

A Tough Year Ahead: Time to Consolidate and Focus on Reforms

The latest World Economic Outlook (WEO), IMF's flagship publication focuses on the global financial crisis and their impact on the real economy. It has revised downwards its forecasts made in July 2008 with the global economy now expected to grow only by 3.9% in 2008 and 3.0% in 2009 which officially makes for a global recession next year. GDP in advanced economies is expected to rise by an anemic 1.5% in 2008 and 0.5% in 2009. Emerging economies are expected to maintaining a growth of 6.9% in 2008 and a lower 6.1% in 2009. This is nearly two percentage points down from the previous two years when emerging economies had registered 8% economic growth with the world output rising by 5% in both 2006 and 2007. Chinese growth rate is expected to come down to 9.7 and 9.3% in 2008 and 2009, while India's GDP is estimated to increase by nearly 8% and 7% in these two years. World trade according to WEO is still expected to achieve a positive growth of 5 and 4 % in these two years.

These numbers reveal a sharp and across the board slowing down of the global economy, largely as a result of the financial sector meltdown that we have witnessed since September 2008 when Lehman Brothers was allowed to collapse. The more worrying aspect of these forecasts is that they are probably already out of date and need to be revised downwards again. For starters, the World Bank has already forecast that world trade growth will be negative this year. From all the news coming out of the US, it is clear that it has been in recession since December 2007 already, which implies that WEO's estimate of US growth of 1.6% in 2008 is overly optimistic. With house prices still declining, construction at a near stand still and unemployment numbers worsening with each successive week, it now seems that US economy could contract by as much as 5% in the fourth quarter of 2008. This will in all likelihood imply that the US economy will perhaps remain recession bound even in 2009 despite the trillion dollar stimulus package, reportedly under consideration of the new administration. The UK and Germany, the two largest economies in the Euro zone are also likely to see negative growth in 2009. And Japan, with its exports in November 2008 plunging 26% over the same month in 2007, is likely to be recession bound in 2009. The news coming out of China also points to a sharper decline in their exports and GDP growth than is forecast in the latest WEO. I will, therefore not be surprised to see the advanced economies actually experience a real contraction and see their GDP decline in 2009. With large emerging economies also now expected to grow much slower, we will be fortunate if the global economy registers a positive rate of growth in 2009. Indeed a tough years ahead.

This implies a very weak external demand for India and other emerging economies. India's is not as dependent on external demand for its growth impetus as for example is China where exports account for 40% of the GDP as compared to India's 23% (including both goods and services). But with very low consumption ratio and high import ratio, China's income multiplier is lower than India's. Therefore, contribution of exports to GDP may not be much lower in India in comparison with China. Merchandize exports have been growing at 31 per cent till September 2008. Software exports grew by 21 per cent till Q1 2008-09 and remittances by over 50 per cent. However, export growth slowed down sharply in September 2008 and turned negative by a large 12 per cent in October.

Export growth could all fall to 10 per cent or below in 2008 and next year due to the weak global economy. This could by itself seriously bring down the GDP growth in 2009.

Therefore, any forecast for the Indian economy, that puts 2009-10 growth rate for the Indian economy at higher than in 2008-09 sounds rather incredible. And to forecast near 8% growth in 2009-10, as some senior official economists have apparently done is perhaps irresponsible. Indian investors would be better advised to completely discount such wild optimism. They should instead consolidate their capacities and try to become more competitive in preparation for the next upturn that could hopefully start in 2010. It is never inevitable that high savings rate like 33% in India and 53% in China will produce high growth rates. High savings rates can simply result in growing bank deposits and worsening deposit to credit ratios as Japan has seen over a decade. Economies suffer from excess capacity expansion that does not generate output. Economies also export away their savings as reflected in current account surpluses which for China is estimated by the IMF to be at about 9% of GDP in 2009!

I think Indian policy makers are less sanguine about 2009 growth prospects as is reflected in the official encouragement to recalcitrant commercial banks to reduce lending rates and in offering incentives to exporters and small house owners. We need to continue with these growth stimulating policies and focus also on structural reforms to ensure that economic growth recovers in the second half of 2009. The first half of next year will perhaps see less than 5% growth and so a recovery in the second half of next year is the best we can hope for.

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