

# **INTERNATIONAL ECONOMICS AND CORPORATE GOVERNANCE IN EMERGING ECONOMIES**

## **THE THEME PAPER**

Are emerging economies like India and China sufficiently insulated against the upheavals in the global economy? What may be the steps to insulate emerging economies from the slowing global economy? How do corporates in emerging economies ensure performance when global economy is sharing symptoms of recession?

In order to answer these questions at the macro level we may have to distinguish between the financial economy and real economy and their respective degrees of integration into the world economy. The 1973 global oil crisis, for example, directly affected the real economies across the globe.

Mr. Marc Labonte, analyst in Macroeconomics, in his report to the American Congress reviews the effects of oil shocks on the economy. He points out that eight of the nine post-World War II recessions were accompanied by sharp increases in the price of oil. At the time of writing this article, oil prices on New York Mercantile exchange have risen to \$ 114 per barrel from \$ 30 per barrel five years ago. Of course, this has a component of a fall in the dollar value itself. The 1973 – 1975 recession followed the oil embargo. The double dip recession of 1980 – 1982 followed the second oil shock, which was caused by the revolution in Iran and Iran-Iraq war. The 1990 – 1991 recession followed the oil price spike caused by the Gulf War and the 2001 recession followed a sharp rise in oil prices from 1999 – 2000. This would seem to be a persuasive evidence that oil prices play a strong role in determining business cycle.

Due to the central role energy plays in the functioning of economy, changes in energy prices are not the same as changes in the prices of most other goods. Economic theory suggests that economies suffer from recessions due to the presence of “sticky prices”. The only way to avoid recessions is for markets to adjust instantly. There are products with high “menu costs”. These are those that are costly to re-price, and therefore have sticky prices. Restaurant menus, periodicals, and catalogue items are examples of products with high menu costs. If markets adjusted instantly, then recessions could be avoided: whenever economic conditions changed, price and wage changes would bring the economy back to high employment. But the menu costs, information costs, uncertainty, and contracts in the economy make prices sticky. As a result,

market adjustment takes time and unemployment and economic contraction can result in the interim. When oil prices rise suddenly the overall inflation rate is temporarily pushed up because other prices do not instantly adjust and fall. At the same time, because energy is an important input in the production process, the price shock raises the cost of production. Because other prices do not instantly fall, the overall cost of production rises and producers must cut back production, which causes the contraction in output and employment. There may also be adjustment costs to shifting towards less energy intensive methods of production, and these could temporarily have a negative effect on output. Typically, the effect on output occurs over a few quarters.

The effects described thus far can be thought of as occurring on the supply side of the economy. Oil shocks may also affect aggregate demand. When energy prices rise they involve an income transfer from consumers to producers. Since producers are also consumers, aggregate demand is likely to fall only temporarily as producers adjust their consumption to their now higher incomes. A second effect on demand can be expected to occur because the rise in energy prices will push up the overall price level because other prices do not fall immediately in the face of a decline in demand. The increase in the price level will reduce the real value of the available amount of money in the hands of buyers, and this reduction in the real money stock will also reduce spending. A third effect on demand can occur if the rise in energy prices increases uncertainty and causes buyers to defer purchases. The magnitude of all three effects will depend on how much energy prices rise and how long they remain high.

Mr. Meghnad Desai has this to say on insulation of emerging economies from the crisis in the global economy [TOI 1 May, 2008]:

“There was an idea that the emerging economies would be decoupled from the western economies and insulated from the downturn. But financial flows bind them in a symbiotic embrace. The surplus savings sustain the innovative but indolent West while the frugal but copycat emerging economies lap up the new innovations and turn them into wealth. The latter have the workforce and the former have the brain force. As long as trade flows are reasonably free of protectionist forces the symbiosis ought to work.

The inflationary forces arise as a logic of this symbiosis. The emerging economies save but what they consume are necessities, mainly food, as previously poor families can afford to eat what their parents could only dream of. Their industrial activity is still run on old energy-intensive lines which went out in the western economies in the

1980s. So oil and food rise in price while computers, mobile phones and iPods get cheaper. This is why the overall price indexes show even now a much lower rate of inflation than people experience in their daily shopping. Prices of what they buy daily or weekly are going up fast as industrial products get cheaper.”

The challenge for emerging economies is to accelerate the growth rate and keep its momentum in spite of increase in oil prices and external recessionary trends. Mr. Alan Greenspan had said, “Accelerating productivity growth entails a matching acceleration in the potential output of goods and services and a corresponding rise in the real incomes available to purchase the new output. The problem is that the pickup in productivity tends to create even greater increases in aggregate demand than potential aggregate supply”. John Vickers had said, “Whatever the supply side may have in store, delivering low and stable inflation—and being expected to do so—is how monetary policy can give sustainable growth its best chance”.

### **Innovation and Entrepreneurship**

What is the role of the financial sector in fostering innovation and growth. Dr. Rakesh Mohan, in his lecture delivered on March 28, 2008 admits, “the primary objective of monetary authorities is to achieve low and stable inflation. A necessary ingredient for achievement of low inflation is the acceleration of productivity growth in an environment of high economic growth. When growth in productivity is high, a sustained increase in income, leading to sustained growth in demand can be managed with low inflation”. It is entrepreneurship and innovation that leads to productivity growth.

Today, the growth is manifesting itself in many ways all across India: innovation and entrepreneurship are in the air. Changes in public policy over the past couple of decades have indeed freed the entrepreneurial spirit in India. But low and stable inflation is essential : high and uneven inflation enhances risk and is hence inimical to innovation and risk taking.

The National Knowledge Commission in its report titled “Innovation in India” has defined innovation. It is a process by which varying degrees of measurable value enhancement is planned and achieved, in any commercial activity. This process may be breakthrough or incremental, and it may occur systematically in a company or sporadically; it may be achieved by:

— introducing new or improved goods or services and/or

- implementing new or improved operational processes and/or
- implementing new or improved organizational/managerial processes in order to improve market share, competitiveness and quality, while reducing costs.”

As Dr. Rakesh Mohan points out what spurred the acceleration of invention in India was the overall economic reform process. For example, de-licensing of industry in 1991 ushered in a new era of competition; which was then reinforced by continuing trade liberalization and tariff reform. The freeing of foreign direct investment not only provided new competition, but brought in new techniques and technology into the country. The Indian industry was forced to innovate in all the different ways.

All the innovations in the real sector needed corresponding innovations in the financial sector as well. Strong public policies and good governance structures nurture the innovations in real and financial sectors and direct them in a non-disruptive and constructive manner so that the positive growth process can be sustained. Financial innovation involves development of new financial services and products. These new products and services need to be easily accessible. Micro finance is a new method by which financial innovation is being sought to be achieved.

Innovation involves risk. If risk is to be financed effectively, it is essential for financial institutions to improve their risk management systems in their entirety. The risk needs to be appropriately assessed. Risk mitigation systems should be developed. As financial systems become more market oriented and as price discovery of interest rates becomes more efficient, financial institutions find better and better ways of managing and allocating risk. Effective development of financial systems to finance innovation takes a good deal of time.

Innovations can either be supply induced or demand led. Supply led innovations arise from new research and development activities that give rise to new technologies, new products and new processes. Demand led innovation essentially arises from the pressures of new competition. R & D itself can be demand induced.

There is a need for an effective national innovative system. Apart from the structuring of in house mechanisms within firms, there is need for the existence of mutually supporting networks of organizations, technical consultancies and the like so that firms have adequate technical support systems. Clusters and incubators are also needed for creating such supportive environment for small and medium firms.

Higher the growth in productivity, higher is the overall growth at given levels of investment. That also means that much higher growth can be sustained by higher investments without arousing inflationary pressures. The best thing thus one can do is to encourage innovation, productivity and growth which can then bring about better control over inflation. What lies behind achievement through monetary policy is also the gains that come through increases in productivity.

We need a conducive microeconomic environment for innovation and growth, a supportive financial system and an innovation nurturing environment through national innovation systems. Even in the global context of inflationary pressures in commodity prices particularly in food and oil and slowing global growth, the outlook for productivity growth is crucial and of great concern to central bankers.

The key issue for innovation and growth in financial sector development is how well the financial system is able to finance new ideas, new products and new entrepreneurs. The decontrol and expansion of capital markets should make for the access to market intermediated financial resources easier for well established, credit rated large incumbents. Reforms in the banking system should aim to bring in greater efficiency by introducing new competition through the new private sector banks and increased operational autonomy to public sector banks. In the Government securities market, the reforms should aim at better price discovery of interest rates by auctioning Government securities and developing the infrastructure for efficient trading. In the forex markets there should be a gradual movement towards a market based exchange rate regime coupled with the introduction of newer products and players. There should be a systematic build up of the institutional architecture in terms of markets, technological and legal infrastructure. The steps towards making Mumbai an international financial center indicate a movement in this direction.

In the Indian context there is some corroborative evidence that suggests the difficulty of entry for new business entrepreneurs. The World Bank surveys on doing business across countries, India ranks quite low in the range of 120-130. At the same time we find that both level of profits of corporate sector and growth of profits are among the highest in the world in India. A possible explanation, according to Dr. Mohan, seems to be the high entry costs: once you get in, it is easy to grow, but getting in, in the first place, is difficult. This suggests that the Indian financial system is, perhaps, still not adequately geared to finance new ideas and new products. In recent years continuously there has been low share of credit going to SMEs. For the financial system to nurture

innovation and growth, its risk assessment practices need to improve while transaction costs are reduced.

If we look to the financial slow down in the global economy due to the sub-prime mortgage crisis, the crisis has spread to even the emerging economies in the financial sector, although the real economies seem to be insulated. Volatility in stock exchanges is not an enigma. It is very much the normality. In fact, stock market players like George Soros have made their fortunes by being one step ahead of volatility on stock exchanges. Today, financial markets, much more so than real economies, are integrated by fast flowing funds which come and go at short notice. Financial economy is becoming global while real economies are integrated only through trading of goods and services. While the financial fund flows are affecting even the emerging economies, the real economies have had little impact of the crisis in financial markets. This will remain so until the monetary policy is sound and financial regulation is working.

As Mr. Meghnad Desai, Member of the British House of Lords, points out the difficulty with economics is that while one can predict an event is likely to happen, given the various related phenomena, one can not forecast the date and time when it will happen. The recent financial crisis in American economy was anticipated in principle. The prediction followed years of cheap liquidity and a lot of new risk vehicles in which people were investing. The results were as expected but nobody could predict the exact time when the crisis would hit.

### **Capitalist Doles**

There is also an element of surprise the way the American and the British Central Banks have stepped out to handle the crisis. Ben Bernanke of the US Federal Reserve decided to come to the rescue of the rich losers on the Wall Street. The large losers who were thitherto believers in free market economy suddenly turned into socialists by turning to Government help when in the mouth of the crisis. Federal Reserve devised a generous injection of liquidity. It rescued Bear Stearns whereby J P Morgan got the assets at a throwaway price. The Fed took a possible loss of up to USD 25 to 30 billion while J P Morgan would lose only upto USD 5 to 6 billion while profiting from the acquisition. When big private players make big monies in times of easy liquidity by borrowing many more times of their net worth, it is difficult to justify government help to them when the tide turns the other way.

When J P Morgan Chase agreed to buy Bear Stearns for about 90% less than its value, it had taken a risk to run a company that had lost 85 years of independence as a securities firm on the Wall Street. Shareholders of Bear Stearns got stock in J P Morgan equivalent to \$ 2 a share compared with \$ 30 at the close on March 14. This, the J P M did with a financial backing from Federal Reserve. JPM bought Bear Stearns for less than the value of its real estate with the background of a client alarm about a cash shortage making them withdraw \$ 17 billion in two days. This proves that a creative mind sees in risks a great opportunity.

Firms like Fanny Mae and Freddy Mack had borrowed up to 30 times of their paid up capital; they found their value collapsing and their lenders demanding money at short notice.

Compare the above American scenario with the one in the UK. Mervin King of the Bank of England refused to help banks that had done foolish deals. In Britain, Northern Rock was a smaller mortgage lender than Bear Stearns, which was an investment bank. When Northern Rock was in trouble first the depositors were assured that their money was safe. But after that, instead of giving it to a private firm, the Government took the Northern Rock over. It was decided that Northern Rock would be denationalized after its support loan of Pounds 25 billion was paid off, while the shareholders would get value equal to the worth of their shares when the takeover took place, that is, zero pounds. Why should Government support large risk takers who make money by borrowing a large multiple of their net worth when liquidity is cheap, asks Meghnad Desai.

While advanced economies follow queer policies to address financial mishaps [like the US Federal Reserve unleashing cheap liquidity that is bound to bounce back after a time lag], how do emerging economies counter the financial crisis eating into their economies? Will the relative insulation of the real sector in the emerging economies as compared to the financial sector continue to be insulated in the medium or longer term?

Let us consider the Chinese economy in the context of the above posers. As the equities have failed to decouple from the global financial crisis, will the commodities remain decoupled? The commodity index of The Economist measured in euros went up from 144.1 on 15 January to 152.5 on 17 March showing a rise of 5.8% in two months. The crashing dollar cannot be the only reason for this rise in commodity prices. There must be other factors pushing up commodities. The Mint of March 28, 2008 observes that with China economy becoming the world's workshop, Chinese demand is also

seen as a factor in boosting commodity prices. If the Chinese demand is a derived demand linked to exports to the US, the demand for commodities will also fall pushing down their prices if Chinese export to the US decline on account of the slowing US economy. [It is pointed out that as compared to the Chinese economy that is export driven the Indian economy is insulated and inward-looking].

A report published by the UBS Economist Jonathan Anderson in September 2007 says that China is not an export driven economy. He argued that while the headline exports to GDP ratio is high in China, that metric is misleading because exports are defined as gross turnover while GDP is measured in value-added terms. Anderson takes the value-added proportion of Chinese exports and conclude that it is just under 10% of Chinese GDP, slightly higher than India. Thus, the impression that Indian economy is relatively insulated as compared to the Chinese economy may be wrong.

Mint points out that with the Chinese economy growing by 11.2% in the 4<sup>th</sup> quarter of 2007, when the US GDP growth was flat, the Chinese government proudly announced that domestic consumption accounted for a bigger slice of GDP growth than investment and exports in 2007. This happened for the first time in Chinese economy in the last 7 years.

Consider the above in the light that until December 2007, the slowdown of the US economy concentrated mainly on the housing sector. Non-housing activities maintained a 2.5% growth and therefore, steady demand for Asian products continued. This picture has now changed. Further, there is a time lag between weakening in US consumer spending and Asian exports. Chinese exports normally lag US consumption by 5 to 6 months.

The other big reason for rising commodity prices is buying by funds that have started adding commodities to their portfolio. But if the balance sheets of the global banks continue to contract showing impact of the de-leveraging, commodities may not remain an attractive investment. Therefore, emerging economies need to decouple themselves from the global slowdown. Otherwise, like equities, the real economy may also experience a decline.

What is the role of monetary policy in insulating emerging economies from the recessionary conditions affecting the global economy? The best contribution that monetary policy can make for fostering innovation and growth is to provide an environment of low inflation and low inflation expectations along with confidence in



the maintenance of financial stability. Entrepreneurs take considerable risk: on top of that if we add macroeconomic risks in terms of higher inflation, high inflation volatility and higher interest rates, then the risk perception can be such that entrepreneurship, innovation and investment get effectively constrained. This will inevitably result in lower investment rates and hence lower economic growth, says Dr. Rakesh Mohan. To keep the momentum of high growth, it is extremely important to recognize that the monetary policy has to ensure that inflation and inflation expectations are well anchored. Monetary policy in emerging economies should work for promotion of innovation, investment and entrepreneurship.

“There is evidence that pro-cyclical behaviour of financial markets and pro-cyclical macroeconomic policies have not encouraged growth; they have in fact increased growth and consumption volatility in developing countries that have integrated to a larger extent in international financial markets. The menu of macroeconomic policies for financial and real economic stability has thus expanded in recent years to multiple objectives and significant trade-offs. Preventive or prudential macroeconomic and financial policies, which aim to avoid the excess accumulation of public and private sector debts during periods of upward cycle, have become a part of the standard policy prescription.

Policy choice presently involves a mix of counter-cyclical fiscal and monetary policies, which also include the practice of an appropriate exchange-rate regime, buttressed by active capital account management that reduces the risks that can arise from turbulence in international financial markets. Such measures would also include adequate prudential regulation of the financial sector, and particularly of the banking system. Thus, for instance, the increase in risk weights on lending to certain sectors such as real estate has been aimed at curbing excessive credit growth to sectors that seem in danger of overextension.

We need to pursue somewhat counter cyclical monetary and fiscal policies with appropriate external sector management, ensuring overall financial stability – price stability, low inflation, low inflation expectations and low inflation volatility. It is only under these conditions, that investment, innovation and growth can be maintained in a sustainable fashion. We must continue to ensure that the growth momentum is sustained with price stability.”

### **African Economies**

Emerging economies in Africa would play a greater role in helping the world economy

in the current slow-down phase. Regional blocks like the Economic Community of the West African States, the Southern African Customs Union and the East African Community will eventually resolve the continent's most intricate and intractable diplomatic and economic problems. Mr. Ian Bremmer, a senior fellow at the World Policy Institute writes in the TOI of 21 April, 2008 that there are three main reasons why many sub-Saharan countries are performing well.

- (1) First, high commodity prices yield windfall profits for the region's leading producers of raw materials.
- (2) Growing demand for energy, metals and minerals, particularly in China, has driven unprecedented levels of Foreign. Even large pension funds are beginning to take notice.
- (3) Moreover, a large number of Africa's poorest countries have benefited from exponential growth in (primarily US based) philanthropy. Every year, African living outside the continent send roughly \$30 billion to family and friends back home. These remittances are vitally important for economic stability in several African countries. An economic slowdown in the US and Europe could substantially slow this infusion of cash, because immigrants are often the first to lose their jobs when recession fears take hold.

Though Africa's frontier economies Nigeria, Kenya and South Africa—are less vulnerable than other emerging markets to global financial turbulence, they are highly vulnerable to political turmoil closer home.

Kenya's troubles run deep. Solid economic expansion and one of the world's fastest growing stock markets have not helped Kenya avert a deepening political crisis and mounting ethnic violence since disputed presidential election results in December.

Most of Nigeria's problems are well known. Militants in the oil-rich Niger Delta region have at times shut down as much as 30 per cent of the country's oil exports.

### **Chinese Woes**

Chinese stock markets have fallen by nearly half since its peak in November 2007. The decline has wiped out \$2.5 trillion in wealth. The benchmark Shanghai Composite Index lost 49 per cent since topping out along with other global markets in October,

2007. The slide was triggered by the global economic slowdown combined with the high valuations of Chinese stocks.

Some international funds have felt pain because the plunge in Shanghai-listed shares has been matched by similarly steep declines in shares of Chinese companies listed in Hong Kong. Other US investors mostly are unlikely to feel much direct impact from China's stock fall, because the shares traded in Shanghai and Shenzhen are off-limits to the vast majority of foreigners. While a few US funds have received permission to invest in these stocks, their perception is that it is very speculative and the quality of companies is not comparable to Chinese companies listed in Hong Kong.

The fall in stocks is testing the Government's apparent resolve to let the market find equilibrium on its own.

While Chinese shares have been amongst the hardest hit, some other emerging markets also have had similar experience. They fell 6% in 2008 after rising an average of 32% a year over the past five years.

Both India and China have seen inflation fears worsen in recent weeks, which could force their Governments to tap the brakes harder on economic growth affecting corporate earnings.

The Mint of April 21, 2008 reports that some emerging markets are holding their own. Russia's stock market is off five per cent in 2008 while Brazil's benchmark index climbed 1.6 per cent. This the analysts attribute to cheaper stocks and the commodity boom. Russia and Brazil are big commodities exporters, although demand growth may slow down along with slower economic growth in India and China. While China has performed weakly on stock markets front, its GDP reported a 10.6 per cent rise for the first quarter. This was caused by double-digit gains in retail sales and home prices that helped offset slowing exports.

China's market turns on individual investors. In 2007, they poured into stocks, driven by the belief that the country deserved a stock market as turbocharged as the economy itself. They closed 33% of the 58 million trading accounts opened in 2007. Among those most affected are big Government entities, which are the controlling shareholders in most listed companies. The Shanghai index has fallen further than the Dow Jones Industrial Average deed when it lost 36 per cent in two months around October 1987. The NASDAQ Composite Index lost 78% peak-to-trough starting in 2000. The Shanghai

index fell 55% between June 2001 and July 2005—years when the economy averaged 9.5 per cent expansion annually in GDP. Some fund-raising plans are now in jeopardy, including a dollars 20 billion securities offering by Ping An Insurance Group Company and the listing of several property companies. A widely accepted measure of stock valuations, the price-earning ratio, has fallen on the Shanghai market to 35 times announced income from a peak of about 70 times last year.

### **WTO and Emerging Economies**

Possibly a majority of the members of the WTO are unhappy over the lack of delivery of the promises of the Uruguay round and the manner in which the organization itself is functioning.

Developing countries [emerging economies] feel that they have been short-changed, forced into trade liberalization patterns that have had de-industrializing effects and created agrarian crises, even as the promised benefits of increased market access in agricultural commodities and textiles have been denied to them.

The spirit of the Agreement on Agriculture and of the Agreement on Textiles has been breached not only in the small print of these agreements but also in the implementation. Developing country governments also feel hemmed in and their citizens feel exploited, by the range of new rules that affect non-trade policies within the country, including those related to intellectual property.

Even developed countries are less than enthusiastic about the multilateral process, which makes complete domination difficult and does not allow for even more aggressive opening up of markets of other countries. The US has treated WTO rules and decisions with a degree of contempt when these do not suit its purpose, even while it had used it as an instrument of pushing for trade liberalization in its favour.

Both the US and the EU are voting in the WTO talks while their hands sign a plethora of bilateral and regional trade agreements outside the scope of the WTO. Such deals now cover 70 per cent of world trade.

The most massive trade liberalization the world economy has ever experienced after the Uruguay Round has been accompanied by no commensurate increase in trade flows! In the period after the signing of the Uruguay Round Agreement and after the formation of the WTO [that is 1995 onwards] world trade experienced no greater trend of growth and possibly even greater volatility compared to the previous decade.

The functioning of the WTO itself has come in for severe criticism. Two of the Ministerial meetings—at Seattle and at Cancun—failed to come to any agreement at least partly because of developing country members' disgust at the heavy handed manner in which the secretariat sought to impose its will [largely reflecting the US-EU positions] to influence the discussions and avoid democratic decision-making.

Aileen Kwa and others have exposed the infamous “green-room” discussions of WTO negotiations, in which small groups of developing countries have been “persuaded” or forced to accept decisions they had initially opposed.

Even the Disputes Settlement Procedures have become another hurdle, especially for small developing countries who find them extremely expensive, cumbersome and unduly prolonged.

Clearly there is much to reform in both the process of negotiations and in the functioning of the WTO. The WTO itself instituted a special commission to look into these matters, focus on institutional issues, and provide recommendations to reform the way the organization works and how decisions are made.

The Report of the Commission titled “The Future of the WTO”, Geneva, WTO, 2005 however justifies and defends not only the entire set of principles on which the trade negotiations have been so far based, but also the clearly problematic working of the WTO. Being headed by Peter Sutherland, the first Director-General of the WTO, and currently Chairman of two international conglomerates of finance and industry—Goldman Sachs International and British Petroleum, the Commission's Report is not unexpected. It also included in its eight members the most vociferous advocates of free trade the Indian economist Prof. Jagdish Bhagwati.

The report argues the “green room” meetings, with limited access, are both appropriate and necessary, notwithstanding their undemocratic nature.

It is an axiom for the Commission that trade does inspire growth and growth will combat poverty. This is accepted so uncritically that the evidence on recent de-industrialization and associated lack of employment in developing countries is simply not considered. “The WTO is about providing opportunities—it does not provide guarantees nor does it provide all the conditions for participation in the global economy.” The Report says. “The WTO constrains the powerful. No doubt that is why the share of the MNCs in global trade has increased dramatically over the past decade, and

concentration of all major spheres of economic activity has accelerated greatly. In any case any shortcomings are not because of the WTO system but because individual member countries are unable to use the manifold benefits. If people are suffering as a result of trade liberalization and increased patent-based monopolies, it is their own fault.”

About loss of policy autonomy of governments and the increasing interference of the WTO rules in domestic economies, the Report feels that in the context of the WTO, the complaint over sovereignty is a red herring. It is misplaced because; as the Report says “the governments can now apparently reclaim control at the multilateral level!”

The Report condemns preferential trade agreements—except, the EU and NAFTA, which are supposed to be all right because they apparently encourage a more positive attitude to multilateralism!

The PTAs of developing countries such as Mercosur [common market at Argentina, Brazil, Paraguay and Uruguay] are seen as undesirable because they only involve trade diversion. They are looked upon as stumbling blocks to multilateral process.

WTO gives Special and Differential Treatment [SDT] to developing countries. The Report opines that SDT is based on two wrong assumptions, viz,—[1] that demands for reciprocal concessions from developing countries are inappropriate because of different effects of trade liberalization in all cases; [2] that the markets of developing countries are so small as to be insignificant and so concessions do not really matter.

Actually, the Report argues the markets in developing countries have actually grown and there are strong benefits of liberalization in all cases. The Report suggests that SDT mechanisms require further study and research.

The Generalised System of Payments [GSP] for developing country exports has encouraged industrialization in these countries. But the Report concludes that the GSP has had little positive effect.

In short the Report calls for continuation and even acceleration of indiscriminate trade liberalization without concern for its impact on employment and economic activity, no controls on unilateralism by the strong members, especially the US, no protection from the monopolies created by the working of the TRIPS agreement. It calls for formalizing the unequal and undemocratic manner of functioning of the WTO.

Emerging economies have to derive their alert from this. Having done so, they have to devise home made strategies to ensure growth and performance even though the global economy is slowing. The deterioration in the health of the global economy had its genesis in the incipient inflation in the US economy between 2004 and 2006. During this period the Federal Reserve increased its discount rates in phases from 1 per cent to 5.25 per cent. It is one matter to say that it was aggressive trade expansion on the part of banks in advanced countries to lend even to NINJA [no income, no job] borrowers in order to command high rates of interests and have surge in incomes. These are called sub-time borrowers. Since August 2007 major banks issued one after another report of disastrous sub-prime losses. Prior to that between 2004 and 2006 when the Federal Reserve discount rate was on the increase, holders of home mortgages found their payments on the home loans rise. This rise in rates brought about a disaster for banks that had given loans to sub-prime borrowers. Further, many large investment banks and other financial institutions took significant positions in credit derivative transactions, some of which served as credit default insurance. Due to the effects of liquidity risk, credit risk and asset price risk, the financial health of investment banks declined. This increased their potential risk to the counter parties creating further uncertainty in financial markets. Bear Stearns was a victim of this imbroglio in global financial markets. One of the effects of the sub-prime prices caused by high-risk US home owners defaulting on their home loans was a tightening of credit conditions. Banks, which were unable to discern who was holding bad debts and who was a reliable borrower, stopped lending to each other sending inter-bank lending rates sharply higher. Adding fuel to the fire the ever-innovative financial services industry repackaged US home loans as new financial instruments. This exacerbated the credit problems as the MBS markets collapsed. When will this global credit crisis come to an end? This will happen when the overhang of the inventory of newly built home loans is largely liquidated and the home price deflation comes to an end. Presently the value of the home equity is uncertain and consequently the buffer for home mortgages is also hazy. This has much more adverse affect on collaterals for residential mortgage-back securities. The crisis is making banks and financial institutions take huge losses. The situation will stabilize when the home price deflation phase ends. This may take a protracted adjustment. But then the affected economy across the globe will come back to business.

## **Derivatives**

How has this affected the corporate performance and consequently corporate governance in emerging economies? The Mint of April 29, 2008 reports about accumulation of

derivatives losses with many Indian companies taking a large hit on their profits. Indian companies and banks have been announcing big mark-to-market (MTM) losses on account of their exposure to exotic instruments of foreign exchange derivatives. The Institute of Chartered Accountants of India has issued a guidance on accounting for derivatives making companies account for negative MTM losses. Accounting Standard 30 (AS-30) deals with a company's MTM losses from the derivatives business. AS-30 will come into effect from 2011, but the ICAI has suggested that Indian companies should start recognizing their MTM losses on derivatives trade from March 2008. Bharati Airtel Limited recorded a MTM loss of Rs.204.5 crore, including Rs.123 crore towards 'embedded derivatives'.

Under the Indian law, Indian banks are not allowed to have a naked or un-covered exposure to cross-currency derivatives. This means, all cross-currency options and swaps of their customers are hedged back-to-back with the same tenure and amount with foreign banks. Thus, if a company defaults, banks will have to pay to settle the contracts with counter parties.

More and more Indian companies are moving courts against banks over the legality of sophisticated foreign exchange derivatives. The ICAI guidance that all companies should disclose and provide for losses on derivative contract from March 2008 is acting as a trigger for more court cases against banks.

### **A Case Study**

An Indian software services company [KPIT CUMMINS INFOSYSTEMS] having about 98 per cent of its revenues in foreign currencies entered into forex derivative transactions worth \$ 42.6 million (Rs.172.2 crore) covering a period of 5 years. Apart from the rupee-dollar conversion rate, the contracts also had a component of 'contingent premium payment with reference to the euro-US dollar rates' beyond the benchmark rates. This meant that the company's exposure was driven by the way the euro moved against the US dollar. The contracts had not yet been cancelled and the loss on MTM basis was only notional. The company is in the process of ascertaining the accounting treatment for these transactions in the context of the latest guidance of the ICAI. If in the context of the contingent premium payment clause the ICAI requires the company to book the MTM loss, the amount of the loss on foreign exchange derivative contracts will be Rs.89.27 crore, although the company thinks this is only a notional loss, while many other Indian companies have booked huge MTM losses on account of foreign



exchange derivatives: Wockhardt Limited Rs.27.90 crore; Maruti Suzuki Rs.50.48 crore; Zee Entertainment Rs.11.16 crore, etc.

AS-30 defines a derivative as a financial instrument or other contract with all three of the following characteristics:

- (a) its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the 'underlying');
- (b) it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and
- (c) it is settled at a future date.

Para 69 of the Accounting Standard requires as follows—

“If there is objective evidence that an impairment loss on loans and receivables or held-to-maturity investments carried at amortized cost has been incurred, the amount of the loss is measured as the difference between the asset’s carrying amount and the present value of estimated future cash flows (excluding future credit losses that have not been incurred) discounted at the financial asset’s original effective interest rate (i.e., the effective interest rate computed a initial recognition). The carrying amount of the asset should be reduced either directly or through use of an allowance account. The amount of the loss should be recognized in the statement of profit and loss.”

Paras 95 and 96 and 97 and 98 of the Accounting Standard require as follows:

- 95. Hedge accounting recognizes the offsetting effects on profit or loss of changes in the fair values of the hedging instrument and the hedged item.
- 96. Hedging relationships are of three types:
  - (a) *fair value hedge* : a hedge of the exposure to changes in fair value of a recognized asset or liability or an unrecognized firm commitment, or

an identified portion of such an asset, liability or firm commitment, that is attributable to a particular risk and could affect profit or loss.

- (b) *Cash flow hedge* : a hedge of the exposure to variability in cash flows that (i) its attributable to a particular risk associated with a recognized asset or liability (such as all or some future interest payments on variable rate debt) or a highly probable forecast transaction and (ii) could affect profit or loss.
  - (c) *Hedge of a net investment in a non-integral foreign operation* : as defined in AS-11.
97. A hedge of the foreign currency risk of a firm commitment may be accounted for as a fair value hedge or as a cash flow hedge.
98. A hedging relationship qualifies for hedge accounting under paragraphs 99-113 if, and only if, all of the following conditions are met.
- (a) At the inception of the hedge there is formal designation and documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge. That documentation should include identification of the hedging instrument, the hedged item or transaction, the nature of the risk being hedged and how the entity will assess the hedging instrument's effectiveness in offsetting the exposure to changes in the hedged item's fair value or cash flows attributable to the hedged risk.
  - (b) The hedge is expected to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk, consistently with the originally documented risk management strategy for that particular hedging relationship.
  - (c) For cash flow hedges, a forecast transaction that is the subject of the hedge must be highly probable and must present an exposure to variations in cash flows that could ultimately affect profit or loss.
  - (d) The effectiveness of the hedge can be reliably measured, i.e., the fair value or cash flows of the hedged item that are attributable to the

hedged risk and the fair value of the hedging instrument can be reliably measured.

- (e) The hedge is assessed on an ongoing basis and determined actually to have been highly effective throughout the financial reporting periods for which the hedge was designated.

The ICAI guidance demands accounting for the losses on financial assets held in derivatives form. What would KPIT Cummins Infosystems do in view of the fact that its forex derivatives contract has a provision for payment of premium covering unfavourable changes in the euro-US dollar exchange rate and the loss as on March 31, 2008 is notional ?

### **Indian Scenario**

As an emerging economy under the WTO, study of India's position and policies for attracting greater resources, investments, technology and trade need a closer look.

Although S&P rates India below investment grade, at BB+ for long-term lending and B for short-term lending, foreign institutional and direct investors have shed their reluctance to profit from the India story. Net capital inflows at \$ 14.7 billion in April-December 2005 were made up of portfolio investment (\$8.2 billion), direct investment (\$4.7 billion), NRI deposits (\$1.1 billion) and short-term credit (\$1.7 billion). Excluding the India Millennium Deposit redemption, external commercial borrowings have been placed at \$4 billion and net capital inflows at \$20.2 billion by the RBI [Hindu Business Line, April 21, 2006]

Reforms launched in India in early 1990s began a gradual shift towards capital account convertibility. Foreign natural persons except non-resident Indians (NRIs) are prohibited from investing in financial assets in India. But such investments were permitted by foreign institutional investors (FIIs) and Overseas Corporate Bodies (OCBs) with suitable restrictions.

### **FII Role**

The Report of the Committee on Liberalisation of Foreign Institutional Investment [Lahiri Committee Report] points out that initially the idea of allowing FIIs was that they were broad-based, diversified funds, leaving out individual foreign investors and

foreign companies. The only exception was the NRI and OCB portfolio investment through the secondary market, which were subject to individual ceilings of 5% to prevent a possible takeover. Individuals were left out because of the difficulties in checking on their antecedents, and of their lack of expertise in market matters and relatively short-term perspective. OCB investments through the portfolio route have been banned since November 2001.

In February, 2000, the FII regulations were amended to permit foreign corporates and high net worth individuals to also invest as sub-accounts of Securities and Exchange Board of India (SEBI)-registered FIIs. Foreign corporates and high net worth individuals fall outside the category of diversified investors. FIIs were also permitted to seek SEBI registration in respect of sub-accounts for their clients under the regulations. While initially FIIs were permitted to manage the sub-account of clients, the domestic portfolio managers or domestic asset management companies were also allowed to manage the funds of such sub-accounts and also to make application on behalf of such sub-accounts. Such sub-accounts could be an institution, or a fund, or a portfolio established or incorporated outside India, or a broad-based fund, or a proprietary fund, or even a foreign corporate or individual. So, in practice, there are common categories of entities, which could be registered as both FIIs and sub-accounts. However, investment in to a sub account is to be made either by FIIs, or by domestic portfolio manager or asset management company, and not directly.

In view of the recent concerns of some unregulated entities taking positions in the stock market through the mechanism of Participatory Notes (PNs) issued by FIIs, the issue was examined by the Ministry of Finance in consultation with the Reserve Bank of India (RBI) and SEBI. Following this consultation, in January 2004, SEBI stipulated that PNs are not to be issued to any non-regulated entity, and the principle of "Know Your Client" may be strictly adhered to. SEBI has indicated that the existing non-eligible PNs, will be permitted to expire or to be wound-down on maturity, or within a period of 5 years, whichever is earlier. Besides, reporting requirement on a regular basis has been imposed on all the FIIs.

The following entities, established or incorporated abroad, are eligible to be registered as FIIs:

- (a) Pension Funds
- (b) Mutual Funds

- (c) Investment Trusts
- (d) Asset Management Companies
- (e) Nominee Companies
- (f) Banks
- (g) Institutional Portfolio Managers
- (h) Trustees
- (i) Power of Attorney holders
- (j) University funds, endowment foundations or charitable trusts or charitable societies.

Besides the above, a domestic portfolio manager or domestic asset management company is now also eligible to be registered as an FII to manage the funds of sub accounts.

The FIIs can also invest on behalf of sub-accounts. The following entities are entitled to be registered as sub-accounts: (i) an institution or fund or portfolio established or incorporated outside India, (ii) a foreign corporate or a foreign individual.

FIIs registered with SEBI fall under the following categories:

- (a) *Regular FIIs* – those who are required to invest not less than 70 per cent of their investment in equity-related instruments and up to 30 per cent in non-equity instruments.
- (b) *100 per cent debt-fund FIIs* – those who are permitted to invest only in debt instruments.

Forward cover in respect of equity funds for outstanding investments of FIIs over and above such investments on June 11, 1998 was permitted. Subsequently, forward cover up to a maximum of 15 per cent of the outstanding position on June 11, 1998 was also permitted. This 15 per cent limit was liberalized to 100 per cent of portfolio value as on March 31, 1999 in January 2003.

Like in other countries, the restrictions on FII investment have been progressively liberalized. From November 1996, any registered FII willing to make 100 per cent

investment in debt securities was permitted to do so subject to specific approval from SEBI as a separate category of FII or sub-accounts as 100 per cent debt funds. Such investments by 100 per cent debt funds were, however, subject to fund-specific ceilings specified by SEBI and an overall debt cap of US\$ 1-1.5 billion. Moreover, investments were allowed only in debt securities of companies listed or to be listed in stock exchanges. Investments were free from maturity limitations.

From April 1998, FII investments were also allowed in dated Government securities. Treasury bills being money market instruments were originally outside the ambit of such investments, but were subsequently included from May, 1998. Such investments, which are external debt of the Government denominated in rupees, were encouraged to deepen the debt market. From April, 1997, the aggregate limit for all FIIs, which was 24 per cent, was allowed to be increased up to 30 per cent by the Indian company concerned by passing a resolution by its Board of Directors followed by a special resolution to that effect by its General Body.

In its latest Discussion Paper the SEBI, in consultation with Government of India, has proposed the following measures in respect of investment in India through participatory notes:

### **Proposed Measures**

- (1) FIIs and their sub-accounts shall not issue/renew ODIs with underlying as derivatives with immediate effect. They are required to wind up the current position over 18 months, during which period SEBI will review the position from time to time.
- (2) Further issuance of ODIs by the sub-accounts of FIIs will be discontinued with immediate effect. They will be required to wind up the current position over 18 months, during which period SEBI will review the position from time to time.
- (3) The FIIs who are currently issuing ODIs with notional value of PNs outstanding (excluding derivatives) as a percentage of their AUC in India of less than 40% shall be allowed to issue further ODIs only at the incremental rate of 5% of their AUC in India.
- (4) Those FIIs with notional value of PNs outstanding (excluding derivatives) as a percentage of their AUC in India of more than 40% shall issue PNs only against

cancellation / redemption / closing out of the existing PNs of at least equivalent amount.

### **Hedge Fund Activism**

Dynamics of global finance is marked by hedge fund and private equity activism. This is proving a spur to several governance issues for corporates. The US SEC Chairperson, Christopher Cox has estimated that in the global financial marketplace, hedge fund assets have increased about 3000 per cent since 1990. Dollars 1.8 trillion in assets is managed by about 9000 hedge funds worldwide. The Report of the Conference Board Research Group on hedge fund activism points out that the capital behind hedge funds no longer represents only the wealthy individuals who had underpinned the industry. The recent growth is attributable to investments by institutions. Long – term investments by institutions such as private and public pension funds, endowments, and foundations are now interested in absolute-return strategies. They view hedge funds as integral part of their asset allocation decisions. A number of hedge fund managers have undertaken an activist role within their portfolio companies, attempting to influence financial and strategic decisions and effect corporate governance changes. Since 2003 the marketplace has registered several instances of shareholder activism involving hedge funds; in nearly two thirds of the cases, corporate management either immediately acquiesced in the funds' demands – or, after a period of initial resistance and negotiation—agreed to major concessions to meet the activists' expectations.

What strategies do corporates adopt vis-à-vis the fund activism? The Conference Board Report makes some recommendations for corporation. It advises them to remain informed on institutional holdings and securities trading activities. They should understand hedge fund investment strategies and activists tactics. They should be aware of strategic, financial and governance vulnerabilities, remain open minded about change. They should participate in formulation of response strategies and ensure their proper implementation. The Report advises them to engage in an open dialogue with investors.

Management should actively monitor trading in the company's securities holdings, including shares, fixed income and convertible products. Particular attention should be paid to large accumulations of stock or extraordinary stock purchase patterns. Companies avail themselves of securities surveillance services and other external resources to gather additional intelligence in stock accumulations and changes in beneficial ownership.

Companies should maintain upto date profiles of private equity groups, hedge funds and other pools of capital with material investments in the company's securities. They should know about such entities' prior investment decisions and current portfolio composition; sources of capital and redemption practices; modes of operation, history of activism, time horizons, compensation structures and performance targets. The Conference Board Report gives a host of details about various funds.

The Report suggests that in-house counsel, CFOs and governance professionals should be familiar with the structure of hedge funds and their performance drivers and recognize hybrid investment vehicles that pursue alternative investment strategies. Legal counsel and governance experts should remain abreast of any case law and legal statutory developments that might influence hedge funds' future behaviour.

"Management and board members should proactively develop (either in-house or with the assistance of outside experts) an inventory of strategic, governance, or financial matters that may single out the company as a target. To facilitate this process, the company should consider designating a corporate governance officer who would report directly to the nominating/governance committee or the full board on emerging best practices. Similarly, boards should expect senior financial executives and internal audit officers to promptly bring to the attention of the board those financial conditions (e.g., a substantial cash balance) that could make the company attractive to corporate activists. Finally, as part of the regular review of the company's strategic plan and business performance, the board should seek updates of investor expectations, as well as industry benchmarks and the competitive environment."

With hedge funds increasingly taking activist stances toward corporate management, companies are often caught unprepared and unable to rely on traditional investor relations exercise. Hedge funds are not a monolithic phenomenon and, unlike other investors, they are not required to disclose their investment strategies.

Developing effective communication channels with major investors is a sound practice, but the stakes are higher with hedge funds.

Board should not assume that requests for change made by activist hedge funds always reflect a hostile orientation or short term investment goals. Instead, directors should be open minded and analytical and review strategic, and governance related demands in light of the company's current strategy, financial and governance analyst reports, the activist's profile, and long term interests of all shareholders.



Management should consider meeting with representatives of activists hedge funds. Boards may designate one or more directors to also meet with activists if circumstances warrant. This should be done after considering insider trading regulations.

The policy dictate to improve governance in emerging economies, particularly India, is to deepen and widen the corporate and Government debt market. This would provide a hedge against fluctuations in the equity markets. Dr. Rakesh Mohan of the Reserve Bank of India makes an interesting study of the steps by the central banker and the Government of India in the interests of the under developed debt market in India. Following are the observations that emerge from his study:

### **Debt Market Reforms**

The face of Indian debt market is changing with Government and RBI interventions and emerging economic development. The Fiscal Responsibility and Budget Management Act has prohibited the RBI from subscribing to Government securities in the primary market with effect from April 1, 2006. This will complete the transitions to a fully market based issuance of Government securities. This process was started in the early 1990s with the introduction of auctions.

The 12<sup>th</sup> Finance Commission recommended the end of the role of the Central Government as a financial intermediary for the State Governments. This role is effectively ending but for a few transitional arrangements. In the coming years the State Governments' borrowings will be more and more market determined. In the long term, we will witness a vibrant sub-national debt market.

With the growth of the economy above 8% and expected to continue to so in the coming year with a moderate dose of inflation, financial intermediation will have to improve especially in the debt market.

Infrastructure financing and investment in industry will require debt financing for medium to long term to supplement traditional bank financing.

As Government finances both at Central and State levels improve with the growth in the economy, the negative savings rate in the public sector is turning into positive since last five years. The gross domestic savings have been around 30% of GDP on a more or less sustained basis. The combined fiscal deficits are falling enabling the canalization of financial savings to the private sector. This may create greater demand for debt securities.

## **Banking Amendment**

An amendment to the Banking Regulation Act has been introduced in the Parliament. This would, if passed, enable the removal of 25 per cent minimum Statutory Liquidity Ratio as and when feasible. The Government Securities Bill (that will replace the Public Debt Act) has been approved by the Standing Committee in Parliament. The passage of the Government Securities Bill will make possible introduction of new instruments like STRIPS. STRIPS is the acronym for Separate Trading of Registered Interest and Principal of Securities. STRIPS let investors hold and trade the individual interest and principal components of eligible treasury notes and bonds as separate securities. STRIPS are popular with investors who want to receive a known payment on a specific future date. STRIPS are called "Zero-coupon" securities. The only time an investor receives a payment from STRIPS is at maturity. STRIPS are not issued or sold directly to investors. They can be purchased and held only through financial institutions and Government securities brokers.

The current account deficit for India has been widening. This reflects heightened investment activity in the country and hence greater absorption of capital flows. Gross capital inflows have gone up by more than half to \$ 227 billion while the net inflows have almost doubled to \$ 45 billion. The net inflows through external commercial borrowings have risen more than five fold to \$ 16 billion. The Prime Minister's Economic Advisory Council estimates that net FDI will almost double to \$ 15 billion, and portfolio flows will grow 76% to \$12.5 billion in 2007-08. There are, in fact, some tightenings in External Commercial Borrowings area to rein in the Rupee appreciation vis-à-vis the US dollar. The money raised from ECBs is either to be kept abroad until the company actually needs it in India or kept abroad and spent on foreign currency expenditure.

The robust growth in industrial activity has resulted in strong credit growth, which has created strong competition for available resources. It has become incumbent that bond financing supplements traditional bank financing to take care of the growing credit needs of the economy. Resource allocation has to be more efficient.

## **Constitutional Provisions**

The Union government and the State Governments have been empowered under Articles 292 and 293 of the Constitution of India to borrow money upon the security of the Consolidated Fund of India and the States within permissible limits. The Constitution also empowers the Union and the State Governments to give guarantees

within such limits as may be fixed. The Union Government debt consists of three components,—internal debt, external debt and “other liabilities”. Similar debt structure exists in case of State Government also, except for external debt component as States are not supposed to borrow directly from foreign countries/sources. This system of classification in three components has been adopted by the Ministry of Finance, Government of India, for statistical reporting purposes in line with SDDS (Special Data Dissemination Standard) of IMF.

Internal debt and external debt constitute the public debt of the Union Government and are secured under the Consolidated Fund of India. On the other hand, “other liabilities” of the Union Government form part of the Public Account of India. The Indian Constitution under Article 292 provides for placing a limit on the public debt secured under the Consolidated Fund of India. This does not include “other liabilities” covered in the “Public Account”. There is also a similar position under Article 293 of the Indian Constitution with respect to borrowing by the States, wherein the State legislatures have powers to fix limits.

The RBI manages the public debt and issues new loans on behalf of the Union and the State Governments under the powers derived from the Reserve Bank of India Act. It also undertakes cash and liquidity management for the Government of India and State Governments and administers the scheme of Ways and Means Advances.

Internal Debt Management Department of the RBI manages internal debt. This involves auctioning the Government debt from time to time, introduction of new instruments, smoothening the maturity structure of debt, placing of debt at market related rates and improving depth and liquidity of Government securities by developing active secondary market for them. The Public Debt Act, 1944 governs Government debt market. This act is proposed to be replaced by a new Government Securities Act in the near future.

Internal debt of the Union Government includes Market Loans, Special Securities issued to RBI and others, Gold Bonds, Compensation, Relief and other bonds, Treasury Bills of different maturities issued to the RBI, State Governments, commercial banks and other parties, WMA, Securities issued to International Financial Institutions, Marketable Securities and Special Union Government Securities issued against small savings.

The internal debt is classified into market loans, other long and medium term borrowings and short-term borrowings and shown in the receipt budget of the Union Government.

External debt of the Union Government comprises both long-term and short-term debt consisting of multilateral and bilateral borrowings of Government, borrowings from IMF, etc.

The liabilities other than internal and external debt include other interest and non-interest bearing obligations of the Government such as Post Office Savings Deposits, deposits under small savings schemes, loans raised through Post Office cash certificates, Provident Funds, interest and non-interest bearing reserve funds of departments like Railways, Telecommunications and others and other deposits and advances, both interest and non-interest bearing.

The “other liabilities” of governments arise in government accounts more in the capacity as a banker rather than as a borrower. Hence, such borrowings are shown as part of Public Account and are not secured under the consolidated fund.

The existence of an efficient Government Securities market is usually seen as an essential precursor for the corporate debt market. The Government Securities market before the 1990s was characterized by administered (and often artificially low) rates of interest, captive investors (banks) due to high SLR requirements, absence of a liquid, transparent secondary market for G-secs and lack of smooth and robust yield curve for pricing of the instrument. Low coupon rates were offered on Government securities to keep Government borrowing costs down, which made real rates of return negative for several years till the mid-1980s. During the 1980s the volume of debt expanded considerably, particularly the short-term debt, due to automatic accommodation to Central Government by the Reserve Bank of India, through the mechanism of ad hoc Treasury Bills. Mr. Rakesh Mohan in his speech at the 3<sup>rd</sup> India Debt Markets Conference of the citigroup and Fitch Ratings India lists the sequence of RBI’s market development activities in the 1990s—

- 1992 : Introduction of auction system for price discovery
- 1993 : Introduction of 91 day T – bill for managing liquidity and benchmarking
- 1994 : Zero Coupon Bonds were issued
- 1995 : Primary Dealer (PD) system was set up: DvP settlement system introduced: Floating Rate Bonds issued
- 1997 : Technical Advisory Committee set up, permitting repos in G-Secs, allowed

FIIIs to invest in G-secs; system of Ways and Means advances introduced for Government of India; introduced Capital Indexed bonds

- 1999 : OTC interest rate derivatives like IRS/FRAs introduced
- 2000 : Introduction of Liquidity Adjustment Facility (LAF) to manage short term liquidity mismatches
- 2002 : Operationalisation of Negotiated Dealing System (NDS) and CCIL. Trade data on NDS made available on RBI web site for transparency
- 2003 : Introduction of trading of G-Secs on stock exchanges, permitting non-banks to participate in repo market, introduction of exchange traded interest rate futures.

Later, there was the introduction of the Real Time Gross settlement system that facilitated better liquidity management. Then there was the introduction of the market stabilization scheme. It expanded the instruments available to the Reserve Bank for managing the surplus liquidity in the system.

The above reforms aimed at among other things, making available an active secondary market for operation of monetary policy through indirect instruments like Open Market for operations and repos. They can also be viewed as a systematic exercise for the development of the debt market as well as integration of financial market by making it deep, wide and transparent.

One must remember, in this context, that a well-developed capital market consists of both the equity market and the bond market; yet, it is generally the experience that the debt market segment of the capital market develops more slowly than the equity segment.

It appears that the Indian debt market, and the Government securities market in particular, is at a turning point on account of the various reforms and changes that are taking place in the system.

The reforms have been linked to the operational autonomy of the RBI. Stabilization of the monetary policy was the aim. In 1997 there was the abolition of the automatic monetization through the issue of ad-hoc treasury bills. This system was replaced by

Ways and Means Advances facility, within limits, to meet temporary cash flow mismatches for the Central Government. The effect of the reforms over the years shows the complexity and difficulty that is intrinsic to the development of an efficient debt market. The development is not made by the regulator alone. It requires collaboration between the regulator and the market players. It also requires consultation between the two. In India, associations like Fixed Income Money Market and Derivatives Association of India (FIMMD) and Primary Dealers Association of India (PDAI) have helped this process well. There is also in existence an active Public Debt system wherein Primary Dealers have acted as a linking mechanism between the market and the Regulator. The heterogeneity of the market participants, some of whom have brought in to the Indian market the best international technology, risk management practices, know-how of the instruments, especially derivatives has also helped greatly.

Another major reform was the introduction of the Real Time Gross Settlement system, which facilitates better liquidity management. The DVP III mode of settlement is the settlement process in which the funds as well as the securities are settled on net basis. It has also permitted the rollover of repos.

Thereafter several other developments have also taken place in the Indian Debt Market:

### **Interest Rate Futures**

When it was decided to introduce IRFs on NSE, guidelines were issued by RBI to enable RBI regulated entities to participate. IRFs are one-to-three month contracts. The underlyings are –futures contracts on notional 91-day Treasury Bills, futures contracts on notional 10 year coupon bearing bond and futures contracts on 10 year notional 10 year zero-coupon bonds. The mode of settlement was cash settlement with respect to the price of the notional bonds prevailing on expiration date. A “notional bond”, as per the Renters Financial Glossary is a standardardized bond with hypothetical terms (coupon and maturity), which represents the basis for a bonds futures contract.

While banks were allowed to use futures only to hedge their G-sec investment in Held for Trading (HFT) and Available for Sale (AFS) categories. PDs were allowed to deal in interest rate derivatives (IRDs) for both hedging and trading. However, due to lack of liquidity of the exchange traded futures market, SEBI in consultation with FIMMBA – simplified futures contracts on a 10-year notional bond, which is priced on the basis of yield to maturity’ (YTM) of a basket comprising of three bonds with maturity ranging from 9 to 11 years.

## **OTC Derivatives**

OTC Interest Rate Derivatives were introduced in 1999. Banks could undertake plain vanilla FRA and IRS (Interest Rate Swaps) contracts for their own balance sheet management and also for market making purposes, provided they ensure adequate infrastructure, risk management systems and internal control systems. Legally, however, OTC derivatives faced problems as section 18A of Securities (Contracts) Regulation Act allows only exchange traded derivatives and no amendment has been made to make OTC derivatives, as notified by RBI, legal.

## **Rollover of Repos**

RBI took the decision to move gradually towards, a pure inter-bank call/term money market. This called for removal of the operational/regulatory constraints in the repo market. One such constraint in the repo market was the inability to rollover contracts. To enable continuous access to the funds from the repo market, it was decided to permit rollover of repos. This is enabled along with DVP III.

## **DVP III**

DVP III mode of settlement is a settlement process in which funds as well as securities are settled on a net basis. In order to reduce the price risk assumed by market participants, sale of securities previously purchased is proposed to be permitted with certain safeguards built in to prevent short sales. To enable this as well as to enable rollover of repos, net settlement of securities is required. Therefore, it was decided to shift the settlement mode to DVP III

## **Market Stabilization Scheme**

Under this scheme introduced by RBI in March 2004 the Government would issue existing instruments such as Treasury Bills and/or dated securities by way of auctions, in addition to the normal borrowing requirements. This scheme was introduced in response to large-scale capital inflows and the consequent problems faced in managing excess liquidity absorption of a more enduring nature by way of sterilization from the day-to-day normal liquidity management operations. To provide transparency and stability to the financial markets, there is an indicative schedule for issuance of Treasury Bills / dated securities. The schedule is issued on a quarterly basis.

### **Capital Charge for Market Risk**

Bases II norms called for measures to ensure smooth transition in a phased manner. According the RBI advised banks to maintain capital charge for market risks over a two-year period as follows-

- (i) Banks were required to maintain capital charge for market risk in respect of their trading book exposures (including derivatives) by March 31, 2005.
- (ii) Banks were required to maintain capital charge for market risk in respect of securities included in the available for sale (AFS) category by March 31, 2006.

### **Primary Dealers' Role**

PDs are supposed to promote retailing in G-Secs and enable price discovery. PDs have improved liquidity in the Secondary market with the order driven trading on NDS, PDs are playing a significant role in developing the retail markets on exchanges. They assume responsibilities for market making for G-Secs and derivatives like interest rate derivatives. This has made the G-Sec market extremely broad based and diversified with the participation of banks, financial institutions, provident funds, insurance and pension funds, gilt mutual funds, corporate bodies, trusts, foreign institutional investors, individuals and NRIs. Auctions for Government securities have developed a high degree of sophistication. There is an ever-narrowing gap between the cut-off price and the weighted average cut-off price. The bids of the primary auction are near perfectly correlated with the secondary market yield curve indicating excellent price discovery. As Shri Rakesh Mohan has found, "a reasonably smooth and elongated yield curve of upto 30 years maturity emerged". This is probably comparable with those in the developed economies. Volumes of trading in the secondary market are increasing and bid-ask spreads are narrow. After Japan, India's G-Sec market is probably the largest in Asia.

Through a process of novation, a central counter party like the clearing corporation of India limited has provided excellent infrastructure and risk management means.

### **Floating Rate Bonds**

There is a perceptible improvement in the issuance of Floating Rate Bonds. FRB is an effective instrument for hedging interest rate risk by investors in that there maybe



elongation of the maturity profile of the Government Debt. These instruments are particularly popular during times of perceived market uncertainty.

### **Capital Indexed Bonds**

The CIBs offer inflation-linked returns both on the coupons and the principal repayments. These are offered with market determined real coupon rate that would remain fixed during the currency of the bonds. The semi-annual coupon payments on the bonds would be made by applying the fixed real coupon rate to the inflation-adjusted principal. The principal repayment at maturity would be the inflation-adjusted principal amount or its original par value, whichever is greater, thus providing an in-built insurance that at the time of redemption the principal value will not fall below par. The first CIB was issued in December 1997 which matured in December 2002.

### **Screen-based Trading**

A country-wide, anonymous, screen based, order driven system for Government securities was introduced in the stock exchanges in January 2003. It provides screen-based order-matching trading system on NDS. The trading platform called "RBI-NDS-GILTS-Order Matching Segment" is a part of RBI's NDS application. It is available to the NDS members in addition to the existing trading mechanism.

### **Clearing of OTC Interest Rate Derivatives**

A central counter party based clearing arrangement for OTC derivatives reduces counterparty risk and extends the benefit of netting. Such a system was being introduced through CCIL in order to strengthen the derivatives market and to mitigate the risks involved. This will strengthen the OTC IRD market.

### **Trade in non-SLR Securities**

Prudential guidelines issued by RBI on banks' investment in non-SLR securities require banks to report 'spot' transactions in listed and unlisted non-SLR securities on the NDS and settle them through CCIL. The settlement is on non-guaranteed basis and disseminates information relating to trades in listed as well as unlisted non-SLR debt instruments by NDS members. This measure is expected to enhance transparency in corporate debt market.

## **Indian Bond Market**

Presently, an attempt is on by the government and financial sector regulators in India to set up the local market for corporate bonds. There is a plan to operationalise a modern and efficient trading platform for corporate debt on the lines of the existing system for trading in government securities and money market instruments. There is also an initiation of other measures like introduction of repurchase agreements (repo) in corporate paper to boost trading in secondary markets, besides encouraging more issuers and widening the investor base for primary issuance. A start is expected to be made with the announcement of an electronic order-matching system, which would be purely quote-driven. The authorities are considering to utilize the option of a module of the Negotiated Dealing System, where government securities, repo transactions and money market instruments are traded for corporate debt. This could mean using the same clearing and settlement facilities provided by the Clearing Corporation of India, which guarantees all trades. The other option is for market participants such as banks and institutions to set up a trading platform or to allow exchanges to offer such a facility. The National Stock Exchange does not offer such a quote-driven system but it is yet to take off. At present, the Indian corporate bond market has a limited number of issuers and investors such as banks and institutions who hold the paper until maturity. The market is highly illiquid and primary issuance is usually through private placement with institutional investors. Companies have to go through the public offering route if the number of investors aggregates 50 or more. The government, RBI and SEBI have agreed on the framework for broadening the corporate debt market. While the local equities and government securities markets have developed over the past decade, the corporate bond market – both primary and secondary- has lagged for behind widening of the local market for corporate debt has become imperative with growing disintermediation and the investment needs of Indian companies. As the current statutory Liquidity Ratio threshold of 25% is lowered after Parliament approves amendments to the Banking Regulation Act, it would be necessary to broaden the investor base away from captive investors such as banks. Banks in India may also be nudged to list their issues, especially for their Tier II capital and to sell down their issues to retail investors. With more Indian corporates seeking to expand overseas and given the rising credit off take, it is reckoned that banks would not be able to meet the potential demand for funds. Infrastructure development also need long term funds, which calls for a focus on the debt segment of the market. Only a well-functioning corporate debt market can provide term-finance to infrastructure building. From the regulator's point of view, the reliance of corporate borrowers on

banks for funds sparks off worries relating to asset liability mismatch. Mr. M K Venu and Shaji Vileraman point out in the Economic Times of 17 April 2006 that banks raise money for lending with an average tenure of three years and then on-lend it for longer maturities. The R.H. Patil Committee on corporate bond market has suggested several measures including uniform stamp duty, introducing repo in corporate debt, bond insurance to protect against default, launching of exchange-traded interest rate Futures, uniform TDA rules and preventing fragmentation of issues. All this will be necessary to reduce reliance of corporates for funding on banks. Prime Database has reported that of Rs. 553840 million at debt, which was privately placed, only Rs.101910 million was accounted for by private companies.

Indian policymakers have not yet fully opened Indian rupee-denominated debt to foreign investors. That policy perhaps needs a review if interest of global investors were to be generated in the local currency emerging market debt. Following are the reasons that suggest the Indian policy needs a review.

As of April 10, 2006 overseas institutional investors had cumulative investment of \$ 202 million in Indian debt securities as compared to the hefty figure of US \$ 45 billion that have been poured into Indian stock markets by the foreign institutional investors. The huge difference is due to the policy of not opening the local currency debt for overseas investors.

International interest in local currency Indian bonds is low in absolute terms as well as in comparison to Indian stock purchases by overseas institutional investors. It is also nowhere near the government ceiling on foreign investment in local currency debt. The Finance Ministry recently increased this limit by 56 per cent to \$ 3.5 billion broken into \$ 2 billion for investment in government securities and \$ 1.5 billion for corporate bonds.

As at December 31, 2005, India had \$ 17 billion of foreign currency debt. This figure is 30 per cent more than Indian exports in 2004. Comparatively, this percentage is quite comfortable the external debt-to-export ratio of 300% Brazil had in 1995.

To enable portfolio diversification by foreign institutional investors in emerging markets, local currency debt provides an attractive, complimentary investment to traditional external dollar-denominated emerging market debt. The Indian government can, therefore, decide to allow rupee-denominated debt to become a globally acceptable product. Andy Mukherjee of Bloomberg reports that Standard and Poor's rates long-

term rupee debt at BB+, one level below investment grade, which is the same for Brazil's local currency-denominated external debt.

India's last years' maturing foreign currency debt was \$ 8.9 billion. This was more than adequately covered by the Reserve Bank's \$ 152 billion foreign exchange reserves. Mr. Andy Mukherjee points out that although India's current dollar liabilities are manageable, they may not always remain so. Indian companies are expanding rapidly, acquiring business globally. The local corporate bond market is almost non-existent; Indian companies are therefore taking on foreign currency liabilities. The government is also making it progressively easier for companies to borrow abroad. "At the same time, by restricting access to the rupee bond market to overseas investors, authorities are repressing the domestic financial system. They are also pushing local banks to take on hard-currency liabilities from Indians living overseas to supplement banks' meager lending resources".

Presently, the Finance Ministry is seeking participant's consent to remove the mandatory requirement that banks invest 25 per cent of their deposits in approved government securities. "One that happens, it will become even more important for the (India) authorities to find potential buyers of Indian public debt. Right now, local banks are the biggest investors in Indian government bonds".

The RBI is also introducing some of the long pending reforms in the Indian bond market. For instance, the RBI will finally bring in the "when issued" market, which would allow trade of government securities even before the auction. This was announced in the annual policy of RBI for 2006-07. "when issued" market is the forward market in government securities. It opens before the auction and remains open during and after the auction. S Bikhchandani, P Edsparr and C Huang of Anderson Graduate School of Management, University of California find that traders in the when-issued market take into account the fact that when-issued prices might reveal, at least partially, their private information. In particular, the change in when-issued prices on auction days after the auction closes but before the announcement of the auction results, is significantly related to the information innovation contained in the auction. [<http://repositories.cdlib.org>] They compare when-issued prices at the auction time with the winning prices in the auction. Both the auction and when-issued market on the day of the auction are markets for forward contracts with three days to maturity, so no adjustment is needed to make the comparison. ["The Treasury Bill Auction and the When-Issued Market : Some Evidence", August 30, 2000]

Further, SEBI issued, on September 30, 2003, guidelines stipulating the conditions in respect of private placement of in order to improve transparency and to improve the market for private placement of debt. These conditions govern issuance, listing and trading of privately placed debt securities. This has led to the improvement of the debt market. The smoothed and elongated yield curve is aided by abundant liquidity in the system. This has, according to Rakesh Mohan, set the stage for growth in infrastructure financing. Developments, in debt market should percolate down to infrastructure sector as well. When infrastructure needs go up they also contribute to an efficient functioning of corporate debt market. When equity markets are fairly well-developed, corporate debt markets need to go a long way so that India has a well-integrated financial market.

In India the policy effort is, as elsewhere, to achieve high growth with low inflation. India seems to have struck a fine balance at present, but the price situation is worsening. The latest inflation data, for the week ended January 19, 2007 showed prices ruling at a five-month high of 3.93 per cent. This number looks deceptively modest because of the high-base effect: inflation in the same period earlier year was 6.31 per cent. The present rise is on account of higher prices of grains, pulses, food-based manufactured items and industrial fuels. If the government chooses to hike petrol and diesel prices, with oil prices ruling very high, inflation might cross the danger marks. India is, however, lucky not to be caught in a high-inflation-low-growth trap, which curtails policy options. In the current situation, it can afford to pursue anti-inflationary policies, despite the world going the other way.

The government is, in fact, trying to leverage its relatively high interest rates by attracting inflows into debt. Following a SEBI announcement on January 31, foreign institutional investors can now part \$2.6 billion so far, besides another \$1.5 billion in corporate debt. This incremental measure suggests that the Reserve Bank wants to shore up reserves by attracting long-term flows. Equities the world over are likely to be volatile this year; in this situation, India's foreign exchange reserves can act as a buffer, particularly if the long-term debt component increases.

As professional bodies of asset managers and financial analysts, FIIs enhanced competition and efficiency of financial markets. Equity market development aids economic development. By increasing the availability of riskier long term capital for projects, and increasing firms' incentive to supply more information about themselves, FIIs can help in the process of economic development [Demigrtic-Kunt, A. and R. Levine (1996):

“Stock Market Development and Financial Intermediaries: Stylized Facts”, World Bank Economic Review, Vol. 10, pp. 341-69.]

FII contribute to better understanding of firms’ operations and improve corporate governance. The corporate governance movement has institutional investors at its core. There is some evidence that institutionalization increases dividend payouts, and enhances productivity growth.

FII inflows carry, on the other hand, the fear of management takeovers and potential capital outflows. The Committee on Liberalisation of FII Investments points out that all takeovers are governed by SEBI Regulations and sub-accounts of FIIs are deemed to be “persons acting in concert” with other persons in the same category unless the contrary is established. Further, reporting requirements have been imposed on FIIs and Participatory Notes cannot be issued to unregulated entities abroad. Hence, the fear of management takeovers may not be real. Thus, if there are domestic regulations that effectively prohibit institutional investors from taking management control, no country may fear management takeovers by FIIs.

FII inflows are regarded as “hot money”, because of the herding behaviour and potential for large capital outflows. Herding behaviour, with all the FIIs trying either only buy or only sell at the same time, particularly at the time of market stress, can be rational [Bikhchandani, S and S.Sharma (2000): “Herd Behaviour in Financial Markets”, Working Paper No. WP/00/48, International Monetary Fund, Washington DC, 2000]

With performance related fees for Fund Managers, and performance judged on the basis of how other funds are doing, there is great incentive to suffer the consequences of being wrong when everyone is wrong, rather than taking the risk of being wrong when some others are right. Value at Risk models followed by FIIs may destabilize markets by leading to simultaneous sale by various FIIs. Extrapolative expectations or trend chasing rather than focusing on fundamentals can lead to destabilization.

Hence what are required is adequate institutional safeguards. Yet, across the board relaxation for FII investments considerably enhances the attractiveness of the country for foreign portfolio inflows.

### **Role of Risk Management**

Financial Risk Management is an integral part of global equity investments. Successful

risk management requires keeping abreast of the markets, company fundamentals as well as client relationships. The same concepts can be applied on macro level for managing risks to the economy.

Financial Risk is managed by calculating both market and credit risk. Market risk is the potential impact of changes in the market for traded instruments. Thus, if the market moves against your positions, finance takes a hit. Market risk is one that cannot be diversified away. It reflects the possibility for the future earnings being affected by the change in market price, due to movements in interest rates or exchange rates.

Credit risk assesses the Financial and business risk involved in investing in particular companies. Relevant factors include company's competitive position within its industry, strategic direction, management quality and financial profile.

Risk management refers to analyzing exposure to risk and determining how to best handle such exposure.

A definitive generic description of risk management originated in Australia and New Zealand. It is set out in the Australian and New Zealand Standard 4360:2004. The core of the risk management process is set out in five stages:

1. Establish the context
2. Identify risks
3. Analyse risks
4. Evaluate risks
5. Treat risks

The risk management job needs skills such as communicating with trading risks about their risk strategies and preparing management reports on risk. It is essential to stay calm under pressure and pay close attention to detail. It is too risky to lose your cool, especially in dealing with high risk matters.

Working within either market or credit risk requires strong quantitative analytic abilities to review, assess and make decisions based upon your analysis of large amounts of information. This requires taking an interest in markets and how they move, as well as current events – anything that can cause the market to fluctuate.

That apart other capacities that are required are – creativity and problem solving; ability to work under pressure; strong innumeracy skills; ability to do a great deal of financial modeling and company-specific analysis; time management and an ability to work as a team.

Risk management for investing involves analyzing and assessing trades in virtually all major financial markets including equities, fixed income, commodities, structured credit, mortgage backed securities, and interest rate derivatives.

GARP, Generally Accepted Risk Principles, is explained in a dated report on [www.riskreports.com](http://www.riskreports.com).

Risks create sensitivities that relate to the reputation of an enterprise. The stakes are therefore, high in a society that unleashes great expectations from corporate enterprises. No enterprise dare stake its brand and reputation by ignoring to manage risks relevant to its image in the society. As corporates enter and act in different cultures and countries risks to reputation become inherently varied needing close monitoring.

Risks are not necessarily to be perceived in the negative sense. Some risks can be used positively to strengthen the value of the corporation. Calculated risk, similar to the one the TATAs took in acquiring Corus and the Jaguar and Land Rover brands in Europe, also add to the reputation and value creation opportunities a corporation has.

The creation of a low-price car that was promised for the mediocre income households for INR 100,000 was a well-calculated risk that TATAs took in India. 'Nano' as the car is called pole-vaulted TATAs reputation in the Indian market. Risks, as said above, can also add to the reputation of a corporate.

The rapidly changing global economy has created an expanding array of risks to be managed if the viability and success of an enterprise are to be ensured. Corporations face the task of managing their risk exposures while remaining profitable and competitive at the same time. In this context managing risks is not a new challenge, yet it may get overlooked due to several reasons including when, the business mood is euphoric. It is the intelligent assumption of risk, not its avoidance, that creates value in a company.

The term risk is almost always looked in terms of the negative consequences of risk assumption: the creation of exposure to the chance of injury or loss. For most people risk signifies danger and is something to be avoided, if possible. Yet within the concept



of risk is another element, opportunity, and the rewards that inure to those who assume risk successfully. The fact as we all know is that it is impossible for an individual or an organization to avoid risk. Governance of risks is a policy issue. Governance in this context calls for articulation of sensitivities at the highest level. All choices, decisions, activities and even decisions not to act contain risk. The challenge is to carefully select the risks that can be assumed and quantify them properly.

Evolving concepts of risk are leading to complex management perspectives requiring an integrated view of the finances and operations of a corporation. Today a risk manager must generate a comprehensive matrix of risks being faced by the organization, and act as a catalyst in successfully dealing with those risks.

The challenge is particularly complex for corporations operating on a global scale. The size, scope and complexity of their activities inhibit the creation of a relevant and meaningful definition of risk encompassing every conceivable situation. A definition of business risk must be flexible and dynamic in line with situations that may arise in future.

Risk management is no longer discretionary but essential for managing business entities in the dynamic corporate world. It takes commitment from the top, a sound methodology and discipline in its application, to obtain the maximum benefit. In short, risk management must become imbibed into the organization's culture.

All companies have express or implied objectives which ultimately contribute to the maximization of shareholder value. Risk management actively supports the achievement of those objectives. It is not a process for avoiding risk. Properly implemented risk management can actively allow a company to undertake activities that have a higher level of risk thereby achieving a greater benefit because risks have been identified, understood and well managed.

Organizations which do have risk management policies in place shall be rewarded by added premium in the market and shall be better placed to pursue objectives and opportunities with confidence

Risk management provides a framework to:

- Help ensure that all the foreseeable risks involved are actually understood and accepted before important decisions are taken.

- Monitor new projects, and ongoing operations, to ensure that they continue to develop satisfactorily, and no problems or new risks emerge.

It is pertinent to note that every activity carries a potential reward as well. Risk management, essentially, is about managing risk against reward.

Properly implemented risk management has many potential advantages to an organization in the form of:

- Better informed decision making - for example in assessing new opportunities;
- Less chance of major problems in new and ongoing activities; and
- Increased likelihood of achieving corporate objectives.

Risk management is the culmination of decision taken to improve corporate governance. Organizations that actively manage their risks have a better chance of achieving their objectives and preventing major problems occurring.

Venturing into new products and new territories involves risks. But that also adds to the confidence of the enterprise creating an opportunity to build up further value. The well-tested parameters of identification, assessment, measurement and strategies for mitigation of risks are good as they are, but may overlook opportunities that risks carry.

When J P Morgan Chase agreed to buy Bear Stearns for about 90% less than its value, it had taken a risk to run a company that had lost 85 years of independence as a securities firm on the Wall Street. Shareholder of Bear Stearns got stock in J P Morgan equivalent to \$ 2 a share compared with \$ 30 at the close on March 14. This, the J P M did with a financial backing from Federal Reserve. JPM bought Bear Stearns for less than the value of its real estate with the background of a client alarm about a cash shortage making them withdraw \$ 17 billion in two days. This proves that a creative mind sees in risks a great opportunity.

### **Governance and Performance**

Lou Lei and Mark Yuen Teen from Singapore have worked on the determinants of Corporate Governance and the link between corporate governance and performance.

Their study includes a more complete set of governance mechanisms like composite governance index as well as ownership and firm leverage. They investigate the interdependence of various governance practices, the change of government structure and the impact on the firm value.

Their findings revealed an interesting relationship between governance and performance.. It is not the level of governance. They found that an investment strategy that buys firms with greatest improvement in governance and sells firms with largest deterioration in governance yields 36.7 percent excess returns over the sample period (1999 to 2003), they find that investors will lose money if they buy firms ranking highest and sell firms ranking lowest.

They have used the scorecard developed by Standard and Poor's to assess the corporate governance of UK listed companies. This is used as a comprehensive measure of the extent to which a company has accepted international best practices in corporate governance, as disclosed in their corporate governance disclosure.

Studies like Gompers et al (2003) for the U S, Klapper and Love (2004) for fourteen emerging markets, Durnev and Kim (2002) for twenty seven countries, Bauer et al (2003) for the EMU and the U.K, use a broader measure of corporate governance through a composite corporate governance rating. Lei and Teen submit that without time series data, researchers cannot study how firms adjust their governance structure over time.

They can not analyze the causality between governance and firm performance without time series data. Lei and Teen study analyzes a number of time-varying firm-specific data. They examine the four mechanisms used in controlling agency problems – insider shareholding, block holdings, institutional shareholdings and leverage status of the firm. Their study uses a comprehensive measure of governance including a corporate governance scorecard and measures governance over a longer time period.

They find that it is the change of governance that determines performance, rather than the level of governance.

Theirs is an empirical study on whether better corporate governance leads to higher valuation through lower expected rate of return.

Some of the earlier studies on corporate governance–performance relationship were as follows:

### **Board Composition**

That higher proportion of non-executive directors in the board helps to reduce agency cost. Kee et al (2003) and Hutchison and Gul (2003) show that higher number of non-executive directors on board weakens the negative relationship between the firm's investment opportunities and firm's performance. Some other studies like de Jong et al (2002) state that there is no significant relationship between non-executive directors' representation and performance. Weir and Laing (2000) (UK) find a negative relationship between non-executive directors' representation and performance.

### **Leadership Structure**

The UK Combined Code regards separation of the role of CEO and Chairperson as a sign of good governance although previous empirical analyses do not support this. Coles et al (2001), Weir et al (2002), etc do not find any significant relationship between CEO duality and performance. Brickley et al (1997) observed that costs of separation are larger than benefits of most large US firms.

### **Board Ownership**

US based research suggests that management is aligned at low or possibly at high levels of ownership but is entrenched at intermediate ownership levels- Morck et al (1988). But UK research works, Faccio et al (1999) and Short and Keasey (1999), find that management becomes entrenched at higher levels of ownership as compared to their US counterparts. Coles et al (2001) do not find any contribution to performance by managerial ownership.

### **Institutional Holdings**

The UK Combined Code encourages institutions to take an active role in governance expecting a positive relationship between institutional holdings and firm performance. But empirical evidence is not supportive of this recommendation. Both Faccio and Lasfer (1999, 2000) do not find such a significant relationship for UK firms, while de Jong et al (2002) find that major outside and industrial shareholders negatively influence the firm value.

## **Composition of Committee**

Canyon (1997) takes a review of the workings of remuneration committees in the UK. He finds that firms with remuneration committees pay directors less remuneration, while Canyon and Mallin (1997) observed that UK firms have been slow in adopting nomination committees, which is regarded as a symptom of failure of the corporate governance system. While the use of audit committees has been fairly widespread in the UK, Foker (1992) showed that the quality of disclosure is only weakly related with audit committees and non-executive directors.

Bhagat and Black (2002) find that firms suffering from slow profitability respond by increasing the independence of their board of directors. But there is no evidence that firms with more independent boards achieve improved profitability. Vafeas (1999) finds that the number of board meetings held in a year increases following share price declines and that operating performance improves following years of abnormal board activity.

Lei and Teen in their research work use the comprehensive measure of corporate governance scorecard to examine the agency problem. The scorecard has the advantage to implicitly incorporate the effect of a variety of governance practices into one study. Past research through this method analyzes either inter-country differences or inter-firm valuations within a country. La Porta et al (2002) investigate inter-country differences in governance standards among twenty-seven countries. They find that firms incorporated in countries with better governance standards tend to have higher valuations. Studies on inter-firm comparisons within one country appear to confirm a positive relationship between governance standards and firm value. The relationship appears to be stronger in countries with less developed standards. Examples are Drobetz et al (2003) for Germany; Gompers et al (2003) and Marry and Strangeland (2003) for the US.

Drobetz et al (2003) and Chen et al (2003) investigate the influence of governance scorecard on cost of equity capital for Germany and nine Asia markets respectively. Their findings show that good corporate governance practices help to reduce such costs.

Lei and Teen start their sample study from set of firms listed in Index Constituent Rankings FTSE 100 and ICR FTSE 250 from FTSE European Monthly Review, January 2001 issue.

The S&P's corporate governance scorecard used by them is a methodology based on a synthesis of governance codes and guidelines of global best practices, as well as S & P's own experience in reviewing individual companies.

Lei and Teen compute the corporate governance scorecard by summing up the scores under five categories of corporate governance. They are Board Matters, Nomination Matters, Remuneration Matters, Audit Matter and Communication.

The financial data employed by Lei and Teen are obtained from Compustat Global Industrial/ Commercial File from 1999 to 2003. Their final sample includes 206 firms with 3 to 5 years data.

They find a positive relationship between institutional shareholdings and SCORE. Institutions require firms to disclose more or they simply follow firms with a transparent disclosure history.

They also find that firms improving their corporate governance over time perform better; changes in governance are of more importance than level of governance in determining market valuation.

### **International Finance**

Apart from testing and exemplifying empirical hypothesis in the context of the Indian economy that will guide other emerging economies to draw lessons for themselves, this Paper also attempts to analyze concepts and developments in international political economy and international finance. It also looks at and hopefully provides insights into the relationships between emerging economies group and developed economies group(s) under the WTO.

Global finance is a subject that continues to develop faster as compared to the other subjects within the ambit of International Economics. International monetary system also has become evermore unstable because of the severing of the link between commodity production and liquidity creation. A study of this diversion may be useful if governance is to be improved in a slowing global economy. Today the degree of international financial integration has increased enormously. The impact of cross-border flows of money and capital to economies that are moving away from central planning and to OECD and developing countries has increased complexities of international finance. The value of daily foreign exchange trading is more than hundreds of times of the

value of annual international trade in goods and services. The pace of innovations that are taking place in the theory, policy, institutions of international finance is mind-boggling. Vast amount of empirical research is being developed and published in this field. The pundits explain new findings in the general equilibrium theory of exchange rate determination; relative immobility of long-term capital vis-à-vis highly mobile short term capital; the behaviour of exchange rates within an exchange rate fluctuation band ["target zone"].

International Economics requires us to study general equilibrium monetary approach to the exchange rate and exchange rate regime volatility; currency crises and speculative attacks; target zones and dirty floating.

### **IMF Role**

Today, economists are facing an odd question: Has the spirit of internationalism been ebbing recently? When they founded IMF, Maynard Keynes and Harry Dexter White saw the need for rules to govern international exchange and flows and for an impartial arbitrator to point out when those rules were being violated. There was then the spirit of internationalism. The IMF was conceived at the 1944 Bretton Woods Conference with the prime objective of facilitating "the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income throughout the globe.

The Fund was to promote exchange rate stability and to avert competitive exchange depreciation. This required the Fund to exercise "firm surveillance" over the exchange rate policies of member countries so that they avoided manipulating exchange rates or the international monetary system "to prevent adjustment or gain an unfair competitive advantage over other member countries."

The Fund was also set up to work as a sort of credit union to lend to countries that suffered adverse external shocks. It could help countries correct balance of payments difficulties by providing temporary financing to limit the impact on economic activity at home and abroad. This would mitigate the country's incentives to export its problems to the rest of the world. In fact, the Fund's financing would be conditional on policies that would limit or avoid such effects.

Statistics show that since the beginning of the Fund's activities, the world trade has grown from 10% of world GDP in 1960 to almost triple in 2005. World GDP has itself grown at an average rate of 3.5% annually during this period.

Mr. Raghuram G Rajan, Economic Counselor and Director of Research, IMF, in his 2006 Krasnoff Lecture delivered at Stern School, New York University, said:

“Even as the world has become more interconnected through trade and finance, even as the Fund’s members have become more successful, the spirit of cooperation that prevailed amongst the members at the time of the founding of the Fund, seems to have waned.....

“Industrial countries recovered from their post-war weakness. They rebuilt their capability to undertake policy analysis. And the system of capital controls and fixed but adjustable exchange rates broke down....Most industrial countries moved to floating exchange rates. This move, coupled with their political stability and strong institutions, ensured that private capital markets would be a reliable source of finance. As a result, industrial countries stopped borrowing from the Fund...as late as 1975, nearly half of Fund lending was to industrial countries, but by late 1980s, it was zero.

“This had two important consequences. The first was that with little gain from the vetting of their policies by the larger Fund membership, important industrial countries started forming groups outside the Fund, with serious policy discussion and economic cooperation taking place within these groups.

The most prominent avatar [incarnation] of this was G-7. While not denying the global benefits of frank policy dialogue and coordination within the group, an unfortunate consequence has been to diminish the relevance of the multi-lateral discussion that takes place within the Fund.

“The second consequence was that the Fund itself was divided – between industrial country creditors who would never borrow and held the weight of the shareholding, and potential debtors who had to subject their policies to multi-lateral advice either within the context of Fund – supported policy programme or for fear that they might otherwise lose access to Fund resources in their times of need.....

“Most recently, some emerging markets have built up their foreign reserves to such an extent that they are unlikely to need Fund resources at least in the short-term. Given the precedent set by the industrial countries, these “advanced” emerging markets are not keen to be seen heeding Fund advice, though, many of them value it privately—— Unlike industrial countries, these advanced emerging markets still have structural vulnerabilities.”



The surveillance by the IMF focuses on the sustainability of the country's policies and their external effects. The surveillance is likely to be most effective when countries use it as a basis for constructive give and take, and not as a means of censoring each other. As industrial countries recognize they are affected by policies in advanced emerging markets like BRIC (Brazil, Russia, India and China), they want to be able to influence those policies. But the advanced emerging markets no longer need funding. They are unwilling to be lectured to. At the same time, they too want influence over the policies of the industrial countries, for these have serious external effects.

Turning back to International Economics, it becomes necessary to understand why real exchange rates wander away for long periods from purchasing power parity and disturb real economic activity and how misinformed speculation and speculative bubbles cause floating exchange rates to be unstable and largely unpredictable. We also need to understand how best to reform the international monetary system. The basic tools, exchange rates and balance of payment theory, still remain as they have been to understand international finance, although complexities are on the rise. The said tools continue to be applied to a number of issues including money and macroeconomics in an open economy; the efficiency or inefficiency of foreign exchange markets; the modeling and measuring of short and long term capital flows; international macroeconomic policy coordination; international financial features of economic and financial reforms in both transitional and developing economies; the economics of monetary union, the functioning of international financial institutions, etc.

### **Monetary and Fiscal Policies**

Opening an economy to international trade and capital flows changes the nature of constraints on policy makers. Depending upon whether exchange rates are pegged or floating, the effectiveness of monetary or fiscal policy is compromised as an instrument of macroeconomic policy.

International economic cooperation results in gain to cooperating countries because of macroeconomic spillover effects of such cooperation. In the case of monetary unions, fiscal policy externalities between member-countries of the union can be managed to the benefits of the union as a whole. In the context of a monetary union, fiscal policy is known as "fiscal federalism." The functions of fiscal federalism remain the same as those of fiscal policy, viz, allocation, distribution and stabilization. Stabilization function is better performed or at least coordinated from the federal level. A change in a country's fiscal stance may create externalities for other members of the union. *Ceteris paribus*

[i.e. all other things remaining equal], an expansionary fiscal policy by nation A may yield an external benefit by stimulating growth and employment or an external diseconomy by increasing inflationary pressures in the union as a whole. These externalities are not internalized by nation A; it is therefore not driven to adopt, from the point of view of the monetary union, the socially optimal fiscal stance. How then to achieve the most desirable aggregated balance of national fiscal policies becomes a moot question. The union may actually require, for its overall well-being, dis-inflationary fiscal policies that are economically and politically most costly. If they do not find adoption, the sum of dis-inflationary fiscal policies would be insufficient, or the burden of adjustment would fall heavily on a few countries, e.g. those in the weakest financial position. An international welfare gain results from international policy coordination.

### **Exchange Rates**

Predictability of exchange rates is important because many economic decisions require knowledge about future exchange rates, especially, long term real investment in traded goods sector. The unpredictability of exchange rates and the deviation of real exchange rates from the level that balances the current account may increase if rational speculative bubbles occur. A bubble can push the nominal exchange rate far away from purchasing power parity. The monetary approach to balance of payments also shows how foreign exchange reserves shall eventually be exhausted if the rate of domestic credit expansion is excessive.

We also need to examine exchange rate behaviour in a target zone [i.e. a pegged rate fluctuation band]. Within the zone the exchange rate may float, being determined by fundamentals; but at its edges intervention may be necessary so that foreign exchange reserves may change.

“Dirty floating” is explained by exchange rate pressure model. This model indicates how, in an environment of floating, a government may use foreign exchange reserves to nudge the exchange rate in the preferred direction.

Understanding the volatility in exchange rates is a key requirement in modern international finance. The view is that foreign exchange is an asset. That is priced in an asset market [rather than in the same manner as stocks or bonds]. An exchange rate is the price of one asset [currency] in terms of another. It is also necessary to understand that the reallocation of currency portfolios by international transactors—such as multinational corporations—affects the exchange rate. That, as a result, the stability of

the international monetary system in an era of highly liquid international money flows is also affected by multinational corporations.

### **Mundell Trinity**

Robert Mundell defined the impossible trinity in international macroeconomics. Capital mobility, fixed exchange rates and interest rate autonomy, the three components, cannot coexist simultaneously, he pointed out.

The announcement that the Indian rupee is moving towards free convertibility has attracted criticism.

The critics have claimed that full convertibility or capital mobility and freely floating exchange rates are inimical to India's interests. The critics have referred to Britain's crisis in 1992 and Asian crisis in 1997.

The criticism appears to be wrong because, firstly, capital mobility and free-floating exchange rates are not joint policy issues. One can exist without the other. Secondly, the crisis in Britain erupted when policy makers understood the axiomatic inviolability of the impossible trinity. Thirdly, the Asian crisis was craftily brewed by central banks that dodged the impossible trinity.

Mundell has shown that the effects of monetary and fiscal policy in an open economy depend upon capital mobility. In particular, he has highlighted the importance of exchange rate systems. Under floating exchange rates, monetary policy is a powerful tool; fiscal policy is powerless. [G Ramachandran, Hindu Business Line]

Under fixed exchange rates, fiscal policy is effective.

He showed that autonomous monetary policy in the hands of the central bank would be necessary to support floating exchange rates and unhindered capital mobility.

Europe's exchange rate mechanism aimed at fixed exchange rates and stable interest rates. Britain walked out of the ERM because it knew that the impossible trinity could not be violated. She regained interest rate autonomy, retained both capital mobility and floating exchange rates. This explains why Britain is a non-euro country.

The impossible trinity does not apply to pegged exchange rates. Pegged exchange rates are not fixed exchange rates; they are not floating exchange rates either.

Hence, many Asian economies saw pegged rates as the perfect tool to fool the impossible trinity. They could have capital mobility, control over exchange rates, and control over monetary policy and interest rates.

With autonomous monetary policy, the exchange rate is on autopilot. With fixed exchange rates, the monetary policy is on autopilot. With pegged rates, nothing is on autopilot.

By appearing to wield control over both exchange rates and interest rates, Asia's central banks seduced as well as calmed investors.

But they did not disclose that fatal conflicts between monetary policy and exchange rate policy could occur. Monetary base under pegged rates includes the domestic and foreign components. Therefore, balance of payments crisis could occur. This is exactly what happened in 1997.

Asian economies that had a prolonged maintenance of pegged exchange rates could not use their monetary tools in a steady and gradual manner to cool off their overheating economies. They pretended that interest rates would be kept low. Thereby they pretended that their currencies would not be weakened or devalued. The pretensions dropped. Interest rates went up. Currencies devalued.

India does not harbour any such pretensions. The rupee is not pegged. Therefore, it appears that India's transition to full convertibility and floating exchange rates will be smooth.

There appears to have arisen a strong difference between the American School and the European School about the role growth of money supply [M3] plays in monetary policy thinking. In a conference that was held in Frankfurt to honour Otmar Issing, chief economist of the European Central Bank, most participants agreed that central banks still need to watch money supply growth. This was on March 16-17, 2006. Precisely a week later, U S federal Reserve stopped publishing M3, its broadest measure of money, claiming that it provided no useful information. An odd thing is that standard academic models used by most economists ignore money altogether. Inflation instead simply depends on the amount of spare capacity in the economy. Nor does the money supply play any role in monetary policy in most countries, particularly, America. Yet Milton Friedman's dictum that "inflation is a monetary phenomenon" is still borne out by the facts. In the long run, countries with faster monetary growth had higher

inflation. Then why is it that central banks, except ECB, are paying so little attention to money?

Over short periods, the link between inflation and money supply is fickle because the demand for money moves unpredictably. Besides, financial liberalization and innovation have also distorted measures of money, making monetary targeting unworkable. But it would be difficult to conclude that money does not matter. Rapid money growth has always been followed by rising inflation or asset price bubbles.

The ECB's monetary policy strategy has two pillars: an economic pillar, which uses a wide range of indicators to gauge short inflation risks, and a monetary pillar as a check on medium-to-longer term risks. The monetary pillar has attracted much criticism from outside the ECB; it is often dismissed as redundant. Mr Issing has justified the pillar as a defence against asset bubbles, which are always accompanied by monetary excess.

According to *The Economist* it may be precisely wrong time to dismiss monetary aggregates: in these days of asset price booms and imbalances, their informational content may be becoming more, not less, valuable.

### **Crisis ridden**

International financial system has been going through crisis after crisis. As Karl Kaiser, John J Kirton and Joseph P Daniels say in their edit role of "Shaping a New International Financial System—Challenges of Governance in a Globalizing World", Ashgate, the G-8 and Global Governance Series, a core issue concerns the causes of the crisis and contagion and whether it has now been finally concluded. Second core issue is how and how well the international community has coped with the challenges of crisis response and systems strengthening, thus far.

Another core issue focuses on critical defects of the old system and the best design for the new mechanisms to be added in response. We need the best weighting and mix of mechanisms for:

- transparency
- surveillance
- precautionary lending
- international standstill or bankruptcy procedures.

We need to choose the best forms, procedures and sequence of introduction and use for each and we do need to keep on bettering these. We may have to consider moving into broader domains such as control of international financial flows and capital flows, better exchange rate management, fixity, or even currency unification, and the rules for international liberalization or foreign direct investment.

### **Reforms are on**

We have seen efforts during the last quarter of the 20th century to reform the international financial system, the role of the G7 in this effort. The world and the G7 confronted as a central challenge the task of altering in basic ways a financial system under severe stress. There was the crisis over the global exchange rate regime that served as very *raison d'être* for the birth of the G7 as an economic institution – the breakdown of the Bretton Woods System of fixed exchange rates in 1971, the failure of the IMF and existing processes to construct a durable, widely accepted alternative and the decisions of the first G7 Summit at Rambouillet, France in 1975 to institute a new system of managed floating. The second was the commercial bank debt crisis precipitated by Mexico's *de facto* default at the IMF meetings in Toronto in 1982, and the work of G7 Summits from Versailles in 1982 to Paris in 1989 to arrive finally, in the form of the Brady Plan, at a solution. The third episode, debt relief for the world's poorest countries, began with the "Toronto terms" for relief at the 1998 Summit and continued through to the Cologne debt initiative of 1999.

In his analysis of the "Asian Crisis and its Implications", Takashi Kiuchi [p.37 of *Shaping a "New International Financial Systems"*, referred earlier] locates the ultimate causes of the crisis in capital account rather than current account problems, liquidity rather than solvency problems, and the herding behaviour of the investors. He also notes how politicians overriding their officials and regulators compounded the problem. He calls for universal guidelines and processes for accounting disclosure, bankruptcy and financial supervision. Japan's response to the Asian crisis came initially in the form of a proposal for an Asian Monetary Fund that was abandoned in the face of US opposition, then with a "New Miyazawa Initiative" of US \$ 30 billion worth of bilateral lending guarantees, proposals to reform IMF and new measures to make the yen an international currency. According to Kiuchi, the crisis taught us the need for decisive action at the early stages, for enhancing the IMF's authority to deal with capital account problems, and closer regional policy coordination, beginning with macro economic policy and the development of an Asian bond market to replace short-term borrowing from distant

bankers. He approves of short term capital restrictions as a transitional measure, mandatory private sector burden sharing and state bankruptcy codes. Above all, he identifies the role of the G7 in moving towards a de facto target zone mechanism and points to the benefits that further moves in this direction could bring. During times of crisis, panicked investors do not distinguish one nation from another in a region. In other words, professional fund managers cannot guide end-investors properly once liberalized financial markets enable far wider participation by amateur investors in speculative emerging markets. Nations within the region have a common stake in preserving investors' confidence. Therefore, the time is ripe for closer regional policy coordination, a process that could begin with the task of macroeconomic policy consultation. Global efforts in this direction deserve further exploration. G7 surveillance and coordination, Kiuchi concludes, should thus be continued, sovereignty over macroeconomic policy has to be compromised considerably in an age of a globalised financial market.

Now, what does the exclusive organisation G7 do for the Newly Industrialized Economies" (NIE's) or in other words, the developing economies of the world? Durican Wood [in his Paper "The G7, International Finance and Developing Countries" presented at Bonn on June 14, 1999, immediately after the meeting of G7 Finance Ministers in Frankfurt, and immediately before the opening of the G7 and G8 Summits themselves in Cologne on 18 June] deals with the issue as follows:

G7 has been an exclusive institution since its inception in 1975. It is an organ representing the interests and policy goals of the seven largest economies in the world. It has a country-club like exclusivity to which those left on the outside can only aspire. The G7 has indeed thrived on such a narrow basis for mutual decision-making! The identification of common interests has been relatively simple, given the similarities of economic development and political systems and the high level of interdependence among its members' economies.

In the 1970's, the exclusive nature of the G7 reflected the dominance of seven states over the global economic system. The same period witnessed a rise in LDC activism with calls for a New International Economic Order (NIEO). By the 1990s, the rise to prominence of several developing country economies, shifts in world trade and competitiveness and the increasing vulnerability of the global financial system and the separation of the G7 from the developing world, in particular from the large emerging markets created, an anachronism.

Witnessing the trebling of the NIE's share of world trade since 1960, the 1988 Toronto G7 Summit concluded that such countries should match their increased economic importance with greater international responsibilities and a strong mutual interest in improved constructive dialogue and cooperative efforts in the near terms between the industrialized countries and the Asian NIEs, as well as other outward-oriented countries in the region.

From the 1996 Lyon Summit, G7 forwarded the ideal of a new global partnership for development focusing on cooperation, burden sharing, and partnership, of a spirit of common purpose and efficiency.

Such cooperation, however, never materialized. The G7, even taking into account its inclusion of Russia continues to be an exclusive club of the rich. Instead, the G7 has attempted to move into the new millennium without the involvement of the largest developing economies. This threatens to pose a serious problem for the Institution in terms of its effectiveness and its legitimacy as an organ of global governance.

The two main areas of interest from an LDC perspective concerned the IMF's Contingent Credit Line (CCL) and "bailing in" the private sector in crisis resolution. The CCL was hailed by the G7 Finance Ministers as playing "an important part in crisis prevention". Its goal is to provide a line of credit to countries following sound macroeconomic and structural policies and with reasonable debt structures so that they are protected from contagion during currency and financial crisis. While this seems a positive form of assistance, in the view of some it actually threatens financial stability by encouraging moral hazard. The argument is simple: if a country following sound policies knows it has access to the CCL, the danger exists that it will be tempted to adopt more risky practices in the knowledge that a bail-out is already available.

## **The G22**

In reforming the international financial architecture a major initiative came from the US. The creation of the G22 in 1998 as an ad hoc grouping of developed and developing states constituted an attempt to pull together the highly varied experiences of national policy makers. This attached importance to incorporating LDC's into the international financial reform. The G22 formed three working groups that examined the issues of international financial crises, strengthening financial systems, transparency and accountability. Each working group was co-chaired by officials from one developed country and one developing country. Despite this cooperative atmosphere, the G22 did



not survive long enough to make a significant contribution to either international financial architecture reform or longer term LDC – G7 cooperation. The group was dissolved after it had published its reports, with the US deciding that it had served its purpose.

### **Institutions**

Since 1995, one of the central issues for International Financial Institutions has been increasing transparency and disclosure of information, in particular from LDC governments.

But data gathering, says Durican Wood, and transparency, are difficult to achieve in LDCs. Many LDC governments have a very real interest (usually political) in preventing the truth about their economies from being known. It is difficult to develop standards that are suitable for such widely varying financial systems as, for example, the US and Mexico. Developing standards is one thing, implementing them is yet another.

The overwhelming liberal bias amongst G7 countries and in the IMF's management is pushing them towards the realisation of a classical liberal assumption: that a market will work perfectly under conditions of perfect information. Whether or not the assumption can ever be realized, or even if it is a correct assumption, remains to be seen.

### **New Perspectives**

It is also suggested that India should not go with the developing countries' position that industrialized countries should fulfill the UN target of foreign aid of 0.7 per cent of their GNP. The arguments for the increase of aid have become weak, mainly in view of the explosive expansion of private capital markets and the weak fiscal positions of many industrialized countries.

It is suggested that India should encourage movement towards economic convergence in terms of real per capita income among nations. This will reduce the relative economic distance amongst groups of nations. Countries should not be grouped in the conventional manner as industrialized economies and developing economies, but as Industrialized Economies; Emerging Market Economies; Transition Economies not categorized as EMEs; and the Rest Of the Economies. Goldman Sachs have projected that Brazil, Russia, India and China together would overtake six major IEs by 2039 going by their economy

size, demographic distribution and patterns of global demand, appreciation of the exchange rates of their currencies, implementation of sound economic policies and existence of supportive institutions. Convergence requires economic cooperation, including technical, financial, technological assistance, to equitably share international economic prosperity. Financial assistance need not be in the form of loans or grants but could well be in terms of debt reduction or swaps for debts or access to domestic markets. India also needs to take initiatives as to how to utilize without delay the contingent credit lines at the IMF. She also needs to thwart the efforts that are currently afoot to allow crisis-hit countries to have access to the IMF resources only if their past record is considered appropriate. The basis for the country's use of the IMF resources should rest on the soundness of adjustment programmes and commitments to undertake institutional reforms. Convergence leads to balanced expansion of international trade.

### **International Banking**

Following is an example of how banks form the habit of overwhelming overbidding in response to appeal by a Central Bank.

During the period January 1999 to June 2000 the European Central Bank conducted fixed rate tenders. Mr Juan Ayuso and Rafael Repullo in their Paper "Why Did the Banks Overbid? An Empirical Model of The Fixed Rate Tenders of the European Central Bank" [published by Banco de Espana—Servicio de Estudios] test two hypotheses for the overbidding behaviour of the banks in the fixed rate tenders. One hypothesis attributes the overbidding to the expectations of a future tightening of monetary policy, while the other attributes it to the liquidity allotment decisions of the ECB.

The monetary policy instruments used by the ECB are—(i) minimum required reserves, (ii) open market operations, and (iii) standing facilities. The minimum reserves help to ensure that the euro area banking system has an aggregate liquidity deficit which is covered by two main types of open market operations [selling of securities to mop up excess liquidity and buying of securities to release more liquidity in the system] and the longer term refinancing operations. The refinancing operations can be conducted via fixed rate or variable rate tenders. In fixed rate tenders, the ECB announces the interest rate and the banks bid the amount of liquidity they borrow at this rate. If the aggregate amount of bid exceeds the amount of liquidity the ECB can provide, each bank receives a pro rata share of this liquidity. In variable rate tenders the banks bid the amount they want to borrow and the interest rates they are willing to pay. In this case, bids with

successively lower interest rates are accepted until the total liquidity to be allotted is exhausted.

From the beginning of the Monetary Union in January 1999 until June 2000 the main refinancing operations were conducted as fixed rate tenders. A striking feature of these tenders was a very high degree of overbidding by the banks. During May and June 2000 the banks were bidding on average an amount that was more than eight times the size of the consolidated balance sheet of the Euro system.

The authors of the Paper tested two hypotheses as pointed above to explain the overbidding behaviour by the banks in the fixed rate tenders. The expectations hypothesis attributes overbidding to the expectations of a future tightening of monetary policy that led the banks to increase their current demand for liquidity in order to reduce the cost of holding reserves over the maintenance period of the reserve requirement. On the other hand, the tight liquidity hypothesis explains the overbidding by the fact that the ECB kept interbank rates over the tender rate, which generated a profit opportunity for the banks that was increasing with the quantity bid.

“Our empirical analysis” the authors explain, “uses two interest rate spreads as explanatory variables: the spread between the one-week Euribor, and the tender rate and the spread between the one-month Euribor and the tender rate. The results show that once we control for the first spread, the effect of the second is small and statistically not different from zero. Hence the evidence supports the view that the reluctance of the ECB to let the interbank rates fall below the tender rate played a crucial role in explaining why the banks overbid.

“The main policy implication of our results is the following. To the extent that overbidding is considered to be a problem, the ECB should decide the quantity allotted in fixed rate tenders in order to keep the one-week Euribor rate close to the tender rate, instead of computing the allotments from the analysis of the behaviour of the autonomous liquidity creation and absorption factors. However, in the presence of expectations of interest rate changes this alternative policy would probably introduce large variability in the sequence of allotments, which may also be regarded as undesirable.”

## **Securitization**

Securitization is a financing option that involves cherry-picking assets from the seller's book, building in adequate credit enhancements and then selling them off to a Special

Purpose Vehicle or Trust. The SPV or the Trust then issues debt instruments on the strength of the underlying assets utilizing the credit rating to obtain competitive market price. As a financial tool, it has been used to finance further assets by analyzing/scrutinizing the past assets. The company raises money by issuing debt securities, which are backed by specific asset pool. The assets are the loans, auto loans, future receivables, etc. The cash flow from the underlying assets is the source of funds for the issuer to make payments on the securities. When compared with the traditional secured debts, securitization provides lenders/investors with greater protection against the credit risk of borrower/issuer.

In a securitization transaction, lender/investor is like a 'super-secured creditor' with rights that surpass those of a secured lender. The subject assets are as if 'sold' by the borrower/issuer to the lender. Therefore the assets do not get entangled with bankruptcy. Bankruptcy court will not characterize the assets as merely pledged to secure a loan. To securitize, the borrower/issuer transfers the subject assets to an SPV/Trust to constitute a true sale. Then the SPV/Trust issues securities backed by those assets. It uses the sale proceeds of the securities to pay the borrower/issuer for the assets.

Banks or finance companies may use securitization to improve the volume of funds for capital deficient sectors by transferring resources from surplus sectors. They may also use securitization to take some customers' loans off balance sheet in order to be able to lend new funds to those customers and still maintain internal credit limits.

A company can diversify its funding resources reducing its dependence on bank loans, corporate bonds and commercial paper by resorting to securitization. It can improve liquidity. Further, securitization can be deployed by a company to place its securitized assets beyond the reach of the bankruptcy system. The securitized assets are excluded from the bankruptcy estate of the company that has filed for bankruptcy protection. Securitization investors are regarded as a special class creditors who can satisfy their claims even without going to bankruptcy court although this is a controversial issue as this causes injustice to other creditors of the company and there is no provision to that effect in the bankruptcy code.

## **Conclusion**

Innovation and entrepreneurship in all aspects, micro and macro, of economic and business like appear to be the panacea for the demanding times of the slowing global economy and the decoupling of emerging economies from the global financial woes.

Even if the symbiotic relationship of emerging economies with the global and affected Western economies prevents effective decoupling, the latent talent among the young from the emerging economies can achieve the miracle. Cost competitiveness, upgradation of labour and skills and promoting innovation and entrepreneurship will enable corporates in emerging economies to overcome the onslaught of global pressures.

Global economy is integrating under the WTO. It is in their interest that emerging economies seek higher participation in global trade and higher investment inflows into their systems. This calls for an understanding as well as an expertise in international finance flows through institutional investors, FDI, Hedge Funds, Mutual Funds, international securitisation and Commodities and Equity Markets. The message is loud and clear. Globalisation requires integration. Integration requires the courage to give up traditional ways of economic behaviour. The new economic way of life under the WTO calls for a mastery over international economic and financial dynamics if emerging economies are to prosper while simultaneously eradicating poverty and pockets of adversity in their midst. It is the professionals like Company Secretaries who can bear the brunt of leadership in this milieu and provide creative good governance among corporates of emerging economies.

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