AVALON
Consulting

Asia's Top 10 Strategy Firm
Vault 2013 List

Avalon Perspectives
2013

Will You Feel Good Tomorrow?

- By Raj Nair,
Chairman, Avalon Consulting

Will you feel good tomorrow?

(This year's global outlook note lays greater emphasis on India than in the previous years as requested by many of our international readers for whom India remains more than an object of curiosity)

I am an optimist, always looking for what can work, but my short answer is 'you are not likely to feel good tomorrow', if tomorrow means 2013. People in most parts of the world will have to wait until, may be, 2016 to see what will feel like a 'good tomorrow'. 'Good' in absolute terms, could require more than 3% real GDP growth in the US, 7.5 % growth in India and in the case of Greece, it could mean even a 1% real growth. The specific answer for the people of different countries in 2013 will depend upon how the continuing global economic problems are handled, viz. the balance in their country between fiscal conservatism and liberal monetary policy on the one hand, and the potential for high growth emerging economies to absorb exports from their country on the other hand. It can be argued that India could have felt almost good in 2012 but the Government shot her in one foot first and then shot the other one, almost as if to ensure that India went nowhere in 2012 and for most part of 2013; more on that later.

Is GDP the only measure of well-being?

It is often assumed that economics, more specifically GDP growth, is the predominant driver of a country's happiness and will drown all other aspects. In 2013, this assumption is at serious risk of being proven wrong. The increasing influence of non-economic factors is a process that has started but has been ignored. It will gather enough momentum in 2013 to be felt and whether it will be a smooth change in the socio-economic fabric of a nation would depend upon how sensitive, responsive and proactive, the leaders in each affected country are. That would include politicians in Government and the ones in the opposition; both have got blind-sighted by the past. Citizens in many countries have got emboldened to stand up against serious income inequality, unbalanced access to the basics required to build a better future (good education, healthcare, employment and career growth, security, etc.), human rights abuse, repression, etc. The media, especially, TV, has emboldened them. Technology has empowered them to network with like-minded people. This will be witnessed across the world including India and China, the ME, Europe and some parts of the Americas. This social dissatisfaction and desire to get redressal will influence the economics of nations in the years to come.

Then, there is another danger that the world at large is not aware of. If there is a poor crop in the major food producing countries of the world in 2013, the poor are in for a situation they will not relish. Due to the fact that in 6 of the past 11 years, the world consumed more food than it produced, the stocks of food available at the end of December 2012, was down to 74 days of consumption. It used to be a comfortable 107 days back in 1974. That according to experts, at the UN, is precarious. In any case, it will take at least 3 years of good crop to move up to respectable levels. In the meanwhile, get ready for food price inflation because hedge funds which are awash with liquidity will not let this opportunity pass. This will impact India as well.

Back to economics before reverting to these overriding issues: There are many economic commentators who are convinced that the global economic crisis has been almost licked and that 2013 will be much better than 2012. Many of the same commentators started 2012 on a somewhat high note and periodically reduced their estimates for good reasons. They include venerable institutions like the IMF, UK's OBR, etc. One of the main reasons is apparently that they tend to consistently over-estimate the positive impact of quantitative easing of money supply on consumer demand and consistently under-estimate the negative impact of fiscal tightening. It is argued that tightening is required since more spending cannot be an antidote to problems caused by overspending in the past. This is not to suggest that deficit financing is the solution. While Ricardian Equivalence is a philosophical issue for many economists, it is hard to ignore the facts on the ground relating to fiscal multiplier which have been seriously underestimated in recent years @ around 0.6 to 0.75. There is evidence that it turned out to be twice or thrice that estimate in many countries. If the fiscal multiplier is 1.5, it means that if there is a reduction of $1 in Government spending, the economy would shrink by $ 1.5. Rarely has it been below 1 in the last 4 decades, but there is a huge pressure on Governments to cut back on spending to contain the impact of debt overhang, ignoring the high negative impact on economic growth. The Report published by the US Congressional Budget Office in November, 2012 titled **Economic Effects of Policies Contributing to Fiscal Tightening in 2013,** is worth a read. It argues that if there is drastic reduction in Government spending, 2013 will see economic contraction and higher unemployment in 2013 in USA but not curbing it at all will also create long term problems which include inability to borrow in the future. Hence the golden mean is required in the US but will the two political parties iron out a sensible truce in March? It appears that large parts of Europe and even to some extent the US will be weighed down by varying degrees of enthusiastic austerity measures. Likewise, there would be exaggerated expectations from additional doses of Quantitative Easing or - release of funds to prime the lending apparatus in 2013 neither of which will offset the impact of austerity measures in countries that are forced into them. Nothing in the US or UK experience seems to justify optimism. In fact, the EU experience is that the huge money that it made available to the European Central Bank in 2012 for on-lending to commercial banks, did not actually get lent to businesses for most part. Banks parked the money because they were concerned about risks of lending whilst high quality borrowers were reluctant to borrow to serve a stagnating market pulled down by lower Government and consumer spending.

Then there is the European debt crisis, which is too real to ignore. On the one hand, more debt restructuring (euphemism for haircuts to be taken by lenders) is unavoidable, but on the other hand the peripheral countries in the EU (Greece for example) are under huge pressure from the EU to go over the top in austerity in lieu of debt write-offs, ignoring its economic and social impact. Some austerity is in order but to expect a low fiscal multiplier and a high offsetting impact of monetary easing is unrealistic, as is not expecting social backlash to Government austerity in times of high unemployment amongst youth. If a social backlash happens the consequences will be unpredictable. 2013 could witness that in many parts of the world where mindless austerity measures are adopted at the cost of the poorest strata of society and the youth. That will make 2013 different from 2012, and hence not a terribly happy year for some.

Iceland is a brilliant example of a country that was down in the dumps but has recovered smartly through a balanced austerity programme in which the rich paid more than the poor. They preserved their social support scheme to prevent a social crisis and ruthlessly refused to bail out creditors. The growth in 2012 has recovered smartly to 2.4% (way above the crisis ridden EU block which shrank by almost 0.3%). Feeling good in 2013 relative to the rest of the World (and not in absolute terms) is possible in some parts of the World. That will include some of the BRIC countries and the emerging 11 nations which account for 4 billion people but provided they are seen by citizens, to be working on solutions to alleviate social problems. India is going to the polls in 2014. The incumbent party will play Santa Claus in 2013 to cover up their poor scorecard on multiple fronts. If done sensibly, the country could see social and economic progress.

In the Western world, crisis resolution is complex on the economic front (they created the crisis in the first place) but relatively easier on the social front because many of them have platforms to provide social support and the cultural backdrop for it. I will use just use two examples to support this contention.. USA, for instance, has been blessed with visionaries amongst politicians like Franklin Delano Roosevelt and industrialists like Henry Ford, besides many others. Roosevelt assumed office in 1932 when the dark clouds of the Great Depression loomed large. He did not say merely that he will rev up economic growth. He offered the American people, what is called the New Deal. He offered them a New Tomorrow based on: Relief, Reforms and Recovery. The first two happened immediately whilst Recovery took a long while till Adolf Hitler helped by setting off World War II which required American factories to work extended hours.

Henry Ford's vision was not to build 100,000 cars a year to increase Ford Motor Co's valuation to make him amazingly rich, unlike the 'Robber Barons' who preceded him and who built incredible wealth for themselves by exploiting the country's natural resources, peddling influence with the Government and by exploiting low wages. Ford's stated vision was, in his own words, "I'm going to democratize the automobile. When I'm through, everybody will be able to afford one, and just about everybody will have one." He continuously reduced prices by adopting a new concept in automobile assembly and by sacrificing profit per car. Prices of Model T dropped below $575 in 1912, (for the first time, less than the average annual wage) whilst sales sky-rocketed to 248,000 in 1913. Society benefited and so did Ford. Today, thanks to the likes of Henry Ford and far sighted politicians like Roosevelt, the infrastructure in US for social relief in bad times, education, healthcare, etc. is still in place. The country needs 3 years to reclaim the economy from some of the financial wizards on Wall Street who hijacked it to satisfy their own greed. That is not a tall ask but will take political guts and time due to the complexity of the financial mess, which I have written about adequately in my previous annual notes.

The same goes for Europe. Unfortunately, neither India nor China has an adequate social net provided by industry leaders and rulers.

Will BRIC countries fuel economic recovery in the Westin 2013?

BRIC countries plus the 'emerging 11' may not provide as much succour to exporters from Advanced Economies as they did in recent years.

Let us step back to appreciate where the world is today. From 2006 to 2012, the annual GDP of Advanced countries led by US, Europe and Japan grew at 1.2% CAGR whereas the Rest of the World grew at an amazing 6.5%. Advanced Economies accounted for only a fifth of the 3.5% global growth in that period.

In the 10 years preceding 2006, the share of Advanced Countries was nearly half. That was a period when the consumption of goods and services in the Advanced Economies was rising and in some sense, there was overspending. Simultaneously, the Rest of the World was growing 78% faster than the Advanced Economies and importing heavily from them. China and India only accounted for 25% the global GDP growth rate back then but in the past 6 years, China and India together contributed to half of the global GDP growth rate. This is what I meant in my 2008 note by the 'Pendulum is shifting to the East'. According to the OECD, by 2030, more than two-thirds of the world's middle class will live in the Asia-Pacific region (including India) up from just under one third today. Europe, by contrast, will fall from having about a third of the world's middle class today to just 14% in 2030.

Over the next 5 years, one expects GDP growth in China and India to moderate to the 6 to 7.5 % CAGR range resulting in a lower growth in their demand for goods from Advanced Economies. This coupled with low growth in consumer consumption within Advanced Economies, would mean a very modest GDP growth rate of approximately 1.2% for Advanced Economies in 2013, (around the same as in 2012) with USA being more robust than Europe which is expected to shrink a bit.

The US may grow around 2% in 2013 if they can resolve their bi-partisan problems quickly but the European situation looks gloomy. "After five years of crisis, the global economy is weakening again. The risk of a new major contraction can't be ruled out," said Pier-Carlo Padoan, the OECD's chief economist recently. OECD expects the euro-zone economy to contract 0.1% in 2013.Germany and France are expected to post positive numbers, 0.6% and 0.3% respectively. Six countries viz. Greece, Spain, Portugal, Italy, Slovenia and Hungary are expected to shrink whereas there is hope that the UK, Belgium, the Czech Republic and the Netherlands may grow modestly in 2013. But the overall European economy may shrink marginally in 2013. The IMF reportedly expects that by 2015, it will be 7.8% smaller than it was in 2010. That seems counter-intuitive if it were on the path to recovery. Hence the prognosis for Europe is grim despite some countries doing satisfactorily.

Growth in Japan could be 0.7%, but the new Japanese PM expects his proposed heavy-duty Quantitative Easing to deliver 2% GDP growth in 2013. For reasons, explained earlier in this note, it could be another case of over estimation of the impact of QE.

What is in store for BRIC nations and a few others?

Other than China and India, the GDP growth of most emerging economies in 2013 is expected to be in the 3 to 4% range. Brazil is expected to grow the slowest amongst the BRICs at 3.26% whereas Russia which is coming out of two poor quarters in 2012 is expected to do better in 2013 at 3.4%.South Africa, which is often touted as an adjunct to BRIC, is expected to grow of 3.3% as would South Korea be. Turkey is expected to rebound to 4.1% after a dip in 2012. Most of the prominent countries in the Middle East are expected to grow at around 3% barring the two stars, Saudi Arabia and Qatar which are expected to top 5% GDP growth in 2013. Indonesia is the other high growth economy, which has grown smartly and steadily on the back of strong domestic demand, and is expected to grow at around 6.3%.

Growth in China and India (to some extent) in the last decade was investment led. In China, investment accounted for 50% of the GDP and is expected to be the driver in 2013 as well. The Chinese have made structural change in their economic strategy. The focus has shifted to building up domestic demand as opposed to exports which will suffer from the travails of importing countries in North America and Europe. The manufacturing sector has overcapacity and is somewhat constrained to invest heavily in new capacity as it is burdened with high debt. China's GDP is expected to grow at around 8% (with a variance of 0.3% on either side) in 2013.

India in 2013:

In 2012, investments in productive assets slowed down in India for a number of reasons including policy paralysis and when policy was announced it was unbelievably perverse. The architect of the regressive and unimaginative policies was promoted mid-year to a decorative post outside the cabinet, thereby creating space for fresh thinking. It is too early to credit the Government of India with firm intent to undo the damage. Hence, it is difficult to predict what policy changes will brought about in 2013 -a by the coalition Government which speaks in many voices and has earned the dubious reputation of sleeping at the wheel and crashing into obstacles whenever they suddenly woke up.It will help to look at factors which will boost the economy and those that will pull it down, in order to make an intelligent guess about what is finally in store for India in 2013. I will just touch upon a few factors.

According to CMIE, only 267 new capital projects worth Rs.583 billion were announced during the December 2012 Quarter(down from 667 new projects worth Rs.2,270 billion in the December 2011 Quarter and 1,203 new projects worth Rs. 3,214 billion in the December 2010 Quarter). A steep drop! Therefore, it is tempting to dismiss the optimism of Indian Business leaders about2013 at their year-end briefings as their wont at this time of the year. However, more serious surveys have confirmed this optimism and the PMI in December 2012 for India is high at 54.2 (Manufacturing) and 55.6 (services), giving a composite PMI score of 56.3. It has not been this high for a while. (Note that a score above 50 means that purchase managers expect things to improve and a score below 50 means the opposite is likely).The key ingredient required for economic revival is optimism and that seems to be in place.

While investments in capital projects by the private sector have not been encouraging, the number of large projects completed this year and expected in 2013 are higher than in many years according to CMIE.

The chances of Goods &Services Tax (GST) being introduced in 2013 seem brighter than before. Some business leaders believe that this could increase GDP growth rate by 1 to 2% whereas economists have varying expectations, with most ranging from 0.9 to 2.5%. Some of that impact will be felt in Financial Year 2013-14.

Under the new Finance Minister, the Indian Government has made moves to introduce reforms which are long over-due, like FDI in multi-brand retail, hiking diesel and LPG prices to reduce subsidies that don't necessarily impact the poor, increased the FDI limit in insurance to 49%, permitting FDI in Pensions, etc. There are more reforms to come.

Let none of this lull us into thinking that all is well on the economic front. The commercial vehicle industry (the pulse of India's economic health for many years) has been in bad shape for 6 months. The goods transported by the Indian Railways have dropped too. The quarterly GDP growth in the manufacturing sector in FY 2011-12 is clear evidence that industrial output has fallen behind the Budget estimates by miles. Many of the commercial vehicle manufacturers, including Tata Motors have been enforcing forced shutdowns every week in addition to the normal holidays. As in 2008, the auto component manufacturers, already facing weak global demand, have been hit badly. When that happens, core industries like steel, cement, etc. get pulled down. This situation is largely created by the stand still in mining and infrastructure projects because of the Government's inaction on the enabling laws, rules and in removing hurdles through timely and transparent decision making. Indian politicians struggle with the latter and it will be a wonder if that will change in a hurry. Infrastructure projects will continue to face the limitations of an infantile capital market for infrastructure funding in India. Hence the Government will have to find money to fund infrastructure revival. That may be better than straight dole which the Government seems to favour.

While 8% monsoon deficit in 2012 may not sound like much, it should be recognised that the average is deceptive; where the deficit occurred and to what extent matters. Monsoon failed in many of the States on the Western side of India from Punjab to Kerala resulting in drought-like conditions in states like Maharashtra. The meagre Government resources will get diverted to combat this in 2013; water levels in reservoir in irrigated districts are low, etc. These have added to the challenge for agriculture and rural economy. While one can hope that El Nino does not again damage monsoons in 2013, the carry forward impact on rural income surpluses to spend in 2013 would already have got negatively impacted.

Inflation will continue to pain India, especially in food for reasons mentioned earlier. That will reduce the RBI's enthusiasm to oblige the Finance Ministry with interest rate cuts that are large enough to excite industry and investors.It is too early to predict the timing of the drop in interest rates despite the new Deputy Governor of the RBI being both, brilliant and independent. Anticipating the pre-poll profligacy of the Government in the coming year, he is more than likely to be cautious about interest rate cut.

Exports will continue to struggle in 2013 as the Euro zone is destined to remain fragile for at least 2 more years and the prospects of smart recovery by the global economy to the heady days of the past decade are ruled out.

Then there are serious deficits on two fronts: CAD (current account deficit) and FD (fiscal deficit). In the April to Sep 2012 period CAD rose to $38.7 billion (5.4% of GDP) and seems to have gone out of control. There seems to be no let-up in the drop in exports even after that. Since it is not adequately compensated with drop in imports, the CAD for the year FY 2012-13 will be dismal. The FD for the year FY 12-13 was budgeted at 5.1% but given the apparent political constraints on reducing subsidies drastically, the actual FD may be closer to the previous year's FD of 5.8% or a shade higher. This may not stand scrutiny with Rating Agencies. If that happens, India's happiness will be dented.

Oil prices could remain high (Brent in the $105 per barrel region unless the global economy tanks) and impact India adversely not only in terms of impact on GDP (thumb rule: ~0.2% GDP drop for every $10 rise in crude oil prices) but also in terms of impact on current account deficit since it is one of the two biggest items on India's imports list, the other being the unproductive import of gold.

The good thing is that the Government is acutely aware of all this and may take steps to contain these deficits in the year FY 2013-14.

Online and offline social networks will converge strongly in India to protest against social injustice, corruption, nepotism, etc. and for women's rights, better healthcare, better access to education, etc. Social protests will be the order of the day in India as also in other parts of the world because of the extra-ordinary ability of social media (especially Facebook, Twitter and YouTube) to catalyse local physical networks of disillusioned middle class citizens into national movements especially when traditional mass media gets into the act in democracies. What we witnessed in 2012 in India is just a trailer of what will unfold in 2013 and the years to come. Indian politicians are not accustomed to listening and understanding, having spent most of their time delivering pointless speeches to the rural uneducated, ignoring the power-less middle class. It is not as if the causes of disillusionment did not exist for several decades (and in some cases, for centuries) but now they are getting broadcast. Our international readers should note that rape has not suddenly become huge in India as it would appear in the media reports that leave little space for reporting other happenings, good or bad. It is still a very small number per million citizens but it is just not going to be meekly tolerated. Women have been constrained to lump it all along but not anymore. The same goes for corruption, crony capitalism, criminals wielding influence in politics, poor civic services, etc. Nothing has changed on the ground in decades but the citizens have woken up and the media is conveying the citizens' voice strongly albeit at the expense of all other news. All this is positive but none of the political parties understand how to deal with this. Their ham-handed response in 2012 when they thought that the messenger and not the issue was the problem lost them respect and resulted in chaos. There is no evidence that either political parties or the police have learnt any lessons. Hence in 2013, they may still behave like rabbits caught in a headlight beam or act with unnecessary aggression against the messengers, both of which will decelerate economic progress and aggravate social disillusionment. I hope that the wise among the law makers and the rulers, will seize this opportunity for their political parties to cleanse themselves and bring out economic and social reforms that are aligned with the new reality of citizens' expectations and their power to demand action, which used to be exercised only once in 5 years at the hustling. In any case, Indian industry and business will not be held hostage by social protests unlike in countries affected by the Arab spring but citizens will not feel good.

On balance, India's GDP India's GDP growth could rise to as high as 6.7% in FY 2013-14, if serious reforms are announced by March 2013, the monsoons are normal across the country, EU crisis does not worsen, and if the Government is able to handle social protests sensibly. Else one is looking at a GDP growth rate of as low as 5.5%. The chances of being between 5.5 and 6 % are high, which is not bad, given the magnitude of challenges, both internal and global. India will have to wait for a year or two more to breast the tape at 7.5% GDP growth rate. That will happen as could socio-political change. Inflation will remain in high single digits and there will be other pains as well. That is no reason for businessmen, investors and other citizens to despair. India will still probably be the second fastest growing nation in the world. As John Maxwell said, "If we're growing, we're always going to be out of our comfort zone."

>> Contact Us

Casa Avalon,
61, Dr. S S Rao Road,
Parel,
Mumbai - 400 012

Phone: +91-22-6619 1100
Fax: +91-22-6619 1122

E-141,
Okhla Industrial Area,
Phase III
New Delhi – 110020

Phone: +91-11-4051 6600
Fax: +91-11- 4051 6650

10, III Floor,
Spur Tank Road,
Chetpet,
Chennai - 600031.

Phone: +91-44-4345 5345
Fax: +91-44- 4345 5338

Avalon Consulting *is an international management consulting firm that advises clients across the world on Strategy, Business Transformation and Transactions. It is part of the 20 year old, 1000-people Avalon Group with offerings across the knowledge value chain including Market Research and Marketing Analytics*

Follow us on: