

GLOBAL GROWTH

Passing the baton to emerging economies

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The worst economic turmoil in 60 years could be over, but the crisis has contributed to strengthening some fundamental trends that will shape the next decade in the world.

In 2010, world growth has and could continue to be led by emerging market consumers. Morgan Stanley, for example, has forecasted 4 percent global GDP growth this year. However, this number conceals two very different states of affairs. One is a moderate recovery for developed economies (2 percent average GDP growth in the advanced G10 economies this year). The U.S. could lead the growth among this group (2.8 percent), the European Union is expected to grow by less than half that rate (1.2 percent), while Japan may hardly grow at all (0.4 percent) and is forecast to actually fall back into a technical recession in the first half of this year.

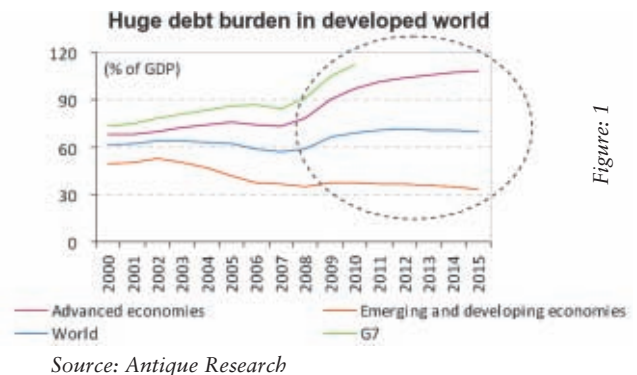
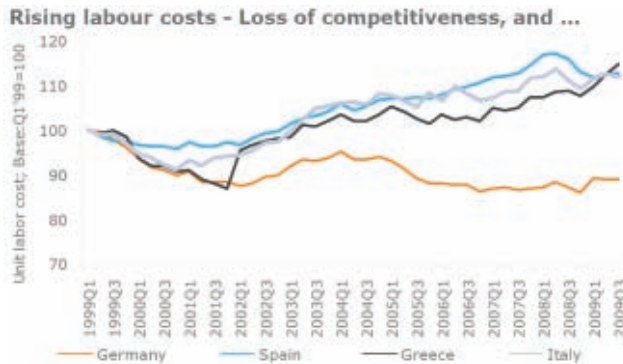


Figure: 1

Two, in contrast to what is seen in the advanced nations of the world, Emerging Economies seem to be displaying the 'staying power' and have in fact even been bolstered by the crisis. To illustrate, growth of wireless services in emerging markets is expected to compensate for the slowdown in the advanced economies. According to the analyst firm IDC, more than half of IT industry growth will be fueled by emerging markets including Brazil, Russia, China and India.

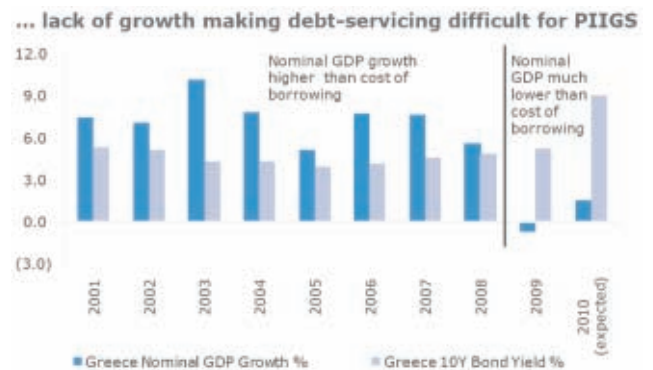


Source: Antique Research

As for the global economy, the recession may not be completely over as the world economy limps back to normalcy, but certainly consumer demand and spending is going up which is good for everyone including emerging economies like India. Already, one has started reading reports of skilled workers in the gem and jewellery sector coming back to diamond cutting centers like Surat and one hopes to see such demand sustain as we move forward in time.

However can we say, “All IZ WELL”? – Not quite !

The advanced world has some deep rooted problems that cannot be easily wished away. The emerging economies would have to keep a keen eye on the pulse of these economies as they advance along the path of economic growth.



Source: Antique Research

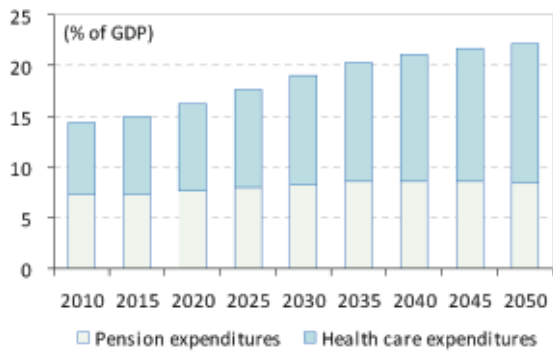
G7 economies comprising of countries such as US, UK, France, Canada, Germany, Italy, & Japan are all embroiled in debt. Debt levels at above 90% of GDP are



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indeed a cause of concern on the back of slow GDP growth and adverse demographic structure comprising of a higher proportion of the aged (Refer figure 1). With health care and pension expenditures at above 20% of GDP, the G-20 nations have a huge challenge ahead.

Aging-Related burden in G-20 Advanced Economies



Source: Antique Research

Looking at countries more specifically one gets a better idea of their economic outlook.

United States

Deteriorating confidence in the economic recovery among the general public has reinforced the belief that the economic momentum is slipping.

According to the Federal officials, if job growth falters or inflation forecasts decline amid less supportive financial conditions, policymakers may need to strengthen the commitment to low rates and easier credit.

didyouknow?

India has received approximately 40% of emerging market funds over the last quarter.

Source: Business Standard, Dtd. 26.8.2010

This does not augur well in the context of fiscal consolidation (gradual withdrawal of fiscal stimulus). The fate of massive tax hikes scheduled for 2011 remains uncertain.

Initial jobless claims are rising again after remaining stubbornly above 460k



Source: St Louis Fed, IIFL Research

US private consumption growth consequently has decelerated over the past 2-3 months. New home sales declined in May after having risen 30% from April 2009.



Deteriorating confidence in the economic recovery among the general public in the USA has reinforced their belief that the economic momentum is slipping.

New home sales declined sharply in May, after rising 30% from April last year



Source: St Louis Fed, IIFL Research

The Institute for Supply Management's service-sector index has declined to its lowest level this year. The service sector accounts for about 80 percent of US employment. Service sector comprises of jobs in hospitals, shops, restaurants, airlines, banks and consulting firms. But service companies have trailed the much smaller manufacturing sector in recovering from the downturn, putting a damper on overall hiring. The service sector mainly depends on shoppers' spending but consumers remain frugal because of high unemployment and uncertainty.



The UK may be better placed to achieve a sustained economic recovery as compared to other Euro economies.

The ISM Index has declined to its lowest level this year



Source: St Louis Fed, IIFL Research

While retailers are largely doing better business than they were a year ago, many remain hesitant about the future. Office supply chain OfficeMax Inc. said it expects small declines in sales for the year as the economic recovery is slower than company executives had expected.

US private consumption growth is decelerating again



Source: St Louis Fed, IIFL Research

The entire world would be watching the manner in which the US economy reacts to the steps taken by the government to gradually withdraw the fiscal stimulus. The path of US economic policy next year would be determined based on this response. While the near term prospects do not appear very encouraging, economists believe that in the long term the US economy would rev up.

United Kingdom

The UK may be better placed to achieve a sustained economic recovery as compared to other Euro economies. The consensus forecasts for the fiscal deficit have been falling, but still project a higher deficit this year as compared to the previous year.

To be sure, the route back to fiscal sustainability will not be painless. Public spending could fall sharply, while the tax burden may rise markedly. But the path to stability is viable, and indeed the UK with the recent fiscal improvement and announcement of major fiscal

consolidation (gradual withdrawal of the fiscal stimulus) is already much further down that path than many would have expected.

Euro Area

Business confidence in the Euro-zone has improved though it still remains below the 2006-07 levels. Though retail sales are rising year on year, they continue to remain sluggish.



Following the Greek debt crisis which had spooked the markets earlier this year, 91 banks in 20 countries were subjected to “stress” tests to see how they would cope with another recession. Just seven European banks failed and were ordered to raise their capital by 3.5 billion euros (USD 4.5 billion). While these results have had the desired result of having boosted confidence levels about the economy some analysts are of the belief that perhaps the tests were too soft and do not fully reflect the reality. Nevertheless, industrial activity is on an upswing with new orders rising.



The crisis deepens when one examines the PIIGS nations (Portugal, Italy, Ireland, Greece and Spain). Currently the cost of borrowing in these countries is much higher than the GDP. Therefore, although retail sales are rising y-o-y, they remain sluggish currently.



However unemployment rate at 10% is at a multi-year high. Consequently it would be nearly impossible for such countries to pay back their debt in normal course as they do not have enough young men to drive their economy in order to pay back the accumulated debt too. As a consequence of this, labour cost has been rising in



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these nations which brings down the competitiveness of goods produced.



Emerging Markets – The panacea for world GDP growth

As advanced nations seem to be finding it hard to grow their economies rapidly for want of consumption demand, an ageing population and a debt trap of their own making, it appears that the emerging nations of the world would be primarily responsible for driving the world economy. The outlook for emerging markets is thus a lot more positive, where Morgan Stanley forecasts output to grow by 6.5 percent this year (China 10 percent, India 8 percent, Russia 5.3 percent, Brazil 4.8 percent), up from 1.6 percent in 2009.

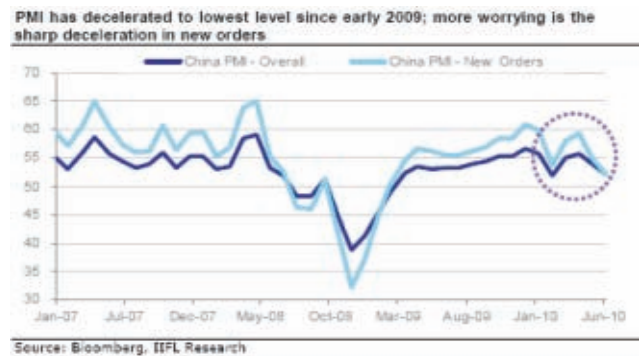
A re-balancing towards domestic demand-led growth in emerging markets is well underway on the back of slowing demand seen in advanced countries.



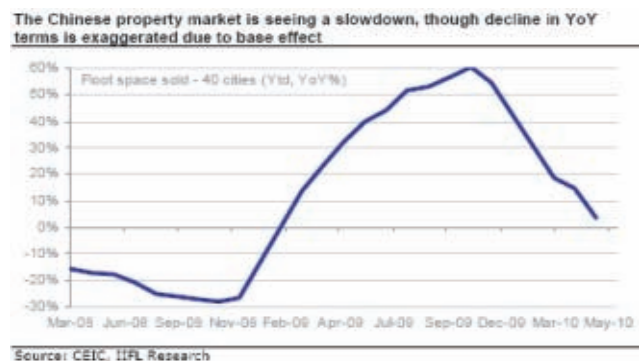
The outlook for emerging markets is a lot more positive as compared to advanced nations.

China

The Purchasing Managers' Index (PMI) for China's non-manufacturing sector rose to 60.1 percent in July, up 2.7 percentage points from the previous month. The non-manufacturing PMI includes a package of indices to measure the non-manufacturing sector's performance. A reading above 50 percent indicates economic expansion, while one below 50 percent indicates contraction. The July, 2010 rise in the index came after two successive monthly drops and was the fifth straight month the reading was above 50 percent.

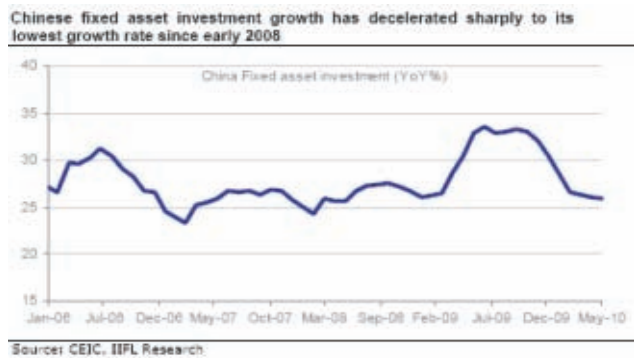


The index for the real estate industry which had taken some beating swung back to a level above 50 percent. China continues to follow a policy of striking a balance between stable and relatively fast economic growth and management of inflation expectations. At the same time policies are geared towards exiting stimulus inducing policies framed during the global meltdown of 2008-09.

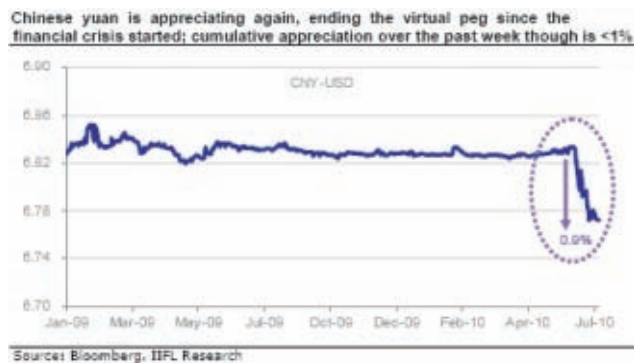


Tight policies are consequently applying the brakes on industrial activity, investments and consumption. Commodity prices and industrial production growth have started to slow down and has helped cool off inflation.

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A rising yen and falling consumption demand in advanced countries could adversely affect export growth. In order to meet such challenges, China would endeavour to develop its domestic market. In this context the Chinese government would be glad that the consumption demand on the back of high wages has held up.



Nevertheless China is clearly in a sweet spot and leads the global economic upsurge with projected GDP growth of 10% and the Chinese government would do all it can to sustain a high growth rate by injecting liquidity in the system and by restarting delayed infrastructure projects.

India

Despite India's many economic woes, it remains the world's second fastest growing economy. Recently, Prime Minister Manmohan Singh stated that the country's economy is expected to grow by 8.5 per cent for the fiscal year ending March 31, 2011. Just to reiterate, in the last fiscal the economy had expanded 7.4 per cent. The fiscal situation, which has benefited from higher telecom revenues, has grown brighter with the government's decision to decontrol petrol prices and

increase in prices of diesel and cooking fuels. With the monsoons appearing to be healthy, one can expect to see inflation cooling off. However India would need to watch out for global developments which could pose challenges by way of fall in export demand. Non- food inflation which has recently shot up prompting the RBI to raise repo and reverse repo rates remains a challenge going forward.

The current account deficit that was spiraling away seems to be clawing back on the back of healthy GDP growth, imports being primarily led by industrial and capital goods (as against consumer goods), capital flows led by more stable FDI, deregulation of petrol prices, disinvestment of PSU companies and other economic reforms.



With a good monsoon, this year, food price inflation is likely to soften.

Infrastructure and Agriculture – Growth drivers

In 2010, a renewed government focus on infrastructure and the rural economy and continued buoyancy in the services sector could sustain a strong growth in other areas of the Indian economy.

This year, India is likely to see significant investment activities in infrastructure. Backed heavily by Government legislation and plans to spend an estimated \$1 Trillion over the next 5 years, it is hoped that infrastructure developments will progress at a faster rate than ever before.

Government policy is expected also to turn its spotlight on the agricultural sector in 2010. The planned reforms

in agricultural production, distribution and logistics through infrastructure investments will benefit agricultural communities. This will, in turn, help to boost GDP and bring about inclusive growth as about 60% of India's workforce is employed in the agricultural sector.

Overall, 2010 could well be a year of fiscal consolidation and lay the foundation for faster economic growth in the years to come. A large part of the infrastructure spend is expected to start paying dividends between 2011-2013 and the benefits of large domestic oil & gas finds is also likely to fully accrue by then.

Challenges

In the case of Asia-Pacific economies, all are expected to post positive GDP growth in 2010. But concerns and challenges remain — inflation is an issue for some while the questions of when and how to exit from expansionary monetary and fiscal policies are critical for all.

Although all economies are now performing better than expected, the extent of recovery varies across the region. Therefore, the policy focus is gradually shifting from managing the crisis to managing the ongoing recovery. Most countries are, thus, likely to gradually withdraw fiscal stimulus.

However, experts opine that just as Asia-Pacific is leading the world in economic recovery, so too will it lead the exit strategy. In other words, the coming year could see all Asia-Pacific economies adopt a tightening stance in one form or the other.

Conclusion

All in all, emerging markets are in a secular bull trend and the general direction of emerging market countries is positive. Many countries have already returned to growth and that growth is expected to only strengthen in 2010.

Thus, one could look to 2010 with optimism founded on: (1) growing investor confidence generally and

emerging markets specifically, (2) strong fund inflows into emerging markets, (3) relatively higher GDP growth in emerging markets, (4) the accumulation of foreign exchange reserves which puts emerging economies in a much stronger position to weather external shocks, (5) the relatively lower debt levels of emerging market countries, and (6) the high level of money supply growth globally. All these factors would thus make emerging markets attractive to investors over the world.

The IMF Report

The International Monetary Fund (IMF) recently raised India's growth forecast for 2010 to 9.5 per cent in an update of its World Economic Outlook, stating that favorable financing conditions and robust corporate profits will accelerate economic expansion. The multilateral lender hiked its growth projection from the earlier estimate of 8.8 per cent it made in April earlier this year.

Moreover, the IMF also expects the Chinese economy to grow by 10.5 per cent in 2010. It said that the first quarter GDP numbers in Asia were generally stronger than anticipated and that the higher growth was on expectations of a modest but steady recovery in most advanced economies and strong growth in many developing and emerging economies.

According to the IMF, the world economy expanded at an annualized rate of over 5 per cent during the first quarter of 2010, mostly due to robust growth in Asia. The lender noted that Asia's strong recovery from the global financial crisis continued in the first half of 2010, despite renewed tension in global financial markets. GDP growth forecasts for Asia have been revised upward for 2010, from about 7 per cent in the April WEO (World Economic Outlook) to about 7.5 per cent.

However, the IMF has warned that despite the stronger than expected first half recovery, uncertainties stemming from sovereign risks could hamper the economic outlook. IMF chief economist Olivier Blanchard also pointed out that downside risks have risen sharply in recent times.

■ Luv Chaturvedi

