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EDITORIAL

The present market conditions and the economic environment have all the ingredients of history in the making. On 24th August 2015, the Indian markets slumped by 6%, Japan's Nikkei dropped by 4% and the Chinese Shanghai composite index crashed by 8.5%. A few weeks back, when we discussed about "Financial History" as part of our Friday Night series in Finance, little did we know the magnitude of the events unfolding.

The recent devaluation of Yuan has sent ripples across the financial world as well as political, which has forced other economies like South Korea, Vietnam and Kazakhstan to correct their currency positions. This move by the Peoples Bank of China is undoubtedly the epicenter of these tremors.

TJEF has endeavored to review the past, analyze the present and predict the players affecting the future. The Chinese Yuan devaluation and the prevailing conditions will be the focus of this Issue. We hope that the readers benefit from the insights of the papers published.

Managing Editor
Solomon Sweecharan

Editors' Note

In recent times, one of the most exciting initiatives at TAPMI has been the setting up of the TAPMI Finance Lab powered by Bloomberg. The TAPMI Finance Lab is the state-of-the-art lab and the largest in the country with 16 Bloomberg terminals. It is home to finance majors and students enrolled in the Banking and Financial Services program and serves as the hub for budding portfolio managers, bankers and thinkers.

We are delighted to announce the launch of the TAPMI Journal of Economics and Finance (TJEF). TJEF is brought to you by the Finance Forum – one of the most active forums at TAPMI. The purpose of Finance Forum is to create a vibrant and supportive environment where students make a significant difference, network with industry participants, develop healthy relationships with fellow students and industry participants and develop leadership skills. The vision of the finance forum is to enhance the knowledge and understanding of students in the area of finance.

The goal of TJEF is to become a leading student-run journal in the areas of banking, economics and finance. The aim is to encourage finance majors to write short articles on current topics in banking, economics and finance. We also encourage students from leading business schools in India and abroad to contribute to TJEF. A special invitation is extended to alumni and practitioners to contribute to TJEF.

We look forward to your contributions!

Managing Editor
Madhu Veeraraghavan
T.A. Pai Chair Professor of Finance

Aims and Scope

TAPMI Journal of Economics and Finance is a peer-reviewed journal. We seek articles in the areas of Banking, Economics and Finance. The main purpose of the journal is to encourage quality submissions from business students. We encourage submissions from students enrolled in leading business schools in India and abroad .We also encourage submissions from practitioners.

Our aim is to provide constructive feedback on all submissions.

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REGRESSIVE EXCHANGE RATE POLICY OF CHINA

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Introduction

There have been many dramatic events in the history of the financial world which have subsequently changed the structure and practices across the world. These practices were mainly intended at getting ahead in the competitive world of trade. And when it comes to trade, all we can talk about is China. Perhaps, China is one of those countries which has tried every possible trade practice to be ahead of other countries. Some of these are unfair. These unfair practices are: Currency manipulation and currency devaluation. But before we go ahead and discuss the impacts of these unfair and regressive trade policies, we first need to understand currency manipulation.

What is Currency Manipulation?

Currency manipulation, also known as foreign exchange market intervention, or currency intervention, occurs when a government buys or sells foreign currency to push the exchange rate of its own currency away from equilibrium value or to prevent the exchange rate from moving towards its equilibrium value. This is basically an act of artificially inflating or deflating the fair value of the currency. In most cases, manipulation is illegal. Usually, the fair value is decided by the demand and supply of that currency in the market. But when a country manipulates its currency, the free market does not remain any free. In that case, the country with trade surplus doesn't allow its currency to get appreciated, which in self-correcting phenomenon should do. Due to this process, the goods from that country would still cost less than those of other countries whose currencies would be wrongly inflated. This way, the country using currency manipulation

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attracts more exports and disturbs the free market.

How does China do Currency Manipulation?

Now suppose, a trade occurs between a US importer A and a Chinese exporter B. After the trade, importer A would transfer its money to the account of Chinese exporter B in dollars. Now, after receiving money in dollars, exporter B would go exchange the dollars in local currency Yuan. But instead of exchanging from its reserves, People's Bank of China (Central Bank) exchanges it with newly created Yuan. This is equivalent to printing money. The Central Bank thus supplies more Yuan in the market. The Central Bank constantly prints new currency and uses it to buy U.S. dollars and U.S. government debt, thereby flooding the market with Chinese currency and increasing demand for American dollar. This way the supply of Yuan would be more than its demand and would result in lower prices of Yuan. On the other hand, the demand for dollar would be more than its supply and would result in an inflated dollar value.

Proof of China's Currency Manipulation

We can observe it from the Figure 1 that from 2005-14, China's export has grown by more than 300% which is 30% growth annually (on average). The monetary value of exports from 2005-14 has grown from \$500 billion to \$2.3 trillion. But in the same decade yuan depreciated by only 25%, i.e. from 8.26 CNY to 6.37 CNY for a unit dollar.

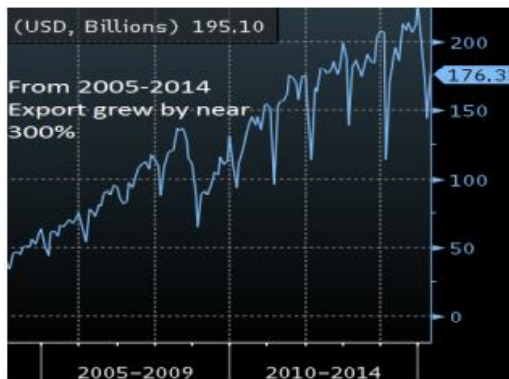


Figure 1: Chinese Exports

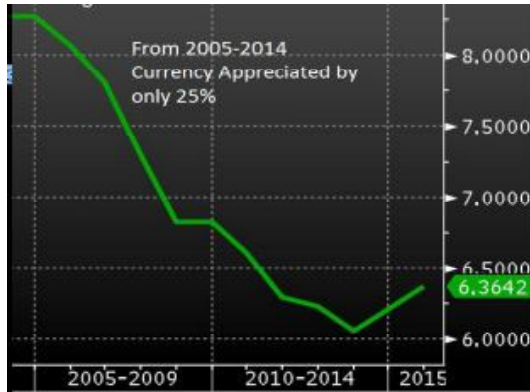


Figure 2: Chinese Currency Movement

How is it possible?

It is only possible by manipulating the currency. In the same decade, the Central Bank has increased its Forex Reserve by more than 600% i.e. from \$500 billion to \$3.7 trillion (Figure 3). This is a clear sign of manipulating yuan by buying more dollars and supplying more Yuan. Figure 4 clearly indicates the increased money supply of Yuan, which is more than 700% in the same decade.

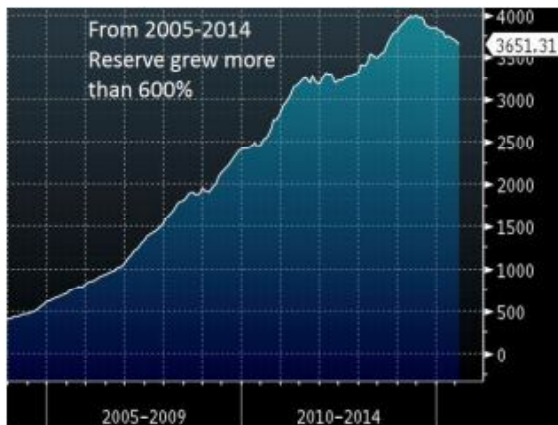


Figure 3: Forex Exchange Reserve



Figure 4: Money Supply

Why is China Devaluing its Currency?

The question which everybody is asking: why did the Chinese government devalue its currency in 2015? The answer is an interplay of many reasons.

First, the global economic slowdown in US and Eurozone: US is slowly recovering from the global financial crisis of 2007-08, but the Eurozone is still in the vicious circle of recession. The export of Chinese goods has reduced due to low demand in US and Eurozone. Inflation in the second quarter of 2015 remained at 2% in US, and abysmally low at 0.2% in Eurozone.

Second, the declining growth rate in China: It also resulted in this devaluation. China has realized that the currency manipulation is not yielding benefits as it did five years back. The exports are declining, which is also resulting in lower demand in the domestic market.

Third, the adoption of quantitative easing by Eurozone: Since the adoption of QE in March 2015, Euro has drastically depreciated against dollar. Now, Chinese government is worried that if this depreciation continues, then their goods would be less desirable in the Eurozone.

At the same time, Japanese government also adopted QE, which resulted in depreciation of yen. The fear of losing this competitive advantage over other countries has forced China to get into this currency war.

Impact on Chinese economy

The recent devaluation resulted in a crash of the Chinese stock markets. Despite the massive stimulus the government unleashed to prop them up the situation remains unchanged. The Shanghai index has fallen by nearly 40% from its mid-June peak. So is this the hour of China's crisis? Not so likely. Stocks and economic fundamentals have little in common. When share prices nearly tripled in the year till June, it was not a sign of stunning improvement for Chinese growth prospects. China's growth has been slow for a while but their stock market kept rising.

Furthermore, the property market of China is far larger than the equity market. Housing land accounts for a major chunk of the financial system and thus plays a much bigger role in spurring growth. House prices have risen up nationwide but this crisis has stopped overvaluing the property market. This stabilization has reduced the risk of property market crash - an event equivalent to that of a stock market crash in America.

Conclusion

This is not the first time that any country has devalued its currency. In 2010, the Japanese government moved to depress the value of yen. South Korea also has a habit of intervening in the valuation of its currency. Switzerland pegged its franc to the euro in the beginning of 2011. But a lesson that these countries have not learnt is that the fluctuation in currencies have global impacts.

Earlier this year, when Swiss Central Bank had unpegged their currency, the currency rose from pegged level of 1.12 Euro to 0.82 Euro in just one day. This is the highest appreciation of a currency in the history of the financial world in one day. The corresponding impact was that the Swiss market went down by 12% the same day. Many big hedge funds went bankrupt. And now, when China has devalued its currency, again, there is a market crash. This market crash is far bigger than the Swiss market crash. It eroded nearly \$1 trillion of wealth in just one day.

China has always used these unfair practices just to get ahead in the world. But now, it should realize that this world is interconnected, and any volatility would cause global crisis. When China last devalued its currency in 1994, there was a financial crisis in Asian economies just after 3 years. Now again, we are at the verge of another financial crisis as the RBI governor, Raghuram Rajan, predicts. And its consequences would be far more fatal than 2007-08 global financial crisis.

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IS THE AGEING DRAGON A BLESSING IN DISGUISE FOR INDIAN ECONOMY?

Shulin V K Satoskar

T. A. PAI MANAGEMENT INSTITUTE, MANIPAL

Introduction

China's devaluation of Yuan, last week, represented the largest depreciation of the currency for 20 years and sent tremors down the Dalal Street. The "Kiss of the Dragon" was felt across already subdued economic conditions throughout the world. Notably, Nobel Laureate and renowned economist Paul Krugman described the decision as "the first bite of the cherry" envisaging that more could follow. The World's largest economy could be weaker than the 7% a year growth that official figures suggest.

In my attempt to explain the slowdown in Chinese economy and a great opportunity for India to bank upon, I have used the concept of business cycles and its impact on economies.

Business Cycle

A business cycle is defined by the fluctuations in an economic activity over a period and covers expansion/recession in any economy. An expansion phase is marked by rising indicators like income, employment, industrial output.

Cyclical fluctuations in economic activity are features of most economies. One of the reasons why nations fail to achieve a sustainable economic growth rate is because the policy makers underestimate economic cycles. Hence, an improved understanding of the economic cycles and policies interaction is imperative in formulating forward looking monetary policy.

Economists are often puzzled by the Growth-Inflation paradox. Most agree

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IS THE AGEING DRAGON A BLESSING IN DISGUISE FOR INDIAN ECONOMY?

that sustained growth rate cannot be achieved above a threshold rate of inflation; there are no models that accurately estimate on what constitutes the “Threshold”. Figure 1 captures an economic cycle in Indian economy from 2005-10. Inflation rate (depicted by the Green line) and Business Cycle (depicted by blue) further help identify the counter-cyclical nature of Growth-Inflation tradeoff with inflation rate almost mirroring the business cycle at identical turning points. Such an economic cycle (typically over a period of 6 years) is known as a Juglar Cycle or J-Cycle. Indian economy currently finds itself at its peak as indicated by the rising trend of the Juglar cycle in 2015, with lower inflation levels, tailor made for a super normal growth stage. However, Juglar peaks are often short lived (1-2 year, see period 2005-07 and 2009-10) and troughs are relatively lengthier (2-3 years, 2010-13).

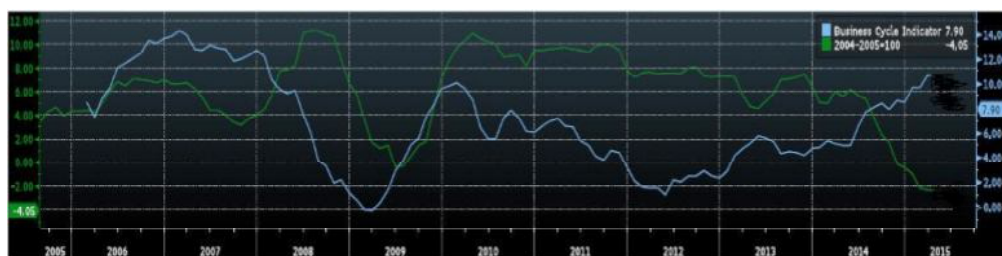


Figure 1 Indian Business Cycle and Inflation Rates (Source: economic indicators, Bloomberg)

There is also a pattern of symmetry around which the cyclical trend oscillates over a period. This is termed as Kondratieff cycle or K-Cycle and usually extends over a period of 42 years. Hence, a K-Cycle typically has 7 J-Cycles. Figure 2 captures a K- cycle in the Indian economy and the breakout started around 1974. A rising trend is indicated by the green trend-line below. Such a trend is typical of a robust economy.



Figure 2 Kondratieff Cycle of Indian GDP (Source: World Bank Database)

Chinese economy, on the contrary, has experienced a slowdown in consumption in the recent years. The J-cycle from 2010 to 2015 accurately captures this falling trend in Figure 3. Chinese economic cycle has not picked up significantly, in spite of recording a lower inflation rate. Recent RMB devaluation and interest rate cuts further confirm the ineffectiveness of policies introduced during the ‘troughs’. Also, the ‘trough’ looks abnormally extended with little signs of recovery.



Figure 3 Chinese Business Cycle and Inflation Rates (Source: Economic indicators, Bloomberg)

Summary of Findings

From the CRISIL research reports and World Bank data, it can be inferred that:

- Domestic investment in China has shown signs of saturation and there is little room for stimulus (Investment accounted for 47.2% of GDP in 2010 and 46% in 2014). India has huge room for public investment and can absorb trillions of dollars in infrastructure alone.
- A very popular argument among economists is that China has an ageing population which is expected to drive the labor costs up further by 2020.
- Going by IMF figures of 2013, consumption expenditure 70.4% of GDP in India compared to that of 49.6% in China.
- Chinese debts have risen to alarming levels (101% from 2007 to 2014). India on the contrary is relatively safe at 5% increase.
- With a subdued demand across the world, China can rely on export driven growth strategy at its own peril. India’s consumption driven strategy leaves a good headroom from potential upside.
- Pressures of the property bubble are already felt in China as real estate prices are on a decline.

India's Improving Macros							
	FY10	FY11	FY12	FY13	FY14	FY15	FY16F
Growth	8.6	8.9	6.7	4.5	4.7	5.5	6.3
CPI Inflation	12.4	10.4	8.4	10.2	9.5	6.7	5.8
CAD (% of GDP)	-2.8	-2.7	-4.2	-4.7	-1.7	-1.2	-1.1
Fiscal deficit (% of GDP)	6.5	4.8	5.7	4.8	4.5	4.2	3.9

Table 1 India's Improving Macros (Source: CRISIL research reports)

The Road Ahead

India is now one of the strongest growing economies and remains better positioned compared to its peers. Our country with a stable political environment recorded a sharp decline in inflation and managed to reduce Current Account Deficit (CAD) significantly. prime minister's foreign visits have managed to win the foreign investor's confidence yet again indicated by rising FII/FDI inflows. A combination of tactical measures like mobilization of NRI deposits, RBI's success in building forex reserves, restriction on gold imports and slowdown in imports augur well for maintaining sustained growth rate. Currency devaluation war, however, is one major external shock that remains a cause for concern. However, global sentiment still remains bullish on Indian economy on account of the following factors:

- RBI Governor, Mr. Raghuram Rajan has succeeded in building a strong monetary policy discipline that focusses on inflation targeting which in turn strengthens the rupee.
- With the Land Acquisition Bill, FDIs and GST reforms round the corner, Indian growth story is expected to continue.
- India Inc's earnings are expected to be 7% this year. Estimated reduction in corporate taxes and GST replacing state taxes will push the earnings upwards.

Major Challenges

- Currency devaluation war is one major external shock that remains a cause for concern
- Subdued global demand can hit India's exports further impacting the economy
- Impending decision by the US Fed to raise interest rates has the potential

to cause volatility in capital and forex markets

Going by the business cycles and the empirical data on macroeconomic variables, Indian economy certainly is in a good shape compared to its northern neighbor. However, the onus lies on the government to bank on a great opportunity that the 'peak' of economic cycle has to offer.

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ECONOMIC CRISIS: WHAT NEXT?

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The global economy can interestingly be compared to a human body and countries to blood cells. When blood cells in one part of the body get affected, the infection rampantly spreads to other parts making the entire body frail. An anti-dote may not be strong enough to help the blood cells recover. A human body makes its own antibodies to fight such infections. It allows the weaker blood cells to die and forms new blood cells to fight the infection effectively.

In this paper, we would try to establish how this phenomenon applies to the global economy where, often the best possible way to revive an economy is to allow it to correct itself with least government intervention.

A downturn in the economies across the globe stems from a slowdown in GDP growth rate. Often inflation (or deflation) and liquidity shortage accompany the downturn as symptoms for bigger events. This leads to financial instability within the country which, in turn spreads to other economies due to globalization. This results in a financial crisis across the globe.

Since a banking system acts as the backbone to an economy, its stability greatly depends on the adopted banking practices. One of the many disguised threats to an economy is the use of fractional reserve banking system. In this system, when a person deposits a particular amount of money in the bank, it keeps a small portion as reserves and lends the rest. The money lent gets deposited in another bank and the cycle continues.

This cycle shows that only a small fraction of money is in the physical form as currency and the remaining is in the form of debts. Such low levels of liquidity become a critical factor for perpetual growth or collapse of an economy.

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Some of the major events of economic downturn across the world for the past 25 years are as follows:

The Energy Crisis (2003 onwards)

In 2003, the oil prices had suddenly gone up from a historic price level of \$25 to \$30. By 2008, it touched \$147, an increase of 390% in 5 years. This was majorly because of unrest in the middle-east, fall in the US dollar, the Israel-Lebanon conflict and hurricane Katrina. This shows how oil prices were impacted by events across various countries in the 2008 recession.

The Housing Bubble (2008)

The collapse of Lehman Brothers – a giant global financial services firm - in September 2008 almost brought down the financial system of the entire world. The credit crunch that followed the fall of many such banks turned the already nasty downturn into the worst recession seen in the last 80 years. The crisis had multiple causes. The financiers, central bankers and regulators were to be blamed.

Some of the events and their impacts were:

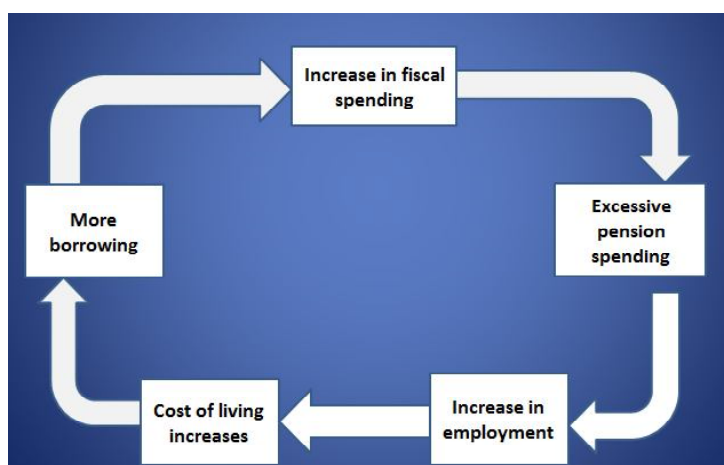
- The emergence of Government Sponsored Enterprise - Fannie Mae and Freddie Mac and the Community Reinvestment Act pressurized banks to provide risky loans.
- Increased savings in Asia led to a fall in global interest rates.
- European banks borrowed American money and invested in dodgy securities.
- Due to low inflation and stable economy till mid-2000s risk appetite of American citizens had increased.
- Huge loans were lent without proper credit checks.

Several of these mortgages were passed on to financial engineers who converted them into low-risk securities. Investors across the globe were attracted to these securities as they gave good returns. In 2008, the borrowers started to default on their payments which became a big threat to investors. This led to the burst of the housing bubble. This economic event had a huge impact on the global economy especially the emerging nations and the Euro-Zone, which are known to be highly correlated to the US economy.

The European Sovereign Debt Crisis (2009)

This is also referred to as the Eurozone crisis. In 1993, the European Union originated from The Maastricht treaty that brought together 27 European countries to reduce the trade barriers between them and boost economic growth across EU. European Central Bank was then formed - a regulatory authority for all the banks in the Euro Zone. Banks from any country within EU could lend to each other. This led to an increase in fiscal spending. There was a rise in employment opportunities in this zone which in turn increased the cost of living and borrowings. This had a cyclic effect.

Figure 1: Eurozone Crisis (Cyclic Effect)



Since the US and the Euro Zone are positively correlated to each other, crisis in the US had a huge impact on European countries. Greece, Ireland, Portugal, Iceland and Spain's debt increased rapidly leading to huge fiscal deficits. There came a situation where banks from stable nations like Germany started implementing stringent policies. This led to a crisis across these nations which were interconnected to each other. As these countries had huge borrowings from each other, all the countries that lent the money were also affected by the crisis.

Fiscal prudence and spending cuts were imposed in these countries following the suit that Germany had started. There was a huge unexpected multiplier effect because of the fiscal cuts which led to fall in employment and prices across EU.

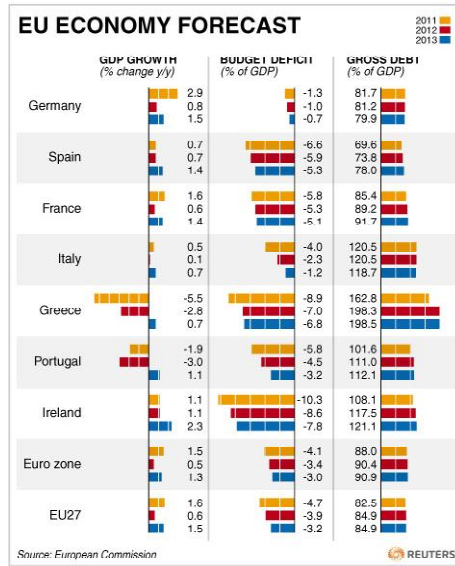


Figure 2: EU Economy Forecast Source: Reuters

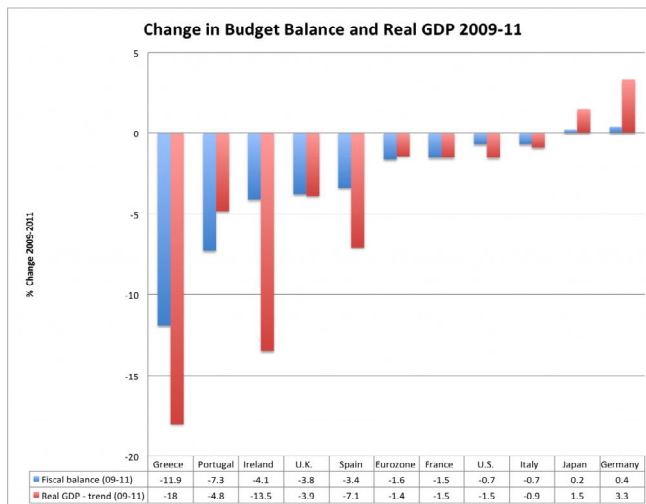


Figure 3: Multiplier Effect on Various Countries Source: OECD

The Arab Springs (2010)

The European financial crisis was contagious to economies beyond its geographic dimensions. The dissatisfaction amongst the people due to high inflation, unemployment and poor living conditions led to a revolt against the ruthless autocrats of the Arabian countries.

Europe is the major trade partner of the Arab countries. About 60-80% of the oil in this region is exported to Europe. Euro crisis also affected the tourism in the Arab region leading to a drop in money transfers. Flow of money through the banking sector also shrank drastically due to fall of the European Banking system.

The result of the Arab Spring had an impact on various countries due to huge rise in the oil prices from \$91.58/barrel in December 2010 to \$126/barrel in April 2011. This led to an increase in inflation across several developing and developed countries.

Russian Crisis (2014)

Crude oil exports constituted a major part of Russia's economy. Although Russia benefitted from the surge in oil prices, it had to face a negative effect in 2014 when the economy crashed due to two major reasons:

- Fall in the price of oil due to increase in production by the US
- Sanctions against Russia due to its military intervention in Ukraine

This shows a negative correlation between US and the Russian economy. Stability in one region leads to a slowdown in the other.

Chinese Economic Crisis (Present)

The global debt is expected to cross \$200 trillion. Apart from countries like US, Japan and the Euro Zone nations, China has a major share in the global debt owing to its expansionary monetary policy. The total debt has increased to around 280% of its GDP. Real estate which contributed largely to the GDP has also slowed down, piling up the unsold properties to a record high. The bonds of Chinese corporates are nosediving and several huge real estate companies sought bailouts from the Central Bank. The Chinese Central Bank responded by cutting the Reserve Requirement Ratio and relaxing the monetary policy. This might have a catastrophic effect on the global economy as it involves huge investments and lending from banks across the world. There is a great possibility of China becoming the epicenter for the second global economic crisis.

From the above analysis, we can infer that a period of rapid economic growth

is succeeded by a slowdown in the economy. This can be termed as a cyclical slowdown. An intervention with an unavoidable delay in implementation could aggravate the situation. In such a scenario, Milton Friedman's free market economy with least intervention unarguably holds true. Hence, allowing the economies to correct themselves with least government intervention would be the best possible solution.

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