

# Developing Trends

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## Italian Wine – Indian Spirit

In a pre-budget special on India less than two months ago (Feb. 24, 1999) *Developing Trends* boldly predicted that: economic reforms were in the offing, interest rates were set to decline, the stock market was set to rally (and one should be 3 units long as opposed to the “normal” one unit), the rupee would continue its stable run, and that political uncertainty did not matter – indeed, the more political uncertainty there was, the more reform oriented would the major political parties become. All of the above forecasts have come out to be accurate – the uncertain BJP government announced a complete reform of excise taxes, and partial reform of customs taxes; the Reserve Bank of India (RBI) cut interest rates by effectively more than 1 percent; the stock market rallied 15 percent, and the rupee stayed stable at 42.5, indeed marginally strengthened to 42.4.

Until the proverbial fat lady began to sing! On April 4, Dr. J Jayalalitha, the mercurial, enigmatic (and confused?) leader of the AIADMK, a major ally of the ruling Bharatiya Janata Party (BJP), broke off her relationship.

These latest political developments have now brought the “final” Oxus forecast into play – political uncertainty. We did not think that we would be tested so soon on our forecast – but we have. What now?

It is our view that this present *political uncertainty* will result in a greater *political certainty* in the very near future. It is also our forecast that the BJP will survive the confidence vote scheduled for next week. However, the chances of a general election in the fall (around October '99) have considerably gone up. But the “certainty” is in

the continuity of economic reform policies, and the continuing irrelevance of Indian politicians – a la Italy.

**Indian Markets:** After an initial flurry, the stock market should be unaffected, which is why *Developing Trends* is continuing with its overweight (3 units as opposed to a neutral weightage of 1) recommendation for the Indian market. The consumer is continuing to impress (e.g. motorcycle sales up 30 %, TV sales up 40 %, software earnings up 75-100 percent). Interest rates should also ease, and the rupee should remain stable within the 42.5 and 44.0 range – a place it has been locked in for over a year.

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### International Currency Markets:

In the end-year issue, Oxus had advised its clients to go flat the yen, and instead go long Euro/yen. The Euro has been a surprise and is now in the category of a wrong forecast. Fortunately, the loss has been minimal (about 1 percent). *Developing Trends* now believes that dollar/yen should range between 116 and 130 and therefore at present levels (\$/yen at 120) one should be a buyer of dollars. The Euro, one should wait and only go long if it closes above 1.095. The Brazilian Real – fair value close to 1.55.

### **Political Uncertainty – Learn to Ignore**

The divorce of Dr. JJ and the BJP was only partially unexpected – Ms. Jayalalitha had been flirting with the idea since Day 1 last year when the government was formed. Many wondered as to why the BJP was not calling her bluff, and why when asked to jump by Dr. JJ, the BJP repeatedly asked “how high?” Or when asked to walk, the BJP shamelessly preferred crawling. All for the sake of keeping the coalition partner happy, and keeping glued to power. Such servility ends in only one of two ways – either the jumping/crawling person loses his legs, or he stands up and tells the tormentor to go fly a kite. The BJP, (finally and thankfully, Oxus believes) has chosen the only responsible course left, and has learnt to play poker – it has called Dr. JJ’s bluff and said “Enough – and No More”.

Various realignments are possible, and are being explored by the different political parties. Two outcomes are possible – the BJP is able to pass a vote of no confidence (our forecast) or the Congress leads a rag-tag group. The latter is considered unlikely because the Congress leadership is not that stupid – leading a new coalition, with Dr. JJ as a major ally, is not learning from history. But the last few years in the wilderness for the Congress party is a record i.e. at no other time in India’s history has the Congress been out of power for three years. The party is lusting for power, and in such situations, lesser mortals have been known to lose their senses. So one should not be surprised if the Congress takes the bait. If it does, then the likelihood of elections by the end of 1999 is a near certainty.

What if the BJP survives the confidence vote next week? Again, two outcomes – either the BJP has a new more solid but thin majority, and/or it forms a caretaker government with elections in November. (While some analysts are calling for elections in the next three months, such an eventuality is physically –

because of the monsoons - not possible). In either circumstance, political uncertainty will go up. So where is the good news?

The good news is in the fact that the Indian economy, and policy making, is maturing – and there is unanimity in economic views between the BJP and the Congress. Both parties are for the patent bill, insurance deregulation, privatization, decreasing the fiscal deficit, controlling inflation, and “economic motherhood”. Not only are they in agreement with the goals, they are also in agreement with the methods, i.e., relying on the increasingly technocratic bureaucrats in the Ministry of Finance, the Reserve Bank of India, the Prime Minister’s office, and the Planning Commission (former Finance Secretary, Mr. Montek Ahluwalia, is housed there). The show will go on – regardless of the party in power.

India is going to increasingly look like Italy – with or without Sonia Gandhi as Prime Minister. Before Euroland, Italy changed political leadership about as often as people changed their underwear. This political uncertainty had a zero impact on the Italian economy and markets. If there had been any long lasting effect, only Italian designers would now be left, and Italy would not have the reputation as one of the best performing European economies. And one of the best performing stock markets (outside of the US, of course). India will look more and more like Italy – the markets will learn to ignore the politicians, and concentrate on economic fundamentals. And the fundamentals look extremely good for a 7 percent economic growth rate, and a further 20 percent appreciation in the stock market – on top of a 18 percent growth already registered so far. The rupee should also stay stable at around 42.5-44 with some chance of a further opening up of the Indian capital account. According to Oxus’s calculations (see next section) the rupee, at 42.7, is fairly valued at present.

## Whither Indian Rupee ?

It is open season on the rupee again. First there was the Government of India's Economic Survey hinting ever so casually that the rupee might be over-valued. On April 4, the Finance Secretary, Mr. Kelkar stated "We have to ensure that interest rates move southwards through better fiscal management both at the states and at the Centre. We have to continue our vigilance on the exchange rate to ensure that the exports continue to be a major source of demand", *Business Standard*, April 5, 1999, p.1. Today (April 9<sup>th</sup>) the newspapers have a headline report that the "Government sees Re. Overvalued by 3 %".

This latest report is an excellent example of the kind of thinking that prevails in our (still heavily controlled) currency market. Our esteemed bureaucrats (control wonks) can pinpoint with a decimal point accuracy what the price of the rupee should be! But it also means that the government agrees with Oxus' calculations that the present turmoil / confusion is really "much ado about randomness."

The rupee has the final date with the Governor of the Reserve Bank of India, Mr. Bimal Jalan on April 20, when he presents the mid-year credit policy. Will he (devalue) or won't he?

Oxus believes he won't. Why? Because no matter what the criteria for calculation of an appropriate value for a *managed* exchange rate, the rupee at 42 to 44 to the dollar is very fairly valued.

What about the need to spur export growth? What about it? Export growth is an important consideration, and for very long the Indian authorities neglected the role of relative prices in determining output. But India missed the undervalued currency motor-boat in the sixties, seventies and eighties. (This art was well practiced by the East Asian economies, and most notably by China, which depreciated its currency in **real** terms by over 400 percent between 1978 and end 1993. (See *Developing Trends*, vol. 2, # 7&8, Aug. 30, 1998 for details). **Now, even if India wants to, it cannot really undervalue the currency, though it can over-value it.** This because of the

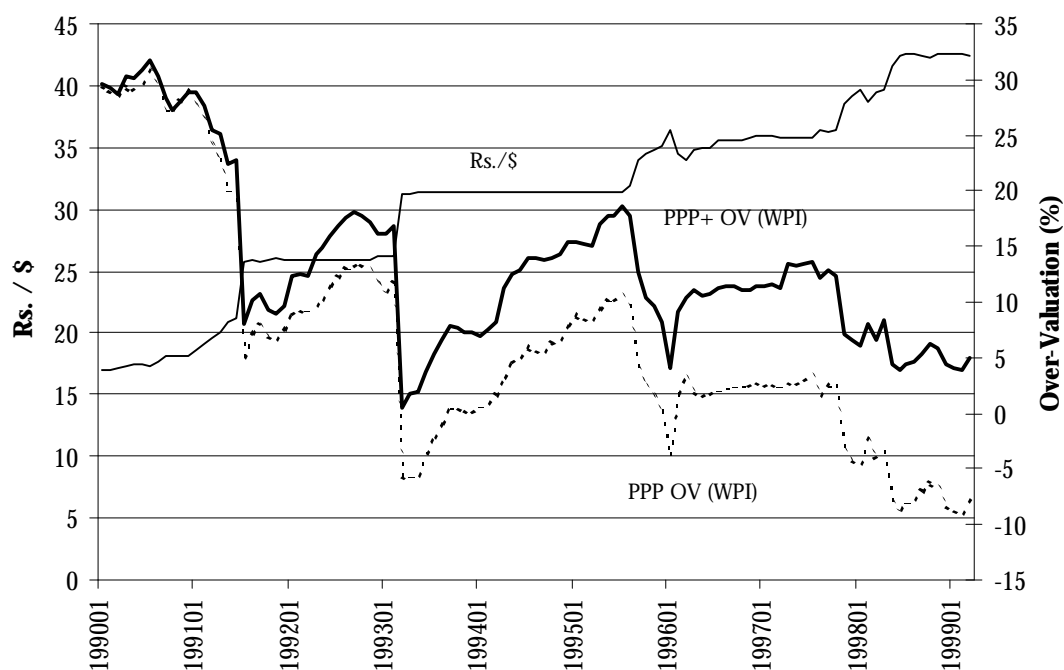
role of capital flows in "forcing" currency adjustments. If, for example, the Indian authorities were to devalue the rupee when the fundamentals do not demand it (as at present), then there is likely to be a net inflow of dollars which will cause the rupee to appreciate. What can negate this inflow is higher inflation – but if higher inflation is the result of devaluation, then what is the contribution of the devaluation?

How will interest rate declines affect the rupee? It is likely to be strengthened, *ceteris paribus*, with a **decline** in the real rate of interest. As consistently argued by Oxus over the last three years (see the pre-India budget special of *Developing Trends* dated Feb. 24, 1999) the major problem with the Indian economy has been its overly controlled capital market, and sky high real interest rates. What has really ailed the Indian economy are not the political shenanigans of neanderthal politicians (Indian specialty over the last fifty years – the names change, the backwardness does not) but rather the high levels of real interest rates. So a decline in real interest rates, which is finally occurring, and has further to go, will help bolster the GDP growth rate to near 7 percent, and will induce more capital flows into India (both portfolio and foreign direct investment). These flows will put pressure on the rupee to appreciate, and any forced devaluation will come asunder.

The table and chart on exchange rate over-valuation puts the above arguments into perspective. Two inflation measures are considered – CPI and WPI. While the former is a preferred measure, in India the latter is considered more reliable and less prone to political manipulation or onion inflation! As shown in the Chart, the two indices have shown broadly similar trends – except in 1998-99 when the political, onion and potato inflation was over 400 percent! So while data for CPI are presented, it is the WPI based calculations that are really of relevance. Further supporting this preference for the WPI is the official RBI practice of using this inflation measure for its REER (Real Effective Exchange Rate) calculations.

### Chart 1: Rupee/\$ Exchange Rate & Over-Valuation

(1993 as the Base Year; WPI as the measure of Inflation)



**Table 1: Whither the Indian Rupee? “Fair” Rates using Different Base Years and Measures of Inflation**

Base Year For	"Fair" \$/Rupee Rate, March 31, 1999							
	PPP		PPP+		PPP Overvaluation (%)		PPP+ Overvaluation (%)	
	WPI	CPI	WPI	CPI	WPI	CPI	WPI	CPI
1990	27.9	30.9	31.7	35.1	-51.6	-37.0	-33.7	-20.8
1991	33.4	36.9	37.9	41.8	-26.7	-14.9	-11.7	-1.3
1992	34.9	38.5	39.5	43.6	-21.5	-10.1	-7.1	2.9
1993	39.3	43.8	44.6	49.7	-7.8	3.3	4.9	14.8
1994	37.5	42.0	42.5	47.6	-12.9	-1.0	0.5	11.0
1995	36.5	40.6	41.5	46.0	-15.9	-4.4	-2.2	7.9
1996	38.6	41.6	43.8	47.2	-9.7	-1.7	3.3	10.3

Source: O[x]us Research & Investments Database.

Notes:

1. The base year chosen for the calculations shown in the above graph is 1993, when the rupee was “unified” and moved to a single value rather than a dual exchange rate.
2. PPP+ represents (relative) productivity adjustments (proprietary Oxus calculations) to purchasing power parity (PPP), or inflation adjusted exchange rates.
3. Negative over-valuation means that the rupee would have a tendency to appreciate if it was market determined.
4. Calculations for the different base years are chosen to fit about any determination of when the rupee was fairly valued.

Table 1 presents two estimates for each inflation measure – the conventional PPP measure (exchange rate adjusted for bi-lateral inflation differentials vis-à-vis the US) and Oxus’s proprietary PPP+ measure which adjusts these values according to bi-lateral differences in productivity growth. (The latter have been computed by Oxus for the different economies). No matter what base year is used, the conventional PPP measure suggests that the rupee is undervalued with respect to the US dollar. Oxus’s proprietary PPP+ calculations do suggest that the rupee is overvalued, but only by 3 to 5 percent depending on whether the 1993, or the 1996, base year is chosen.

There are two “official” measures of real exchange rates floating around. The Reserve Bank of India publishes a five country (UK, US, France, Germany and Japan) based REER index and the Commerce Ministry a ten country (above five plus Australia, Italy, Netherlands, Belgium and Switzerland) based index. Both measures use the WPI and 1993 as their base year. At end-March 1999, the RBI measure indicated that the rupee was **undervalued** by 3 percent, and the Commerce Ministry index suggests that the rupee was overvalued by about 3 percent – in other words, by all measures, the rupee is “fairly, and competitively”, valued at present.

**Table 2: Patterns of Over-valuation, Indian Rupee 1993-1999**

Percentile	WPI Inflation Based, 1993 Base Year	
	PPP	PPP+
Highest	11.6	18.6
99%	11.6	18.6
95%	10.2	17.7
<b>90%</b>	<b>8.7</b>	<b>15.4</b>
75%	4.0	13.4
<b>50%</b>	<b>1.9</b>	<b>10.7</b>
25%	-3.6	6.5
<b>10% (March 1999 level)</b>	<b>-7.8</b>	<b>4.1</b>
5%	-8.4	3.8
1%	-9.0	0.5
Lowest	-9.0	0.5

Source: Oxus Research & Investments Database.

Notes:

1. PPP+ represents (relative) productivity adjustments (Oxus proprietary calculations) to purchasing power parity (PPP), or inflation adjusted exchange rates.

Table 2 shows the pattern of overvaluation for the two different measures since 1993 (monthly data). On an average, the PPP measure suggests an overvaluation of 2 percent, with the present -7.8 % level only exceeded 10 % of the time. In other words, only 10 % of the months has the rupee been *more* undervalued in the last six years. The PPP+ measure has an average of 10 % and the present value (4.9 % overvaluation) is also close to the 10 % level.

The data clearly suggest that the rupee is undervalued at the present Rs.42.5/\$ levels.

Further, that if pressure on rupee to appreciate is to be averted, the authorities should consider opening up the capital account. This would be a much more productive exchange rate policy than the current “managed control” “prudential motherhood” policy favoured by the government. In conclusion, no matter what the criteria, or the source, there is **zero** basis for arguing that the rupee should depreciate. **If sops have to be given to inefficient industrialists, they should be told to make money the old fashioned way – by earning it.**

**Central Bank and RBI's credit policy:**

Clearly, the most important function of any Central Bank is to monitor, and control, the rate of inflation. Normally, the consumer price index is *the* index of inflation. However, in India, most of the government agencies, including the Central Bank, use the wholesale price index for their calculations. The reason – the CPI has ancient “weights”, an old base year, is subject to politics (cost of living allowances or COLA clauses) and is therefore not reliable. The CPI is also a favourite of the politicians which is a major reason to eschew its use.

The Chart provides additional evidence of the vagabond nature of the CPI. Since 1993, the CPI has been trending *upward* from about 8 percent to the recent high of 18 percent in November 1998. The WPI, on the other hand, has been trending *downwards* from about 8.5 percent to 5 percent during the same time-period. At the time of the November elections in 1998, the discrepancy between the two indices was the highest ever – about 10 percent! All evidence to suggest that analysts prefer the WPI, while politicians prefer CPI.

**Chart 2: Divergent Measures of Inflation – CPI & WPI**



Note: The divergence between the two measures of inflation is highest in the onion-induced political inflation of 1998

The Indian record on inflation control, while not exceptional, is “good”. As the next section documents, monetary policy seems to have relatively little to do with it. What does determine inflation will be the subject matter of another *Developing Trends* piece; for the moment, it is sufficient to note that globalization is affecting India, and that inflation is likely to trend downwards – perhaps below 4 percent, in 1999-2000.

Given prospects for low inflation, and a stable rupee, what should the RBI do in its credit policy to be announced on April 20<sup>th</sup>? Cut interest rates, of course. As documented in the next section, what ails the Indian economy more than anything else is the high (highest) level of real interest rates for non-crisis economies. At present, the industrial sector is in a growth recession (4 percent growth), inflation is low and declining (below

5 percent) and “reduced” lending rates are at 12.5 percent! It is unlikely that a genuine Indian revival can take place with real interest rates around 8 percent. Another 100 to 200 basis points decline over the next year, in nominal interest rates, is an absolute necessity. Oxus believes that the Governor of the

Central Bank, Mr. Bimal Jalan will make an attempt to free up deposit rates (still controlled – surprise, surprise – in India) and other interest rates in his new credit policy. And that India will begin to catch-up with its potential.

### Whither the Indian Economy?

The determinants of growth is a much researched issue. It is not our intention here to resurrect an academic debate; rather, the purpose is to document the relationship between some of the important macro-

variables – GDP growth, inflation, money supply growth, fiscal deficits and interest rates. Table 3 presents non-overlapping three year averages for the various periods since 1980 i.e. almost the last twenty years.

**Table 3: Indian Economy – Several Hindu Constants**

3-Year Period	GDP Growth	Industrial Production	M3 Growth	FD/GDP	Inflation		Real Interest Rates	
					WPI	CPI	Overnight	Prime
1980-82	5.6	4.6	16.1	6.0	11.7	10.8	-4.0	4.8
1983-85	5.5	8	17.8	7.5	7.4	8.6	2.0	9.1
1986-88	6.5	8.5	18.2	8.6	6.3	9.0	3.6	10.2
1989-91	4.2	5.6	16.5	7.3	9.6	9.7	5.8	8.1
1992-94	5.9	5.8	18.0	6.6	10.0	9.5	0.4	6.0
1995-97	6.4	9.9	16.2	5.5	7.0	9.5	3.5	8.4
1998-99	5.8	3.3	19.0	5.6	6.9	13.0	1.2	6.1
1999-2000*	6.6	7.5	18.0	5.2	5.0	8.0	11.5	5.7

Source: O[x]us Research & Investments Database

Note: Figures for 1999-2000 are Oxus's forecasts.

**Summary observations:** Even a cursory glance at the Indian data for the last twenty years suggests that several macro variables are a “Hindu” constant. The most fixed variable (“as constant as the Northern star, Of whose quality there is no fellow in the firmament”) turns out to be M3 growth – over this twenty year period, M3 growth has ranged between a low of 16.1 and a high of 18.2 percent! The lowest and highest single-year M3 growth rates have been 14.7 (1982) and 19.9 (1994) respectively! And yet there are monetarists and economists lurking around who contend that every random move of money supply should have a policy prescription. Most

recently, when the politically induced onion inflation caused WPI to reach almost 9 percent, there was a clarion call among the diehards to raise interest rates to combat inflation! As readers of *Developing Trends* are aware, Oxus has always maintained that this prescription was erroneous – indeed, our recommendation was to lower interest rates, something that the RBI did do right after the budget.

It does not take a lesson in econometrics to understand that if a fixed variable is related to an unfixed variable, there will be no relationship observed. Table 4 reports

statistics for a straightforward regression between GDP growth and several independent variables. In the case of M3 growth, the adjusted R-squared is 0.04. Not surprisingly, inflation measures also have a zero relationship with M3 – India must be the only country in the world which yields a negative R-square between inflation and the major cause of inflation – excessive monetary

expansion. Nor does money supply growth have any relationship with interest rates, either short-term or long-term. Again, testimony to the overly controlled nature of the Indian economy, and how clueless such policy has historically been. At the same time, policy is glacially changing. India is moving towards interest rate targeting.

**Table 4: Macro-Relationships in India – Do they Exist?**

Dependent Variable	Independent Variable	Independent			Adjusted R <sup>2</sup>
		Constant	Variable Coefficient	t-statistic	
GDP Growth	<i>M3 Growth</i>	-0.9	0.38	1.29	0.04
	<i>Fiscal Deficit/GDP</i>	5.5	0.03	0.08	-0.06
	<i>WPI</i>	5.8	-0.14	-0.15	-0.06
	<i>CPI</i>	8.3	-0.28	-1.89	0.13
	<i>Real Overnight Rate</i>	5.9	-0.10	-1.05	0.01
	<i>Real Prime Rate</i>	15.2	-0.59	-1.92	0.13
WPI	<i>M3 Growth</i>	4.3	0.27	0.35	-0.05
	<i>Fiscal Deficit/GDP</i>	17.6	-1.25	-1.43	0.05
CPI	<i>M3 Growth</i>	7.6	0.11	0.23	-0.06
	<i>Fiscal Deficit/GDP</i>	17.9	-1.23	-2.60	0.24
Nominal Interest Rate (Overnight Money)	<i>M3 Growth</i>	19.3	-0.52	-0.91	-0.01
Nominal Interest Rate (Prime Lending)	<i>M3 Growth</i>	18.7	-0.14	-0.65	-0.03
Fiscal Deficit	<i>M3 Growth</i>	3.4	0.20	1.00	0.00

Source: O[x]us Research & Investments Database

Data on the growth rate in M2 for **155** countries (developed and developing) were collected for the years 1970 to 1995. The country with the least volatility in growth rates – you guessed it, India. Table 5 reports on these data for some selected countries ranked by their (lack of) volatility. Only

Thailand comes close in terms of control, though even there the volatility is 33 percent higher than India. Korea, still controlled, has double the volatility of India! An open non-controlled economy like the USA – its volatility is more than 200 percent larger .

**Table 5: Volatility in Money Supply (M2) Growth, 1970 - 1997**

Country	Mean Growth	Standard Deviation	Stability Index Coeff. Of Variation (=S.D./Mean)
<b>India</b>	<b>15.8</b>	<b>2.3</b>	<b>0.15</b>
Thailand	17.5	3.5	0.20
Colombia	25.6	6.4	0.25
Korea	20.6	6.4	0.31
Singapore	13.1	5.2	0.40
Malaysia	15.5	6.4	0.41
Philippines	18.3	7.6	0.42
Pakistan	14.7	6.1	0.42
Germany	7.6	3.4	0.45
USA	7.5	3.7	0.49
Japan	9.3	5.4	0.58
New Zealand	16.3	13.5	0.83

Source: O[x]us Research & Investments Database

Notes:

1. The mean and standard deviation are calculated in log terms
2. India has the most "stable" money supply growth, or the least volatility. The higher the stability index is, the less volatile M2 growth is.

**Fiscal Deficit:** The other popular variable (with both policy wonks and fund managers) is the fiscal deficit. The relationship between fiscal deficit and GDP growth in India – a big zero. Actually, a simple regression shows a negative (adjusted) R-squared. In a recent paper (See Surjit S. Bhalla, "Economic Freedom and Growth Miracles: India is Next", paper presented at the World Bank – IMF Meetings, Hong Kong 1997) more "complicated" regression models were estimated. The result – the same i.e. no discernible relationship between growth and the level of fiscal deficits, or the change in such deficits.

The investment community has come full circle on the fiscal deficit issue – in the olden days (in fact, the eighties) a fiscal deficit was good because it meant higher growth and a stronger currency. The high tide for this view was the explosive movement of the US dollar (and the US economy) in the early to mid-eighties. Somewhere around that time governments became politically incorrect; and the Hayekian (and in our view, correct) view began to take hold. Governments mean well, and invariably end up doing bad. Further, no matter how smart the bureaucrats, or the

policy makers, they cannot, and therefore, should not, control the economic decisions of individuals. In the West, and South-East Asia, this view gained ascendancy very quickly. By the mid-nineties, East Asian economies had fiscal surpluses, as did Mexico (for three consecutive years) prior to its own financial and currency crisis in 1994.

Financial crises are for advanced economies – India has a lot of catching up to do. For the moment, the concern here is with decreasing government control, and government deficits. But is there any relationship between fiscal deficits, money supply growth, and GDP growth? No.

It is not our contention that GDP growth is a random walk – or that the Indian GDP growth has *not* moved up to a higher "permanent" level than the 4-5 percent level of 1950 to 1980. But it is our contention that the reasons for the structural change are not in the usual suspects – fiscal deficits, and/or money supply. Rather, the reasons are to be found in the greater openness of the Indian economy, and the *forced* integration of India with the world commodities, and financial, markets.

While the structural level of growth has gone up, several problems still remain. Financial markets are still too controlled, and real interest rates still too high, and the economy still too closed. And that is precisely why one is bullish – the Indian economy is reforming, and at an accelerating pace (albeit from a low level and low pace!). Econometric estimates suggest that these incremental reforms

(decrease in exchange controls, decrease in interest rate controls, tax reform, tax simplifications etc) add up to about 1.5 percent of GDP growth per year i.e. about 6.5 to 7.5 percent GDP growth is to be expected! And if the world economy recovers, then an additional 1 percent GDP growth would be realizable. (See “Economic Freedom and Growth Miracles” op. cit.)

### Interest Rates are the Key:

As Table 6 documents eloquently, the true “cause” of insipid (relative to potential) growth in India is the high level of interest rates. Interest payments have been one of the fastest growing items of expenditure, and today account for close to 90 percent of the total fiscal deficit. A 1 percent decline in interest rates will lead to about an 8 percent reduction in interest payments; a 2 percent decline will lead to an 18 percent reduction. In other words, if interest rates do decline by another 1 percent (on top of the 1 percent reduction already in place) then interest payments for 1999-2000 will turn out to be Rs. 75,000 crores rather than the Rs. 88,000 crores budgeted. Ceteris paribus, this would mean that the fiscal deficit /GDP ratio would come in below 5 percent.

There is some more good news. Equally damaging as the high interest rates has been the growth in wages and pension payments of the public sector. These payments have galloped at an average pace of 30 percent in the last two years. This was a result of the Pay Commission recommendations: a highly political exercise where the public sector appropriates to itself the goodies every few years. The next Commission is not likely for at least the next five years. Which means that growth in expenditure should be severely curtailed over the next few years i.e. towards less than 10 percent which is less than nominal GDP growth (expected) of 13 percent. Which means that the fiscal deficit will decline more than expected, and that interest rates can be reduced further.

**Table 6: Fiscal Summary of Union Govt. Budgets (Rs. ‘000 crores)**

	1991	1992	1993	1994	1995	1996	1997	1998 (R.E)	1999 (B.E.)
<b>Total Expenditure</b>	111	123	142	161	183	202	232	282	309
<i>Growth of Total Exp.</i>		10.1	15.7	13.3	13.9	10.5	14.7	21.5	9.6
Defence	16	18	22	23	27	29	35	41	46
<i>Growth of Defence Expn.</i>		7.6	24.2	6.4	15.6	9.7	19.6	16.8	10.9
Interest Payments	27	31	37	44	50	59	66	77	88
<i>Growth</i>		16.8	18.2	19.9	13.6	18.8	10.5	17.6	13.9
Subsidies	12	12	13	13	13	14	18	21	22
<i>Growth</i>		-2.1	5.7	2.0	-3.0	13.4	29.0	14.7	6.5
Wages & Salaries				12.6	14.9	17.0	22.7	28.5	
<i>Growth</i>					18.1	14.2	33.6	25.6	
Pensions				3.7	4.3	5.1	6.9	10.0	10.1
<i>Growth</i>					17.3	18.6	35.3	44.9	1.0
Salary + Pension				16	19	22	30	38.5	
<i>Growth</i>					17.8	15.2	33.9	28.3	
<b>Fiscal Deficit (FD)</b>	36	40	60	58	60	67	86	104	105
<b>FD/GDP</b>	5.8	5.7	7.6	6.5	5.4	5	6.1	5.6	
<b>GDP growth</b>	0.42	5.4	4.8	7.6	7.1	6.8	5	5.8	

Source: Budget Documents, GOI; O[x]us Research & Investments Database

Notes: Rs. 1 crore is 10 million; Rs. 1 crore is approx. \$ 250,000 at present exchange rates.

### Major Exchange Rates: New Forecasts

Oxus's proprietary exchange-rate forecasting model analyzes currency over-valuation over the January, 1991 to March, 1999 period. Under-valuations for Australia, Canada, Germany and Italy are each in the 10<sup>th</sup> percentile. This suggests that during only 10% or less of our chosen period have these currencies been as (or more) under-valued as they are at present. Further, it suggests that they cannot become significantly more under-valued, and are likelier than not to head north.

This has implications for the Euro (not analyzed because of lack of historical data). The currency has shown a disappointing performance since its creation. However, on a long term basis it is likely that the Euro will be close to 1.15 than 1.0. In other words, at around 1.05 to 1.08 levels, the Euro should be bought against the dollar.

On the other hand, \$/yen has been equally (or more) over-valued during a full 60% of this time period, while the pound sterling is "more" under-priced than its historical

average. The yen has remained over-valued about 90% of the time since 1991, and during the *rare* moments when it *was* under-valued, it remained so in the 0-5% range. On average, the currency has been over-valued by 15.1%, right about where it is now.

Where does \$/yen go ? Oxus believes that the Japanese economy cannot recover if the yen remains below 115 yen. Thus, this should be a floor, and a tendency for the dollar to gravitate towards 130 yen should be expected.

Turning to emerging markets, the Brazilian real is under-valued, but is unlikely to show much movement (its under-valuation is less than its historical "average" of around 22%). Between January, 1991 and mid-1994, the real remained under-valued by between 50% and 100%. From then on, and until January, 1999, the currency remained within a peg, over-valued by about 15-20%. The current under-valuation suggests either a continued under-valuation or a slow movement towards the real's "fair value" of 1.51.

**Table 8: Exchange Rates – Nominal and Predicted, March 31, 1999**

	Exch. Rate	"Fair Value" Exch. Rate		Currency Overvaluation(%)		PPP+ OV %tile	Expected Direction
		PPP	PPP+	PPP	PPP+		
Australia	1.58	1.23	1.09	-28.5	-44.8	10	Up
Canada	1.51	1.08	1.10	-39.4	-36.7	10	Up
Germany	1.81	1.52	1.62	-18.6	-11.8	10	Up
Japan	118	126	141	6.2	15.8	60	Down
Italy	1790	1317	1366	-35.9	-31.1	10	Up
U.K.	0.62	0.58	0.59	-6.7	-4.8	70	Flat, to Up
Brazil	1.71	1.22	1.51	-39.9	-12.9	40	Flat
Chile	485	515	887	5.9	45.3	75	Down
Mexico	9.5	9.0	11.9	-6.3	20.1	99	Down
China	8.28	9.61	7.19	13.9	-15.1	55	Flat
Indonesia	8620	5374	7791	-60.4	-10.6	20	Up
Korea	1226	886	1173	-38.4	-4.5	20	Up
Malaysia	3.80	3.05	4.28	-24.4	11.3	40	Flat
Philippines	38.6	37.2	57.8	-3.7	33.3	70	Flat
Singapore	1.73	1.67	2.12	-3.4	18.5	45	Flat
Thailand	37.5	31.5	43.2	-19.0	13.0	60	Flat
India (WPI)	42.4	39.3	44.6	-7.8	4.9	15	Flat
India (CPI)	42.4	43.8	49.7	3.3	14.8	50	

Source: O[x]us Research & Investments Database

Note: Up means an appreciation of the currency with respect to the US dollar.

## ***Developing Trends and Oxus Fund Management:***

During the last two years, *Developing Trends* has examined issues relevant both to India and to emerging markets in general. While a large portion of our studies have concentrated on developments at the macro-level (the East Asian crisis of 1997, interest rates in the developed world), we have just as frequently examined financial markets in India. Our study of Indian mutual funds, for instance, examined (at that time) a poorly-functioning sector, and was ground-breaking in scope. As important for investors, *Developing Trends* has carried specific trade recommendations, often for international markets, and almost always for the rupee and Indian markets.

Recommendations for the Indian stock market (at a general level) have been largely profitable: out of a total of 16 recommendations, 10 trades (including 3 open positions) have been highly profitable. Unleveraged returns to these trades have totaled 112.5%, outperforming the Sensex (which gained only 9.1% over the period) by 103.4%.

One cannot over-emphasize the link between macro-trends and the performance of financial markets. Political issues, global economic events, and other “large” developments, have either necessitated us to react (with a recommendation) or have been anticipated in our newsletter. *Developing Trends*, looking at the larger picture, seeks to advise investors on the *timing* of investments. In doing so, we seek to inform readers on opportunities for entering (or exiting) the market, and by implication, benefiting from “big” developments.

The newsletter’s success and approach to financial market operations is embodied in Oxus Fund Management (OFM), a New Delhi based emerging markets advisory and fund management firm, which came into existence in mid-1998. OFM is a one-stop financial services company offering such services as:

- Brokerage on Indian equities, debt, and foreign exchange.
- Research on all aspects of capital markets: macro policies’ impact on markets; international developments and their effects; firm-level analysis; technical analysis and development of pattern recognition models for investment and trading decisions.
- Portfolio Management for individuals, corporates and financial institutions
- Foreign exchange risk management for corporates and institutions.

Oxus’ emphasis on research, both fundamental and technical, and backed by exhaustive databases, allows us a long-range view of financial market developments. The *Developing Trends* issue of May, 1997, anticipated that, given a likely decline in interest rates, a sustained GDP growth in excess of 5.9% per annum, a restructuring of industry, and sustained industrial growth, the market (Sensex) was likely to reach “7000 (end 1998) and beyond.” While this prediction has not materialized, we remain bullish. Oxus was among the first to predict the boom in software when we stated that, “...considerations of catch-up and differential productivity levels dictate that service industries – e.g., advertising, software, banking, will do relatively well in India.” (See *Developing Trends*, Vol. 1, Issue 3, May 26, 1997.) We predict that – with real interest rates at unjustified levels and a reduction in nominal long-term rates imminent – the banking sector is finally set to take off. Oxus remains overweight in the software and banking sectors. We are now adding cyclicals, and some commodities, to our list.

From June, 1997 to September, 1998, a private fund of Rs.49 lakhs (\$135,000) was managed by one of the principals of Oxus Fund Management, Surjit S. Bhalla.

## Developing Trends

Outperforming the Sensex by 50.5 percent, this portfolio earned returns of 43.9 percent. OFM obtained a Securities and Exchange Board of India (SEBI) license to manage money in September, 1998. By the end of December, 1998, OFM was managing a

portfolio of over \$ 400,000, for seven clients. By the end of March, 1999, OFM was managing close to \$ 1 million in Indian equity, and a further \$ 300,000 in Indian debt..

**Table 9: Oxus Fund Management – Assets and Returns**

	<b>Time Period</b>	<b>Assets Under Mgmt. \$ Millions</b>	<b>Absolute Returns</b>	<b>Returns Over Benchmark</b>	<b>Comparator Rank</b>
<b><u>Equities</u></b>					
<b>Mulberry Fund</b> (Zero Leverage)	Jun. '97- Sept. '98	0.05	43.9%	<b>50.5%</b>	<b>2</b>
<b>Mulberry Fund</b> (Zero Leverage)	Sept. '98– Mar. 31, '99	1.2	61.4%	<b>40.8%</b>	<b>5</b>
<b><i>Developing Trends</i></b> (Monthly newsletter on Emerging Markets and India)	Feb. '97 – Mar. '99	N/A	112.5%	<b>103.4%</b>	N/A
<b><i>Quantum Investor</i></b> (Weekly newsletter which contains specific stock recommendations)	Apr. '98- Mar. '99	N/A	39.9%	<b>46.6%</b>	N/A
<b><u>Currency Management</u></b>					
<b>\$/Yen, \$/Euro, \$/Rupee</b> (Zero Leverage; gains above benchmark)	Aug. 13, 98- Mar. 31, '99	50	N/A	<b>2%</b>	N/A

Source: O[x]us Research & Investments Database.

Note:

- Mulberry, a private fund managed by Oxus Fund Management, has been in operation from February, 1997. A total amount of \$135,000 (Rs.49.5 lacs) was invested over the period Feb-June, 1997; hence the base point of the analysis. This private fund was owned and managed by one of OFM's principals, Surjit S. Bhalla. Since obtaining a portfolio manager's license in September, 1998, Oxus has grown to manage funds totaling Rs. 2 Crores (approx. \$0.5 Million) for 8 clients, and a further Rs. 1.2 Crores in Indian debt.
- Ranks for equities are arrived at through a comparison of returns to funds managed by Oxus with returns to Indian mutual funds during the same period. NAVs for mutual funds were obtained from Value Research.

OFM's performance has consistently ranked among the best of Indian asset management companies. In comparison to growth-oriented mutual funds, OFM registered the 2<sup>nd</sup> highest returns (132.2%) – within a universe of around 31 mutual fund families – during the

June, 1997 to end-March, 1999 period, and the 4<sup>th</sup> highest returns (56%) in the January 1 – March 31, 1999 period (See Table 10 for a comparison of Oxus Fund Management's track record with those of the leading mutual fund families in India.)

**Table 10: Indian Mutual Fund Families**

Asset Mgmt. Company	Assets		Returns		Composite Rank	Sept. '98 - Mar. 31, '99		Jan. 1-Mar. 31, '99	
	Managed (Rs. Crores)	# Funds	Jun. '97-	Jun. '97-		Returns	Rank	Returns	Rank
			Sept. '98	Mar. 31, '99					
20th Century/Zurich	134.1	3	27.6	104.9	1	60.5	6	40.2	10
First India MF	0.6	1	66.9	191.2	2	74.4	1	58.5	2
Alliance Capital	72.5	2	17.1	89.1	3	61.5	4	62.8	1
Apple MF	108.5	2	23.8	92.2	4	55.3	8	47.4	9
DSP Merrill Lynch MF	82.4	1	14.9	76.5	5	53.7	9	49.5	7
<b>Oxus Fund Management</b>	<b>5.02</b>	<b>1</b>	<b>43.9</b>	<b>132.2</b>	<b>6</b>	<b>61.4</b>	<b>5</b>	<b>56.0</b>	<b>4</b>
Kothari Pioneer MF	333.7	7	11.3	83.5	7	65.0	2	48.6	8
Birla MF	162	2	31.3	55.9	8	18.7	25	7.5	31
ITC Threadneedle MF	51.4	1	7.6	43.3	9	33.2	17	32.8	18
Prudential/ICICI	249	1	0.8	40.6	10	39.4	11	37.1	13
Reliance MF	74	2	-5.1	29.3	11	36.3	12	35.0	17
Morgan Stanley MF	982	1	3.2	35.6	12	31.5	18	36.6	15
Tata MF	147.1	3	0.7	53.0	13	52.0	10	51.6	5
IDBI MF	220.1	3	-5.6	15.6	14	22.4	21	20.3	23
JM MF	629.7	7	-7.4	25.1	15	35.1	13	37.0	14
SBI MF	2305.1	11	-6.7	25.9	16	34.9	14	39.0	12
HB MF	24.5	2	-10.3	39.8	17	55.9	7	50.9	6
Canara Bank MF	2764.3	8	-8.4	14.9	18	25.4	20	24.4	20
Taurus MF	304.2	3	-13.1	16.8	19	34.4	15	35.6	16
UTI	41720.7	22	-21.7	-4.8	20	21.6	22	20.5	22
Bank of Baroda	62.2	4	-14.9	-4.8	21	11.9	26	18.4	25
LIC MF	989.5	12	-17.5	-11.8	22	6.9	27	9.2	27
Bank of India	612.7	7	-15.4	0.6	23	18.9	24	19.2	24
PNB MF	357.8	7	-9.7	-9.9	24	-0.2	31	7.9	30
IndBank MF	545.4	5	-13.8	-11.1	25	3.1	29	8.5	28
GIC MF	1326.8	5	-20.8	-18.9	26	2.3	30	9.7	26
Templeton MF	50.5	1	-33.7	-31.0	27	4.1	28	8.4	29
Sun F&C MF	N/A	1	.	.		62.6	3	56.4	3
Jardine Fleming	15.9	1	.	.		34.0	16	39.7	11
Sundaram MF	17	2	.	.		29.9	19	29.1	19
Cholamandalam	N/A	1	.	.		19.4	23	22.8	21
Dundee	N/A	2	.	.		.	34	.	34

Source: Value Research; O[x]us Research & Investments Database

Notes:

1. Ranks are based on a comparison between equity-oriented Indian mutual fund families.
2. Assets are a mutual fund family's entire portfolio under management, including debt and equity instruments. Oxus manages equities and debt with a mark-to-market value (March 31, 1999) of Rs. 5.02 crores.
3. Missing ranks and returns indicates that the AMC did not operate any growth funds during the period in question.
4. By law, a mutual fund must be controlled by an Asset Management Company (AMC). Hence, an AMC may control several mutual funds.
5. Oxus Fund Management is not a mutual fund. Returns and ranks for OFM during the June '97- Sept. '98 period are for a private fund of \$135,000 (Rs.49.5 lacs) managed by own of OFM's principals, Surjit S. Bhalla. Thereafter, returns and ranks are for funds managed by OFM for 8 clients. (Oxus received a portfolio manager's license in September, 1998).
6. Composite rankings capture an "average" of rankings (cumulative) for a fund (or AMC's) existence. Values given are for end-Feb. '99. AMC's are ordered by their composite rank.

# Developing Trends

**Developing Trends** is a monthly newsletter published by O[x]us Research and Investments (ORI). Fund managers and investment banks, both in India and around the world, are its clients.

The most recent three issues of **Developing Trends** had the following trade recommendations:

**Developing Trends Vol.2, No.10, dated Dec. 28, 1998:**

- There were several “bold” trades that were mentioned in the double Developing Trends issue of end August '98. Incredibly, almost all trades have turned out to be highly profitable. Except one trade – going long the Indian stock market. The rest of the world rallied, and India dived. ...Oxus now believes that clients should not only go long the Indian market, but that they should do so aggressively. Instead of our normal 1 unit trade, clients should be long 2 units.

**Developing Trends Vol.2, No.9, dated Nov.16, 1998:**

- “Short term money is tight in all the four economies, and tightest in the US. Long-term yields, however, in all four countries, are on the “low” side, with UK gilts showing the largest probability of relative decline. A “strong” trade recommendation emerging from the analysis is that of curve steepeners in all the four economies.”
- “Oxus’s forecast is for the world economy to bottom out in the fourth quarter of 1998. Further that the increase in world economic growth will be closer to 1 percent, i.e., world economic growth next year to be closer to 3 percent (2.75 to 3 range) than the conventional wisdom estimate of 2 percent.”
- “So equity markets will likely boom – they should be allowed to do so without monetary policy being dictated to. As far as real rates are concerned, if CPI inflation does edge up to 1.8% and FED funds remain at 5 percent, that would suggest a real rate of 3.2 percent – and that would still be among the top 20 percent of such rates in the nineties. Clearly, little to be gained and much (world recovery) to be lost by stubbornly staying on course with an unduly restrictive policy.”

**Developing Trends Vol.2, Nos.7&8, dated August 24&30,1998:**

- “The Dollar has topped against the Asian currencies...The dollar has also topped against the majors.”
- “The Yen beyond 145 is likely to be no different than the Yen below 85, i.e., turbulent and characteristic of an extreme.”
- “No matter what the criteria, and several are offered, Asian equity values (in dollar terms) are at extremely attractive, and yes, rock bottom levels.”

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Subscription to **Developing Trends** is only \$ 5000 (£ 3200 pounds) a year for twelve monthly issues and special issues on newsbreaking events. For Indian subscribers, the rate is a reduced \$ 2,500 a year, or Rs. 1 lac. Make checks payable to Oxus Fund Management

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