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Conclusions Paper

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A Mixed Picture

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A MIXED PICTURE

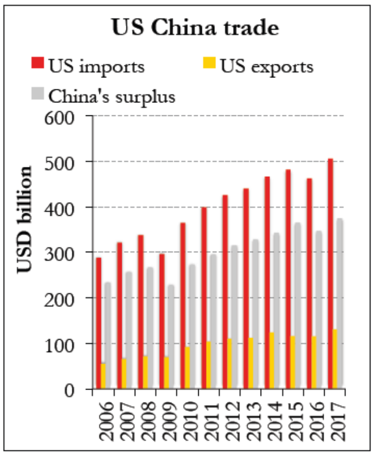
Global growth is today strong and well balanced. In 2017, the world economy grew by 3.8%, its fastest since 2011. The IMF forecasts similar growth this year and 3.7% in 2019. Barring Japan, all major advanced economies are growing at over 2% with the US at 2.3% in 2017 and the Eurozone at 2.4%. Emerging markets are also rebounding and EM Asia is currently at over 6.5%, led by India and China. However, economies move in cycles and the current upswing has already lasted a long time. It will take just a trigger or two for the cycle to turn again and currently, there are several such triggers. These include rising nationalism, geopolitical tensions and a reversing dollar carry-trade led by US monetary tightening. However, there are a few threats more worrying than a potential breakdown of the global trade architecture. The Trump administration is undermining the post-World War II, rules-based order built around liberal values, the free flow of goods and people and a security paradigm built on NATO. Given how deep the global economic inter-linkages run, any of these risks can play out in unpredictable ways, pulling down world growth with it.

HEADWINDS FACING THE WORLD ECONOMY

The great trade war

The US-China trade war could turn ugly in the short term, with both sides standing to lose. China will be impacted more, given its large trade surplus

- The Trump administration has four grouses against China. First, that China's 'currency manipulation' has tilted the US trade balance (USD 350 billion) in its favour. Second, it resents the loss of millions of US jobs to China. Third is China's practice of stealing American IP and its bullying of US companies. Finally, there is China's push into strategic regions like the South China Sea, and into domains like AI, robotics, solar, electric vehicles and biotech, where it seeks global domination.



Source: Statista, IMA analysis

- Initially, the US will levy tariffs on USD 200 billion worth of Chinese imports, but it may go the whole hog and cover *all* imports. Rather than being just a tactical measure, this is a strategic move that is designed to *decouple* the US economy from China's.
- Both countries stand to lose, but China will be impacted more, given its large trade surplus with America. Yet China will also make things very difficult for US companies operating there, just as it did with Japanese firms during a period of strained Sino-Japan relations. China could also block agricultural imports from the US; place restrictions on the export of rare earths; and try to prop-up the Yuan as a trading currency.

In the long run, the trade war has strategic overtones of decoupling the US economy from China

- Outside of trade, China may escalate the 'war' by selling some of the ~ USD 1.2 trillion worth of Treasurys it holds. However, the US does possess the ultimate weapon: the dollar. Since the bulk of world trade is dollar-denominated, were the US to impose sanctions on Chinese companies, it could get banks to stop dealing with them in dollars, thereby isolating them.
- Unlike an authoritarian China, the US will find it hard to play a long game, because it has to worry about Congress, elections, lobbyists and vested interests. Ultimately, US public opinion will drive politics and policy.
- The trade war could trigger a cold war, extending into areas such as investment, and may even spur a military confrontation, such as in the South China Sea. This could divide the world into disparate trading blocs, as

opposed to a single, open architecture. If other countries start to defy the rules laid down by the WTO, it could cripple the global trading system.

Rising commodity prices

Oil appreciation is on account of many factors: OPEC production cuts, US sanctions on Iran, dollar depreciation and speculative trades

- Since 2016, commodity prices have been on the mend. Metal prices – tin, zinc and aluminium, among others – are up strongly, natural gas has doubled in price, and oil has more than doubled from ~USD 30/barrel.
- Several factors are driving up oil prices: OPEC production cuts; a rising geopolitical risk premium; Mr Trump's aggressive Iran policy; the dollar's depreciation for much of last year (a falling dollar tends to fuel oil inflation); and speculators buying up oil futures.
- Shale production failed to 'kick in' when oil hit the USD 50 mark, because too many investors got burned in the previous bust, when they had to write off ~USD 130 billion of loans.

With Shale production kicking in, oil prices are expected to fall to USD 65/barrel in 2019

- In the longer term, big oil companies – which have already committed to invest USD 40-50 billion over the next 5-10 years – will drive up Shale oil production. Going forward, many forecasters believe that oil prices would be in the USD 63-65/barrel range in 2019.

Monetary tightening

Rising bond yields have serious implications especially for high-debt economies like Italy and China

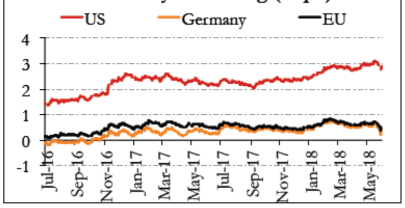
- The global interest-rate cycle is turning faster than many had expected.
- A robust US economy – marked by strong consumption, near-full employment, and buoyant house prices – will cause the Fed to continue hiking interest rates. From zero, the US Federal Funds Rate has edged up to 2.25%, and is likely to end up at or close to 3%, which is considered to be the inflation-neutral level. 10-year bond yields have jumped from 1.4% to 3.15%.

US bond yields (% pa)

A financial crisis in China could spread to the rest of the world and wipe out trillions of dollars across the western and EM markets

- Similarly, bond yields are up in the Eurozone, while yield gaps, such as between Germany and Italy, have surged to 3%. This is critical, because Italian debt is now over 140% of GDP, most of Italy's banks are in bad shape, and the country does not have a stable government. If Italy fails, it could trigger the next major financial crisis, or even a complete collapse of the European Union.

Bond yields rising (% pa)



- The implications for EMs will be huge, especially for China, where debt now exceeds 280% of GDP. Most of this is corporate debt, two-thirds of which is held by state-owned enterprises (SOEs) and real estate companies, but the shadow banking system also holds debt worth about 30% of GDP. A financial crisis in China will have a contagious effect, wiping out trillions of dollars of global wealth.

The rising threat from nationalism

Nationalism and all-right movements have created political and economic tensions in Europe

- Rising nationalism is personified in Donald Trump's rise, in Brexit, and now in Angela Merkel's weakened position in Germany. Across Europe, those that were once at the fringes of policymaking are now at the heart of it, and even the 'centrist' parties contain such elements.
- Anti-trade, anti-immigration views pressure governments not only to cap

the movement of goods and people, but also to walk away from global security and environmental deals, or, say from the common currency.

- Europe is divided between a more liberal West and a less open East, but both sides have an equal say in the EU, creating huge internal tensions.
- The UK and Europe have just 6 months left to negotiate Brexit. The option of a 'soft' exit – keeping Britain inside the customs union – still exists, but many in the UK no longer want to play by 'Europe's rules.'

The India Outlook

The NDA: the hits…

In the NDA's 4 years, India's strategic relationships have deepened; it has avoided a ratings downgrade; the tax base has widened, fiscal federalism has improved, and India has become more 'financialised'

- In its four years in power, the NDA government has had several important achievements, including vastly improved strategic relations with countries like Japan, Israel, and even the UAE and Saudi Arabia.
- Crucially, it has consolidated the fiscal position (~3.5% of GDP, from ~6.5% under the UPA), despite only moderate GDP growth. This averted a ratings downgrade to junk-bond status that many believed was inevitable. There has also been a marked improvement in global perceptions of India.
- Under the NDA, India has become increasingly 'financialised'. Net financial savings have nearly doubled, from Rs 8 trillion to Rs 15 trillion, with people moving from low-yielding gold and land to higher-performing ones.
- Initiatives like direct benefit transfers (DBT), the growing use of Aadhar, and the Jan Dhan Yojana have improved financial inclusion, and will spur longer-term economic efficiency and growth.
- The Centre's commitment to spend Rs 15 trillion on infrastructure over 5 years, including on the Bharat Mala programme, will spur profound change.
- Landmark legislation like the Insolvency and Bankruptcy Code – which has already shown some early results with Rs 830 billion in settlements – will help clean up bank balance sheets, promote a healthy borrowing culture, boost the bond markets, and encourage constructive asset churn.
- Pushed by its anti-laundering initiatives, including demonetisation, and by the data-mining made possible by the GST, there are now 85-90 million tax payers, up from 60 million 3 years ago. For the first time, in 10 years, India's tax buoyancy has reached 1.22. Indirect tax collection in FY18 was Rs 9.4 trillion, up by 6% from Rs 8.9 trillion in FY17.
- Finally, federalism has strengthened under the NDA, with the states now receiving 42% of tax revenues, up from 32%.

…the misses

The banking system remains in deep trouble, and progress on crucial reforms is slow

- The NDA could have done more on land and labour reforms. Judicial reforms have also failed to take off, while defence modernisation – which suffered under the previous government – has been slow.
- The banking system remains in deep trouble. Although the first steps have been taken to fix the bad loans problem, much more remains to be done. The only permanent solution is to open PSU banks to public scrutiny, which requires privatisation.
- The Revenue Department also continues to function as it has for years, with trillions of Rupees stuck in litigation.
- Finally, religious nationalism, and the government's inability to control certain fringe elements reflect poorly on it.

In 2019, the BJP may come back with a reduced majority….

The outlook for the 2019 elections…

- Indications are that the BJP may win next year's General Elections with a reduced majority from 2014's. Its target of raising the vote share from 31% to 41% will be a tough ask.

	North & Central	West	South	East and others
BJP	145	50	21	58
BJP allies	6	18	0	12
Opposition	26	8	51	63
Others	2	0	71	5
Total seats	179	76	143	138

Source: Lok Sabha website, IMA analysis

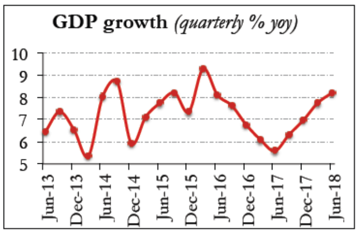
- What the BJP has in its favour is an iconic leader; top-notch, data-driven electoral management systems; grassroots coordination through the RSS; and a huge war-chest. In a close fight, it may get 220-230 seats.

…the alternative to a BJP-led government is a hotchpotch coalition that would have negative implications for the economy

- The BJP will likely see losses in Chhattisgarh, Madhya Pradesh, Rajasthan and Uttar Pradesh. Even accounting for gains in Karnataka and the North East, its overall count may fall, compelling it to work within an alliance system, and consult its partners more closely.
- The alternative to a BJP-led government is a hotchpotch coalition, under which bond yields would go up, and the Rupee down; liquidity would dry up, and the investment cycle would take a hit.
- The Congress can at best hope to take its count up to around 100, which could severely mar its chances of forming a coalition government.

….and the economy

The Rupee has fallen sharply, mostly on account of global factors…



- The economy is in good shape: GDP growth accelerated to 8.2% in Apr-Jun; the investment curve is reversing (GFCF grew 10% in Q1); credit growth improved from ~5% in 2017 to ~12% now, and capacity utilisation is hovering at 72-76%.

…but the fundamentals remain strong

- Despite strong macroeconomic fundamentals, the Rupee has fallen by 15% this year on account of a reversing carry-trade; contagion fears sparked off by Turkey; concerns about the current account; and worries about the fiscal deficit.
- The RBI's direct interventions to arrest the Rupee's fall – through USD 21 billion worth of spot purchases and USD 10 billion in forward sales – proved ineffective. It may now hike interest rates or launch an NRI bond deposit scheme. Separately, the government can hike tariffs on imports.

The contents of this paper are based on discussions of The India CMO Forum in New Delhi with Adit Jain, Editorial Director, IMA India, in October 2018. Please visit www.ima-india.com to view current papers and our full archive of content in the IMA members' Knowledge Centre. IMA Forum members have personalised website access codes.