ISSUE
11
APRIL
2013

MONTHLY
JOURNAL OF
FINANCIAL
MARKETS
InteliGen

In this issue

Currency War: Devaluation of Currencies

A currency war sounds weirdly abstract, like a game played by rival politicians – but it can have devastating effects in the real world. It is a condition in international affairs where countries compete against each other to achieve a relatively low exchange rate for their own currency. This policy is also referred to as **"Beggar Thy Neighbour"**.

However, the emergence of currency wars came from different sets of policies. The huge stimulus from developed economies' central banks flooded the markets with their currencies leading to lower value of their currencies. This concern especially picked up in Sep-2010 when it became apparent that Fed would initiate another round of quantitative easing (or QE2). Brazilian Finance Minister Guido Mantega termed the practice of trying to keep currencies undervalued as **'Currency War'** and this sentiment picked up after his comments.

It can be defined as competitive devaluation of a country's own currency so that exports become more competitive and imports become costly. As a result imports are expected to reduce and exports are expected to go up. As a further result, employment within the country goes up and employment in the competing country may go down. The country which devalues its currency may get net trade surplus (exports more than imports) and its foreign exchange reserves go up.

Mechanism of Currency Devaluation: How it works?

In order to understand the mechanism and outcome of the currency devaluation game – let's imagine a pair of brothers together owns a honey-making business in Lahore, (undivided) India. After the partition, one brother decided to move to India, just a few miles away to Amritsar, while the other one decided to stay back – so they divide the company in two.

Now, assume that both businesses make the same honey, sold in a 1 Kg. jar; priced the same, Rs. 1 per jar. When the partition happened and the brothers moved apart, the Indian and Pakistani Rupees were at parity, so a jar of honey – regardless of where it was made – was worth both 1 INR and 1 PKR.

All goes well, until....CURRENCY DEVALUATION! The brothers wake up, and find that 1 PKR is now worth just 0.50 INR! Or, to put it another way, 1 INR is worth 2 PKR. And now an Indian consumer can buy two jars of Pakistani honey as his 1 INR will now buy him 2 PKR.

The currency devaluation allows him to get two jars of honey for the price of one. It is great news for Indians, as it is a good deal; and it is great news for the Pakistani honey company, also, since the cheap Pakistani currency has allowed it to boost its share of the market.

But this is really bad news for the elder brother and his Indian honey company as he can't afford to compete in given situations. Unless the government does something to weaken the INR, he's going to go out of business, which means he'll have to lay off honey workers and sell off those bees. And this will be happening all over the country, eroding India's manufacturing base and accelerating unemployment.

History of Currency Devaluation

An important episode of currency war occurred in the 1930s. As countries abandoned the Gold Standard during the Great Depression, they used currency devaluations to stimulate their economies. Since this effectively pushes unemployment overseas, trading partners quickly retaliated with their own devaluations. The period is considered to have been an adverse situation for all concerned as unpredictable changes in exchange rates reduced overall international trade.

Following the turmoil of 2007-08 crisis, states engaging in competitive devaluation have used a mix of policy tools, including direct government intervention, the imposition of capital controls, and, indirectly, quantitative easing. As the price to buy a particular currency falls so too does the real price of exports from the country. Imports become more expensive. So domestic industry, and thus employment, receives a boost in demand from both domestic and foreign markets. However, the price increase for imports can harm citizens' purchasing power.

This policy can trigger retaliatory action by other countries which in turn can lead to a general decline in international trade, harming all countries. While many countries experienced undesirable upward pressure on their exchange rates and took part in the on-going arguments, the most notable dimension of the 2010-11 conflict was the rhetorical conflict between the United States and China over the valuation of the Yuan.

Recent Woes

Japan has also joined the money printing spree like its peers from the developed world. The Bank of Japan, in a statement released on April 4, 2013, said, "The Bank will achieve the price stability target of 2% in terms of the year-on-year rate of change in the consumer price index (CPI) at the earliest possible time, with a time horizon of about two years. It will double the monetary base."

In plain language what the statement means is that the BoJ will try and create an inflation of 2% in the earliest possible time with an overall limit of two years.

Japan's decision of doubling its money supply to $2.71 trillion in order to propel its economy out of two decades of stagnation eventually devaluing her currency, sparked concern of a possible second 21st century currency war breaking out, this time with the principal source of tension being not China versus the US, but Japan versus the Eurozone and other Asian nations.

Rationale behind this megalomania

For the period of three months ending December 2012, the Japanese economy grew by a minuscule 0.5%. In three out of the four years for the period between 2008 and 2011, the Japanese economy has contracted. To get over this, Japanese politicians have wanted to create some inflation so that people will start spending again.

The question is how will this inflation be created?

The BoJ plans to print Yen and double the money supply in the country. This money will be pumped into the financial system by the BoJ buying various kinds of bonds, including government bonds and exchange-traded funds from Japanese banks and other financial institutions. Banks can then go ahead and lend this money. As an increased amount of money chases the same amount of goods and services, the hope is that prices will rise and some inflation will be created. And this will put an end to the deflationary scenario that has prevailed over the last few years.

So by trying to create some inflationary expectations in Japan the idea is to get consumption going again and help the country come out of a more than two-decade-old recession. With prices of things going up people are more likely to buy now than later and thus economic growth can be revived.

There is another angle to this entire idea of doubling money supply, and that is to cheapen the Yen against the Dollar. As the BoJ starts printing the Yen to create inflation, there will be more Yen in the market than before. And this will lead to a fall in the value of the Yen against other currencies. A greater price competitiveness will ensure that exports pick up and that in turn will help revive economic growth. At least that's how things are supposed to work in theory.

Neighbours, those are wary of becoming beggar…

The Japanese currency, the Yen, has dropped by 25% in value since the last government was voted in power in November 2012 as they pledged to kick start the economy by creating demand devaluing their currency. This has already given a major boost to Japanese goods and services. There is little confidence that the Yen will stop here as the government pursues an inflation rate of about 2% a year in order to end deflation and stimulate consumer spending.

With the price of Japanese exports becoming daily more attractive, neighbouring countries are weighing their options, and devaluing their own currencies is at the top of many lists. There is a good deal of outrage and anger among Japan's neighbours. Not only neighbouring nations but even billionaire investor George Soros also criticize the Abe government and said, "If the Yen starts to fall, which it has done, and people in Japan realize that it is liable to continue, and want to put their money abroad, then the fall may become an avalanche."

Although some of the strongest criticism of the Japanese program has come from China, the impact is unlikely to be felt as strongly there as in other parts of Asia. Most Chinese exports do not compete directly with Japanese products. Indeed, some Chinese companies may benefit from importing cheaper Japanese components.

The prospects for South Korea, whose manufactured goods from cars to washing machines do compete directly with Japanese brands, are much more troubling. About 60% of South Korea's GDP comes from exports and the Seoul government has said it is very worried by the probable fallout from the Japanese stimulation program.

The barometer of currency values is also being watched carefully among the exporting countries of Southeast Asia.

Where it could go wrong?

In fact, by wanting to double money supply by printing the Yen, the BoJ is only doing what various other central banks around the world have already been up to. The Federal Reserve of United States has expanded its balance sheet by 220% since early 2008. The Bank of England has done even better at 350%. The European Central Bank came to the party a little late and has expanded its balance sheet by around 98%. The BoJ has been rather subdued in its money printing efforts and has expanded its balance sheet only by 30% over the last four years.

What is apparent that central banks can print all the money they want, they can't dictate where it goes? Central banks which have tried this path have managed to create very little inflation and economic growth. The money that they have been printing is being borrowed by large institutional investors at close to 0% interest rates and being invested in all kinds of assets all over the world into speculative oil futures, luxury real estate in major financial capitals, and other non productive investments.

So the question is what stops all the money that will be printed in Japan from meeting the same fate, as the money that was printed by other central banks? And the answer is, Nothing.

With the BoJ expected to buy all kinds of bonds from banks and other financial institutions, it means that the financial system will be flush with money. This along with a depreciating Yen is expected to unleash a massive Yen carry trade.

Investors will borrow in the Yen at very low interest rates and invest it in various kinds of financial assets all over the world. This is called carry trade because investors make the carry – i.e. the difference between the returns they make on their investment (in bonds or even in stocks for that matter) and the interest they pay on their borrowings in the Yen. This money will be invested in all kinds of financial assets around the world.

What is the fate of such printing mania?

This stance of easy monetary policies has already been greatly criticized. Huge monetary accommodation by developed economies is being blamed for sharp surge in commodity prices elevating inflation levels globally. This has been sharply criticized by developing economies who have recovered smartly from the crisis but growth prospects are being hurt by inflation. Hence, any more monetary accommodation via the currency route is not going to be appreciated.

The BOJ says it just wants to get inflation to 2%. It says it will buy assets with money that didn't exist previously...and keep buying...until inflation reaches 2%.

Then what? Well, we guess it will stop. And then what? Will the economy collapse when the money-printing stops? Or will the economy pick up...and the banks begin to lend...and the people go on a spending binge? Or will investors all over the world dump their Yen back onto the home islands...eager to get out of the Japanese paper money before inflation levels get out of control?

We don't know. But neither do the Japanese nor for that matter other central bankers. As Reuters describes it is a 'radical gamble' and for a central bank to make a 'radical gamble' bespeaks desperation and lunacy. ■

Financial Jargon's

Exchange Traded Funds

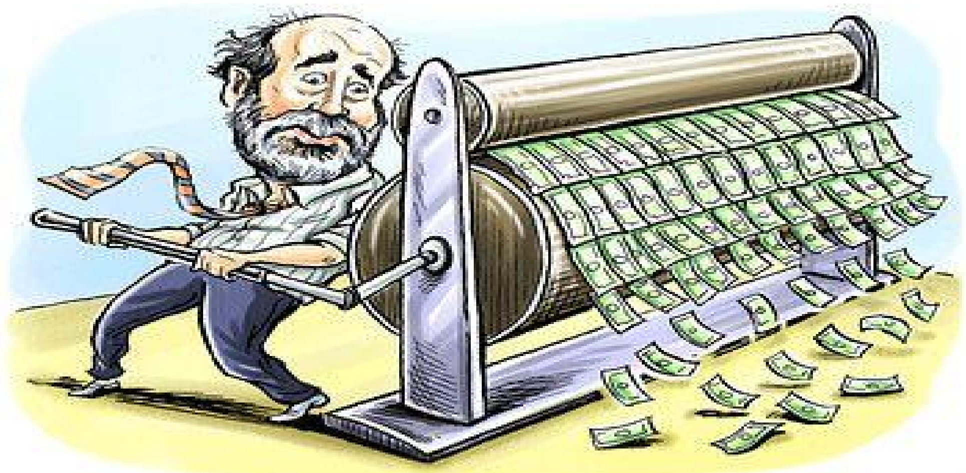
Exchange Traded Funds are Open ended funds that track an index, a commodity or a basket of assets like an index fund but trades like a stock on an exchange. ETFs offer public investors an undivided interest in a pool of securities and other assets and thus are similar in many ways to traditional mutual funds, except that shares in an ETF can be bought and sold throughout the day like stocks on a securities exchange through a broker-dealer.

Actively Managed Funds

Actively managed funds are funds where the fund manager has the flexibility to choose the investment portfolio, within the broad parameters of the investment objective of the scheme. The manager performs an in-depth analysis of many investments in an attempt to outperform the market index.

Passively Managed Funds

Passively managed funds are funds in which a fund manager invests in accordance with a pre-determined strategy that doesn't involve any forecasting. The idea is to minimize investing fees and to avoid the adverse consequences of failing to correctly anticipate the future. Passively managed funds have lower expense ratios and lower capital gains distributions.



Knowledge Bank

Discovering Opening Price through Pre-Open Session

In order to discover correct opening price and eliminate/minimize opening volatility in opening prices of securities, SEBI advised the exchanges to formulate a Pre-Open Session of 15 minutes ahead of the normal market using Call Auction mechanism. Earlier, price of first trade in any security used to be ascertained as its opening price, but this practice was manipulated and maligned by forming a cartel to open the prices at one's desired level.

What is a Call Auction market?

In a Call Auction market, orders are pooled in the order book but remain unexecuted till the end of the order entry period, when the orders will get matched and get executed at the single call auction price that is so determined. At the call, all buy orders are aggregated into a downward sloping demand function and all sell orders are aggregated in an upward sloping supply function. The market opening price and quantity traded are derived based on aggregated supply and demand for the underlying. The orders that trade and the price and quantity at which they trade, are set by multilateral matching, rather than by the sequence of bilateral matching used to determine trades in earlier system of normal market.

Pre-Open Session

Pre-Open Session is a new innovation on exchange side to arrive at the ideal opening price of scrips for the current trading session. The session intends to reduce the volatility that accompanies during the beginning of the day and facilitates better price discovery.

The duration of Pre-Opening Session is of 15 minutes – from 9:00 A.M. to 9:15 A.M. The session has three phases–

Timings	Details
9:00 a.m. to 9:08 a.m.	You can a) place, b) modify and c) cancel orders in this Pre-open session.
9:08 a.m. to 9:12 a.m.	Exchange performs functions like – a) Price Discovery, b) trade confirmations and c) converts unexecuted market orders to limit orders at discovery price (limit orders remain at your specified price) in this pre-open session.
9:12 a.m. to 9:15 a.m.	Transition time from pre-open to normal session. All unexecuted orders (limit & market) will be carried forward to normal trading session by exchange during this pre-open session.
9.15 a.m. to 3.30 p.m.	Normal trading session i.e. Continuous trading as per existing practice.

Under this new arrangement, the exchange collects the orders for the first few minutes of this session. On the basis of orders received, the exchange arrives at an Equilibrium Opening Price and trades matchable orders on that price. Remaining orders are moved to normal trading session.

Equilibrium/discovery price

An equilibrium/discovery price is the price which is discovered in the pre-open session and all matching orders during pre-open session are executed at this price. Further, the normal market opens at this discovered price.

The equilibrium price is the price at which the maximum volume is executable. In case more than one price meets the said criteria, the equilibrium price shall be the price at which there is minimum order unmatched quantity. The absolute value of the minimum order unmatched quantity shall be taken into consideration. Further, in case more than one price has same minimum order unmatched quantity, the equilibrium price shall be the price closest to the previous day's closing price. In case the previous day's closing price is the mid-value of a price or prices which are closest to it, then the previous day's closing price itself shall be taken as the equilibrium price.

Example 1: Let's suppose, we have the following Order Book on a scrip:

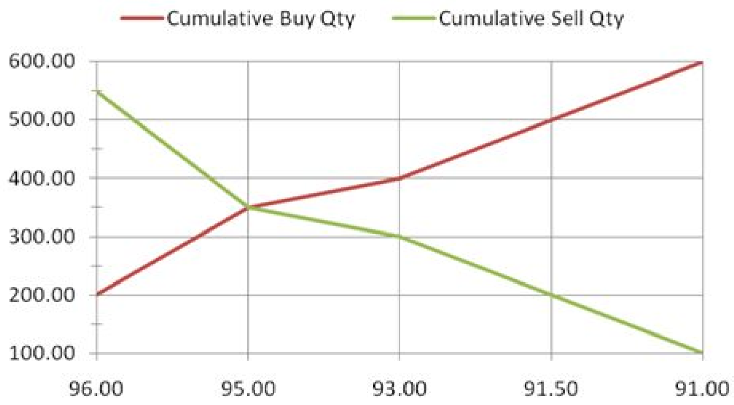
Buy Quantity	Buy Price	Sell Price	Sell Quantity
100	Market	91	100
100	96	91.50	100
150	95	93	100
50	93	95	50
100	91.50	96	200
100	91		

The system will now calculate the cumulative tradable quantity @ each price

Price Point	Cumulative Buy Qty	Cumulative Sell Qty	Tradable Quantity
96.00	200	550	200
95.00	350	350	350
93.00	400	300	300
91.50	500	200	200
91.00	600	100	100

The maximum Tradable Quantity is @ Rs. 95, so the system will mark Rs. 95 as Opening Price and execute the tradable quantity at that price.

If you create a demand – supply curve based on the price and cumulative values, it would look like this.



The intersection of this curve is the price at which maximum transactions can be conducted and that's the equilibrium price that comes out from this pre-open call auction.

Key Economics Events

BRICS Nations Plans to Form Development Bank

On 27 March on BRICS annual summit in Durban, South Africa, the leaders of Brazil, Russia, India, China and South Africa have agreed to form a new development bank that will fund infrastructure projects and development of BRICS nations. It has been described as an alternative to the IMF and World Bank for developing countries in the global financial system. BRICS contain more than 40 percent of the global population and conduct 17 percent of world trade.

India Industrial Production Beats Estimates

On 12 March, Industrial Production in India increased 2.40 percent in January of 2013 over the same month in the previous year. It was -0.6% in the month of December. The General Index for the month of January 2013 stands at 181.8. The cumulative growth for the period April-January 2012-13 over the corresponding period of the previous year stands at 1.0%. In terms of industries, eleven (11) out of the twenty two (22) industry groups (as per 2-digit NIC-2004) in the manufacturing sector have shown positive growth during the month of January 2013 as compared to the corresponding month of the previous year.

Economic outlook for G-7 economies

G7 economies are expected to grow at an annualized 2.4 per cent rate in the first quarter of 2013 and at a 1.8 percent rate in the second. The OECD projects that the euro area's three largest economies – Germany, France and Italy – will grow by 0.4 per cent during the first quarter and by an additional 1 per cent in the second. Growth in the United States economy is expected to see a rebound of 3.5 per cent in the first quarter of 2013 before returning to moderate growth of 2.0 per cent in the second. Canada is set to grow by 1.1 per cent during the first quarter and 1.9 per cent during the second. Growth in Japan is projected to accelerate from previous low levels to a 3.2 per cent pace during the first quarter and 2.2 per cent in the second, while the United Kingdom is expected to grow by 0.5 percent during the first quarter and 1.4 percent in the second.

Example 2: Another example of more than one price having minimum unmatched quantity–

Price	Buy (Qty)	Cumulative Buy (Qty)	Sell (Qty)	Cumulative Sell (Qty)	Unmatched Qty	Volume Tradable
106	0	0	3000	8000	-8000	0
103	2000	2000	3000	5000	-3000	2000
96	3000	5000	1000	2000	3000	2000
94	1500	6500	1000	1000	5500	1000
92	2000	8500	0	0	8500	0
90	1000	9500	0	0	9500	0

In the above example 103 and 96 are the prices wherein, the volume tradable and unmatched quantity is the same. To derive the equilibrium price only one price, which is closest to the previous day's closing price of the said prices i.e. 103 and 96, will be considered. If previous day's closing price is 95, then 96 may be considered as the equilibrium price. In case the previous day's closing price is 105, then, 103 may be considered as the equilibrium price. In case the previous day's closing price 99.5 which is the mid-value of 103 and 96, then the equilibrium price shall be the previous day's closing price i.e. 99.5.

What happens to the pending unexecuted orders in pre-open session?

Pending unexecuted orders in pre-open session are shifted to the order book of the normal market session. All the unmatched market orders are converted to the limit orders at the discovery price as discovered in the pre-open session and carried forward to the normal trading session. All unmatched limit orders of pre-open session remain at the limit price as specified and carried forward to normal trading session.

In case the equilibrium price is not discovered in the pre-open session, wherein there are only market orders, the market orders shall be matched at previous day's close price. All unmatched market orders shall be shifted to the order book of the normal market at previous day's close price following time priority. Previous day's close price shall be the opening price.

In case of equilibrium price is not discovered in the pre-open session and there are no market orders to be matched, all unmatched market orders (at previous day's close price) and limit orders shall be shifted to the order book of the normal market following price time priority.■

Market Overview March 2013

Equity market roundup

In the month of March Indian indexes SENSEX and NIFTY were down by 0.1% and 0.2% respectively. Healthy US data at the start of the month and growing SEZ exports (35.3%) in Q3FY13 (Y-o-Y) – as per data released by Export Promotion Council for EOUs & SEZs (EPCES) – moves market to northward direction. India's IIP growth increased to 2.4% in January 2013 due to the better than expected growth in the manufacturing sector, IIP growth for December 2012 was -0.6%. After showing growth in January HSBC services PMI slips to 54.2 in February, down significantly from 57.2 in January and increase in the CPI from 10.79% to 10.91% of February puts Indian market into pressure. India's current account deficit hit an all-time high of 6.7% of the country's GDP for the quarter ended December 2012. The CAD stood at $US 32.6 billion compared to previous high of $ 22.3 billion in the July-September 2012 quarter. SENSEX ended at 18835.8 and NIFTY at 5682.6 levels.

Forex market roundup

In the month of March Indian rupee fell down by 1.0% due to decline in Indian equity market and withdrawal of DMK support to the government. RBI cuts repo rate by 25 basis point on its mid quarter review. Heavy capital outflows and government proposal of about 17000 crore net borrowing target in the budget failed to cheer investors' sentiment. Healthy US data strengthens the dollar against a basket of major currencies puts Rupee under pressure. USD pair closes up at 54.46 against the previous month close of 53.94.

Bullion market roundup

In the month of March MCX April delivery gold fell down by 0.5%. Cyprus bailout deal with the EU eased fears of a financial meltdown in euro zone and hurt gold's safe haven buying. Favorable US data strengthen Dollar against the Rupee which in turn pushed the prices of gold upwards. International gold prices breached $1600 due the Cyprus bailout. International gold closes at $1595.7 went 1.1% higher than the previous close of $1578.1, while MCX gold of April expiry closes at Rs. 29394.

inteli visto
KNOWLEDGE REDEFINED
AN ISO 9001:2008 COMPANY

Intelivisto Consulting India Private Limited

C-131, Sector 2, NOIDA,India-201301
t: +91-120-4314666/4324666

Aekveera Regency, Shanker Lane,
Kandivli (West), Mumbai,India-400067
t: +91-22-65305201