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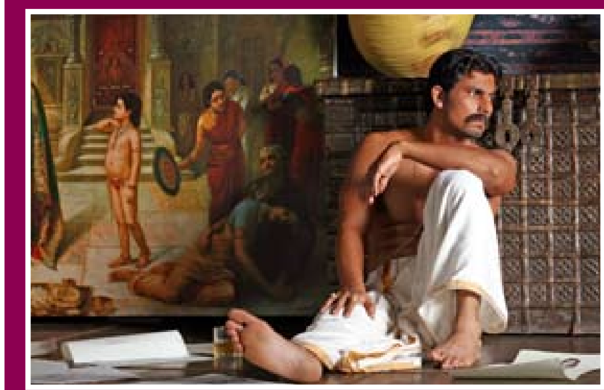

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COVER STORY

INTERESTING, CHANGING TIMES

Shanta Acharya

The times they are a changing...We certainly live in interesting, changing times—stagnant economic output in the developed world coupled with high levels of debt not seen since 1970s in the UK; high unemployment; rising inflation; fall in real incomes and living standards; largest gap between rich and poor in decades; negative real interest rates; banks failing to lend; Greece on the verge of default; Italy looking to China for a handout; the US already at its maximum indebtedness to China; China poised to overtake the US as the world's largest manufacturer; the US government's credit rating lowered; riots and the promise of strikes and social unrest in UK/Europe; high volatility in stock markets nervous of continuing uncertainty making matters significantly worse... Is this the legacy of western capitalism?

'The Great Moderation': an illusion

So how did we get here? Not long ago we were basking in the Goldilocks economy with booming stock markets, rising corporate profitability, low inflation, low unemployment, and a budget surplus. Mervyn King, Governor of the Bank of England, described it in 2003 as the 'NICE' decade—the non-inflationary, consistently expansionary decade! Ben Bernanke, member of the US Board of Governors in 2004, referred to 'the substantial decline in macroeconomic stability' as being 'one of the most striking features of the economic landscape over the past twenty years or so'. 'The Great Moderation' we know now was an illusion—based on debt, cheap money and cheaper imports. Gordon Brown assured us that Britain had achieved economic nirvana; boom and bust were things of the past! Now we are told living standards may not ever recover.

Yet money is still cheap, real interest rates are negative in many countries. But overall trade and growth remain weak, individuals and businesses are finding it difficult to borrow. What precipitated the financial crisis in 2008 was the banks' unwillingness to lend to each other. It may not be as bad today, but the banking sectors' problems are far from over, particularly if their reserves need to be strengthened. Negative real rates are inflationary; but in recessionary times lack of demand, pay freezes, fall in household affordability and the lack of credit has restrained inflation to some extent.

The devaluations forced upon ailing economies makes imports costly, inflationary. The Eurozone, UK and the US have been experiencing low or no growth and consistently rising inflation. How long will this state of affairs last? Much depends on central bankers and governments of these countries. Luckily the emerging countries' economies are growing at reasonable rates. But will it be enough to sustain global growth? One of the positive developments of the past decade, 2000-10, for example, was that Britain became the destination of $129 billion of emerging market acquisitions. America received more ($193 billion), but in proportion to the size of its economy Britain got four times as much. Its open economy, plentiful supply of expertise and global brands attracted investments. The creation of the European Union was definitely a strong contributory factor. As Europe faces financial difficulties, will the cycle of investment be maintained?

In heavily indebted economies where one would expect savings to be at a premium, we have a curious state of

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COVER STORY

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affairs where savers are punished with negative real rates of interest. The government is caught Janus-faced—looking on the one hand to stimulate investment in the economy and growth, and on the other to reduce debt and interest payments. An efficient financial system is essential for economic stability. It is a well established fact that poorly invested savings pose a problem for individuals as much as the economy. Bank lending to small businesses remains at best anaemic. Companies find it harder to borrow, or to raise equity capital. This lack of investment is dampening economic growth. Well functioning financial markets are essential for all kinds of reasons—from enabling investors to price risk adequately to securing a stable society. When investors/ savers are faced with extreme market volatility, negative real interest rates, and an uncertain economic outlook, their cautious response makes matters worse.

Absence of robust bank bailouts

The primary reason why governments bailed out the banks was the fear of a global banking collapse leading to a 1930s type recession. The prospect of such a thing happening was not a risk worth taking. But, the bailout could and should have been managed more robustly. The billions spent on bailing out the banks did not flow back into the economy; that is not what John Maynard Keynes had in mind when he advocated public spending in crisis.

Imagine if those billions had indeed been invested directly in the economy—improving our infrastructure, providing jobs, improving education and health, growing the economy, bringing in revenues via taxes and spending! Unfortunately, governments and bankers were unable or unwilling to do so. It may be encouraging to hear now of monetary activism, of 'credit easing' to help small businesses. One cannot help asking why the government, as owners of several banks, could not achieve this earlier.

Why the reluctance on part of leaders and governments to lead? Bankers were allowed to reward themselves with unearned and undeserved bonuses. We were told they would leave the country—though nobody ever informed us where they would actually go to—if they did not receive ridiculous amounts of money in compensation for their multiple failures. The stock market collapse was the market's way of disciplining profligate, irresponsible bankers. In bailing out the banks we interfered with the market's 'creative destruction' mechanism. No senior banker was tried or put in jail; those who resigned left with multi-million pensions and bonuses.

The financial crisis did not happen overnight. It had been brewing for some time. The entry of the Asian giants into the world economy provided a huge pool of savings. These savings were absorbed by industrialized economies, and helped in ensuring a sufficient level of demand in stabilizing inflation and maintaining desired levels of output and employment. Low real interest rates fuelled economic growth but did not help savers/investors. The search for yield was intensified. Investment bankers who make a living by passing on risk to savers/investors sought new means of doing so.

The scale of global imbalances and mismanagement is worth examining simply because we have a way of forgetting. Prevention is better than a cure. The tragedy of our times is short-sightedness; a long-term investment these days is less than three months. Europe is considering a transaction tax to kill two birds with one stone—curb the high level of trading and raise money in the process. Such a tax though is likely to have unintended consequences unless it is applied globally. Investors complain high market volatility forces them to trade. How do we create an environment where investments will prefer to invest long term? Surely addressing the compensation arrangements for investors and traders is the right way forward rather than introducing another tax?

Lack of regulatory oversight, incredible

Let's go back to 1999, on the verge of a new century, markets were bullish, the technology bubble was building. Two major acts were passed in the US altering the financial services industry—not only in the US but its ramifications were felt in Europe, thanks to globalization. Europe too was getting its act together. Not for an integrated economic entity like the United States of Europe. Considering the European Union was a marriage of convenience, the due diligence process appears to have been flawed. Will expanding the powers of the European Financial Stability Facility, the main bail out fund, now be enough? Europe is like a play in the Theatre of the Absurd—seventeen characters in search of an author! The author of greater economic integration is still to be found.

Greece's problems did not happen overnight, nor did Italy's or Ireland's—the mismanagement with the deficits have been around for years. Why were the inherent weaknesses of these economies not addressed earlier—after all, Europe has had at least a decade to put things right? Why was economic union—the issuance of European bonds, for example, not on the agenda? Bringing so many countries together at different stages of their economic cycles is not easy. Even in the UK with just four entities—England, Scotland, Wales and Northern Ireland—a single interest rate does not work for all the regions. As long as the crisis is used to usher in deregulation where it is needed and regulation where it is necessary, the outcome could yet be positive in the long term.

In the US, the two acts that changed the landscape of financial services were—first the repeal of the Glass-Steagall Act of 1933 which had required banks, investment banks, securities firms, and insurance companies to operate separately. The Glass-Steagall Act had also prohibited banks from trading on their own account. The other was the Gramm-Leach-Bliley Act of 1999, known as the Financial Services Modernization Act, which exempted investment banks from direct federal regulation. These acts were passed in the name of innovation, liberalization, creativity, greater operational efficiency etc. The lack of regulatory oversight ushered in by such legislation is incredible. It can be argued that the current financial crisis that originated in America was state sponsored as the banking deregulation was implemented by successive governments, and as a result long-standing regulatory checks and balances were removed.

In 2000, the Commodity Futures Modernization Act barred federal regulation of swaps, which enabled financial institutions to develop, market and trade unregulated financial products, such as credit default swaps, foreign currency swaps, interest rate swaps etc. In 2002, the Treasury allowed banks to hold less capital in reserve if they held securitized mortgages with investment grade credit ratings. In 2004, the Securities and Exchange Commission relaxed capital requirements for larger broker dealers who traded in such products. By September 2008, an unregulated credit default swaps market stood at $60 trillion. The financial meltdown was a direct result of the failure of regulation, undisclosed conflicts of interest, flawed compensation structures, under-pricing of risk etc. The US authorities passed legislation after legislation sponsoring legal weapons of mass destruction! Warren Buffet pointed that out soon after the invasion of Iraq.

There were regulatory failures in the UK too. The UK government under the leadership of Gordon Brown made the Bank of England independent, and that was a positive development. But regulatory oversight was split between three different institutions—the Financial Services Authority, Bank of England and the Treasury. The three institutions were not the Three Graces or the 'three eyes of wisdom' in Eastern traditions; no they were more like three eyes in a cubist painting imitative of Picasso—lacking a coherent overarching vision. None of these entities, individually or collectively, appreciated the extent of the problems in the banking sector.

The scale of deregulation in the US was mind-boggling to say the least, leading to irresponsible risk taking and overleveraging. Inadequate oversight, undisclosed conflicts of interest, creation of complex financial products, easy credit, the lack of independence of credit rating agencies, globalization, and flawed compensation structures generated an environment of incorrect pricing of risk. Normally risk is associated with reward. If compensation structures reward true skill, that is healthy. Unfortunately, the compensation culture in the industry has been such that senior managers rewarded themselves without taking any real risk; risk was passed on to the investor. When banks were bailed out, the risk was passed on to the population at large like a deadly virus. Greater distribution of risk does not mean the elimination of risk. In times of crises it becomes a highly leveraged risk.

Responsible investors get crucified too

Investors too are to blame—nobody forced them to buy financial instruments they did not understand. The problem however lies in the fact that the market does not discriminate between good and bad investors. There is no safety for investors who behave responsibly; they too suffer severe losses as markets collapse. So, where do long term investors turn to if they wish to preserve the real value of their savings—particularly in a world where governments expect individuals to provide for their own retirements?

If Lehman Brothers or Northern Rock had collapsed without causing widespread damage to the economy that would have been manageable. Individuals like central bankers need not be concerned if a collapsing financial asset

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PROFILE

SRINIVAS RAMANUJAN: UNTUTORED MATHEMATICAL GENIUS

By **Dr. George Gheverghese Joseph**

Srinivas Ramanujan was born in 1887 in Erode, a small town near Madras in southern India. The eldest of three sons, he came from a family of Ayyengar Brahmins, a group noted for their traditional learning and strict religious observances. His mother, the dominant figure in the family and who was to have a decisive influence on Ramnujan throughout his life, was well-known locally for her interest in astrology and numerology. Traditional astrologers in South India are known for their agility in mental arithmetic. It is possible that Ramanujan's extraordinary intuition for, and ability to manipulate numbers owed a lot to his mother. After a distinguished school career, he failed at college as a result of his neglecting to study any other subject apart from mathematics. Between ages twenty and twenty five, he was unemployed and impoverished, devoting all his time to mathematics and scribbling the results of which he established in a series of tatty notebooks. Once his mathematical gifts were recognised, it was only a matter of time before he was invited to Cambridge University as occurred in 1914. In the next five years, he produced about twenty research papers of the highest quality, in many cases in collaboration with one of the prominent mathematicians of the time, Professor G. H. Hardy. He was awarded the B.A degree by research in 1916, elected a Fellow of the Royal Society in February 1918 and a Fellow of Trinity College in October 1918. This is what a historian of mathematics (J.R. Newman) has to say of Ramanujan's achievement. "With hardly any training in pure mathematics, Ramanujan arrived in England abreast, and often ahead of contemporary mathematical knowledge. Thus, in a lone mighty sweep, he succeeded in recreating in his field, through his own unaided powers, a rich half century of European mathematics. One may doubt whether so prodigious a feat had ever before been accomplished in the history of thought."

In 1919, Ramanujan returned to India after having contracted tuberculosis. He died a year later at the age of 32, working at a furious pace up to the last. The results of that year's labour, contained in what is often referred to as the "Lost Notebook", are being mined with

increasing success and excitement by mathematicians even today. A result from that source has contributed to one of the most revolutionary concepts of recent theoretical physics—superstring theory in cosmology. And a formula from Lost Notebook was used to program a computer a few years ago to evaluate (perhaps the most widely known mathematical symbol indicating the ratio of the circumference of a circle to its diameter) to a level of accuracy (to millions of digits) never attained previously. Most of his work is in a highly abstract area of mathematics, known as the theory of numbers.

How did Ramanujan produce such remarkable mathematics with his limited formal education? I think that part of the explanation may lie in his culture and upbringing. A source of embarrassment to many of his admirers both in India and in the West was his tendency to credit his discoveries to the intervention of the family goddess, Namagiri. Mathematics and numbers have always had a special significance within the Brahmanical tradition as extra-rational instruments for controlling fate and nature. And an enduring aspect of Indian mathematics over a long time: a fascination with numbers and a positive delight in calculations.

Fascination with numbers can take another form—an instant recall of the peculiarities of different numbers almost in the same way as you would remember the idiosyncrasies of your friends and relations. According to Littlewood, one of his colleagues in Cambridge, every positive integer was one of Ramanujan's personal friends. Hardy recalls going to visit Ramanujan lying in his sick bed in London. Wishing to divert the patient, Hardy remarked that he had just driven up in a taxi whose number was 1729 and that the number seemed to be a dull one. "Oh no," replied Ramanjan in a flash. "It is a very interesting number. It is the smallest number expressible as a sum of two cubes in two different ways." To relieve any anxieties, the Ramanujan solution is:

$$93 + 103 = 1729 = 13 + 123$$

Dr. George Gheverghese Joseph teaches at the School of Education (Mathematics Education) University of Manchester

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bubble does not threaten to impair the real economy—its production, jobs and price stability. The problem arises when irresponsible risk-taking threatens to bring down the entire edifice—the too big to fail syndrome is really not worthy of capitalism. This fictitious capitalism lies at the heart of the matter. Such a threat has been allowed to grow because risk takers have been encouraged to pass the buck to others—perfect example of having your cake and eating it! That is where the inequity and injustice lies; those who bear the risk must also be rewarded. But, where are the rewards for the citizens of the USA, UK and Europe?

On the other hand, the financial sector has usurped a disproportionately large portion of resources that could have been better utilized in other sectors of the economy. It is true we all depend more and more on markets and financial innovation in most areas of our life. A change in our collective attitude to risk/compensation is critical in a world where individuals are increasingly expected to fund their retirements, when parents need to invest in their children's education or farmers depend on derivatives to secure a better price for their produce.

Governments have an obligation to provide economic stability, an infrastructure where enterprise is rewarded and the market is accessible to the largest number of participants. Unfortunately, we are left with a shrinking economy with high unemployment and skewed compensation arrangements. In a global world such matters need to be addressed globally. Also, markets are not good at addressing complex social issues; that is where governments play a key role. The world we have inherited today is not a fit tribute to democracy or capitalism.

It is worth pointing out that unlike doctors who take the Hippocratic Oath to practice medicine ethically, bankers and other professionals in the financial services sector are not obliged to take any oath to practice theirs ethically or to serve their clients' interests first. The CFA (Chartered Financial Analyst) Institute traces its lineage back to 1947, yet its members today are confined largely to professionals in the 'Buy' side—i.e. analysts, fund managers etc. The 'Sell' side professionals—i.e. commercial and investment bankers, traders, corporate financiers etc.—do not have an equivalent regulatory requirement.

Members of the CFA Institute are required to disclose any conflicts of interest and adhere to clearly defined codes of ethical conduct. The institute's vision is built on a clear mission—that financial markets should be equitable, free, and efficient so that every investor has a chance to earn a fair return; the interests of the ultimate investor takes precedence over the interests of all other market participants; and that high individual ethical principles and self-regulatory standards are as important to market efficiency and fairness as rules and regulations.

The financial services sector faces changes on many fronts as regulation aimed at stemming systemic risk and augmenting investor protection is implemented. As long as misaligned incentives remain, no amount of regulation will be enough. Recent unauthorized trading, involving fraud and false accounting, at the Swiss Bank, UBS, is just another example of how regulation has its limits, particularly in an environment where money and power attract the greedy and corruptible.

Shanta Acharya was born in India, educated at Oxford, and was a Visiting Scholar at Harvard. She served as a fund manager with several asset management firms in the City, and worked at London Business School. She is the author of nine books. www.shantaacharya.com