



INTELLECT

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A small
WORLD



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A small world



The disruption to manufacturers worldwide from Japan's disasters will force a rethink of how they manage production.

It's not too long ago when volcanic ash disrupted air transport across Europe and choked the world's manufacturing supply chain - One of its biggest tests since the advent of the low-inventory JIT (just-in-time) era. Now, Japan's disaster - earthquake, tsunami, nuclear crisis and power shortages - has put the whole supply chain under far greater stress. Weeks after the massive quake, the extent of the disruption is still unclear.

Not surprisingly, there seems to be some similarities between the current shocks that manufacturing received and the subprime shocks that battered the banking and financial system way back in 2008. In both cases, the problems began in a seemingly well-off part of the system and quickly spread like wild fire sparing no one.

Just like the financial crisis caused a huge liquidity crisis, similarly manufacturing industries are finding that spare parts that had always turned up reliably have stopped coming.

Hitungshu
Debnath

Dharmendra
Satapathy

Savio
Crasto

Biren
Shah

Dinesh
da Costa

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Editorial Team. Send
your article to
intellect@tataamc.com

Dear Readers,

This edition of Intellect covers a snapshot on how the recent natural disasters in Japan impacted the supply chain balance globally. It has forced experts to wonder whether JIT or Just In Time Inventory is the best solution for the global economy. The middle-east crisis seems to be lingering on spreading from region to region and not showing any signs of abating. Two of our stories dwell on this issue - its genesis and impact on both the global as well Indian economy. Remember we are largely dependant on oil imports. We hope you will find the stories interesting. We look forward to your feedback.

- Hitungshu Debnath

The financial downturn led to many of us learning about unheard of terms and products like “shadow banking” and “arcane derivatives contracts”. Similarly manufacturers are discovering how little they know about their suppliers.

During the Lehman Brothers crisis, financial institutions, including big banks, struggled to survive themselves as they were all in a tangle. Similarly, assembly firms are now finding that their supply chain looks much the same.

As with a few financial institutions which were “too big to fail”, similarly some Japanese suppliers are now being seen as too critical to do without. Let us take the case of two major chemical firms - Mitsubishi Gas Chemical and Hitachi Chemical. These two firms control about 90% of the market for a speciality resin used to bond parts of microchips used in smartphones and other devices. The plants of both these firms were partly damaged in the earthquakes leading to a supply crisis. The compact battery in Apple's iPods relies on a polymer made by Kureha, which holds 70% of the market, and whose factory was damaged.

Due to the Japan crisis, manufacturers around the world are battling to secure components and materials from elsewhere leading to price rises and hefty premiums.

This had led to carmakers in Japan and America scaling back production. Toyota fears a scarcity of rubber, plastic and electronic parts. It is not yet clear how worse things will get as existing stocks run down. Nor can

Japanese suppliers be sure of how soon they can get back up to speed with Japan still facing aftershocks and new earthquakes. The loss of a very large nuclear plant and shutdown of others has led to unheard of power shortages and load shedding.

Smaller rivals also look set to gain as customers switch part of their orders. For example, Hiwin, a Taiwanese firm with 10% market share for “linear motion guides”, used in industrial machines, may gain share from customers of Japan's THK, which dominates the market with a 55% share and which faces power cuts.

The current crisis may also force suppliers who have near-monopolies on crucial parts and materials to spread production facilities geographically.

As assembly firms face financial pressures to keep their inventories down, the crisis may see a new industry emerge - one that maintains essential stocks on behalf of manufacturers.

Over the past decade, the JIT (just-in-time) concept of having supplies delivered at the last minute to keep inventories down spread across the global manufacturing chain. Industrial firms, having spent years becoming ever leaner now realize the risk associated in, making themselves more exposed to these sorts of supply shocks, will now have to go partly into reverse, giving up some efficiency gains to become more robust.

■ Biren Shah



The Middle East Rev-“oil”-lution



Just as the world was hobbling back to health, the middle-east crisis has put a spoke in the wheel. Oil inflation is different from other kinds of inflation because on one hand, the use of oil is ubiquitous (everybody needs it) and on the other hand its demand is consistent and insensitive to price increase to a large extent. So in order to meet their insatiable demand for oil, people have to make compromises by reducing their demand for other goods and services. This fall in demand naturally impacts the health of industry and economy. According to the IMF, a 10% increase in the price of crude shaves 0.2% to 0.3% of global GDP. As a direct fall out of the middle-east crisis, the price of crude has gone up by 10%. Hence global GDP which was forecast at 4.4% would now be 4.2%.

Are we revisiting the 1970 situation?

The oil price spikes of the 1970s found its way into broader inflation and central banks had to intervene to

control inflation. However economists do not expect the current situation to snowball into a 1970s kind of crisis in advanced nations as their economies are less dependent on oil now as compared to 1970s. This is borne out by the resilience displayed by the advanced world to oil spikes in 1999 as well as in 2002 which were of similar magnitude as the spike of 1970s. While in the 1970s, inflation flared up by 4.5 percentage points, the impact on inflation during the subsequent spikes were muted at 0.7 percentage points. Most of the advanced nations have been growing more efficiently as compared to yesteryears. While the economy of America has more than doubled as compared to the 1980s, the oil consumption is nearly the same as it was back then. Therefore inflation expectations are more stable now compared to the 1970s and hence central banks have reacted moderately to the high oil prices. Unemployment levels in America and Europe have been high and inflation is lower as compared to 2008 except

for Britain. Thus in the advanced nations, the impact of higher commodity prices on inflation is expected to be subdued.

Emerging Markets

However as compared to the advanced nations, emerging economies would be more affected. This is evident from the fact that although America's economy is thrice as large as China's, its oil consumption is just twice as large. But even in emerging economies, the impact of increasing oil prices is expected to remain subdued. This is because of more efficient manufacturing sector that consumes less oil for the same output as well as higher contribution to growth from the services sector. Emerging Asian countries have been subsidising fuel cost and thereby limiting the impact on consumers. It is estimated that developing countries subsidized fuel by about \$250billion in 2010. Therefore as far as India is concerned, it is estimated that every \$10 rise in the oil price costs India's state owned oil marketing companies an equivalent of 0.5% of GDP and only one half of this is absorbed by the budget while the balance gets dissipated by way of inflation. Inflation in India is extremely sensitive to rise in oil prices also higher commodity prices would have significant impact on inflation due to its higher weight in the consumer's basket (14.2% for India). Moreover “food” which has a significant weight in the consumer's basket is energy intensive in its manufacture.

Besides the supply shortage one also needs to understand that “price” is a function of consumer's confidence in the future outlook of the economy. Therefore the middle-east crisis weighs down this confidence and adversely impacts the price of goods and services. Such unexpected supply shocks are known as “non-linearities” in the language of economists. At such times when prices rise all of a sudden, businesses trim their spending and investment plans which eventually shave of some of the expected GDP growth projection.

Dual Impact

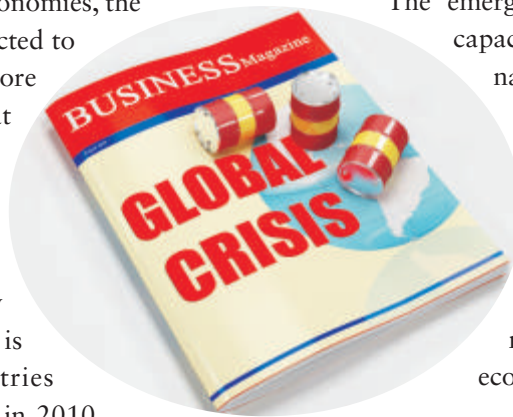
Today we are facing the dual impact of supply limitation and increase in demand. Most economies are limping

back to life after the 2008 slow down. Hence there is an increase in demand from these economies and in such a situation, the middle – east crisis is putting additional pressure on prices.

In all likelihood, advanced countries would be able to bear the brunt of higher prices. The demand there is more controlled as Americans shift to fuel efficient vehicles and shift to alternatives like ethanol.

The emerging economies running at full capacity to catch up with the advanced nations will feel the braking effect of higher energy prices more as they combat inflation which consequently impacts the confidence of people who in response to the price rise slow down their spending momentum and thus hamper the economy's growth trajectory.

So how do governments deal with the impending oil crisis? As oil price rise directly impacts inflation, the natural tendency of central banks is to hike interest rates. However interest rate hikes adversely impacts economic growth. A high inflation coupled with slow economic growth drives the economy towards stagflation so clearly the future is in exploring clean alternate energy sources and increasing productivity by the usage of energy efficient machinery through innovation that no economy would want to bargain for.



■ Dharmendra Satapathy

The Genesis of the Middle-east crisis and its impact on Indian economy

For long the US has viewed the Arab world as a collection of gas stations. Every country in this region has been shielded by the west in return for oil related favours. In turn, the west turned a blind eye to several human rights violation in these regions. Over the years the Middle East mushroomed with youth deprived of education and opportunities. Both men and women have been kept suppressed. In short, nobody has a voice. This has helped the Kings and Sheikhs to rule without any disruption. Whenever there was an uprising, it was crushed with an iron hand while the west looked the other way.

However there's a force we often fail to notice. The force of changing demographics that every country experiences. The youth often question the status quo for it throttles their journey towards a better tomorrow. Social media, a powerful catalyst the birth of social media came as a boon for this generation. It proved to be the most potent democratic tool in their hands. Social Media tools helped an entire generation to reach their voice to every nook & corner of the world and aggregated people together to pursue a cause that meant a lot to them. Thus, Tunisia, Egypt, Jordan, Algeria, Bahrain, Libya, Yemen and many others found themselves engulfed in democratic smog. While the people have conquered the old regime in some places, they are still fighting with hopes in their hearts in other places. The west has realized the irrepressible determination behind the uprisings and has now chosen to back the dissidents.

In a globalized world, all nations are interconnected by trade. The connection of the world with middle - east is through the oil pipeline. Therefore the effects of this upheaval are now being felt the world over.

India which imports 80% of its oil requirement has started to feel the heat. With crude comfortably

having crossed the \$125 mark, policymakers are having sleepless nights. So far inflation had been a stumbling block for them and now this oil price spurt is making it all the more difficult and is providing wind to rekindle inflation even before it could get tamed.

Libya is the 18th largest oil producer and the 10th largest exporter. The current unrest has the potential to disrupt 20 to 30% of oil supplies. What appears to be worse is that this problem does not appear short lived. Further, fear of the contagion spreading to other parts of the region makes matters quite grave indeed.

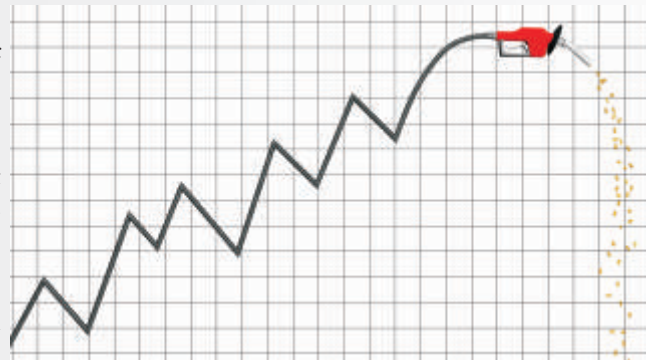
The problem of inflation in a year packed with several state elections is a top priority for the

government. Hence the government might be either tempted to insulate the public from the oil price spurt or alternately pass on a part of the pain. In any case its subsidy to the oil sector is set to rise and at a time when

fiscal consolidation was being talked about, this would be quite an irony. Higher subsidies would induce more borrowing by the government which would in turn put pressures on interest rates and challenge economic growth.

Clearly the economy has to brace up for some unexpected turn of events and the markets might continue to display volatility. Shifting from road haulage to rail or coastal shipping would save considerable amount of petroleum energy. Moving from diesel based electricity generation to coal based power would ease the pressure on petroleum imports. Putting serious weight behind non-conventional energy generation appears to be the cornerstone of future energy policy making.

■ Dharmendra Satapathy



Understanding how “Investments” help the economy

– *By Prof. Simply Simple™*

Most of us work for a living. But what do we do the income that we earn? Many of us simply keep the money in the form of cash

Did you that just by keeping money as cash at home we are not helping our economy?

Sounds confusing????

Let me throw some light on this

Let's say there is a community of people living in a particular area. Let's also assume that these people have their houses around a huge piece of barren land. So in a sense their houses run around the periphery of the barren land

Now

Most of these people love their homes.

They all have flower pots in their homes which they water without fail

They also love to keep their floors clean and wash it daily.

But

They never bother to walk out of their homes and water the barren land nearby

So the field continues to be barren and of no use to anyone

Then one day a wise man comes to town. The people of the town look towards him for solutions to their day to day problems. He tells them “ Just water the barren land daily”. Most people are amused with this strange recommendation. How would watering the barren land help them

Nevertheless from the very next day the people make it a point to water the barren land. They do this on a daily basis. Slowly as time goes by, the people see plants grow on the barren land. Over time these plants grow and become trees. They bear fruits and

vegetables in very large quantities. The people not only consume the fruits and vegetables but also sell the produce in the market and earn out of it

The wise man revisits them. He finds out that all the residents are extremely happy. They tell him that not only are they enjoying the fruits from the garden but are also earning from the same.

The wise man tells them that the field at the center of their houses was like the economy of the country and the water that was provided was like the money in our pockets. Just as the regular watering of the barren land converted it into a garden full of fruits and vegetables in the same manner regular investments in the economy provides the money needed by the economy for creating wealth.

Thus the wise man successfully convinces the residents that they should not save money as cash or near cash but instead invest the same in stocks, mutual funds, bonds etc for the sake of creating wealth for themselves as well as the nation.

Hope this story has clarified the role of investments in nation building



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