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From the Desk of...

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Has India's curve tipped-over? Adit Jain, India economist and business commentator assesses India's economic fortunes

In an earlier report, IMA's Operating Environment Assessment Report (Jan08), I contended that the growth curve was likely to tip-over in Q1 2008. The growth momentum contained in the economy, I argued, had created asset price bubbles – more evidently so in the stock and real-estate markets. Such valuations were simply unsustainable. The Sensex had increased four-fold over a three year period and by 50% in the previous 12 months; housing loans had grown by 54% in a year and commercial ones by 100%; real estate prices had doubled over two years in most metropolitan cities. Salaries were growing at about 20% compared to an average of 10-12% over the previous four years. The current account imbalance had touched 3% of GDP from a surplus of 1.5% in 2003 – a classic sign of excessive demand, driven by domestic consumption. All of these were adequate warnings of trouble ahead. But oddly, very few seemed to notice.

My hypothesis is that the markets drive the economy, not the other way around

Things have changed quite suddenly. The Sensex (the Bombay Stock Exchange's sensitive share index) dropped by 30% in a few weeks and the rupee by 4% against the US dollar, after having appreciated by thrice that amount in a year (it fell much more against other currencies). Credit growth too has fallen by a third and so have the order bookings by capital goods companies. In November and December 2007 the Index of Industrial Production (IIP) rose barely 5% and 7.5% compared with 15.9% and 13.4% in the same months of 2006. This is evidence enough to indicate that the growth curve may have finally tipped over.

TN Ninan, Editor, *Business Standard,* suggested in a discussion with IMA Forum members that India's economy will grow by 7.5%-8.0% in the fiscal year 2008-09. We think he may possibly have been cautious in expressing the full extent of bad news. Economies move in cycles – from crests to troughs. Global developments, especially in the context of events in the United States, would suggest the onset of a global slowdown in 2008 extending well into 2009. What started out as a sub-prime loans problem was compounded by the intriguing world of unlisted financial derivatives into a liquidity crisis, and now into a full-fledged banking one. Banks have been uncomfortable to lend to each other as they remain unsure of the quality of the collaterals being offered. Some of the world's leading financial institutions have provisioned large write-offs and many have had to be bailed out by sovereign funds from near bankruptcy. Valuations of assets have tumbled and consumer sentiment, which essentially comprised the main driver to the US economy, is now bleak. The inter-linkages in the global economic architecture are several and often both difficult to understand or fully determine. The 'decoupling' theorists who claimed that Asia (specifically India and China) would sustain their growth without the United States are mistaken. Capital flows are as much responsible for driving growth as local consumption and other factors. All of these will be affected deeply in the months ahead.

I have observed and commented on the subject of India's economy for many years. This leads me to subscribe to the hypothesis that it's the markets that drive the economy, not the other way around. A buoyant market generates a positive wealth-effect phenomenon, creates a feel-good factor which in turn encourages urban consumers to spend. Industry responds by creating new capacities and

consequently there is growth, motivated both by investment and consumption. Banks are willing to lend money on the back of the growth optimism. But when the cycle changes, the positive wealth-effect phenomena gives way to a negative one and consumption falls quite suddenly. This is precisely what is beginning to happen. Banks pull back, revisit their asset portfolio and become cautious in consumer lending as defaults take place on home and personal loans. It's a dangerous path that contains the risk of going out of control. Governments intervene by creating more disposable income amongst consumers (tax rebates and fiscal sops announced in the finance budget this year essentially recognize an impending slowdown in consumption and thus the economy) and central banks lower interest rates at the risk of price instability. However, these initiatives usually have limited influence. Years of imprudence need to be rectified and the economy's response is explained by the cyclical correction.

Businesses should recognise these changes, moderate their ambitious growth plans and move into a phase of consolidation

The automotive sector has been under pressure for several months. Sales growth for cars has declined to 12% (about half of last year) and for two-wheelers to -5% (14% last year) and the industry is now reconciled to troubled-times lingering on a bit longer. Consumer durables too have been under pressure, as have, more recently, consumer electronics. The industrial economy was driven largely on the back of infrastructure expenditure and the petroleum sector. Order books for EPC contractors and capital goods producers were full six months ago. However, the growth in bookings has tempered more recently and the first signs of a slackening in buoyancy are becoming evident. With consumption moderating, investment will surely follow, albeit with a slight lag.

A correction in asset prices has taken place in the equity markets and the real estate market will perhaps happen next. Home prices have fallen, by one estimate, by as much as 10% in the metropolitan cities over the past six months. Despite this slight correction current prices are not indicative of realistic market conditions. Developers, who have made large profits over the preceding few years, retain enormous holding power and are artificially protecting the price line. Clearly, the demand for new bookings has fallen with speculators out of the market and if this fails to recover then developers will have no choice but to drop prices. Some estimates suggest a further fall of about 10-15% over the coming six to eight months.

The impending slowdown does come with a silver-lining. Costs that have been escalating over the years will be brought under check. Hotel rates will correct as would unsustainable salary hikes. The important thing for businesses is to recognise these changes, moderate their ambitious growth plans and move into a phase of consolidation. Possibly, the slowdown in India's growth will be both slight and short-lived, but it is hard to say for sure.

About Adit Jain and The Insight Bureau

Adit Jain is based in New Delhi and is a highly respected commentator on the Indian economy and political development and provides strategic advice to businesses investing and operating in India. He is the CEO of IMA India, which provides research and advisory services and which brings together the chief executives of over 200 MNC companies in New Delhi, Mumbai and Bangalore regularly throughout the year. Mr.Jain 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/insight_speakers/profile/Jain.pdf

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