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POLICY BRIEF

Global Headwinds Affecting India

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Introduction

Volatility in global financial markets has increased significantly in recent months. This reflects several concerns including the likley delay in US Fed raising rates; flat consumenr spending and continued price weakness in Japan despite BOJ introducing negative interest rates; slowing growth in emerging markets specially China and Brazil; falling commodity prices, fresh fears about sustainability of Greece debt; and recession in Russia and Brazil.* The seminar discussed the impact of these global headwinds on India, with a particular focus on the slowing down in China.

Summary of the Panel Discussion

IMF has been continuously revising down its growth forecast for the last few years and its recent forecast is as much as 170 bps lower than its 5-yearly forecast made in 2011 for 2016. Global growth forecasts of from other multilateral agencies range between 2.9% to 3.1%. This is accompanied with a sharp slow down in global trade in nominal terms.The global economy is in some disarray.

Stress in banking sector has increasing globally. Low oil price is expected to make shell gas production in US unviable resulting in increase in bad loans in US banking sector. Some analysts estimate that NPA in Chinese banking sector is as large as 30-40% of total commercial bank assets. There is significant pessimism as far as global growth is concerned. World economy is looking for a new equilibrium,with existing drivers of growth showing marked weakness.

China has slowed down from its peak growth rate of 14.2 % to around 6.7% expected this year. The stock market turmoil in China wiped away half of Asian index by end 2015. According to Institute of International Finances (IIF), capital reversal from emerging market economy last year was huge at $800 billion compared to mere $12 billion capital withdrawal witnessed during the Asian crisis in 1997 as markets were much less open and weakly integrated with global markets.

Out of this $800 billion outflows, $670 billion were withdrawn out of China itself. This has raised questions about its adoption of capital account convertibility for the inclusion of Renminbi in the SDR basket. China has already lost $512.7 billion in forex reserves during 2015. However, with $3 trillion in reserves, China has sufficient systemic resilience for the present. Chinese stock market has recovered since end-January 2016 and macro parameters have also marginally improved. This could imply that Chinese growth has possibly bottomed out. Given that Chinese currency has been overvalued by 25- 30% in last couple of years, China may devalue its currency to shore up its exports.

China's manufacturing is slowing down, but according to ADBI, in an as yet unpublished working paper, argues that China is doing a lot to improve its productivity. China still has large pool of low cost labour available in its inland provinces (less than half of those of coastal region) and there has been some dramatic flow of inward investments in these areas. Land and labour are still competitive in China. Chinese provinces have stepped up capital expenditure.

India needs to implement significant structural reforms in order to capture the manufacturing space being vacated by China. Quality of spending of India's five big states indicate that infrastructure spending has been increasing only hesitantly while revenue expenditure has been increasing at a much faster rate. Moreover, Indian average land price is estimated at 2.9 lakh per acre for agricultural land which is as expensive as extremely productive agriculture land of Illinois. The adverse impact of high land prices on manufacturing sector also needs to be looked at. Real interest rate that Indian corporates face is considerably high and close to double digit. Facilities to set up an industry, trade facilitations, logistics remain cumbersome. The resulting high cost of land, capital, labour will make the shift of global value chain from East Asia to South Asia that much harder.

It is impractical to expect India to take the place of China as a major contributor to growth or consumer for industrial commodities in the short term. Indian economy being a fifth of the Chinese economy and also less material intensive can hardly substitute for China as a global growth driver.

The channels of impact of China slowdown on global economy will be different from those seen during taper tantrum of 2012-13. During taper tantrum, deteriorating financial conditions had increased global risk. However, rebalancing in Chinese economy will impact the real economy directly affecting trade flows and supply chain movements that will have indirect impact on financial conditions.

Assuming a soft lending of China, it is estimated that the impact on India's GDP will be relatively small and largly manageable because of low trade integration with China. RBI has enough tools to manage a slowdown. Moreover, lower global coommodity prices, have a positive and significant impact on India's economic performance. One of India's strength lies in its ability to mobilise foreign exchange from its diaspora to stabilise the economy. It is appreciable and not every emerging market economies can boost of a pool of non-residents that can be mobilised.

China slowdown will impact India through bilateral trade channels. Indian imports from china are 7 times higher than its exports to china. India exports raw material such as iron ore and imports steel, machinery from China. So, there will not be any direct impact of China slowdown on India exports but imports from china into India could cause severe damage. Cheap steel imports from china have already flooded the market in last couple of months and that has hit the sector hard. There might be some indirect impact also as other trade partners of India slows down due to China's low growth and their export demand from India reduces in proportion. One solution is that India could export services to China, e.g., legal services where India has comparative strength.

The important question today is whether domestic demand will compensate for the loss of external demand, which continues to be weak to sustain India's high growth tajectory. India was one of the fragile economies two and half years back due to high current account deficit (CAD), double digit inflation and high fiscal deficit. India has made lot of headway on lowering CAD and bringing inflation down towards RBI's glide-path. Headline inflation after stripping off inflation of pulses is around 4.7%, even lower than RBI's target of 5% in January 2017. Distribution of Core inflation has no outlier in past 12 months and has settled in band of 4.5- 4.6 %. RBI has successfully prevented inflationary expectations from getting generalised which has been helped, to a large extent, by lower global oil and commodity prices.

Conclusion

- There exists further downside risk to global growth. World economy is looking for a new equilibrium. Hence there is a need to look more toward domestic demand rather than relying on global growth to try and further accelerate India's GDP growth.
- Indian economy being a fifth of the Chinese economy can hardly substitute for China as a global growth driver.
- Assuming a soft lending in China, it is estimated that the impact on India's GDP will be small and manageable because of low trade integration with China.
- India needs to implement significant structural reforms in order to capture the space in global manufacturing output being vacated by China. Measures to integrate the Indian economy into the regional production chains should be taken expeditiously.
- India's trading partners have much lower inflation and that has caused the REER to appreciate steadily for the last 18 months, thereby making India's exports uncompetitive. This needs to be changed and strict neutrality and even a relative weakness in exchange rate is necessary to give Indian exports a fillip in coming years. This should be supplemented with effective industrial policy and other structural reforms.
- China has excess capital along with the expertise for developing large infrastructure projects both at home and abroad. On the other hand, India is infrastructure deficient. China should be seen as huge opportunity for attracting much needed investments in India.

[*] These were discussed in the fourth seminar of the BSE-CPR macroeconomic seminar series held in CPR on 24th February, 2016. The topic of the seminar was 'Global Headwinds Affecting India'. A panel of Dr. Thomas Richardson, IMF, Dr Johanna Boestel. ADB and Dr Soumya Kanti Ghosh, SBI moderated by Dr Rajiv Kumar led the discussions.