banks should hike their inflation targets. This brought into fore-front an ongoing debate on inflation targeting, its need and its success.

In a white paper, titled “Rethinking Macroeconomic Policy” IMF Chief Economist Olivier Blanchard, along with Giovanni Dell Ariccia and Paulo Mauro suggested that Central Banks across the world raise their inflation targets from the current range of 2% to around 4%. The explanation cited was that this gives Central Banks more room to act in a situation of crisis. In other words monetary policy can respond better in a situation of shock as in the current financial crisis.

WHAT IS INFLATION TARGETING?

Inflation Targeting is pursued as a monetary policy by many Central Banks in which the Bank estimates and publicly declares a “target” rate of inflation and attempts to keep the actual inflation around the target level. Interest rate is the prime monetary tool used. When actual inflation exceeds the target, the interest rates are hiked to choke liquidity and spending and vice versa when actual inflation is below the target.

The main characteristics of inflation targeting are as follows:

- A public announcement of a target rate of inflation.
- Acknowledging that a stable and a low rate of inflation is the priority of Central Bank.
- Communicating to the public the policies taken by the Central Bank to achieve the target.
- Increasing accountability of the Central Bank.

In the pre-crisis period, Central Banks led by New Zealand steered monetary policy to achieve price stability. This was reasonably successful. The belief was that price stability brought financial stability. This belief was proved wrong by the financial crisis. Indeed not only is there an absence of link between the two, there might actually be a tradeoff where price stability might cause greater financial instability. The IMF suggestion of a higher target translates to a higher interest rate which implies that the central banks have scope to reduce interest rates if a crisis occurs. The current financial crisis saw many large central banks facing near zero rates of interest which implies that there were very little effective monetary policy options left to stimulate the economy. Under the policy of setting a target, the investors are aware of the Central Bank’s target of an inflation rate and hence all interest rate changes in the future are factored in. This is expected to promote economic stability.

The history of inflation targeting can be led back to Keynes in 1923, who suggested exchange rate fluctuations as a means to achieve a target rate of inflation. Whenever there was an international inflation, he suggested that currency be appreciated and the opposite when there are international deflationary forces. After the Bretton Woods system, the interest in inflation targeting reduced significantly as the exchange rates were pegged. In 1990, New Zealand pioneered Inflation targeting. Since then many more countries have taken up a policy of inflation targeting. They are Chile in 1991, Canada in 1991, Brazil in 1999, Australia in 1993, Israel in 1991, Mexico in 1999, United Kingdom, Czech Republic, Poland, South Korea, Egypt, Columbia, South Africa, Hungary, Thailand, Iceland and Norway.

Inflation Targeting is a debated issue as price stability might not always imply economic stability. Inflation is measured in most economies by a change in prices of consumer goods. This is called the Consumer Price Index (CPI). There is certainly a link between this figure and increase in money supply but the former does not always indicate the latter. When prices in the domestic economy increase due to external shocks such as oil price hikes, inflation increases although money supply may remain the same. In such circumstances, the hike in interest rates will not affect inflation. If inflation is a supply side concern then the interest rate adjustment has marginal impact on inflation. Instead, increasing interest rates may adversely impact growth. A serious objection to inflation targeting has been suggested by the “Dynamic strategy theory”. This suggests that inflation targeting disturbs the long run dynamic
mechanism. The growth inflation tradeoff suggested by the Philips curve supports this view.

The IMF view by Mr. Blanchard suggests that with a higher target, interest rates would be higher. Hence in case of a crisis as the one just faced, the Central Bank has margin to reduce interest rates and policy making is not dependent on fiscal policy alone. The Central banks such as Fed having already reached the floor on interest rates had to resort to extensive quantitative easing. With inflation Targeting, Monetary policy would thus become more effective in any crisis. IMF also suggested automatic cash transfers to the poor when unemployment is high as well as exchange rate intervention for small economies. According to them, the “flaws in the pre-crisis framework forces us to think on the architecture of post crisis macroeconomic policy”. With a 4% inflation rate, short term interest rates would hover around 6 to 7% giving Central Banks enough room to cut rates.

The higher level of inflation would require an adjustment of tax brackets such that higher inflation does not push tax payers into higher tax brackets. Investors could be protected from the costs of higher inflation by inflation adjusted bonds. The following box shows the current inflation rates for major economies in the world in January 2011. Most of the Central banks have an inflation target of 2%.

![Inflation Rates Chart]

(Source: www.tradingeconomics.com)

TAYLOR’S RULE

Taylor’s rule is a monetary policy rule that indicates how much a central bank should change interest rates when the target rate differs from the actual rate. It was proposed by John Taylor in 1993. The rule suggests a “tight money policy” - high interest rates when the actual inflation is above target and vice versa. An increase in inflation by one percent point should be accompanied by a hike in interest by more than one percentage point. According to Taylor, this rule was not followed in the US in 2000s leading to the housing bubble. Taylor also suggested that if GDP falls by 1% relative to its potential, interest rates should be cut by half percentage points.

SHORTCOMINGS OF INFLATION TARGETING

Monetary policy according to the proponents of inflation targeting has been given the sole responsibility of maintaining prices. In doing so, one important policy tool - fiscal policy have been ignored. According to the famous Tinbergen rule two instruments should be chosen for two objectives. In other words monetary and fiscal policy should jointly work in achieving low inflation and high growth rate. Currently, inflation control has become the sole responsibility of the Central Bank whereas Fiscal policy is concerned with growth and employment. Also in their zeal to achieve the target, the Central banks have played with interest rates alone, and thereby created asset bubbles as was visible in the US. Hence, financial stability has suffered.

INFLATION TARGETING & FEDERAL RESERVE

After being latent for many months, inflation targeting as a policy option was back in the US in January 2009. Ben Bernanke, the FED Governor and Frederic Mishkin, have always argued in favor of inflation targeting as a way to economic stability. Their approach involves the public announcement of official target rates and increased accountability in the operation of the Central Bank in the achievement of those objectives. But earlier suggestions were rejected by Congressional opposition in 2007. In December 2008, following the crisis, the FOMC declared that a “more explicit indication of their views on what longer run inflation would best promote their goals of maximum employment and price stability “This would control inflation expectations and hence keep real interest rates low such that aggregate demand could be encouraged. So far inflation targeting was seen as an anti inflationary tool and hence went hand in hand with monetary tightening with a positive bias towards price stability rather than higher employment. Given the Japanese crisis and subsequent deflation, one realized that inflation expectations work in the negative direction
as well. An inflation target in a situation of recession would tell the public that the central bank can use other means such as quantitative easing to prevent prices from falling any further. It would also give confidence that when the credit programs and fiscal stimuli are unwounded, the FED would control the resulting inflation.

Allan Greenspan, as the earlier chairman of the FED had opposed announcing a target as he believed that a publicly announced rate would take away the flexibility of Central Bank to respond to any crisis. Greenspan predicted a period of high increase in productivity which would curb inflation and hence made fellow policymakers reduce interest rates although most forecasts suggested accelerating inflation. This made the economy grow but sowed the seeds of the financial crisis later. Bernanke on the other hand believed that a “transparent “Federal policy would promote stable economic growth as it would give more certainty to consumers and producers about future rates of inflation. In fact as a complete contrast, he suggests that inflation targeting gives more flexibility to manage recessions. The FED had in fact removed official targets and instead in 2007 extended their inflation forecast horizon from two to three years. However it never really worked and the Fed admitted that the inflation forecast of 1.4-1.7% may be below what in their opinion was consistent with price stability.

In words of Mishkin, “increase in horizons is not long enough to substitute for a target” The important issue is to anchor inflations on either side. As Mishkin, who co authored a book on inflation targeting along with Bernanke Wrote:” the key issue is the management of expectations.”Till recently inflation targeting was seen as anti inflationary tool. But if a scenario like Japan occurs where inflation expectations move in the negative direction, it will be as much a matter of concern.

There is enough criticism that Bernanke’s 2% target led to the asset price bubble. Hence there is an apprehension that 4% might create bigger asset bubbles.

**INFLATION TARGETING & EUROPEAN CENTRAL BANK**

The ECB’S monetary policy strategy provides a quantitative definition of price stability. It has defined price stability as a year on year index of consumer prices for the Euro area of below 2%. This is to be maintained over the medium term. In order to maintain price stability the ECB uses a two pillar approach - economic analysis and monetary analysis. ECB does not follow formal inflation targeting. There is concern that if the EU goes for a 4% target now, it will spell disaster for economies like Spain and Greece. In fact the policy of one interest rate for all members saw massive inflation in Spain but not in Germany.

**UNITED KINGDOM**

The 1998 Bank of England Act made the Central Bank independent to decide on interest rates. There is full transparency and the Bank is accountable to the parliament and to the public. If the target of 2% is crossed by one percent or the inflation falls below 1%, the Governor of the Bank has to write an open letter to Chancellor explaining why the target was missed and what are the proposals to bring it back to target. The Central Bank tries to achieve the target through interest rate changes. The interest rate is decided by a Monetary Policy Committee (MPC). This committee consists of nine members, five from the Bank of England and four appointed by the Chancellor. The chair person is the Governor of the Bank of England. Decisions are made by votes of the members.

Every quarter, the Bank publishes its Inflation Report which provides a detailed analysis regarding prospects of growth and inflation. The interest rates are not changed continuously to achieve the target. Instead the MPC sets the interest rates in a way that the inflation can be brought to the target within a certain period of time. In January, the inflation target was crossed by one percentage point requiring the governor to Governor Mervyn King to write an open letter to the Chancellor.
SOUTH AFRICA

From February 2000, South Africa adopted a policy of formal inflation targeting. The target band was kept within 3% to 6%. Since 2006, South Africa has continuously increased its interest rates in order to achieve its inflation target. This was completely contrary to policies taken by other Central Banks who either lowered or at least maintained their interest rates in the same period. Interest rates went up to almost 13% before the financial crisis. After the financial crisis, South Africa lowered its interest rates but still remained comparatively high at 7.55. As a result, the housing and automobile industry suffered major losses. In 2009, Stiglitz, the Nobel Prize winner cautioned South Africa that in view of the current crisis inflation targeting should get a lower priority.

South Africa has been outside the target band for the past two years raising questions of how effective an inflation target can be.

INFLATION TARGETING & RESERVE BANK OF INDIA

According to Dr. Subbarao, the current RBI Governor, “pure inflation targeting is inadvisable and the mandate of Central Banks should extend beyond price stability.” According to him, price stability does not ensure financial stability. Actually there is a trade-off between the two and more the Central Bank concentrates on price stability, more it puts financial stability into danger. Though there is an inflation forecast made in the monetary policy, the number is not used to make changes in policy rates. According to the Central Bank, the RBI has a “reasonable framework for controlling inflationary expectations”. In its latest policy review the RBI has raised its inflation projections from 5.5% to 7% for end March.

If the Central Banks aim towards financial stability, they must avoid excessive volatility of interest rates and exchange rates as well as avoid illiquidity in the financial markets and institutions. To achieve the role of central bank as the lender of the last resort cannot be undermined.

CONCLUSION

Inflation Targeting goes much beyond a public announcement of an inflation target. Emerging economies must have a strong fiscal discipline and sound financial institutions in order to make it successful. The basic premise of inflation targeting rests on the idea that an officially declared target will achieve a stable rate of inflation and anchor inflationary expectations. However cross country experience of inflation targeting has not yielded positive results. Countries such as New Zealand, Australia, South Africa, and United Kingdom show no better results in inflation management than countries who have not adopted it such as US, Japan and European Union. Inflation targeting albeit with a higher target needs to be restructured to take into account the need for financial stability.
Indian economy is one of the few economies in the world to have both fiscal and current account deficits. Hence it is also termed as a twin deficit economy. The few economies which are a member of this club are US, UK, Greece, Ireland etc. In other words, this membership is nothing to be proud of as all these economies have faced severe recession in 2007 crisis.

An economy is seen as crisis prone if it runs even one of the deficits persistently. Fiscal deficit (FD) means government expenditure is more than its revenues leading to government borrowing from markets. This leads to government absorbing higher portion of domestic savings. This leads to both crowding out of private sector and higher interest rates which could lower the private sector investment and consumption. In many economic history cases, we have seen governments resorting to printing press to manage their deficits leading to hyperinflation as seen in cases of Germany, Hungary and Zimbabwe.

**Current account deficit (CAD)** means imports are higher than exports. An economy manages its CAD by foreign savings/foreign capital inflows. Unlike FD the impact of current account deficit is less clear. Ideally, it should lead to depreciation of the currency but the currency can actually appreciate if capital inflows are more than the current account deficit (like in the case of India).

In case of twin deficits, an economy needs both domestic savings and foreign savings to manage its deficits. In normal times, both can be managed but in case of a shock, the deficits could lead to a severe crisis. The impact of twin deficits has to be taken more seriously now as we have multiple cases of twin deficit economies in crisis and this includes developed economies.

Before we understand the twin deficit situation in India, let us do a quick review of twin deficit economies in the 2007 crisis. In some the deficits acted as a trigger for the crisis and in others it worsened the impact of the crisis. For instance, US economy has been running twin deficits since 1980s. In the 2007 crisis, government could not intervene aggressively as fiscal position had worsened over the years. Some economists criticized the fiscal stimulus as very small compared to the size of the US economy. Others criticized that the fiscal stimulus has made the situation of US public finances highly precarious and will affect growth over a long-term. As far as US CAD is concerned, it is one side of the global imbalances debate with high savings of developing economies (in particular China) being the other. These imbalances did lead to spillovers with financial crisis & sub-prime crisis becoming a global crisis.

![US Twin Deficits (% of GDP)](chart.png)

(Source: IMF, OMB)

In UK, persistent FD put the government in similar problems like US. The scale of the problem was worse for UK as it depends more on financial sector. Hence, the pressure on UK government was more as the financial firms suffered and tax revenues declined. The situation has normalized now but it raises the dilemma of how to control financial sector size and also ensure tax revenues don’t decline. One is also waiting to see the impact of fiscal austerity in UK. In terms of CAD, GBP depreciated significantly in wake of the crisis. So, there was more currency adjustment in UK than US. This led to better export potential but pushed inflation higher.

The EMU economies ran their own mini imbalances with some economies like Germany running current account surpluses whereas others like Greece and Ireland running deficits. As it was a monetary union, currency adjustments were not possible. So, the four economies had to adjust internally via lower wages which was difficult given inflexible labour markets. People also could not migrate to more prosperous regions like Germany given vast cultural differences and language issues. Then countries like Greece ran huge fiscal deficits as well violating the Stability and Growth Pact under which fiscal deficits of EMU economies have to be
capped at 3%. The crisis put pressure on EMU economies to generate both foreign and domestic savings to manage their deficits. A late help from EMU members prolonged and worsened the crisis.

To sum up, for US and UK twin deficits amplified the crisis fallout whereas they acted as a kind of a trigger for the EMU crisis.

India has been running persistent twin deficits since 1980s. Current account deficit has still been around 1% but fiscal deficit has remained at an average of 5.8% for the period 1980-2010. If we include the state deficit as well, the combined fiscal deficit shows an alarming average of 7.8% for the time-period. It is not that India has managed to escape a crisis despite running these twin deficits for such a long time.

The real concern is we have not managed to learn any lessons from our economic history. The 1991 crisis is widely known as the balance of payments crisis but was basically a twin deficit crisis. The earlier research on the 1991 crisis said it was basically a result of high current account deficit and inability to finance it via capital inflows. Later research showed that it was actually a fiscal crisis in mid 1980s that led to the BoP crisis. In the first half of 1980s the total fiscal deficit was around 6.0% to 7.5% levels. It increased to touch around 9% levels from 1985 onwards. Revenue deficit also continued to rise, implying much of the expenditure was going to meet expenditure of Government. As fiscal deficit was high, there was crowding out of domestic savings. The investment was mainly financed by borrowings from abroad, which proved to be inadequate as concerns over both fiscal and current account deficit rose. The confidence in economy deteriorated and resulted in BoP crisis. Hence, we have already had a situation where twin deficits in the past acted as a trigger for a wider crisis in the economy. India had to take assistance from IMF and Bank of England to come out of the crisis. The crisis also led to much-needed reforms in the economy but the deficits still continue.

Within the two deficits, persistent and high fiscal deficits remain the major worry as seen earlier as well. India never really managed to lower the fiscal deficits despite the 1991 crisis, leading to implementation of Fiscal Responsibility and Budget Maintenance Act in 2003 (FRBM). The fiscal deficits did come down after FRBM but the actual numbers were much higher as certain bonds like oil, food and fertilizers were kept off the balance sheet and were not accounted. The adjusted fiscal deficit showed fiscal deficit was higher by 0.5%-1% from the reported figures depending on the bond issuances.

Shankar Acharya a noted economist said that despite fiscal prudence being the big-bang reform of 2000s, it still remains a major concern. The 2007 crisis again led to widening of the deficit and combined fiscal deficit has again touched the highs seen in 1986-87 and 2000-03 period. Fiscal deficits rose in other economies as they faced steep crisis but this was not the case in India. The growth did slow to touch 6.8% in 2008-09 but was much higher than the decline seen in other economies. Revenue deficit as a % of GDP increased from 41.4% in 2007-08 to touch 75.2% on 2008-09, implying much of the deficit was actually to cover the revenue expenditure of the government.

In the third quarter review of monetary policy, RBI pointed that financing of CAD is as important. If it is financed primarily by short-term flows it could lead to a problem as the flows can dry once advanced economies start to pick-up. This indeed is the case as India’s CAD is financed majorly by short-term flows like FII, ECB, short term trade credit etc. This is similar to the trends we saw before the 1990-91 crisis, though this time we also have equity flows compared to just debt flows then. RBI has stressed that this widening of CAD is not sustainable and there is “a need for concerted policy efforts to diversify exports and contain the CAD within prudent limits.”

The Government has promised to lower the deficits going forward. The fiscal deficit for 2011-12 is pegged at 4.6% of GDP with expenditure projected to rise by just 3%. Economists have said this is so far the strongest intent shown by government for fiscal consolidation. It will be interesting to see whether the promises are kept by the government.

Summing up, twin deficits remain a major risk for Indian economy going ahead. The policymakers need to remain vigilant and work towards reducing these twin deficits.
The Union Budget 2011

The Union Budget FY12 has been presented at a time when the Indian economy is heading towards a high growth trajectory, albeit certain challenges such as elevated inflation, high current account deficit, and moderating growth of industrial production, which have surfaced in the recent past. At the current juncture, what was required from the Budget was to address the issue of inflation and support growth momentum, while maintaining the focus on fiscal consolidation and continuing ahead on the reform agenda. Increased allocation of planned resources towards infrastructure projects along with the proposals to direct foreign funds and private saving towards infrastructure sector will unlock much of the growth potential of the sector. The FM’s measures to control the deficit and the plans to reduce borrowing have been positive for the markets. This would give adequate room for the private investments to grow with the crowding out fears being shelved off.

The emphasis is now on addressing structural concerns such as weak supply chain linkages, and shortcoming in distribution and marketing systems of agriculture commodities. This is expected to provide long term solution to these issues, which have been contributing to high inflation in the past. Nonetheless, effective and timely implementation of proposed initiatives remains the key to tackle these long pending issues in the agricultural supply chain.

**DIRECT TAXES**

- Basic exemption limit marginally increased to benefit individual tax payers. Corporate tax rate remains unchanged.
- No change in the corporate tax rate except for a reduction in the surcharge on tax from 7.5 percent to 5 percent in case of domestic companies and from 2.5 percent to 2 percent in case of foreign companies.
- Rate of MAT increased from 18 percent to 18.5 percent. Levy of MAT extended to Limited Liability Partnerships, SEZ Developers and Units operating in SEZ.
- Dividend Distribution Tax exemption withdrawn for SEZ Developers. Dividends received by Indian companies from their foreign subsidiaries during Financial Year 2011-12 to be taxed at a concessional rate of 15 percent on a gross basis.
- Income of notified Infrastructure Debt Funds to be exempt from tax. Interest received by non-residents from such funds to be taxed at a concessional rate of 5%.
- Tax holiday for undertakings engaged in the power sector and commercial production of mineral oil – commencement date extended to 31 March 2012.
- Employer contribution towards pension scheme shall be excluded from the limit of 1 lakh provided under Section 80CCE.
- Specific deduction allowable to the employer on contributions towards the New Pension Scheme up to 10 percent of the salary of the employee.
- Additional deduction of INR 20,000 for investment in long term infrastructure bonds is extended for one more year.
- Collection of information on requests received from tax authorities outside India in terms of Tax Information Exchange Agreements.

**INDIRECT TAXES**

- Constitutional amendment bill for GST would be tabled before the Parliament in the current session.
- 4% excise duty on a few products has been increased to 5 percent (such as prepared foodstuffs, paper and articles of paper, textile intermediaries and textile goods, medical equipment, medicaments, etc.).
- Duty of 5 percent levied on specified products which were earlier exempt. Option of payment of excise duty at 1 percent on around 130 specified items (without CENVAT credit) has been provided.
- All items attracting basic customs duty of 2 percent and 3 percent will now attract uniform rate of 2.5 percent duty.
- Ambit of service tax enhanced to cover hotel accommodations above INR 1,000 per day, air conditioned restaurants with licenses to serve liquor.
- Changes proposed in Export and Import Rules for certain services as well as service tax refund scheme for SEZs.
- Radical changes have been introduced under the CENVAT credit scheme.
- Maximum VAT/ sales tax to be levied on ‘declared goods’ (coal, cotton, cotton yarn, crude oil, hides and skins, iron and steel, jute, LPG for domestic use
and oil seeds etc.) under the CST Act to be enhanced from 4 percent to 5 percent.

- Several changes proposed on the tax administration front including facility of self-assessment introduced for import/ export clearances.
- Rate of interest in case of short/ delayed payment of customs/ excise duty and service tax to be increased from 13 percent to 18 percent.

**BUDGET FINANCIALS**

**Sources of Rupee**

- Corporation Tax
- Income Tax
- Customs
- Union Excise Duties
- Service Tax & Other Taxes
- Non-Tax Revenues
- Non-Debt Capital Receipts

The Annual Financial Statements of the Government of India (GoI) for 2010-11 are set to reflect a fiscal deficit of 5.1% of GDP, lower than the budget estimate of 5.5% for 2010-11. The target fiscal deficit for 2011-12 is 4.6%. For 2011-12, revenue deficit is estimated to be 3.4% of GDP, which is the same as the revised estimate for 2010-11. Market borrowings are expected to finance 83.09% of the Government’s fiscal deficit in 2011-12. According to the revised estimates, the interest outgo as a percentage of the revenue receipts is set to decrease considerably to 30.72% in 2010-11 from 37.20% in 2009-10 and is estimated to be 33.93% in 2011-12. Gross tax revenues are at INR 9,324.40 billion, representing an increase of approximately 18.50% over the revised estimates of INR 7,868.88 billion for 2010-11. Planned expenditure is at INR 4,415.47 billion, representing an increase of approximately 11.78% over the revised estimates of INR 3,950.24 billion for 2010-11.

**Utilisation of Rupee**

- Central Plan
- Interest Payment
- States’ Share of Taxes & Duties
- Defence
- Other Non-Plan Expenditure
- Subsidies
- Plan Assistance to State & UT
- Non-Plan Assistance to State & UT Govts

**SECTORWISE IMPACT**

**Infrastructure: Focus Remains For Key Economic Development**

- 44% of total plan outlay allocated to infrastructure & 
  Budget allocates Rs 1.73 lakh crores for Infrastructure.
- IIFCL to double disbursement & refinance.
- Delhi-Mumbai industrial corridor taken up for development.
- Road transportation kitty increased 13% to Rs 19,894 crores.
- Government allocates Rs 16,500 crores for railways.
- Rs 66,100 crores allocated for rural development in FY11.
- 35% of development funds to be invested in rural India.
- Urban development allocation up more than 75% to Rs 5,400 crores.
- Allocation for Bharat Nirman at Rs 48,000 crores.
Additional Rs 20,000 tax deduction available for investment in long term infrastructure bonds.
Government committed to SEZs to promote exports.
Full exemption from import duty for specified machinery for road construction projects.

**Real Estate: Encouraging Affordable Housing**

- The construction period for real estate builders to avail benefits under section 80(10) has been extended to 5 years from 4 years.
- Rs.12.70 billion has been allocated for Rajiv Awas Yojna for slum dwellers, up from Rs.1.50 billion, an increase of 700% with the aim of creating a slum free India.
- Rs 100 billion have been allocated for Indira Awas Yojna.
- Interest subvention scheme for home loans extended till March 2011. Under the scheme, home buyers get 1% interest subsidy for loans up to Rs 1 million, provided the cost of house does not exceed Rs 2 million.

**Power Sector: FM Doubles Allocation**

- Allocation to the power sector has been doubled to Rs 5,130 core in Budget 2010.
- Announcement to form Coal Regulatory Authority - The move will help expedite the process of allocation mining resources to consuming firms.
- Solar energy also found a special mention in the Union Budget. The government proposes to establish a national clean energy fund and is targeting the setting up of 20,000 MW of solar power by 2022.
- Increase in allocation to renewable energy sector at Rs. 1000 Cr (increase by 61%)
- Clean energy cess of Rs. 50/MT on both domestic and imported coal.
- Excise duty on photo-voltaic and solar panels has been waived while central excise on LED lights have been cut to 4%.

**Banking & Financial Services: Budget 2010 Aims To Improve Growth Prospects**

- RBI to consider giving banking licenses to Private Sector Companies / NBFCs.
- Government of India to recapitalize Public Sector Banks by Rs 165 billion to maintain Tier -1 ratio above 8% by FY11E end - Infusion of capital to improve capital adequacy of banks.
- Regulatory framework for the financial sector to be strengthened: Apex level financial stability & Development council to be set up.
- Increase in interest subvention from 1% to 2% for the farmers who pay as per repayment schedule.
- Extension of debt waiver and debt relief scheme for farmers extended by six months to June 30, 2010.
- GOI’s focus on financial inclusion through introducing/improving financial service penetration & focus on rural budgetary allocations would improve the growth prospects of financial service sector.

**Oil & Gas Sector: Low Reforms & High Taxes**

- Continue to provide oil subsidy in cash instead of bonds - The industry expected a clear subsidy-sharing mechanism of cash subsidy/oil bonds and clarity on tax breaks for natural gas produced under NELP I-VII.
- GoI promised to discuss Kirit Parikh report in due course. The sector expecting de-regulation & an increase in fuel and gas prices. Industry is optimistic that some of the recommendations made by the Kirit Parikh committee would see light of the day.
- Oil exploration & production companies would be hit by increase in MAT from 15% to 18%.
- Restoration of basic customs duty of 5% on crude petroleum, 7.50% on petrol and diesel and 10% on other refined petroleum products.
- Enhancement of central excise duty on petrol and diesel by Rs. 1/litre each.
- Post budget announcement of hike in petrol and diesel prices by Rs. 2.67/litre and Rs. 2.58/litre respectively.

**Auto Sector**

- Hike in excise duty from 8% to10% - Would benefit companies with tax haven operations.
- Excise duty on large cars, SUVs, multi utility vehicles raised to 22% from 20%.
- Implementation of GST would prove to be beneficial for auto companies. The GST aims to bring other taxes like excise, VAT, CST and other taxes under one umbrella and the GST rate may be lower than the combined total of the current taxes.
- Another minor positive for auto companies is the weighted increase in research and development (R&D) exemption from 150% to 200%.
- Allocation for road development increased by 13% to Rs. 198.94 billion - Continued thrust on rural India will further improve demand for 2 wheelers, cars and LCVs.

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Rahul Mahajan  
PGDM 2012  
rahulmah86@gmail.com
Private Equity: Opportunities & Challenges

The world today sees India as a land of opportunity and a driver of global growth. The sustainability of our growth story as well as our resilience to external shocks as severe as the recent global financial crisis makes the Indian growth story more attractive.

This has attracted various financing institutions such as Private Equity (PE) firms to set up shops here. Major global PE firms such as KKR, Blackstone, Bain Capital, Warburg Pincus, Sequoia Capital and many others have already invested billions of dollars in Indian enterprises. Broad economic forces, including robust GDP growth and rapid expansion in both manufacturing and service industries, have been major draws for PE interest.

Since then, the PE funds have actively contributed to India’s growth. Many young Indian firms still have only limited access to capital through the public equity markets, and PE investors have stepped in to fill the void. Growth capital has become a preferred source for mobilising funds in India, and many Indian companies have aggressive growth and investment plans. Therefore, PE funds can play an important role as financial backers of entrepreneurial Indian companies.

“Private Equity is an asset class consisting of equity securities in operating companies that are not publicly traded on a stock exchange. The most common investment strategies in private equity are leveraged buyouts, venture capital, growth capital, distressed investments and mezzanine capital. Here the private equity firm buys majority control of an existing or mature firm”.

SIGNIFICANCE OF PRIVATE EQUITY

Private Equity offer distinct benefits to the companies in which they invest. In early-stage investments, they foster entrepreneurship, providing capital and expertise to first-generation company founders. As companies grow, PE firms provide deep industry knowledge and operational expertise derived from their previous work in the industry and the experiences of other companies in their portfolios. By tapping their extensive networks of experts and international relationships, they help their portfolio companies expand internationally or facilitate cross border mergers and joint ventures.

In India, PE has become a significant source of capital for Indian companies. The major reason being the India’s capital hungry businesses which are looking for various avenues to fund their growth plans. The second is the expanding size and geographic reach of private equity as one of the world’s most powerful sources of value creation.

The structure of a generic Private Equity (PE) fund is depicted below:

PRIVATE EQUITY INVESTMENTS

The PE investments in India have increased significantly and amount to $40 billion over the past 5 years (2006-2010). PE activity witnessed a revival in 2010 with $7.5 billion investments as compared to $3.6 billion but it is below 2007 peak of $13 billion. The PE firms have participated in more than 1500 transactions over the past 5 years (2006-2010). Usually the deal sizes in India are small compared to those in mature markets such as USA and European Union.

However, a significant number of transactions occur above $50 million which is targeted by the established PE players in India and $23 billion (58% of overall investment value) was invested in transactions above $50 million over the past 5 years (2006-2010).

The transactions in India are predominantly minority investments, usually late-stage growth capital in private companies or Private Investment in Public Equities (PIPEs). Greater than 90% of transactions are minority transactions. As a consequence, PE funds play a less active role than in majority or buyout situations, and participation is generally limited by promoters to a board seat and corporate governance roles. The investments in
private companies dominate the landscape and more than 80 percent transactions over past 3 years were in private companies.

Nearly 80 percent of the funds invested in India were sourced internationally (according to Bain Report/IVCA 2010 Report).

There are significant numbers of PE firms operating in India as of now. About 300 PE/VC funds operate in India. Most funds invest opportunistically across a broad spectrum of industries, and sector specialists are a rarity.

More than 30 per cent of PE investments in India have been made in companies that have since grown into the nation’s 500 largest firms (according to Bain report/IVCA 2010 report). Successful examples include Bharti Airtel, GMR group and Idea Cellular.

Opportunities

**INDIA OFFERS AN ATTRACTION AND UNIQUE INVESTMENT DESTINATION:**

- India’s is the 11th largest economy with a GDP of $1.2 trillion and is the 2nd fastest growing economy which is expected to become the 3rd largest economy in the world.
- As growth in western markets is expected to be sluggish, India and China continue to be dynamic emerging markets driving global growth.
- Some investors view India to be less opaque and culturally easier to understand compared to China.

EXITs NOT A CONCERN FOR INVESTORS AS FUNCTIONING MARKETS EXIST FOR PUBLIC EQUITY & M&A:

- Equity market exits include IPO of SKS microfinance and open market sale of Manappuram Finance.
- In total, 9 billion was raised in 62 IPOs in 2010.
- Examples of M&A based exits include strategic sales (Sale by Actis/Sequoia in Paras Pharma) and secondary sales (Sale by GA in Patni, Dr Lal Pathlabs stake sale to TA Associates.

PRIVATE EQUITY ACTIVITY TO EVOLVE CREATING NEW OPPORTUNITIES:

- Buyout and control transaction expected to grow, which would give PE players additional levers to create value.
- Larger family backed conglomerates could begin a process of portfolio rationalization, selling non-core businesses.
- Investors’ expect deal sizes to grow.
- Deals will evolve from pure equity deals to include other structure like convertible securities common in mature PE markets.
- Over time, stratification based on stage, sector or other expertise expected among PE firms

**CONDUCIVE REGULATORY ENVIRONMENT EXPECTED:**

- Foreign investment is generally viewed as desirable by industry and government, except in certain sensitive sectors (FDI limits have decreased across sectors over time; there is dialog on opening up FDI in multi-brand retail and revising cap in insurance).
- Overhaul of regulatory environment underway (examples include implementation of DTC, new takeover code, move to IFRS for financial reporting).

Challenges

**COMPETITION FROM OTHER SOURCES OF CAPITAL:**

- In certain situations, other sources of capital – bank loans or public equity - are favored as PE comes at higher costs and with more strings attached.
- Significant liquidity in public equity markets ($16 billion raised 70 public issues in 2010, of which $9 billion was raised in 62 IPOs).
- Capital Markets willing to fund relatively small and early stage businesses - Issue size below $50 million for 75% of IPOs since 2007.
- PE funds are often seen merely as a source of capital and not as an added source of expertise and networks, making it difficult for PE to compete purely on price with capital sources with lower return expectations.

**PRIVATE EQUITY INVESTORS ARE LARGELY LIMITED TO PASSIVE MINORITY STAKES AND ARE NOT ABLE TO PLAY ACTIVE ROLES THEY ARE USED TO PLAYING IN MATURE MARKETS:**

- Promoters are generally not looking to cede control.
- Availability of professional managers and teams is limited.
- In certain sectors such as insurance and retail, sector caps prevent majority ownership by foreign investors.
PREMIUM VALUATIONS:

- Competition from other sources of capital (as well as among PE players) drives up valuation.
- Premium current valuations of public markets have also driven up expectation.

REGULATORY ENVIRONMENT BURDENS INVESTMENT PROCESS WITH RISKS AND COSTS:

- Ambiguity over rules and regulation.
- Delays in issuing clearances.
- Complex tax laws.
- Sector caps on foreign ownership in certain sectors.
- Slow pace of decision making in the judicial system (and lack of speedy resolution in case of conflicts).

CORPORATE GOVERNANCE AND INFORMATION TRANSPARENCY REMAIN MAJOR CONCERNS:

- Desire for appropriate board oversight, independence of directors and protection of minority investors.
- Lack of transparency in financial reporting and information systems.
- Limited separation of ownership and management - family based management culture and limited development of professional management cadre.
- Widespread prevalence of corruption and fraud, including several examples in the corporate sector (e.g. accounting fraud, related party transactions) and capital markets (e.g. securities trading).

Sunrise Sectors For PE Players

Over the past 5 years, PE funds have invested approximately $40 billion across sectors.

Four sectors have attracted more than $5 billion cumulative investment each over the past 5 years.

**THESE INCLUDE:**

<table>
<thead>
<tr>
<th>Sectors</th>
<th>Value (Billion)</th>
<th>Growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>BFSI</td>
<td>$5.80</td>
<td>15 Percent</td>
</tr>
<tr>
<td>Energy</td>
<td>$5.70</td>
<td>14 Percent</td>
</tr>
<tr>
<td>IT/ITeS</td>
<td>$5.20</td>
<td>13 Percent</td>
</tr>
<tr>
<td>Telecom</td>
<td>$5.10</td>
<td>13 Percent</td>
</tr>
</tbody>
</table>

(Source: FICCI)

2010 saw a remarkable increase in investments in the Energy sector ($2.1bn, 28%) which was more than twice the investment in BFSI ($1bn, 13%), the second largest sector for investments.

The sunrise sectors as per various leading PE firms in the coming decade are likely to be around the following major themes:

Private Equity investments have played a very constructive role in building the Indian enterprises. Large number of PE firms has their presence in India. Even in the coming decade, there would be significant number of deals in the identified hot sectors.

Muralidhar Rao Gopidalai
MMS 2012
Muralidhar.g@simsree.net
The World Economic Forum (WEF) is a Swiss non-profit foundation based in Colony, Geneva, best known for its annual meeting in Davos, Switzerland. This annual meeting brings together top business leaders, international political leaders, selected intellectuals and journalists to discuss the most pressing issues facing the world, including health and the environment. The foundation was founded in 1971 by Klaus Schwab, a German-born business professor at the University of Geneva. According to Forbes magazine, 69 billionaires from 20 nations have attended the economic forum in the Swiss ski resort.

The World Economic Forum (WEF) event was held between 26th & 29th January 2011 at Davos, Switzerland.

India @ WEF: India’s Inclusive Growth Imperative

Growing by nearly 9% a year, India has become a model of an economy that is expanding rapidly within the context of an open, democratic society. The biggest challenge for the country is to ensure that growth is inclusive. Today the Reserve Bank of India and the Government of India is striving hard to achieve the dream of Inclusive growth in rural and urban areas of the country.

Ms. Chanda Kochhar, Managing Director, CEO, ICICI Bank

“Examples like China have shown us that, as growth takes place, poverty comes down substantially,”

“Growth and inclusion have to go hand in hand.”

Mr. Azim Premji Chairman Wipro

“What is really happening is a slowdown of the western world and the growth of the emerging markets. This is a complete shift in the balance of power”. “In 10 years, the economy of the emerging world will be … equal or slightly larger than the US economy,” added the billionaire at the WEF.

One moment of light entertainment from Azim Premji, In a parable of how the west misunderstands the developing world, he recounted an anecdote about Ford developing one of its cars for the Indian market.

“Thinking the $20,000 price tag too steep, its engineers in Detroit decided to strip out some of the jazzier functions to reduce the assembly costs. One function removed was the electric windows in the back seat. The car was released to market in India at $15,000, which Mr Premji pointed out meant it could still only be afforded by the wealthy. The wealthy, though, tend to have drivers. So while the driver could enjoy opening his
Launching the network here, the WEF said the platform will help member nations to better understand, manage and respond to complex and intertwined risks worldwide.

The Risk Response Network (RRN) will address concerns about widening economic inequalities and failed global governance systems underpinning a raft of other inter-related risks, ranging from financial governance to cyber-security and resource scarcity.

According to the WEF, the network will also assist in giving a global insight to emergency response in real-time.

(RRN) is an umbrella of projects and initiatives all designed to help global leaders better understand, prepare for and respond to risk,” World Economic Forum USA Chief Operating Officer Kevin Steinberg, Head of RRN.

WEF will employ permanent staff for the RRN, which will use a proprietary online platform to enable virtual collaboration between global leaders.

“I will not call China and India as ‘emerging’. We are ‘reemerging’, because together we contributed 52% of the GDP of the world, until the 17th century.

It is a re-balancing of the world economy. It is historical distortions getting corrected.”

“Manufacturing - conventional, traditional manufacturing - is going to move East, because that’s where the lower labour costs are, that’s where the better capital efficiencies are. So this is the shape of things to come, and the West has to accept it.”

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The World Economic Forum launched a Risk Response Network to help global leaders collectively address various risks related to financial governance and resource scarcity, among other things.
India is on the verge of gaining the status of an economic superpower in the near future, but there are a range of serious challenges in this path. India's prosperity will be recognized in true sense when millions of people who live in abject poverty and below standard of living are involved in the growth story of Indian economy. In India, numerous government schemes have tried to provide various subsidized services to the poor households. However, various studies have exposed the limitation of these programs, showing the lack of access of mainstream financial services for these poor households and their over-dependence on the local moneylenders in meeting their consumption and micro-enterprise demands.

According to an estimate, only 16% credit usage was met by the formal sources, while the remaining 84% was met by the informal services. Despite having a wide network or rural bank branches in the country and implementation of many credit linked poverty alleviation programmes, a large number of the very poor continue to remain outside the fold of the formal banking system. Despite the density and robustness of the formal Indian financial system, it has failed to reach the deprived segment, leaving approximately 135 million households entirely unbanked. The size of India's unbanked population is one of the highest in the world, second only to that of China.

**SHG Model in India**

In India, during the year 1992, NABARD launched the Self Help Group - Bank Linking Programme (SHG-BLP), bringing together Self Help Groups (SHG) & banks. This programme has expanded and had been in existence for nearly two decades to cover millions of rural families. The Model has worked well bringing in groups of borrowers together and accessing the funds granted by Institutions. But this hasn’t led to large expansion of the SHG network due to its ‘Non-Profit Model’.

**Micro Finance Institutions In India**

In this period, the Micro Finance Institutions (MFI) Model drew attention of the world leaders in making the banking services available to the lower strata of the society. One individual who gained worldwide recognition for his work in microfinance is Prof. Muhammad Yunus for his Grameen Bank Microfinance Model that had won the 2006 Nobel Peace Prize. Yunus and Grameen Bank demonstrated that the poor are bankable if properly served. Following the success of Grameen Bank’s MFI Model in Bangladesh, the MFI in India has gained significant momentum and since then, the microfinance sector has grown significantly. National bodies like the Small Industries Development Bank of India (SIDBI) and the National Bank for Agriculture and Rural Development (NABARD) have been devoting significant time and financial resources to microfinance as the developments in this sector would have multiplier effect in achieving financial inclusion that would lead to upliftment of the deprived sections of the society.

Most MFIs started with a ‘Non-Profit Model’ but ‘Non-Profit Model’ had limited reach and it was dependent on donor finance or government subsidies. This led to many switching to a ‘For-Profit Model’, which enabled them to raise money for expansion from private equity investors and banks. Such MFIs have expanded hugely, reaching millions.

The Indian MFI industry has close to Rs 30,000 crores of outstanding loans and 30 million borrowers. Currently, as many as 54% of all microfinance clients are concentrated in the Southern States: Andhra Pradesh, Karnataka, Kerala and Tamil Nadu. Alternatively, there is an extremely limited microfinance presence in the North and North-east India.

MFIs services are becoming overly saturated in Southern Indian territories and there is a commercial need to expand to newer geographies to ensure continued growth and maintain the quality of their portfolio. It has become imperative that MFIs diversify their operational base and limit overexposure to heavily serviced areas and clients.
Large number of Private Equity deals was signed in this space. The 2010 SKS Microfinance has opened doors for MFIs to tap the capital markets. With the exit of Mr. Suresh Gurumani of SKS Microfinance after the top management tussle with Mr. Vikram Akula (Chairman, SKS MFI) regarding share of powers, the functioning of the MFIs came under scrutiny and since then all is not well for the MFIs. Unfortunately, the industry’s fortunes have steadily plunged thereafter.

The developments in the Indian microfinance sector, particularly in Andhra Pradesh (AP), have been distressing. Within a relatively short period, a sector heralded as representing a commercially viable solution to the problems of financial inclusion, poverty reduction and female empowerment is now being accused of various improprieties. MFIs have been accused of lack of transparency in its internal operations and charging exorbitantly higher interest rates.

With the MFIs charging higher fees and interest rates, the Andhra Pradesh government quickly passed an ordinance to put a limit on the maximum interest charged by these institutions. This resulted in bringing all microfinance repayments to a halt in AP, the state which ironically led the microfinance revolution in the country. The sector plunged into a crisis with Andhra Pradesh, the largest market for microfinance, introducing the restrictive law for the MFIs and introducing a cap on interest rates.

The expansion is so high that the quality of assets is being affected. Some of the borrowers from MFIs being over-extended, resulting in repayment problems and voices have also been raised on the methods of collections. Questions were also raised about the poor governance practices and an alleged overemphasis on profit rather than social objectives by some MFIs in the country.

While a combination of factors may have contributed to the above situation, multiple lending and coercive collection practices are frequently being cited as the causes of the crisis. These may be the major reasons but there are other underlying reasons. These include a lack of financial education of microfinance customers, the nature of incentives offered to field staff by microfinance institutions (MFIs) and the lack of a uniform code of conduct for the sector. The widespread politicisation of microfinance especially in AP is an additional contributing factor.

Government officials, economists and activists have criticised the practice of high rates of interests charged by the MFIs. There has been a demand to establish a MFI Regulator to look over the operations of MFIs in order to protect the poor people’s interests and also bring an end to the problems in this industry.

**Mallegam Committee Report**

With the MFI deep in crisis, the RBI has set up a sub-committee under Mr. Y H Mallegam to study the Industry. The Mallegam Committee set up by the RBI has come out with its recommendations on regulating the sector.

- The committee has recommended the creation of a separate category of NBFCs operating in the microfinance sector to be designated as NBFC-MFIs.

- To qualify as a NBFC-MFI, the Sub-Committee has stated that the NBFC should be “a company which provides financial services pre-dominantly to low-income borrowers, with loans of small amounts, for short-terms, on unsecured basis, mainly for income-generating activities, with repayment schedules which are more frequent than those normally stipulated by commercial banks”.

- The Sub-Committee has recommended that bank lending to NBFCs which qualify as NBFC-MFIs will be entitled to “priority lending” status and suggested a cap of 24% for interest on individual loans.

- It has also proposed that, in the interest of transparency, an MFI can levy only three charges, namely, processing fee, interest and insurance charge.
Microfinance: The Way Forward

What is required to pull MFIs out of this mess is the establishment of an MFI regulator that would balance the need for encouraging the growth of the sector with the social objective of providing cheap loans to the poor. But Finance Minister Pranab Mukherjee in the Union Budget 2011 didn’t announce anything related to the MFI Regulator, but instead announced the setting up of an MFI equity fund with a corpus of Rs.100 crore in association with SIDBI.

All the MFIs in India are complaining about the inadequate support of funds from banks & financial institutions and if this situation continues than Indian microfinance sector would be very close to destruction. Now the need of the hour is to support the MFIs to carry out the smooth operations of delivering loans to the poor people.

Need for a Regulator: The GoI should ensure that a regulator solely focused on overlooking this industry is established in order to support the growth of these MFIs. What the sector really needs is a transparent environment that would facilitate smooth operations of the MFIs. The Regulator would ensure that there is transparency in interest rates as well as the internal operations of MFIs. Regulator would also ensure that MFIs’ objective should not be solely profit-making but making loans available at cheap cost and on the other hand making enough profits for being commercially viable.

Potential Convergence between Banks and MFIs: Although current regulations maintain a clear demarcation between scheduled commercial banks and MFIs (the large MFIs are mostly regulated as NBFCs), the mutual advantages to each other are fairly obvious. MFIs can significantly lower their cost of funds, and also remove potential hazards of dependence on institutional liquidity through conversion to a banking model; banks can get into the financial inclusion game through best practices from MFIs. From the government’s perspective, this could be a one of the best strategies to fulfill the Financial Inclusion objective as well as to get the situation politically correct.

Public Private Partnership (PPP) Model in MFIs: The PPP Model is also a way forward with the support of apex Institutions such as NABARD, SIDBI to the MFIs. Public and private players can engage to ensure smooth operations of delivering loans to the poor people. In such a Model, the government, through various agencies like NABARD and Commercial Banks (PSUs) would be funding and supporting the MFIs which will then disburse the same to the borrowers through SHGs. This would help in bringing transparency in the operations and also restricting the charging of high interest rates from the poor people. Here, the role of regulator is vital, as it would ensure that there is transparency in interest rates as well as the internal operations of MFIs. Regulator would ensure that MFIs chief objective being the disbursement of cheap loans by making sustainable profits.

Partnership with Regional Rural Banks (RRB): As per the data till last financial year, there were 82 RRBs (with a network of 15475 branches spread over 619 districts in 26 States and 1 Union Territory), of which only 3 RRBs out of 82 RRBs were incurring losses. In addition, the RRB’s were given a target by the Finance Ministry to open 2000 branches by March 2011 with the right banking technology platform as part of their financial inclusion strategy. Partnership with MFIs could be one of the routes which could be explored by RRB’s to have better access to similar client base and to fulfill their mandate of financial inclusion.

Consolidation within The MFI Industry: Consolidation amongst existing MFI players could help the conditions of the MFIs. However, the challenges in this case are - borrowers defaulting, very limited access to capital, regulatory risks, ratings with negative implications and political resistance.

Securitization of Loans-Borrowings By MFIs: Securitization of loans-borrowings and passing it to banks to recapitalize MFIs is another option. Recently, SKS Microfinance has sold Rs. 1200 crores securitized assets covering close to 3 million borrowers to banks.

It is therefore essential that the policymakers in India and particularly in AP should create a conducive environment to let financial inclusion take place based on good governance and sound regulation.

Muralidhar Rao Gopidalai & Ritesh Soni
MMS 2012 MMS 2012
gmdr2008@gmail.com riteshasoni@hotmail.com
Policy Rates

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<tr>
<th>Policy Rates</th>
<th>Reserve Ratios</th>
<th>Lending &amp; Deposit Rates</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank Rate: 6 %</td>
<td>CRR: 6 %</td>
<td>Base Rate: 7.60 - 8.50 %</td>
</tr>
<tr>
<td>Repo Rate: 6.75 %</td>
<td>SLR: 24 %</td>
<td>Savings Bank Rate: 3.5 %</td>
</tr>
<tr>
<td>Reverse Repo Rate: 5.75 %</td>
<td>Deposit Rate: 7 - 8 %</td>
<td></td>
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GDP (Purchasing Power Parity)

<table>
<thead>
<tr>
<th>Country</th>
<th>GDP (In $ Million)</th>
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<tbody>
<tr>
<td>Italy</td>
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<td>France</td>
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<td>United Kingdom</td>
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<td>India</td>
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<td>Japan</td>
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<td>China</td>
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<tr>
<td>United States</td>
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</table>

BSE Sensex 19,451.45
Dow Jones 12,380.05
NASDAQ 2,780.42
Nikkei 9,768.08
Hang Seng 24,396
Bovespa 6,8718
IIP 5.2 % (Feb'11)
WPI 8.31 % (Feb'11)
CPI 8.82 % (Feb'11)
As on April 2011
The Indian Foreign Exchange Reserves is the 7th highest in the World with $305.5 Billion as on April 2011.

India’s Foreign Exchange Reserves comprises of:

- **Foreign Currency** ($275 Billion)
- **Gold Reserves** ($22.9 Billion)
- **SDRs** ($4.5 Billion)
- **Reserved Tranche Position** ($2.9 Billion)

The Top 3 Nations with highest Foreign Exchange Reserves are:

- People’s Republic of China: $2850 Billion
- Japan: $1092 Billion
- Russia: $500 Billion

*Data as per the following: 1 (Dec’10); 2,3,5,10,11 (Jan’11); 6,9 (Feb’11); 4,7,8 (Mar’11)*
This can be called India’s most transformational decade with a host of reforms initiated in the areas of taxation and reporting. Along with the major way in which the system is expected to revamp taxation by bringing to the fore Goods and Services Tax (GST) and Direct tax code (DTC), a reform is expected on the similar lines in financial reporting and accounting with India initiating to adopt the International Financial Reporting Standards (IFRS).

With Dr. Manmohan Singh making a commitment to converge to IFRS at the G20 summit in 2009, Ministry of Corporate Affairs (MCA) has laid out the path for Indian companies to follow the IFRS system and start its implementation by giving the deadline as April 1, 2011 where almost 300 companies are expected to change their accounting system and confirm to the global standards. The reform process is laid out in a phased manner where initially companies that are listed on the Nifty and the Sensex as well as overseas stock exchanges and those with a net worth of over 1000 crore are expected to adhere to the deadline of April 1, 2011. So why is IFRS being the victim of constant news and controversies?

IFRS are principles-based Standards, Interpretations and the Framework (1989) adopted by the International Accounting Standards Board (IASB). It is a uniform accounting system based on certain standards that are globally followed and by this year (2011), it is expected that more than 150 countries would be following this system. With such a huge entry point in confirming with global standards and directly comparing with competitive companies abroad, IFRS poses huge opportunities as well as challenges too. While US SEC still follows US GAAP, it has allowed foreign listed entities to report using IFRS with an objective of ultimate convergence to IFRS.

India has been on a growth trajectory surviving the financial crisis and treading back on the path of high growth rates. India definitely does not want to compromise on the path of growth and is in a phase of continuous development for which it needs funds from outside the country at a lower cost of borrowing. We can see that especially when we come across tight liquidity conditions in banks as also with infrastructure projects.

Risk is a factor which is always on the minds of the investors when they look for projects and investments in emerging economies. India has also been recently marred by issues like the corporate scams, political upheavals and economic volatility which have affected the investors’ confidence and the way in which foreign investors perceive the market. India has also been giving birth to a whole new gamut of companies that have plans of going public or listing on overseas exchanges for which it would be necessary to adhere to IFRS When a company confirms with IFRS standards, it brings in more transparency and quality in reported numbers. The assessment of the said risk is eased for the potential investors.

If IFRS poses a huge opportunity then what is holding it back from a smooth implementation?

IFRS outlines, ‘A financial statement should reflect true and fair view of the business affairs of the organization. As these statements are used by various constituents of the society / regulators, they need to reflect true view of the financial position of the organization’, as its objective of Financial statements. The qualitative characteristic of IFRS aims at:

- Understand ability
- Reliability
- Comparability
- Relevance
- True and Fair View/Fair Presentation

The key elements of IFRS in terms of convergence would be in area of fair value concept. Indian GAAP allow for historical costs method along with selective revaluation
of fixed assets. Also, fair value concept is presently limited for testing of impairment of assets, measurement of retirement benefits and ‘mark-to-market’ accounting for derivatives. IFRS would mandate for initial recognition of all financial assets and liabilities at fair value. Also subsequent measurements of all financial assets held for trading or for sale at fair value. Banking, NBFCs and Financial Services companies would be the most impacted with these regards in terms of their various assets and investment portfolio measurements.

In terms of substance over form, IFRS mandates preparation of consolidated financial statements to reflect the true picture of the net worth to various stakeholders. Exceptions for preparation of consolidated financial statements are very limited. In India, currently consolidated financial statements are mandatory only for listed companies and that also only for the annual financial statements and not the interim financial statements. Consider, upfront fees charged by a telecom service provider. Under Indian GAAP, several companies recognize such upfront fees as income because it is contractually non-refundable and is contractually received as fees for the activation process. Under IFRS, the fee is accounted for in accordance with the substance of the transaction. Under this approach, the customer pays the upfront activation fee not for any service received by the customer, but in anticipation of the future services from the telecom company. Thus, despite the non-refundable nature of the fees, revenue recognition would be deferred over the estimated period that telecom services will be provided to the customer.

There would be increase requirements on account of disclosures for qualitative reporting in terms of notes to accounts. All events and transactions are treated under normal course of business. If an item is material, must be disclosed. Restatement of accounts, interim dividend policy and determination of functional currency are other important areas of concerns for convergence to IFRS from Indian GAAP.

The other issue is that certain optional standards might be adopted by a foreign entity abroad but not by Indian firms which does not achieve the purpose of direct comparison and might also be against the favor of an Indian firm. International Accounting Standards board (IASB) have notified certain deviations from IFRS which could be allowed but again, that does not serve the purpose of complete compliance. However, this not a major concern, since globally a host of countries has notified sections of IFRS to which they would not converge at the outset of adoption.

The other major issue is taxation. Indian companies have been following a standard of accounting system for tax purposes over the years and when they shift to IFRS, they end up in paying huge taxes. This is the reason why infrastructure companies have been exempt from confirming to the standards since they would have to shell out a huge sum in taxes. Further, certain issues related to taxation would need time to clear out. Whether a company should prepare two sets of accounts for tax purposes and IFRS, the implications of that on the Government and the company and the implementation of carrying forward this transformation, all of this would need clarity.

Companies Act inconsistency with IFRS with regards to treatment of redeemable preference shares is another area which needs to be addressed before convergence. RBI guidelines on reporting formats for banks, NBFCs as well as of IRDA for insurance companies are not all consistent. Similarly SEBI guidelines for quarterly numbers on standalone basis for listed companies do not confirm to IFRS. All these need to be overhauled as IFRS more than covers required norms in its substance over form requirements. IFRS requires immediate compliance in all M&A, restructuring and amalgamation transactions, including for subsidiaries and parent holding companies.

In response as a step to convergence, the Ministry of Corporate Affairs has notified 35 accounting standards in convergence with IFRS. Further it has deferred the deadline of April 1, 2011 to clear out certain tax related issues. For the smooth implementation of the system and its convergence to IFRS, it is necessary that the Government stays committed to the convergence process clears out taxation issues and garners its support to the companies who would view a major change in the accounting standards it follows. It can definitely be said that it would be a huge transformation that would be gradually implemented and would entail a major change in the way the numbers were being presented and balanced till now.
Bullion Market

A place where precious metals such as gold, silver, platinum and palladium are bought and sold. Price depends on supply and demand. These two factors drive the underlying price which is then adjusted upwards or downwards depending on the form of the precious metal.

Investing in the Bullion Market

Spot Market

Large buyers and institutional investors generally buy the metal from big banks.

London is the hub of the global spot gold market, with the daily trading of more than $26 billion. To avoid cost and security risks, bullion is not usually physically moved and deals are cleared through paper transfers.

Other significant markets for physical gold are India, China, the Middle East, Singapore, Turkey, Italy and the United States.

Futures Market

Investors can also enter the market via futures exchanges, where people trade in contracts to buy or sell a particular commodity at a fixed price on a certain future date.

The COMEX division of the New York Mercantile Exchange is the world’s largest gold futures market in terms of trading volume. The Tokyo Commodity exchange, popularly known as TOCOM, is the most important futures market in Asia.

China launched its first gold futures contract on Jan. 9, 2008. Several other countries, including India, Dubai and Turkey, have also launched futures exchanges.

Exchange Traded Funds

Media coverage of high gold and silver prices has also attracted investments into exchange-traded funds (ETFs), which issue securities backed by physical metal and allow people to gain exposure to the underlying gold prices without taking delivery of the metal itself. Launch of exchange traded funds have helped the small investors so that even they can invest and reap the benefits of skyrocketing bullion markets.

New York’s SPDR Gold Trust is the world’s largest gold-backed ETF. Other gold ETFs include iShares COMEX Gold Trust, ETF Securities’ Gold Bullion Securities and ETFS Physical Gold, and Zurich Cantonal Bank’s Physical Gold. Nowadays, even the investors in India are taking interest in ETFs.

- Bars & Coins

Retail investors can buy gold from metals traders selling bars and coins in specialist shops or on the Internet. They pay a premium for investment products of 5-20 percent above spot prices, depending on the size of the product and the weight of demand. Even banks have entered into the business of selling gold bars.

Key drivers to the Bullion Market

- Investors

Rising interest in commodities, including gold, from investment funds in recent years has been a major factor behind bullion’s rally to historic highs. Gold’s strong performance in recent years has attracted more players and increased inflows of money into the overall market.

- Foreign Exchange Rates

Gold is a popular hedge against currency market volatility. It has traditionally moved in the opposite direction to the U.S. dollar as weakness in the U.S. unit makes dollar-priced gold cheaper for holders of other currencies and vice versa.

- Oil Prices

Gold has historically had a correlation with crude oil prices, because the metal can be used as a hedge against oil-led inflation. Strength in crude prices can also boost interest in commodities as an asset class. More recently this correlation has weakened, with gold prices hitting a series of highs in the past two years while oil prices retreated from record peaks, though both have been boosted in recent weeks by Middle East unrest.
Fiscal & Political Tensions

The precious metal is widely considered a “safe haven,” bought during uncertain times in a flight to quality. Financial market uncertainty, as seen last year in the case of burgeoning debt problems for Greece and other euro zone countries, tends to boost inflows to gold. Major geopolitical events, such as the recent outbreak of unrest across the Middle East and North Africa, can also induce price rises.

Central Bank Gold Reserves

Central banks hold gold as part of their reserves to bring stabilisation in the currency market. More recently, central banks, chiefly in Asia, have shown a tendency to add to their gold reserves, with India, Thailand and Bangladesh some of the most recent countries to purchase bullion. This has also provided a major support to prices.

Hedging

Gold producers sell a part of their expected output with a promise to deliver the metal at a future date, which is known as Hedging. Usually, they try to avoid risk by entering into futures contracts. This helps in determining prices of gold at various exchanges.

Demand & Supply

Supply and demand fundamentals generally do not play as big a role in determining gold prices as those of other commodities. Peak buying seasons in major consuming countries such as India and China exert some influence on the market, but other factors such as the dollar and financial risk carry more weight.

Gold To Silver Ratio

The ratio means how many ounces of silver it takes to buy one ounce of gold. Historically, that ratio has been about 16-to-1. Right now, that ratio is hovering around 62-to-1. For silver to ‘correct’ by returning to its long-term silver/gold ratio of about 15, gold at $1,360 means silver should be priced at $90 already, far above even its 30-year high around $21, where it stands today. This shows that silver is cheap compared to gold, which opens the door for investors to come in at a good price.

Bullion in India

Trading of gold is known as bullion trading. India is the leading consumer and importer of gold in the world. Due to this, the potential of the India bullion market is very promising. The gem and jewelry industry of India is one of the fastest growing sectors of the economy at an approximate rate of 15%. The India Bullion market is under the strict supervision of the Government as bullion is one of the major indicators of the wealth of the country.

India is the largest investor in gold jewelry as a large number of people believe that investing in gold is beneficial.

The domestic consumption of gold depends on factors like the:

- Wedding season,
- Festive season,
- The performance of the harvest and the monsoon of the country.

<table>
<thead>
<tr>
<th>Country</th>
<th>Bullion (In Tons)</th>
</tr>
</thead>
<tbody>
<tr>
<td>United States</td>
<td>8133.5</td>
</tr>
<tr>
<td>Germany</td>
<td>3408.5</td>
</tr>
<tr>
<td>Italy</td>
<td>2451.8</td>
</tr>
<tr>
<td>France</td>
<td>2445.1</td>
</tr>
<tr>
<td>China</td>
<td>1054.0</td>
</tr>
<tr>
<td>Switzerland</td>
<td>1041.5</td>
</tr>
<tr>
<td>Russia</td>
<td>568.4</td>
</tr>
<tr>
<td>Japan</td>
<td>765.2</td>
</tr>
<tr>
<td>Netherlands</td>
<td>612.5</td>
</tr>
<tr>
<td>India</td>
<td>557.7</td>
</tr>
<tr>
<td>ECB</td>
<td>501.4</td>
</tr>
</tbody>
</table>

Arjit Agrwal
MMS 2012
arjitagrawal@gmail.com
Mr. Deepak Parekh is the Chairman of Housing Development Finance Corporation, India's leading housing finance company.

He has completed B.Com from Sydenham College and is a Chartered Accountant from the Institute of Chartered Accountants in England & Wales (ICAEW).

A pioneer in mortgage finance, he has enabled scores of Indian middle class people to own their houses or apartments through affordable loans.

In 1970, Mr. Parekh began his career with Ernst & Ernst Management Consultancy Services in New York. Thereafter he worked with Grindlays Bank and Chase Manhattan Bank for about three years each prior to joining HDFC in 1978.

In 1978 Mr. Parekh joined India's premier housing finance company HDFC Ltd. as Deputy General Manager and then went on to become its Chairman in 1993.

HDFC's growth in stature and strength since its inception (1977), has been achieved by a steadfast focus on sound values such as integrity, transparency and professionalism, and underpinned by a basic belief of trust by the Indian middleclass. Mr. Deepak Parekh, has not only preserved the ethos of the company, but has also strengthened it with time. His astute business acumen and farsightedness has not only made HDFC the leader in Mortgages, but also transformed it into a financial conglomerate with presence in Banking, Asset Management, Life Insurance, General Insurance and Real Estate Venture Fund.

Besides HDFC Group Companies, Mr. Parekh is on the board of several leading corporations across diverse sectors. He is the Non-Executive Chairman of GlaxoSmithKline Pharmaceuticals, Infrastructure Development Finance Company (IDFC), Lafarge India and Siemens India Ltd. He is also on the boards of Castrol India Limited, Hindustan Oil Exploration Co. Ltd., Hindustan Unilever Limited, Mahindra & Mahindra Limited, Indian Hotels Company Limited among others and international board of WNS Global Services Pvt. Ltd. (USA).

In addition to being known for his vociferous views seeking standardization and transparency in the real estate sector, Mr. Parekh is dubbed as the unofficial crisis consultant of the Government. Be it his recent role as Special Director on the Satyam Board to revive the company or the crucial role played by him sometime back during the UTI mess (late 90's') to recommend measures for sustaining investor confidence, Mr. Parekh has always been willing to share his ideas and experience to formulate reform policies across sectors. It is this quality of a master trouble-shooter that makes him a guiding force and an active member of various high-powered Economic Groups, Government-appointed Advisory Committees and Task Forces which includes housing, financial services, capital markets and infrastructure sector reforms.

**Awards & Accolades**

- Awarded Padma Bhushan (2006) by Govt. of India.
- Forbes-India person of the year 2010 as “Institution Builder”.
- Most Inspiring Business leader Award from NDTV Profit 2010.
- Lifetime Achievement Award by The Economic Times in 2006.
- Internationally some of his recent prominent awards include, Republic of France conferring the Honour, “Knight in the Order of the Legion of Honour” one of the highest distinction by the French Republic in 2010.
- The first International recipient of the Institute of Chartered Accountants in England and Wales’ Outstanding Achievement Award - 2010.
- Top 25 most influential people in business and finance across Asia-Pacific by Asiamounty.
- Awarded the prestigious Lifetime Achievement Award for his contribution to the Financial Sector by Finance Asia magazine, Hong Kong & many more.

Mr. Parekh’s philosophy on Corporate Social Responsibility (CSR) is simple yet profound. He believes that if a company earns, it must also return to the society and that companies owe a responsibility not just to shareholders, but also to all its stakeholders. This has meant nurturing every social initiative undertaken by HDFC as an investment.

In recognition of these initiatives in the areas of philanthropy and social commitment Mr. Parekh was honoured by the American India Foundation in 2007 & HDFC was also honored with the Economic Times Corporate Citizen of the Year Award in 2004 under his leadership.
SIMSREE Finance Forum is a student body that strives to assist the students in the development of financial acumen through collective effort. The Forum aims to bridge the gap between students and corporate leaders through various Interactive Sessions on a regular basis. Various Programs & Events form part of our Forums’ initiatives to provide the students with a multitude of opportunities.

SIMSREE is ranked as one of the Premier Institutes of our country, and it attracts the finest management minds from India. SIMSREE has been consistently being ranked among Top 20 Business Schools in India. CRISIL has recently rated SIMSREE with A*** at state level (Maharashtra) & with A** at National level.

- Muralidhar Rao Gopidalai
- Rahul Mahajan
- Alok Kumar
- Sangeet Srichandan
- Pratik Mittal
- Santosh Jhawar

Contact Us @ Simsreefinanceforum@gmail.com