http://www.rediff.com/money/2008/sep/17bcrisis25.htm

Indian economy decoupled from US? Bah!

Kunal Kumar Kundu

September 17, 2008

As early as even last year, economists and analysts argued that the engine of global growth has shifted. The world has, according to them, decoupled from the American economy.

China, India (which warmed the cockles of our heart) and other emerging market economies were starting to provide a consumer base for the world that can stave off any problems emanating from the economic slowdown in the United States.

Added to these were Europe's new and growing markets and things looked pretty hunky dory.

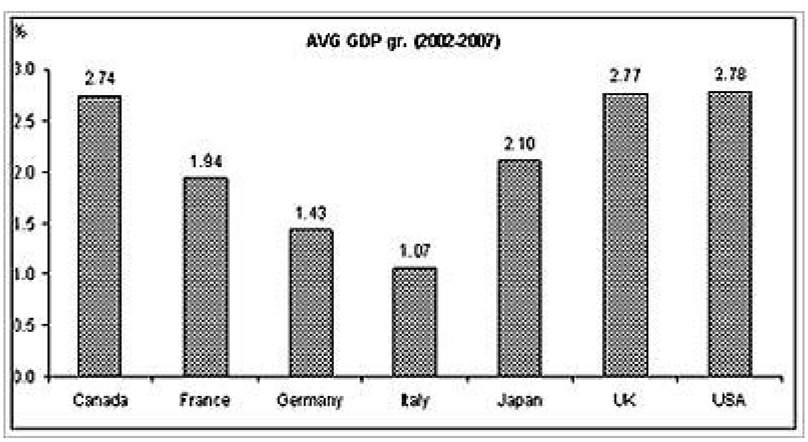
Not any more.

With the Indian economy exhibiting distinctive signs of slowdown (a real growth rate of even 7.5 per cent for the current financial year seems well nigh impossible), the Chinese growth slated to slip to a single-digit level -- possibly for the first time in six years -- and the European majors flirting with their old nemesis (exhibiting occasional spurt of good growth but only flattering to deceive) of anemic growth, the much avowed decoupling theory is at mortal risk of failing to run its course.

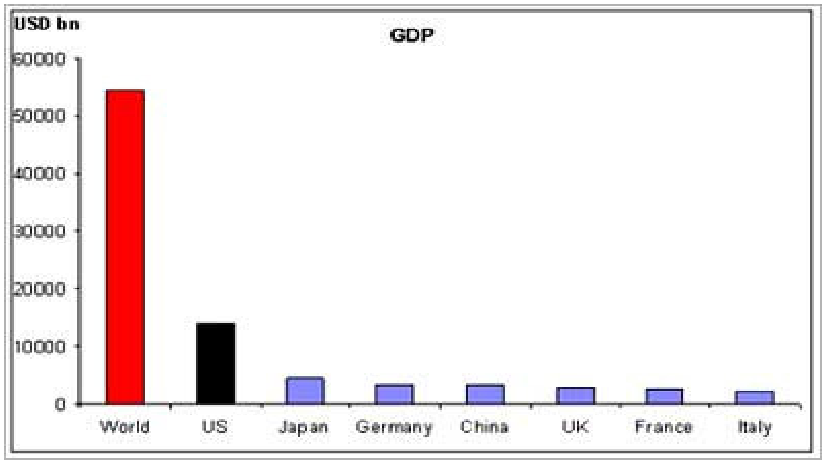
But, first things first.

How credible was the theory in the first place? A look at the data reveals that the proponents of the theory might be missed something obvious.

America, the largest economy in the world, has grown faster than the G-7 economies in the last five years and accounts for about 25% of the global output.



Note: CAGR calculated from the Real GDP (in USD terms) data (SA, @ 2000 prices and exchange rates)
Source: National sources and my calculation



Source: World Bank

Also, with the countries being highly integrated both through the real economy as well as the financial economy (maybe more so financially), the necessary pre-condition to decoupling could have been the following:

- Milder US slowdown;
- Relatively stronger Europe; and
- Slower transmission of global problems

As things stand as of now, none of these conditions are satisfied.

The US economic slowdown is likely to be anything but mild, especially in the light of sub-prime crisis. With the pain of the sub-prime crisis seemingly only half way through (a write-off so far to the tune of about $500 billion as compared to an estimate of $1,000 billion), its spillover impact on the real economy seems to have just begun and is no where near to have been played out.

About 100 US banks might fold up

First, the likely impact of the sub-prime crisis. According to Institutional Risk Analytics, about 100 banks are likely to fail between now and July of 2009. Most of them will be small, but there will be a few large banks.

The total assets of those banks are estimated to be $850 billion. Those are the assets the FDIC (Federal Deposit Insurance Corporation) is going to have to cover when they take over the banks.

Take Washington Mutual as an example. Their debt now trades at 20 per cent, which is worse than junk. There is no way they could issue preferred stock to recapitalize their business. And they are going to need more capital, as they have write downs in their future due to the slowing of the economy.

Any common issue would have to seriously dilute existing shareholders almost to the point of nothing.

The FDIC has about $50 billion. These reserves have been built up over the years from deposit insurance paid by banks that are part of the programme. They are going to need an estimated $20 billion just to cover the failure of Indy Mac.

The FDIC will have to cover only a small percentage of the $850 billion, as some of those assets will surely be good. But if they have to cover 10 per cent, then the FDIC would need another $50 billion. Not a very encouraging scenario.

And then there’s Freddie Mac and Fannie May. Companies that were leveraged more than 60 times the owners fund and covered half of the $12-trillion mortgage market.

Their effective nationalization, while addressing the short-term concern (especially the likely catastrophic effect of these institutions going bust), however, will not be a solution to the basic problem and will also come at a great economic cost. Insurer American International Group too has received a $85-billion bailout from US Fed. The Fed will extend a 24-month bridge loan of $85 billion to the insurer, in return for an unprecedented acquisition of a 79.9 per cent stake in the firm by the central bank.

How many more write downs and credit losses are expected, both in the US and abroad?

The Federal Reserve Board published a paper recently with the title: Foreign Exposure to Asset-Backed Securities of U.S. Origin (by Beltran/Pounder/Thomas). According to Dr Nouriel Roubini, the Federal Reserve's Flow of Funds data reveals that foreigners hold about 39 per cent of outstanding ABS (asset-backed securities) backed by US assets. Therefore, foreigners will bear 39 per cent of any mark-to-market markdowns associated with those securities.

US economy faltering

In this backdrop, how is the US economy going to fare?

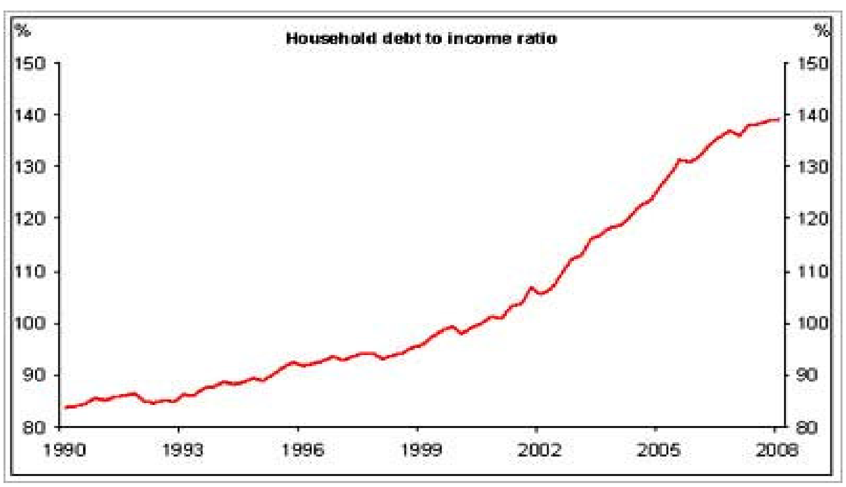
The perennially consumption-driven US economy is facing a strong headwind of faltering demand and even more likely anemic demand going forward. The traditionally low-saving US consumers went on a consumption binge as positive wealth effect kicked-in following the abnormal rise in home prices.

So much so, that their savings rate were almost in the negative territory. Debt ratios for the household sector are high and rising: the debt to disposable income ratio for average US households has increased from 100 per cent in the year 2000 to almost 140 per cent today.

Time, however, is now for a reversal in this trend and the process has already started what with the positive effects on consumption of the tax rebates already fading away. That rebate boost was supposed to stimulate consumption until August of this year.

However, after a recovery of retail sales, real personal spending and consumption in April and May, real retail sales and real personal consumption spending have fallen already in June and July. So consumers stopped consuming in spite of the tax rebates instead of spending such rebates (so far only 30 per cent of them have been spent). And, this is not surprising.

Employment generation is on a clear wane what with August payrolls down 84k -- the eighth month in a row -- and there were 58k in downward revisions to the previous two months. Private payrolls were even weaker, down 101k and down on average 92k over the past 3 months. The unemployment rate at 6.1% is the lowest since October 2003.



Source: Federal Reserve Board (FRB)

Rising unemployment and inflation have been forcing the consumer confidence to much lower levels. The University of Michigan Consumer Sentiment Index has been falling consistently since the middle of last year. The August index (though recovered marginally) recorded 63, a level that was not seen over decades. Home prices have plummeted and more is likely to come.

Home equity withdrawal (HEW) that peaked at $700 billion in 2005 is now down to about $24 billion (practically zero). And financial institutions are sharply cutting back on outstanding home equity loan obligations.

Thus, borrowing against housing wealth is now collapsing. Lower availability of liquidity and rising energy prices are displacing normal consumption.

The economy is in such a shape currently that the Fed, despite the rising inflation, has shifted its focus to growth stability (rather than price stability) and is trying its best not to raise interest rates so that the economy does not go on a tailspin.

They are hoping that the slowdown in the economy will take care of inflationary concerns going forward. In fact, economists are expecting near zero GDP growth rate in Q3 and slight improvement in the next quarter. If things turn out to be even worse, we are in for contraction as well.

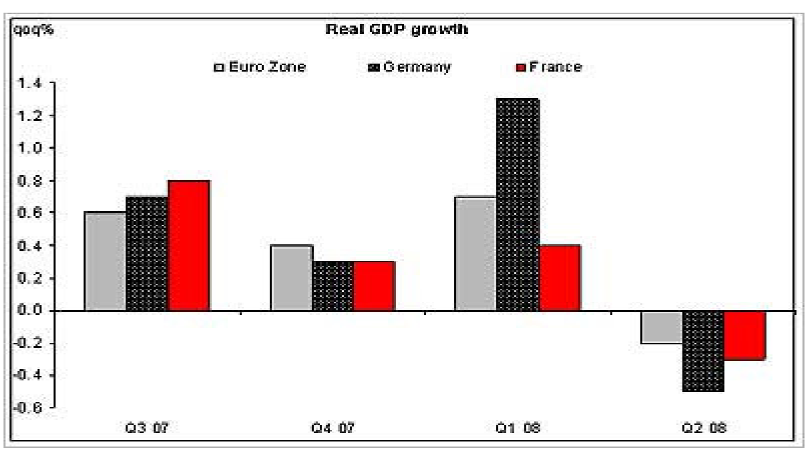
A long dark period awaits US

While technically, the US has been able to avoid recession so far, the economy is in for a long bout of anemic growth. In fact, former Fed chairman Paul Volker predicts, "Growth in the economy in this decade will be the slowest of any decade since the Great Depression." These are ominous words from the man who sailed the US through one of the country's worst economic times in the 1980s, when inflation touched 15 per cent forcing him to raise interest rates to as high as 20 per cent.

Clearly, not much good news is in store for the economy. Even if the US itself creeps along and avoids sharp economic slowdown, the rest of the world is beginning to feel the discomfort of slow growth and inflationary pressures.

Unfortunately, Europe is unlikely to come to the rescue. We are now seeing the major European economies go into simultaneous recessions while inflation continues to remain a concern. Indeed, the GDP growth is easing in a number of European economies as highlighted by national accounts figures announced recently.

The flash second quarter GDP data for the euro zone noted a 0.2 per cent q-o-q (quarter on quarter) contraction, following a 0.7 per cent expansion in the first three months of the year. This was primarily the result of a 0.5 per cent downturn in the region's largest economy, Germany, and a 0.3 per cent contraction in second biggest, France. This is shown in the table below:



GDP growth (%age change quarter ago)
Source: National sources

And it's not just Germany and France. Preliminary data suggest the Italian economy also contracted 0.3 per cent during the quarter, the Netherlands reported no growth, and Spain grew at its slowest pace since the 1993 recession, with a minimal 0.1 per cent expansion. The Spanish government fears recession in the second half of the year and called for emergency discussions on Thursday to deal with the situation.

Latvia and Estonia also contracted in the second quarter, with Estonia reporting a technical recession after also shrinking in the first three months of the year. While no flash estimate is available for Ireland, the economy is on the brink of recession.

A look at composition of Euro Zone Q2 GDP figure shows weaker private consumption (-0.2 per cent) and investment (-1.2 per cent). In fact, total investment contracted the most since 2002.

Seemingly we are entering a weaker capex cycle that can slowdown the economies going forward. This is more likely to happen because the European non-financial companies are currently highly leveraged.

Europe is not far behind

While the world is busy criticizing the US for its subprime misadventure, the European Central Bank and the Federal Reserve have recently found that Europe's non-financial companies are currently burdened with Euro 5.3 trillion or $7.5 trillion of debt, equal to about 57 per cent of the Euro-zone economy.

This figure is up 48 per cent since 2001 and comparable with 46 per cent in the US. A decade of investing more than they have earned has loaded companies in the 15-nation Euro area with debt, leaving them thinner cushions of cash to fall back on than their US and Japanese counterparts.

Companies in this region are now under pressure to curtail hiring and capital spending to meet rising interest payments, as lower growth has already impacted their profitability.

Even as the US and Japanese companies were already taking measures in terms of getting rid of idle factories and excess workers and repaying their debt since the early part of this decade, European companies, on the other hand, took advantage of easy credit to increase borrowing, allowing them to make acquisitions and bolster investment for 20 straight quarters.

Companies across sectors in Europe have reportedly accelerated their borrowing in the period 2005-2007, adding Euro 1.8 trillion to their debt.

What is also important to note is that the euro zone retail sales report for July were weaker than originally anticipated, falling 0.4 per cent m-o-m with a q-o-q rate of -0.8 per cent.

Car registrations are down almost 6 per cent q-o-q, the largest decline since 2001. Moreover, consumer confidence and households perceptions of inflation, has deteriorated further in Q3 relative to Q2.

Even the United Kingdom is probably already in recession and the Bank of England is forecasting a flat (0 per cent growth) GDP next year.

Clearly Europe is facing strong headwinds going forward and it is very unlikely that it can act as global growth engine in the current situation where US is also slowing down.

And what about India?

This brings us to India, China and other Asian economies. Are these economies truly decoupled from US or for that matter rest of the world? Not really.

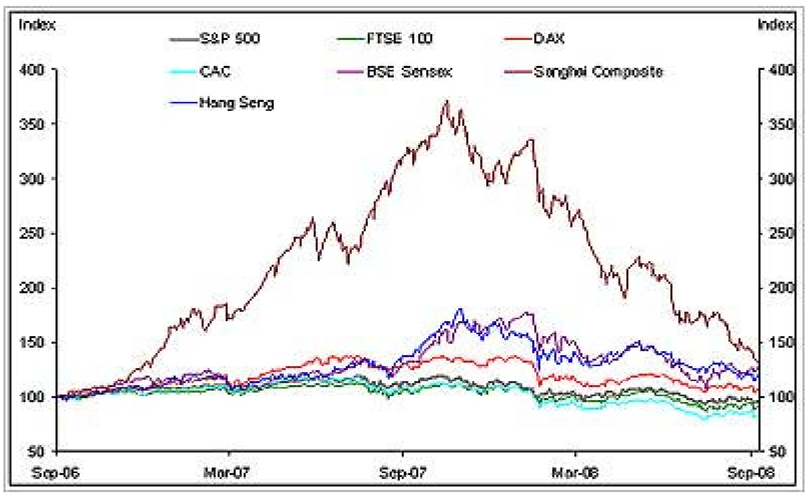
Most of these economies have become strong because of liberalization that allowed the flourishing of the conspicuously consuming middle class. These economies are actually more coupled with the rest of the world than they earlier were and this made them stronger.

And now, following the sub-prime crisis, credit crunch did not remain contained within US leading to a global risk aversion.

For the Indian and Chinese economies for example, domestic demand has been an important growth factor, more so for India than China. The common driving factor for domestic demand in both the countries, however, has been benign interest rate and inflation scenario and of course huge flow of global liquidity on the back of ultra easy monetary policy (especially by Fed).

With inflation rising and liquidity easing off globally, domestic demand is under pressure. In case of China, the problem is compounded because of their dependence on exports. With their major trading partners experiencing slowdown, Chinese exports are on the wane. Large stock build up due to falling exports have resulted in their inflation easing off recently.

Even their stock markets are showing clear indications of coupling.



Source: Yahoo Finance

As can be seen from the above chart, when the sub-prime crisis first emerged, the stock markets in Asian economies namely China, India, Hong Kong etc continued to ignore the likely implication of the systemic problem, fully believing in the decoupling theory and hoping that the problem will be contained within the US only.

However, as the crisis imploded and got transmitted across the globe, the markets reacted viciously. This is because, in a highly globalized world, the transmission mechanism gains pace and as the markets realized the likely implication on the domestic economies, they tanked.

Even the central bankers everywhere are faced with a similar and serious dilemma. Do they raise rates to fight inflation, cut rates to stimulate their economies, or sit tight and hope that prices moderate as the world economy slows?

In short, the world has not decoupled, but is more closely intertwined because of the global financial community. Housing problems and excesses in California (and the rest of the US, the United Kingdom, Spain, etc.) affect banks in Europe and Asia and the US simultaneously.

One cannot have a worldwide recovery until the financial crisis in the major lending institutions is dealt with. A functioning banking system is the lubricant for a world economy, and the banking industry is cutting back on loans and tightening the standards by which they do make loans.

This is not only hurting domestic demand, but also impacting otherwise sound companies what with the pains from the crisis yet to be fully realized. This means that the banks and the financial institutions, over time, are going to have to increase their loan loss provisions, hitting both earnings and capital.

And that means they will have to raise more investment capital and equity at a time when their stock prices are low. A vicious cycle. Banks have less capital, so they are able to lend less to the very businesses that need the money; and without the said money the businesses will be less capable of paying their current loans, which means that banks have less capital.

That will prolong the recession, which will hurt consumers and corporate profits, which in turn puts more pressure on banks. Ultimately it means that banks are going to have to raise a lot more capital than anyone who is buying financial stocks today imagines.

And it is largely going to be expensive capital. Clearly the world has caught a cold as US sneezes. And, make no mistake, the sneeze can become severe cough going forward.

The author is COH, Global Market Research, at Infosys BPO, Bangalore. The views expressed are his own. He can be contacted at kunalkumar_kundu@infosys.com