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## INDIA: BEHOLD THE BANKS, BUT BEWARE THE BUDGET

On Tuesday, Dr Jon Thorn of India Capital Fund gave us a fascinating update on the India story, setting it in the context of the China comparison and the complex issues surrounding institutional investment in the country. Whereas economic change in China was a long time coming, it happened abruptly as can only happen where there is a centralisation of power. In India, political and economic change is evolutionary and the challenge is to keep up the momentum. China's economic revolution began in 1978-79 in the coastal regions and India's has followed the same pattern, beginning in 1991. Although it is less obvious than in China, the social and political imperative is to develop the interior, to deliver more employment and better living standards. This is why next Monday's Indian Budget – a legacy of the UK template – assumes such great significance. It is possibly the only opportunity that the ruling triumvirate – prime minister, finance minister and deputy planning minister – will have to implement some radical taxation reforms in order to speed the progress of liberalisation.

The measures to be introduced span tariff reductions, less protection for corporations, VAT on the service sector and the broadening of the tax base in a country where only 35m pay income tax, many fewer than own a mobile phone. The tricky part is that the Budget must also shrink the budget deficit and bolster infrastructure spending. The sweetener for investors could be the abolition of the 10% short-term capital gains tax, although a share turnover tax will remain. It appears that there is no shortage of potential investors in this burgeoning 'knowledge superpower', as the 19th February issue of *New Scientist* describes India in a 20-page plug for its scientific and technological achievements. The tricky part is the bureaucratic domestic investment process, now compounded by the long reach of Sarbannes-Oxley. All hedge and offshore funds in which US investors participate must comply with the SEC regulations by next February.

Of all the attractions offered by the Indian stockmarket, the banks offer exceptional potential. The ratio of consumer debt to GDP is less than 7% and the average home purchase is achieved with 40% loan and 60% equity! The top three banks own 50% of the loans and are clearly well placed to succeed as the consumer economy becomes broader and deeper. It is unclear whether the foreign direct investment rules would allow a foreign bank to buy an Indian bank outright, but ING owns a significant minority stake in one. Other investment opportunities are provided by infrastructure bonds, backed by the US Treasuries in India's reserves, as a massive road building project is underway. The plan is to complete the quadrilateral between Calcutta, Delhi, Mumbai and Madras and then to build out radial arteries. India remains one of the least globalised economies. Only 11% of Indian GDP is exported, giving it a degree of insulation from the vagaries of world trade. However, India is one of the most heavily exposed economies to the oil price, evidenced by the surge in inflation to around 8% last year. Much more to tell that space will not allow, but we are very grateful to Jon for sharing his thoughts with us in so much detail.

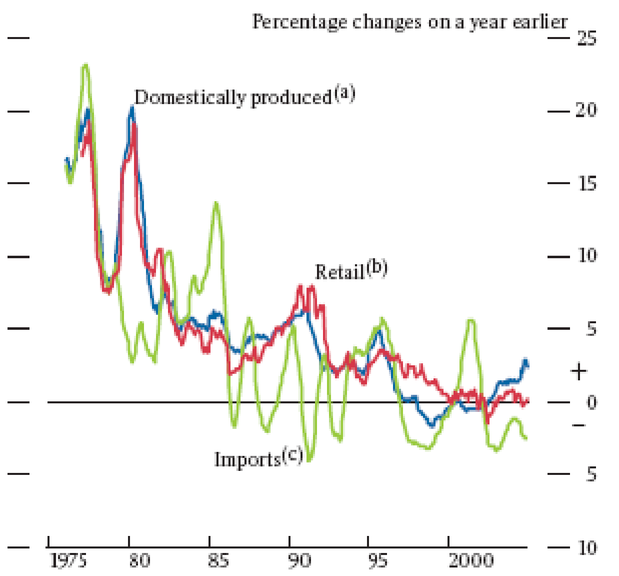
## ARE CREDIT DERIVATIVES SPINNING OUT OF CONTROL?

The notional size of the credit default swap (CDS) market reached over US$5.4 trillion by the middle of last year according to the International Swap Dealers Association (ISDA), more than double the figure of a year earlier and an eightfold increase over three years. The US Federal Deposit Insurance Corporation (FDIC) data shows a similar trajectory but on a smaller scale. These OTC instruments are unregulated and difficult to track. Although CDS is the main type of credit derivative, there are others – total return swaps and credit linked notes. According to Bianco Research, US depository institutions (primarily banks) own gross credit protection equivalent to 17% of all loans and leases, up from 3% three years ago. Credit derivatives are arrangements that allow the protection buyer, or originator, to transfer credit risk of a reference asset (which it may or may not own) to one or more other parties (the protection sellers). Typical sellers are US and European insurers, but one has to wonder whether hedge funds have also been active. Whilst trade will always establish a price, the troubling aspect to credit derivatives is that current pricing models lack reliable data inputs. Doubtless, fools and their money are being parted. The UK's FSA is worried about the lack of proper procedures and the long delays in completing the paperwork. Rather, it should be worried why there is such heady demand for credit protection in the first place.

## TUCKER BREAKS RANKS ON THE UK'S MPC

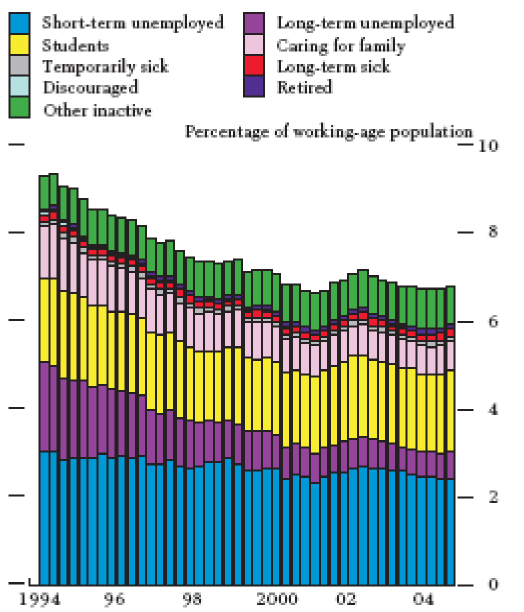
It is a measure of the determination of the media to make a story out of the Bank of England's monthly deliberations that they have overdosed on UK inflation worries once again. The consumer price index for January fully unwound the December increase in index terms, but the fact that the 12-month rate stayed at 1.6%, up from 1.1% in September, has put journalists on high alert for a repo rate rise. So, when it was revealed yesterday that Paul Tucker emerged as a hawkish dissenter from the majority view for no change, this was interpreted as conclusive evidence that a further rate rise, to 5%, was in the pipeline. This is an extraordinary reading of events considering that consumer spending is decelerating, housing transactions are floundering, unemployment is edging upwards and retail goods prices are virtually static, according to the Bank's own *Inflation Report*. Despite his token objection, it is clear from the MPC minutes that Paul Tucker still believes that the risks to the inflation forecast are "skewed to the downside."

### Retail goods prices and producer prices




(a) Excludes food, beverages, tobacco and petroleum products.
(b) Retail prices have been used in this chart, rather than consumer prices, because they are constructed in a similar way to the import and output prices indices. Pre-1988 data are calculated by the Bank from more disaggregated data.
(c) Finished consumer goods excluding cars. Twelve-month on previous twelve-month percentage change.

### A weighted measure of labour availability(a)




(a) This measure is similar to that presented on page 27 of the August 2004 *Report*. The weights used in this measure are calculated as backward-looking four-quarter moving averages of the quarterly transition rates of each group into employment. Data are shown for calendar quarters.

Source: Bank of England *Inflation Report*

## DOES FANNIE MAE ALSO HAVE A CASHFLOW CRISIS?

Suddenly, everyone is an expert on Fannie Mae. Tuesday's *Financial Times* article quotes sleepy fund managers as "starting to realise that if Fannie has to de-leverage, it will have a real economic impact". It is astonishing how long it has taken since the OFHEO report last year and even the SEC ruling on Fannie's accounting and derivatives practices for Fannie to suffer stockmarket fallout. If Alan Greenspan had not reiterated his criticisms of the GSEs last week, perhaps we would still be waiting. If only these tardy fund managers, insisting until now that that the company's business fundamentals were sound, had read Charles Peabody's analyses over the past two years. His latest warning is that Fannie may have cashflow problems on top of everything else. "Fannie Mae sold nearly US$6.4bn of its mortgage portfolio in January, which amounts to a monthly record." Tight mortgage-to-debt spreads were blamed, but these have been around for a couple of years. "Perhaps, the company's asset liquidation was necessary given the growing concern over its pending restatement." Charles and his team at Portales Partners believe that there were non-capital motivations for Fannie's large portfolio sales in January and that cash may be a concern.

## SCIENCE IS OBSESSED WITH THE END OF THE WORLD

Traditionally, religions are obsessed with the end of the world but that mantle seems to have passed to science. (Perhaps popular science is a religion.) The cover of the 5th February edition of *New Scientist* reads "The End: four routes to cosmic oblivion" while *Focus*, a monthly title, announces in its February issue that: "the biggest volcano the world has ever seen is about to erupt – how will humanity survive?" This speculates that there is a 50,000-year cycle in supervolcanoes and Yellowstone is a prime candidate for eruption. North America could be plunged into a volcanic winter. This is small beer to the *New Scientist* authors who classify their oblivia as: one, the Big Rip, where the planets fly out of the solar system and our sun explodes; two, the Big Crunch, where the universe implodes and turns blue; three, the Cosmological Constant, where the stars go out, the sun becomes a diamond and "every single particle becomes imprisoned in its own universe"; and four, Quintessence, like three, only "life will be just about possible." And you thought we were bearish!

**Peter Warburton**

## AN AMERICAN IN BRUSSELS (and Berlin and Moscow – anywhere but Paris)

George Bush's visit to 'good ol' Europe' has been treated with objective politeness by most of the UK press, which has welcomed the attempt at reconciliation, while acknowledging the historic wounds. The European press has been rather less forgiving: even Germany's equivalent of the BBC World Service (or VOA to our American listeners) carried the headline 'Warm Smiles Belie the Continuing Chill' in its internet edition. But everyone knew what the Bush visit to Europe was about: trying to mend fences, and erect new, slightly friendlier, ones. It is diplomacy as it used to be: all about interests and the occasional gunboat, not a head-on culture clash with your 'allies'. So far, so good; but 'old Europe's sceptics remain unconvinced.

There is a strong suspicion that US policy eyes are so fixed on the 'macro-global' agenda (unspecifics like the 'defeat of terrorism'), that they are missing some of the micro details. Perversely, George W Bush's visit to Europe has highlighted some of the more subtle areas of discord. First, there is the question of 'arms to China' – a genuine conflict of diplomatic ideology, where reconciliation seems unlikely. More immediately, there is Russia. George Bush wants to talk tough with Vladimir Putin about his authoritarian style and his imposition of the 'right way' onto far-flung corners of what he (Putin) perceives as Russia's imperial domain. Meanwhile Gerhard Schröder, aware of Germany's critical dependence on Russian oil and gas supplies, has a different agenda. The divergence of ideology, style and interests runs so deep, that it is hard to see a rapprochement. Germany and Russia are part of an Old Europe whose geonomic boundaries are in rapid transition. To them the Bush version of the New World still looks more like a potential obstacle to their interests than an ally in the defence of 'freedom'.

**Robin Aspinall**

## JAPAN: UNDERMANNED

The *Financial Times* has entered the debate about Japan's ageing and declining population ("Fall in number of Japanese men heralds overall population decline", 23 Feb 2005). What prompted the article was a report by the Ministry of Internal Affairs that the number of men in Japan fell in the 12 months to October 2004 (detailed figures are on the ministry's website: population estimates).

This particular fact is brushed off by the ministry as being due to a rise in the highly variable number of men posted overseas for long-term business assignments. In truth, however, this is a feeble excuse that merely serves to show how close Japan is to the population turning point. It is but an early signpost on what is going to be a long and complicated road. Expect many more articles on this subject in coming months, particularly when the total population shrinks for the first time.

The implications of the combined trends of an ageing and shrinking population are many and varied. In a relatively short article, the *FT* manages to convey a sense of how multi-faceted the forces at work will be. It talks of "a historic shift in Japan's population … which is likely to have a profound influence on the country's pension system, labour market and tax base". Two foretastes of that influence: current pensioners will take more out in pensions than they put in while current 20-year olds will receive less than they contribute; and severe estimates of Japan's population suggest it could fall by nearly two thirds by 2100, to the same level as in 1910.

Our focus is on the economic implications, but there is much scope for discussion of broader social aspects of these trends. Does it matter if the population shrinks? If so, how can such trends be reversed? Answers on a postcard to home affairs ministries in Japan, Spain, Italy, Germany…

## CHINA: FOREWARNED

It would be forgivable, reading the *FT* article, to conclude that Japan is going to slide slowly under the ocean as an economic power. It would be unforgivable to assume that China is going to be anything but a major economic and cultural power (cultural in the broadest sense, encompassing military, political, social and linguistic might). Just in case you should be in any doubt about that, the English-language *People's Daily* has stamped its foot yet again about Taiwan. The tone of these comments is too harsh and their increasing frequency too insistent to ignore.

The reason this time was a joint statement by US and Japanese foreign and defence ministers in Washington over the weekend. That statement listed the Taiwan question as one of their "common strategic objectives". An editorial in the *People's Daily* takes great exception to this: "Taiwan is an inseparable part of China's territory and the Taiwan question is China's internal affairs. The joint statement over the Taiwan question by the United States and Japan interferes severely with China's internal affairs." Full article: Vigilant.

A news article in the same edition of the paper quotes pointed phrases from a Chinese Foreign Ministry spokesman: "grave concern", "irresponsible remarks" and "untenable". Perhaps strong words will sublimate these passions, but there is no excuse for not being forewarned. Article: Critical.

**Robert Brooke**



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