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THE FIVE GO TO DELHI AMIDST OPTIMISM IN A FRAGILE WORLD

- Raj Nair

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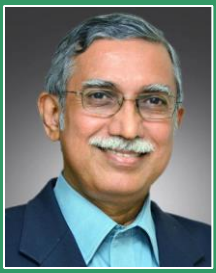
ABOUT THE AUTHOR



As a strategy consultant, Raj has helped companies across diverse industries in India, USA, Europe, and the Middle East to develop strategies, align strategy to vision, grow in competitive markets, restructure to make companies more customer focused etc.

In his current role, Raj serves as – Chairman: Avalon Consulting, Director: OC&C Strategy Consultants India, Chairman: Ugam Solutions Pvt Ltd., Chairman, Avalon Global Research and Chairman: Germin8 Solutions Pvt Ltd.

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THE FIVE GO TO DELHI AMIDST OPTIMISM IN A FRAGILE WORLD

By **Mr. Raj Nair**, Chairman of Avalon Consulting

Modi, Kejriwal, Jayalalitha, Mulayam and Mayavati want to be crowned in Delhi. Each of them has started preparatory work for their journey to Delhi. Each of them could take India in a different direction. India's performance in 2014 depends on who wins. There is a different group of 5 wise people whose conversations have for the past 6 years, formed the basis of my annual predictions which I put down as my original thoughts for the year ahead. They found out last year that I have been cunningly passing their uncanny ability to accurately look into the future as my very own predictions, obviously hogging credit that did not belong to me. Not even my closest colleagues at work knew about this plagiarism. On the last day of every year, I used to take time off from work to quietly join them at their favourite table in an Irani restaurant and I secretly recorded their intense discussions on matters which I understood very little of. The routine that I followed every year was to carry their secretly recorded conversation to my two Anglo Indian friends, Peter and Harry. Peter Wren used to transcribe the conversation and Harry Martin then redrafted the transcript in good English for me to send out the article the next day. For the rest of the year, I would glow with modesty when one by one the predictions came true. The Group of 5 fixed me this year by going off to Delhi ostensibly to see Kejriwal in action (but to spite me, I suspect) while Harry went off to Sydney to spend Christmas with his long lost cousin. Peter joined him since he had nowhere else to go. Not to be outdone by these plotters, I am putting down an article this year too for which I will still borrow the thoughts of the same five wise people which I remember from snatches of conversations during the 30 or so chats over the year but this time, I will give them due credit. Without Peter and Harry to help me, this piece is poorly structured and will be found wanting in good grammar.

Back in August, the Five were discussing how gloomy things were in India. Nitinya Purohit (political analyst) and Aarti Shastri (economist) convinced the other three that the Indian economy was actually going to start turning around and that the sentiment would turn positive despite India's GDP being likely 5% in FY 13-14 (against the Government's reduced estimate of 5.3%). I promptly used that to deliver 6 speeches and followed it up with an article (titled **India: Looking Beyond the Obvious**[1]) in September.

After two cups of tea on a mid-December evening, the Five got down to the subject of whether the global economy will slide back further, given that the IMF had recently downgraded their optimism for a recovery in 2014 a bit. "Will developing nations, especially India, be better off than in 2013?" wondered Udaya Mitra, the entrepreneur. Immediately, Anu Sandani, the market researcher, said that it should be discussed in the context of whether pruning of the US Quantitative Easing (QE) would wreck global economic recovery, especially emerging markets. They agreed that this would be a determinant of economic wellbeing in Emerging Markets because the months between May and December 2013 witnessed frantic reactions to Ben Bernanke's guidance on QE, with many EM currencies tanking and with EMs striving to make efforts to build up defences against the impact of imminent QE pruning by the US. Hence this will be the focus of my article.

Tapering of US QE will not hurt the world as much as imagined, they concluded.

Aarti Shastri, the economist, convinced the group that the world is obsessed with liquidity or the

[1] http://consultavalon.com/looking-beyond-the-obvious/

absence of it does impact growth, asset prices, interest rates, etc. Pruning of QE in the US, therefore, can be a determinant of economic well-being in Emerging Markets. QE did not create much additional supply in the US, just the usual 6% rise in M2 (a broad measure of money supply in an economy) as in pre QE times; therefore pruning will not hurt the US economy's recovery especially if interest rates are held at near zero level for the next 2 years.

"Why did money supply not increase in the US?" enquired Udaya Mitra to which Aarti gave a long-winded explanation. "In the first place, QE did not create money in the hands of people or corporations to spend or save. The FED only electronically credited the reserves of banks at the FED. That made banks seem healthy and capable of lending for good commercial purposes. Money supply increases when Banks lend. The FED bought bonds to keep interest rates low. So low that, returns on savings in banks enticed citizens to move to higher risk assets like shares. In fact, global fund managers moved money to the US from EMs and other Advanced Markets because they expected US stocks to rise in value due to QE1. Stocks prices rise was supposed to move the economy upwards by creating a wealth effect that would lead to consumer spending. Corporations too were expected to feel the pressure to invest in new capacity to meet the new consumer demand. Whether this worked exactly as per this script or not, the US economy has moved up to the point that QE does not seem to be required any more but the need to keep interest rates down to near zero persists . In order to ensure that the bond yields and then interest rates do not rise suddenly, the FED has opted for a calibrated reduction in QE. In the midst of all this, the US Treasury has built up a massive balance sheet. If it aggressively starts selling the bonds that it owns, liquidity will get eroded but they cannot do that without causing interest rates to jump. By announcing near Zero interest rates for the next 2 years, the FED has more or less committed that they will not sell off the bonds that they have accumulated.

"Unlike QE1 (2008-09) where outflow from the world over into the US happened, the dollar appreciated and the low bond yields triggered US equity buying, the impact of QE2 & QE3 (2010 onwards) when the FED did large scale purchase of treasury bonds and MBS, was that funds moved out of the US to Emerging Markets (EM), increased asset prices there, caused the dollar to depreciate, etc. An extensive research study *(On the international spill-overs of US Quantitative Easing by Marcel Fratzscher, Marco Lo Duca and Roland Straub published by the ECB in June 2013)* showed that in EMs, the impact was more on asset prices than on monetary flows. Comparison of 65 countries showed that the effect of QE policies on different economies is related to risk perception, and that sound domestic policies and strong domestic institutions help insulate countries from US monetary policy spill-overs. India with its weak governance, high current account deficit and high fiscal deficit, was a sitting duck. The Rupee tanked with mere fears of QE withdrawal. Desperate measures have since, reduced the Current Account Deficit for this year. The Government's action on this front will determine the impact in 2014."

Turning to Nitinya Purohit, the political analyst, she added, ""The steady decline in US QE2 over 2014 is expected to be offset by additional QE by Japan and the EU. The FED is going to prune the QE program and not suck out money; they will be adding about $320 to 500 bn in 2014 to the monetary system instead of $1020 bn. This reduction in QE level by about $520 to 700 bn could probably be offset by Japanese and EU's QE. Some experts recommend that the EU either goes for negative interest rates on bank deposits or the more acceptable QE in 2014. The latter could be as high as $ 400 to 700 bn in 2014 if the ECB boldly adopts the US and Japanese strategy but they have not shown political will thus far. Even without that, one can bet on QE from Japan to more or less offset tapering by the US FED. It will be surprising if the US did not take into account Japan's additional QE while tapering its own. It helps that this may be largely in the form of FDI in ASEAN and India. Japan has already revealed its cards in that some of their important corporations have been very actively looking at investments in India. Their Emperor's recent visit to India and Abe being invited as the Chief Guest at India's Republic Day event on January 26, 2014 are strong signals.

"Another reason to not despair is that India has $295 Bn of forex reserves. That is 6 times the Forex reserves of South Africa, twice that of the US & France, and 33 times that of Pakistan. It is no pushover.

"Despite all this, India has reason to worry because its Current Account Deficit (CAD) is funded by hot money (risk assets-seeking end of the global liquidity pool) which will flow elsewhere if India does not manage risk perceptions. There is no better way than to shrink the CAD and to convey the feeling that governance of the country is in safe hands. The current Government failed on both counts but is now trying to contain the former. There are solutions but they need time. Fortunately, India may get 15 to 24 months to get its act together but short term signalling that a solution is at hand, is as important as medium term implementation. This signalling is essential in order to contain the volatility of the Rupee during 2014 especially till the next Government settles into the job. It needs to be 61+/- 3 so that investors (especially FDI), importers and exporters have confidence. If not, FDI interest in India will dwindle."

Nitinya Purohit and Aarti Shastri debated and concluded that Japan's pursuance of Abenomics may however trigger currency wars in 2014 that may adversely impact the export competitiveness of USA, and exporting nations in Europe, S Korea, China, etc. The excess liquidity that Japan is creating to achieve positive inflation and growth after 23 years of being in a moribund state is likely to keep the Yen range bound around 115 to 120 to a US$. China whose currency is gaining against the US$ will be particularly hurt by a weakening Yen at a time when China's labour costs are rising. Not known to passively capitulating to circumstances like these which are beyond their immediate control, China can be expected to do what they are wont to do, viz. get aggressive in the South China sea, create political and economic tensions. Developed countries will also not be amused by the 'deflationary' impact of Abenomics. After all, there may be an axis between the US and Japan to keep China at bay and that would include overtures from Japan towards India.

India whose currency has fallen against the US$ and the Yen, may not get impacted negatively by the weakening of the Yen. On the contrary, Japanese overseas investment policies seem to indicate a positive drive towards investing substantially in India's infrastructure and manufacturing sectors in 2014.

From all this, I understood that the obsession in India with the negative impact of pruning of QE in the US is largely misplaced. The RBI is apprised of the issue and with a little support from the Government, it is capable of guiding India out of QE pruning trouble.

"What about the rest of the World? Will it grow in 2014?" asked Anu Sandani. Immediately, Aarti Shastri who had done her homework got into another long explanation:

"The global economy will grow, albeit slowly.

The global economy is going to be a bit healthier in 2014 (3.6%) than in the current year (est. 2.9%), largely because of recovery in the US and the UK, high growth in China albeit a tad lower than in 2013, uptick in the rest of Asia and many other parts of the world despite a sluggish EU and a somewhat uncertain Japan, which is going all-out for growth. The Kondratiev Long Wave which we discussed about 6 years ago is unlikely to lift the world into the serious growth zone till 2016 but the upturn will be felt. Falling real incomes in the West and high level of joblessness amongst the youth will continue to make their people unhappy no matter the uptick in the next two years. Europe in particular faces the prospect of a very long drawn out recovery. India could do better in 2014 than in

2013 if there is adequate focus on supply side issues and if the Union Government undoes all the mindless policy mess it created in the past 2 years. In 2014, one will need to look at India till June and India after June because they could be different."

Exhibit 1: Latest IMF Projections

Global growth dynamics are changing. Growth is projected to drop to 2.9 per cent in 2013 and pick up to 3.6% in 2014, driven largely by advanced economies.

(percent change)

			Projections		Difference from July 2013 WEO projections	
	2011	2012	2013	2014	2013	2014
World Output	**3.9**	**3.2**	**2.9**	**3.6**	**-0.3**	**-0.2**
Advanced Economies	**1.7**	**1.5**	**1.2**	**2.0**	**0.0**	**0.0**
United States	1.8	2.8	1.6	2.6	-0.1	-0.2
Euro Area	1.5	-0.6	-0.4	1.0	0.1	0.0
Germany	3.4	0.9	0.5	1.4	0.2	0.1
France	2.0	0.0	0.2	1.0	0.3	0.1
Italy	0.4	-2.4	-1.8	0.7	0.0	0.0
Spain	0.1	-1.6	-1.3	0.2	0.3	0.1
Japan	-0.6	2.0	2.0	1.2	-0.1	0.1
United Kingdom	1.1	0.2	1.4	1.9	0.5	0.4
Emerging and Developing Economies	**6.2**	**4.9**	**4.5**	**5.1**	**-0.5**	**-0.4**
Russia	4.3	3.4	1.5	3.0	-1.0	-0.3
China	9.3	7.7	7.6	7.3	-0.2	-0.4
India	6.3	3.2	3.8	5.1	-1.8	-1.1
ASEAN-5[1]	4.5	6.2	5.0	5.4	-0.6	-0.3
Brazil	2.7	0.9	2.5	2.5	0.0	-0.7
South Africa	3.5	2.5	2.0	2.9	0.0	0.0

Source: IMF, World Economic Outlook, October 2013

[1] Indonesia, Malaysia, Philippines, Thailand and Vietnam

She handed out a table (see exhibit 1) and continued, "The world may grow @ around 3.4 to 3.6 % in 2014. The big news is that the US is now emerging from the darkness of the past 5 years, not healthy but with a momentum that allows for optimism. Critical indices for new housing and unemployment are healthy. The latter at 7%, the reduced possibility of a government shutdown after the Congress approval of the spending budget for next year or so on 18th December, as also the FED guidance on QE pruning etc., make the glide path for the US economy in 2014 more predictable. GDP growth rate is expected to rise from the 1.6% estimated in 2013 to somewhere between 2.6 and 3% in 2014. The smart shift towards energy self-sufficiency and a lower cost regime due to cheaper and plentiful gas and tight oil from shale, is expected to improve the competitiveness of US manufacturing, much to the discomfort of the manufacturing sector in Europe which continues to struggle with high cost energy.

"Across the Pond in the UK, this development is matched with its own plans to get energy security from shale gas and to add to that, her economy is in decent shape. It is the only major economy for which the IMF raised its GDP growth guidance recently to 1.4% in 2013 and 1.9% in 2014.

"The EU, however, is still in the throes of resolving the struggle between what is good for some constituent countries versus the EU as a whole. While the EU struggles to agree on the right balance, it would have contracted by about 0.4% this year. It is poised for a positive 1% GDP growth in 2014 but that depends upon a number of factors falling in line, most importantly political will to do what it takes to lift the EU out of deflation despite the needle of competitiveness shifting slightly from Europe towards the US, the impending currency war in which the Yen may make Japanese exports more competitive than those from Europe, etc., below target inflation and a high unemployment of about 12.2% which do not augur well for a robust recovery. That much of unemployment amongst the youth is troublesome. Against a 24% youth unemployment in the EU, Spain and Greece reported nearly 56% and many others in the high thirties, making Europe ripe for disruptive social upheavals. No short term relief is in sight.

"Developing nations as a whole are expected to fare better in 2014 (5.1% GDP growth against 4.9% in 2013). India, Russia, Brazil, Indonesia, Turkey and South Africa, also stand to benefit from the recovery of the developed nations but they remain fragile, each for its own reasons.

China will continue to grow at 7% or higher despite the mid-year slowdown in 2013 from which it recovered towards the end of the year. The reforms announced in November auger well for a more sustainable growth in which consumer spending will increase its share of the GDP. Growth in 2014 is expected to be between 7 and 7.5%, down from 7.6% estimated in the current year despite concerns about excess bad debt in local governments, liquidity issues, real estate bubble and the like. It will continue to flex its military muscle as it moves along the path towards global dominance. Neighbours, including Japan and India, beware.

It is really difficult for anyone to project the economic growth India could achieve in FY 2014-15. There are so many estimates floating around. The OECD puts it at 5.1%, The World Bank at 6.2 %, ADB at 5.7%, and the UN at 5.2%. In reality it will be a movie with an intermission due to elections. The Five have not returned from Delhi as yet. I wished they had shared their views on what impact Kejriwal's Aam Admi Party will have on the Parliamentary elections in 2014, Government formation, society in general, the grammar of politics and finally on the India economy. Ungrateful wretches these Five whom I have housed in my head for the best part of my life!

Now I will have to risk sharing my own thoughts. A lot will depend upon supply side reforms by the Government of India which could ease the availability of key inputs like coal, ores, power, etc. Public sector investments in projects worth ₹5.5 Tn ($89 Bn) held up due to policy paralysis which in spite of the present inept Prime Minister, may start trickling in soon and may impact the economy significantly in Q2 of FY 2014-15, and investments by the Private sector, which are not likely to happen significantly before the new Government announces its intent in June 2014. High Current Account Deficit and High Fiscal Deficit continue to haunt India. The impact of AAP on BJP's fortunes is difficult to predict today. My guess would be an overall real GDP growth for India of about 5.8% to 6% in FY 2014-15 if the BJP comes to power and a dismal 5% or less if a Third Front supported by the Congress gets in the saddle. If the BJP forms the Government, the private sector would take the risk of investing in new capacity to exploit the special export opportunity created for several manufacturing sectors by depreciated Rupee. FDI investments from Japan and many other countries can be expected if there is serious intent to implement structural reforms and there will be serious investments in infrastructure as had happened during the NDA regime. I sincerely hope that the UPA does not mess up the economy in the months leading to the elections.

Before the Five left for Delhi, my technologist friend, Praoudh Yogi, who did not get much of a chance at most of the tea sessions in 2013, gave me a rare insight into over a hundred major technologies that would impact us in 2014-15 and beyond. For want of space, I will mention just three and not even the best three. He believes that Coursera, a leading provider in the MOOC space (Massive Open Online Courses) which

provides free access to over 4,000 high quality online courses from several top universities will open multiple offline hubs in India with access to the internet. That can have massive impact on India's rickety education sector and with that, on the upward mobility of large sections of society who are given English language instructions in schools.

We heard of a complex emergency surgery being conducted in rural Maharashtra in 2013 without adequate infrastructure by a general surgeon guided by an expert surgeon accessed remotely on a smart phone. More instances of systematic use of easily accessible, innovative technology to get reliable healthcare to rural areas will be seen in India thanks to tech savvy young medical professionals and institutional initiatives in 2014-15. India needs this.

Consumer buying patterns and work place rules will see big change in the metros. All of this because of smart mobile devices, free video conferencing software and storage of information and numerous applications on the web coming together, which some people refer to as 'personalised cloud'. A lot of what needs to be done face to face, touch and feel, will give way to remote purchase, virtual offices, etc. using light devices which do not need much storage capacity. This will impact brick and mortar retail, business travel and commute, education and training, commercial real estate due to telecommuting (working from virtual offices), etc. albeit in a small way next year.

I cannot end my note without talking about wearable devices that will take centre stage for early technology adopters, for whom mobile devices are passé and PCs dead. Every half decent Mobile phone maker, computer manufacturer and chip maker is obsessed with developing wearable devices. Let us wait to hear from Apple, Samsung, Google and Intel in the next few months. You need to pay for all these purchases. How about using Bitcoins next year?

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Content: Courtesy **The Five**

It was easy to choose to befriend them because they were named after their professions. They chose to live inside me because I have a fondness for their professions

- **Nitinya Purohit** (Political Analyst)
- **Aarti Shastri** (Economist)
- **Udaya Mitra** (Entrepreneur)
- **Praudh Yogi** (Technologist)
- **Anu Sandani** (Market Researcher)

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