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US Fed may complete tapering by late summer: Kunal Kumar Kundu

Q&A with vice-president and India economist, Societe Generale

The year 2014 will be a busy one for policy makers across the globe as they fine-tune their strategy in the backdrop of the US Federal Reserve's (US Fed's) tapering of the bond buying programme. ***Kunal Kumar Kundu***, vice-president and India economist, Société Générale tells *Puneet Wadhwa* in an interview that though the US Fed is likely to complete tapering by late summer, the first rate hike is seen only in early 2016. As regards India, he expects the annual GDP (gross domestic product) growth to be around 4.6% with a minor pick-up next year, especially during the second half, on the back of some sensible policy making. Edited excerpts:

It has been a topsy-turvy 2013 for the global economy and the markets. What is your assessment of how things have shaped up over the past six months and what is the road ahead?
The leverage cycle is at the heart of global developments. In much of the pre-crisis period the advanced economies were in private sector deleveraging mode whilst emerging economies in aggregate increased leverage. This dynamic started to shift already in 2013 and looking ahead, understanding where economies are in the leverage cycle will hold the key to success in 2014.

In the US, UK and Japan, spring is just around the corner. The euro area continues to battle the headwinds of deflationary pressures and financial fragmentation. 2014 will be a critical year for European Banking Union. Turning to the major emerging economies of China, Brazil and India, autumn is creeping in as these economies embark on a process of deleveraging.

What is your assessment from the economic data coming from the US?
On the criteria for sustainable recovery, the US now checks most boxes; (1) private sector deleveraging is well advanced, (2)credit channels have been repair, (3) there is now a deficit of housing stock relative to demographic trends and inventories have been significantly reduced, (4) policy uncertainty has been significantly reduced with the budget agreement, (5) there is ample spare

capacity to accommodate recovery, (6) having exerted an estimated drag of just over 1% of GDP in 2013, the fiscal drag will ease and (7) the US benefits from a flexible economic structure.

So the taper, then, is par for the course?

Over the coming years, we see US GDP growth of around 3%. Against this backdrop, we expect the Fed to complete tapering by late summer, but the first rate hike is seen only in early 2016. In our opinion, the Fed will be able to anchor the shorter yield maturities, however, long bond yields are set to increase leading to significant curve steepening. We see the 10 year at 3.75% by end-2014; a level that the US economy can easily absorb given the strength of the recovery we forecast.

How are you evaluating the economy progress in the Euro-zone, Japan and China? Could there be any negative surprises from these economies over the next few quarters?

Our building blocks for sustainable recovery offer a guide across the globe. Common to the euro area, Japan and China is the need to pursue structural reform, but here any similarities end.

In the euro area, the economy is still facing headwinds from deleveraging and we expect to see slow repair only of the financial fragmentation in the periphery. Our forecast is below consensus, looking for real GDP growth of just 0.6%.

In Japan, the policy stance is highly supportive and will remain so even as the consumption tax is hiked. Medium-term, the key lies with ‘Abeconomics’ ability to encourage corporates to invest and hire; this in turn requires structural reform. We are encouraged by the first steps, but there is still a long road ahead.

In China, the dynamic is governed by the speed of deleveraging and reform. Our long held scenario of a bumpy landing remains on track and we look for GDP growth of 6.9% next year.

The risk-off trade in the global equity markets in 2013 was partly due to what happened to the currencies, especially in Asia? Do you expect more pressure on Asian currencies over the next few months? What levels can one expect on the rupee in the near-to-medium term?

We believe that the start of tapering – and particularly a faster tapering than markets are currently discounting – will lead to a steeper US yield curve, with yields rising in the three – five year area in particular. This should drive the USD higher against Asian currencies generally. In the near-term, we see further pressure on the rupee, with a move to 66 possible by March. After the elections, however, we believe the Indian currency can recover towards 63 by the summer, and 61 by year end.

Where does it all leave the Reserve Bank of India in terms of its monetary policy? Do you believe that the case for buying into emerging markets equities, especially India is getting weaker by the day?

Near-term, the RBI is likely to adopt an additional rate hike in weighing the balance on inflation risk. Structural reform after the elections holds the key for the markets.

Two of the world's largest economies will face polls in 2014 – the US that goes into a mid-term poll and India that may see a change of guard at the Centre. Do you expect more populist measures being announced that will put burden on the already strained macros of these countries?
In our baseline scenario and given the recent budget compromise, we consider it unlikely that the US mid-term election will bring a major shift in policy.

In India, the key challenge is for the new government is to drive a program of structural reform, and for that the new government will requires a strong parliamentary majority. From the economy point of view, we believe that the economy has bottomed out.

While during the current financial year, we expect the annual GDP growth to be around 4.6%, we expect a minor pick-up next year, especially during the second half, when we will see some sensible policy making coming to fruition and investment will pick up steam aided by improvement in business sentiment.

In your opinion, do you think that Indian policy makers have failed to deliver as regards economic reform policies? What are the key numbers / assessment of Societe Generale as regards how the current account deficit (CAD), inflation and other variables will pan out going ahead?
Back in 1991, media described India as a caged tiger; once let out the roaring performance of the economy was impressive. Subsequent poor policy choices, however, have put that bars back on the cage.

We identify seven bars below that need to be removed to unlock the growth potential: Boosting power supply and rationalising power tariffs; Optimising use of natural resources; Streamlining administrative procedures; Leveraging favourable demographics; fiscal consolidation; Building a single flexible market and Reduce policy uncertainty to boost investment.

While some recent measures to tackle the bulging CAD has been fruitful and will ensure that CAD will be lower than earlier anticipated, further steps are required. In particular, India needs to improve efficiency in investment and can ill-afford multiple investment projects being stuck at various levels. Also, India needs to address issues regarding falling savings, especially drastically falling financial savings of the households and high dis-savings of the government (caused by persistently high fiscal deficit). As economic growth picks up slowly, we expect the impact to show on trade deficit as well.

Overall, we expect the CAD to be around 3.5% of the GDP going forward. As for inflation, while some base effect will see inflation easing going forward (after multiple years of high inflation), we expect India's headline WPI inflation to hover around 5.5% going forward, given the structural impediments.

How bumpy has the road to recovery become for India Inc now? By when do you think a recovery will start to get meaningfully reflected in the

financial performance and the stock prices?
Structural reform holds the key.