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From the Desk of...

Dr. Yuwa Hedrick-Wong

Asia Economist & Business Strategist

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Dr Yuwa Hedrick-Wong, global economist and business strategist, provides an analysis of India's prospects for growth within a post-crisis global economy

India's economic growth slowed to just 5.3% by the fourth quarter of 2008, a big shock to many who have been accustomed to annual growth rates of 8-9%. Many thought that India could avoid the worst of the global financial crisis, being less dependent upon exports and with the domestic banking sector by and large untouched by the toxic assets that have resulted in the global credit turmoil. The India story has been one of domestic demand-driven growth and so arguably not likely to be affected by the collapse in consumer demand in the US and Europe. All these observations are all valid, yet the impact of the global crisis has indeed hit India. Alarm bells are now ringing and the old complacency has all but evaporated.

Calls have been made for the government to increase fiscal expenditure to boost economic growth, and indeed the government has tried to comply; first with the announcement of a US$5 billion package of new spending and subsequently with the introduction of tax reductions for both businesses and consumers. But the reality is that the government's fiscal power is limited. Delhi has unfortunately pursued a pro-cyclical fiscal policy in recent years; providing massive fuel and consumption subsidies and forgiving farmers' loans during 2006 to 2007, a time of rapid economic growth. Budget deficits have shot up; central and state level deficits combined make up over 11% of GDP, shackling the government's ability for more aggressive fiscal spending. In addition, this is an election year in India where politics will certainly dominate debates. The Reserve Bank of India (RBI) has been impressively vigilant in keeping inflation in check, especially when inflation increased in the 2007-2008 period, raising interest rates steadily to keep inflation under control, and then with inflation turning to deflation in 2008, cutting rates in response.

The glut of easy money did offer corporate India a new source of overseas borrowing to fund their domestic investments and international acquisitions. The global credit crisis meant the drying-up of this source of credit

Adding to the gloom has been the dimming outlook for India's brightest economic star, the IT and business outsourcing sector, accounting for over 25% of total exports and having enjoyed growth at around 30% a year for almost a decade. Yet, there is now rising concern that its growth will also be impacted by the global crisis.

In spite of this litany of gloomy news, the outlook for the Indian economy is positive. Indeed, India may be set to enjoy a new level of competitive advantage in the post-crisis global economy. In the past, an important, though often neglected, aspect of India's strong economic growth has been its broad base, encompassing not only the IT outsourcing sector but domestic manufacturing and the agricultural sectors as well. It was this broadly based growth that gave the economy as new dynamism, reviving business investment which in turn generated more employment and income in both urban and rural sectors. A virtuous cycle kicked-in, pushing growth rates higher each year since 2004-2005.

While the global credit melee did not directly hit India, the impact was both sudden and severe. Compounding this has been a dramatic reversal of portfolio investment flows. During 2007-2008 close to US$30 billion flowed into India's equity markets. Then the flow reversed. During the March to September 2008 alone, some US$9.2 billion flowed out of the equity market and out of the country. The plunge in the Mumbai Sensex then further squeezed the ability of Indian corporates to raise new capital. The net result has been an abrupt slowdown in business investment, leading to weaker income and employment creation and subsequently consumer spending. This reversal of capital flows has also led to a deepening of the current account deficit, from US$17 billion at the end of the fiscal 2007-2008 to almost US$24 billion during the March to September 2008 period. An immediate consequence is the weakening of the rupee exchange rate against the US dollar. Given the large overseas borrowing (in US dollars) by India's corporate sector in the recent past, the debt servicing burden has clearly increased.

In the real economy, manufacturing has been particularly hard hit. For example, the textile industry, the second largest employer in India after agriculture and contributing 9% of GDP in 2007, had seen brisk business investment with industry leaders aiming to compete with China in the global market. However, the global credit crisis simultaneously impacted this industry via the drop in exports to the US and Europe and through the drying up of credit. Many businesses in this sector are small operators who typically end up at the back of the queue for new bank loans.

The global credit crisis is impacting India in other indirect ways too, for example from lowered remittances by Indian workers overseas, especially from the Middle East, which has seen major construction sector slowdowns and many expatriate workers being sent home. The financial impact of such loss of remittances is expected to be serious.

Growth in recent years has been broad-based, encompassing sectors as diverse as IT and outsourcing, manufacturing and agriculture On the contrary, India is set to recover faster and stronger than many other markets; returning to higher growth in the order of 6-8% in real GDP as early as fiscal year 2009/2010

India's strong economic growth in recent years has been broad-based, encompassing sectors as diverse as IT and outsourcing, manufacturing and agriculture. The current difficulties, however, are not portents of a premature end to the Indian growth story. On the contrary, India is set to recover faster and stronger than many other markets, returning to higher growth in the order of 6-8% in real GDP as early as fiscal year 2009/2010. Furthermore, a new dynamic in the post-crisis global economy will enhance India's competitive advantage in the coming years. India could recover faster than many other markets because it has always been less capital intensive in its development. Even after the reforms in the early 1990s that largely dismantled the License Raj, Indian businesses continued to be very investment capital efficient.

Compared with the investment-output ratio in China from 1997 to 2007, China has consistently been a quarter to a third higher than India's. China's massive investment in infrastructure and urban facilities has been sustained for over a decade. Chinese companies, especially the State-owned enterprises (SOEs) with preferential access to bank loans have tended to invest heavily in capacity expansion and technology upgrades in recent years. Their growth has turned out to be extraordinarily capital-intensive, given China's per capita income level. In contrast Indian businesses have retained a relatively lighter touch when it comes to deploying investment capital. This in turn means that Indian businesses can operate more effectively under today's condition of credit squeeze and may consequently be able to move faster when recovery begins.

Another factor that could help India to recover faster is better quality investments. Because the RBI has been vigilant in controlling inflation, the setting of commercial interest rates in India is more market driven. Nimble and capital efficient businesses, combined with better quality investments, will enable the Indian economy to navigate more effectively out of the current economic slowdown.

Once the recovery begins, however, India's leading sector, IT outsourcing, will be in an enviable position to enjoy unprecedented competitive advantages. This is because the post-crisis global economy will be saddled with massive over-capacity in manufacturing while suffering from supply constraints in high-end services. In addition to overcapacity, manufacturing producers outside of China will also be in the unenviable position of having to compete with China, whose labour markets have been shown to be extremely flexible. Migrant workers are reported to have successfully found new jobs after the Lunar New Year, albeit at lower wages. The dreaded "China price" is set to return with a vengeance!

In spite of the increasingly shrill political rhetoric of protectionism, service outsourcing will become more of a necessity. Intense competition coupled with consumer demand for better value in whatever they buy, will place a hefty premium on business' ability to be more efficient

The high-end services that India's IT outsourcing sector are best positioned to supply. In spite of the increasingly shrill political rhetoric of protectionism, service outsourcing will become more of a necessity than a nice-to-have option for many US and European businesses, once they have survived the global crisis. Intense competition, as they fight for consumers' shrinking wallets, coupled with consumer demand for better value in whatever they buy, will place a hefty premium on business' ability to be more efficient and innovative. Their ability to outsource effectively will virtually be a lifeline to their continuing survival.

In this new post-crisis global environment, India's IT outsourcing sector will therefore shine brighter than ever before. If the Government can also follow through with the much-needed reforms and address infrastructure deficits, then economic growth in post-crisis India could easily outperform what has been achieved in the recent past.

This article was edited from a report published by MasterCard Worldwide International. The full report is available by downloading this link;

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About Dr Yuwa Hedrick-Wong and The Insight Bureau

Yuwa Hedrick-Wong is based in Singapore and is an economist with focusing primarily on Asia Pacific. He is an economic advisor to MasterCard Worldwide and to Southern Capital Group and is an adjunct professor at Funan University, China and at the University of British Columbia, Canada. His in depth analysis and his ability to communicate his insights have made him keenly sought after both in economic business summits as well as company strategic retreats, planning and strategy sessions or board room briefings. Dr Hedrick-Wong is part of The Insight Bureau's resource network that provides confidential, in-house briefings to senior executives, a service that helps to achieve a better understanding of the world in which businesses operate around the world and therefore ultimately to enable companies to make better business decisions. Mr Jain also speaks at, and chairs, business dialogue at major business conferences in India and around the world.

http://www.insightbureau.com/HedrickWong.html

www.insightbureau.com +65-6300-2495 engage_us@insightbureau.com