Global Meltdown and Emerging Economies

Introduction

As the economy became global, the concept of Emerging Economies gained perspective. These economies began attracting attention from the global investment community on account of their growing markets, and potential for high returns. Their untapped mass consumer markets and their maturing money markets throw open new vistas of opportunities for both – the FII route and the FDI route. Nevertheless, for an institutional investor, the awareness of pitfalls associated with the emerging capital markets, in terms of excess volatility is a matter of attention. In the wake of the recent financial turmoil, these markets have taken maximum beating, with Russia, India, and Korea witnessing as much as 36%, 25% and 24%, respectively, of erosion in the annualized returns on investment during October 2008. With the subprime crisis spreading its tentacles in all directions, the once resilient emerging economies have been impacted severely.

Genesis of the Subprime Crisis

What initiated as the US Subprime crisis (over USD 5 trillion in losses) in the last quarter of 2006, soon send the world in dire straits, toppling financial markets worldwide, sending most of the economies into recession, and pushing marginal countries, like Iceland, on the verge of bankruptcy. The crisis was more a result of blind enthusiasm riding on the back of a decade long rally from mid-1990s to 2006, and utter disregard for the fundamental business cycles related to the real estate markets. The market players, during the building up of housing bubble in the US, carried the misplaced optimism that property rates will continue to rise indefinitely, ignoring the fact that the principles of demand & supply affect the realty sector, as much as any other sector and it follows the same expansion-equilibrium-decline-absorption cycle.

Driven by climbing oil and food prices in the world markets in 2006, the inflation rates started climbing. At the same time, with the sliding of property prices on account of oversupply of built-up homes, the cost of the mortgage loans (most of which were adjustable rate loans) shot up for most borrowers. As a result, the loan to rental value ratio began increasing considerably. The matters got worse, as a sizable number of homeowners driving the market rally, were subprime borrowers. With the rise in inflation, the purchasing power of the subprime borrowers eroded and they began defaulting on loan repayments. Since, the Alt A, or subprime loans (for the borrowers with no, or inferior credit records) carry higher interest rates than prime loans, the lenders freely offered loans when prices were rising. The US Government encouragement to subprime lending, especially through its sponsored organizations, Freddie Mac and Fannie Mae, added steam to the then rallying markets. The highly developed secondary mortgage market in the US, and its inherent financial engineering techniques fuelled the crisis further. Investment banks and other financial institutions repackaged the mortgage loans as MBS (Mortgage Backed Securities) or CDO (Collateralized Debt Obligations), thereby maintained money supply for further lending, apart from taking large exposures in such securities.

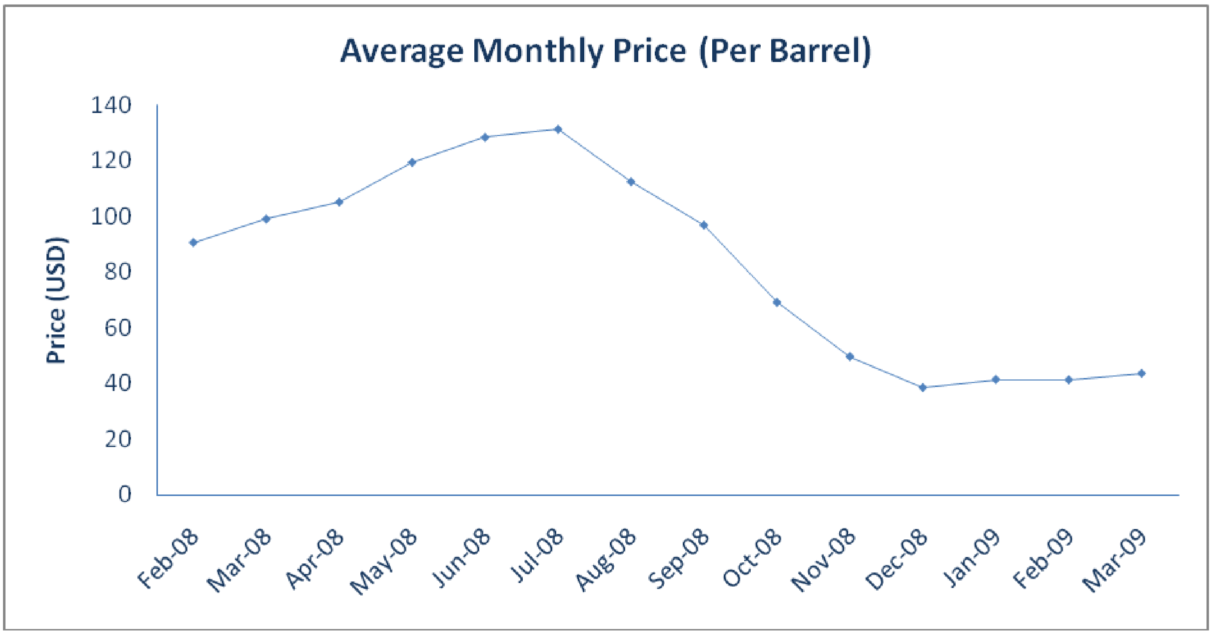
Year 2007 started on a grim note of an impending possibility of an approaching financial turmoil, and by mid-2008, it became clear this predicament would not remain limited to the US. The fall of 158 year old Lehman Brothers triggered a chain reaction world over – the leading institutions at the Wall Street were wiped out, the world stock markets crashed, the credit lines froze, the business activities dipped and there was an overall liquidity crunch.

Impact on the Emerging Economies

In the globalized economy of present world, no country can prosper by doing business in isolation and at the same time, no country can remain insulated from the tidings in the global economic scenario. The subprime crisis concerned primarily the US, but had a ripple effect on almost all of the other nations due to the interdependence and interlinking of individual economies. The Emerging Economies, though, have been robust in terms of fundamentals, were severely affected by the global meltdown. Developing nations like India, China and other Southeast Asian countries have the potential to pull out the World out of the recession, but it is expected to take longer than previously thought.

Oil Prices

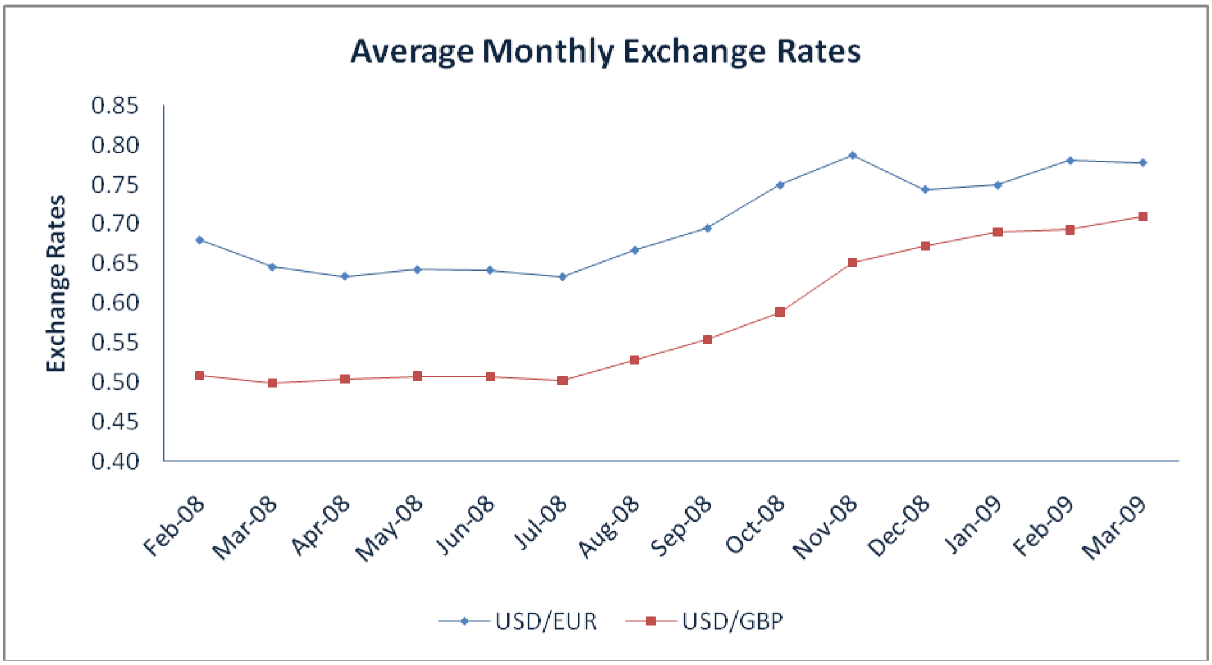
Arguably, oil prices have been both cause and effect of the current economic downturn. Crude prices began their rally in 2007, hitting an all time high of over USD 140 per barrel in June 2008. Following graph represents the price trend of crude oil in years 2008 and 2009.



Source: Basket Price Archives (OPEC Website)

Crude oil price, one of the key drivers of global inflation rates, is traded internationally in New York and London. The trade is denominated in US Dollars, with major players from developed countries dominating the market, which explains the effect of Foreign Exchange Rates on the price levels of crude, up to some extent. In all market conditions, it is not easy to establish a direct correlation between US Dollar rates and crude prices, nevertheless, in the recent scenario the connection was easy to see. The main factors affecting the oil prices were:

- Tumbling Dollar
  In the wake of the subprime crisis, when the demand for US assets and investments fell, the demand for US Dollar began sliding, with a corresponding impact on the exchange rates against all of the major currencies. The investors found it prudent to invest in oil futures for hedging their Dollar positions, as rising crude prices made its a safer investment. This propelled the oil prices even further.



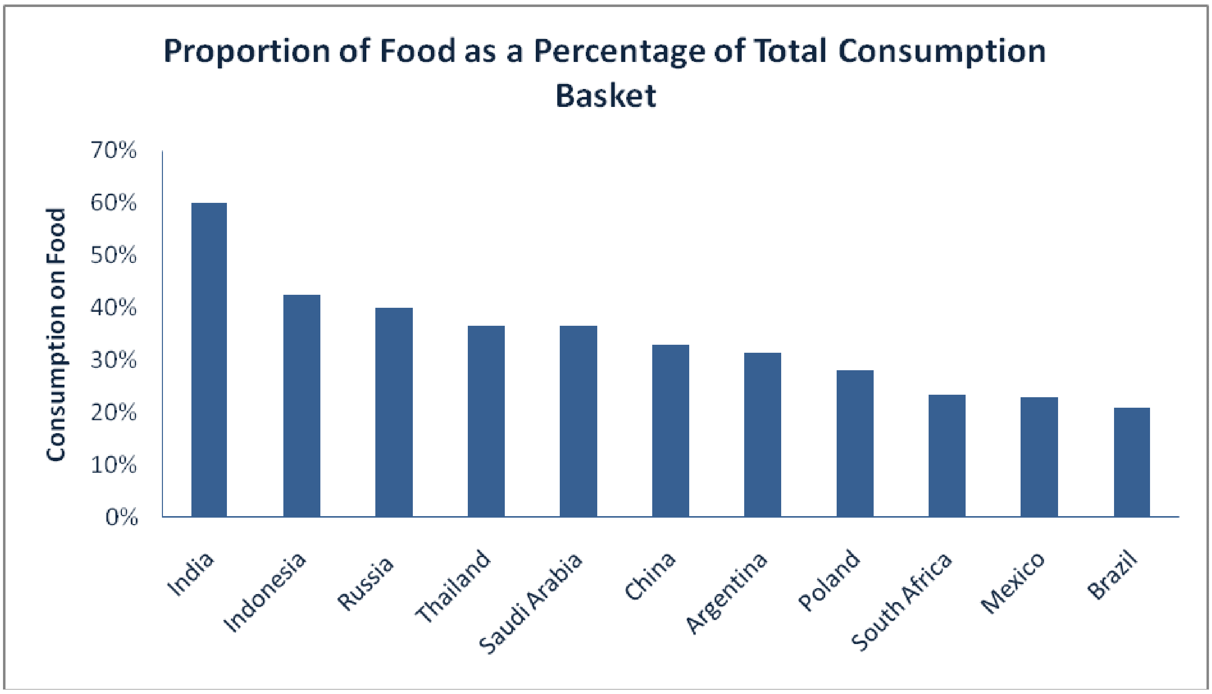
Source: www.oanda.com

- Speculation
  Speculative trading in oil futures on the expectation of further rise in prices, led to the already high prices to skyrocket.
- Growth
  The economic growth in the emerging markets has been creating demand for fuel and putting upward pressure on crude prices, though this factor has had a smaller contribution in the recent oil price rally.

The rising oil prices aggravated the financial troubles of the subprime borrowers, apart from affecting every other section of the society world over, deepening the crisis to unmanageable levels.

Food Prices and Inflation

The low per capita income in a developing economy makes it quiet vulnerable to the inflationary pressure of oil and food prices. The diagram below, illustrating average percentage consumption on food by per capita, explains the unprecedented levels of inflation in the emerging economies during 2007-2008, directly impacted by the food prices.



Source: HSBC

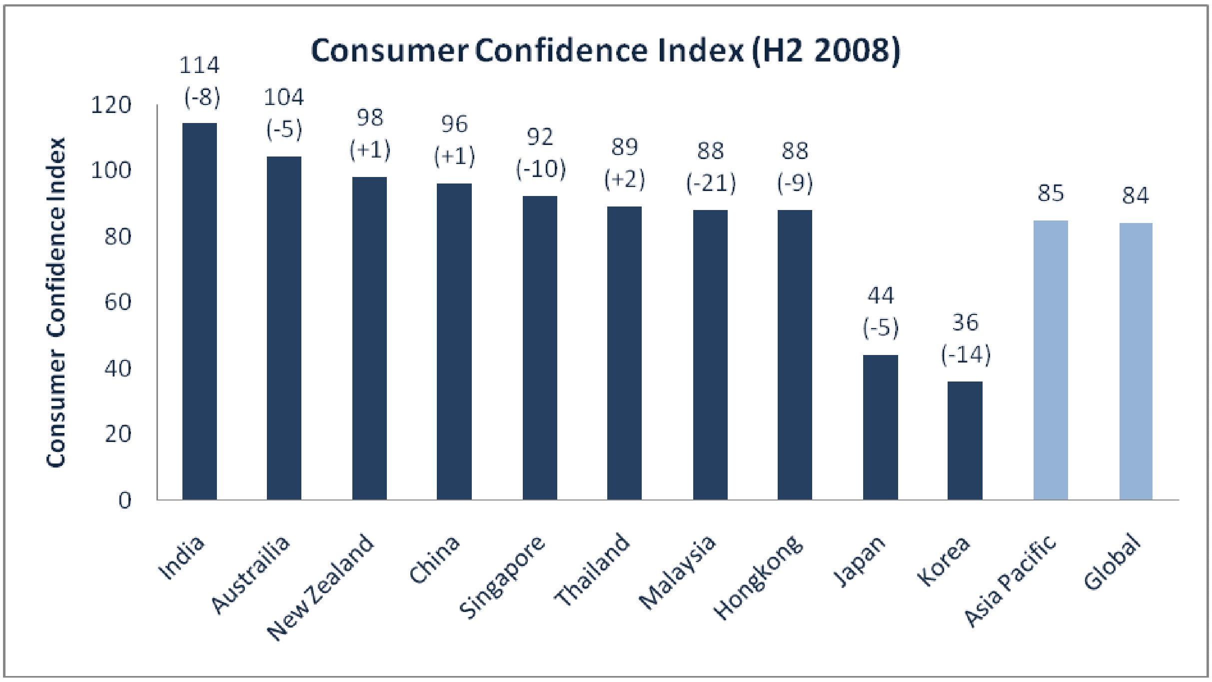
Main factors exerting price pressure on commodities market in general and food prices in particular, were crude oil prices and commodities markets. The supposed commodities hedging soon took the form of speculative trading in futures creating a virtual food crisis and pushing millions of people below the poverty line across the globe. According to *Centre for Research on Globalization (CRG), Montreal,* by the year 2008, the average price of rice had risen by 217%, wheat by 136%, maize by 125%, and soya beans by 107%, over the 2006 price levels.

Foreign Investments

Foreign investment through FII route has become a major source of liquidity and volumes in the capital markets of the Emerging Economies, especially, in countries like India and China. This mode of investment largely remains risky, since, it can be liquidated anytime. In fact, the FII activities often set the tone of the capital markets. As the financial crisis grew in magnitude in late 2007, the FIIs began liquidating their holdings in the foreign countries for meeting their obligations back home. The heavy selling by FIIs made created a sudden hiatus in the capital markets, causing the indices to dip steeply, and wiping out investors' savings in no time.

Consumer Confidence and Consumption

In an attempt to take the essential lessons from the US economy, other nations started resorting to a more cautious, and even conservative approach towards the current economic scenario. They began cutting down their budgeted spending and consumption, starting from non-essentials like holidays, out-of-home entertainment, upgrading technology, clothing, telephone expenses, and replacement items and so on. This reduced the demand for product and services in the market, giving rise to recessionary trends in the economy. The graph below illustrates consumer confidence index in the Asia Pacific region in H2 2008, and its change over H2 2007.



Source: Neilson Media Research

Exports of Goods and Services

According to IMF World Economic Outlook for 2009, the US has formally entered into recession, and is expected to see a growth of meager 0.1%. Therefore, the export demand from this country is in for a contraction. The impact of this will vary in magnitude for different countries, depending upon the volume of their exports targeted to the US. The BRIC (Brazil, Russia, India and China) nations have not been severely hit on this count as they have diversified their exposure to other developed and developing nations. Currently, Brazil's exports to US account for 3% of its GDP. Similarly, for Russia, India and China, this figure stands at 1%, 4% and 8%, respectively. However, overall export volumes across nations have shown a negative trend in 2008.

Drivers of a Nation's Economy

GDP, or Gross Domestic Product, is usually considered a barometer for economic growth of a nation, defined as all final goods and services produced in an economy in a year, measured at market prices. GDP can be summed up as,

GDP = Total Consumptions + Total Investments + Government Expenditure + Net Exports,

the components of which, can be described as follows:

- *Consumption:* It is the total expenditure by all the consumers on the purchase of goods and services. Demand and consumption are one of the most powerful drivers of an economy, as they provide the business incentive to produce more, thereby fuelling growth through increased business activities and employment generation.

- *Investment:* It is the sum total of all investments in capital goods and services, including housing, by the consumers and business enterprises. In growing economies, it forms an important part of GDP due to high investments in infrastructure and industrialization.
- *Government Spending:* It includes both expenditure and investments by the Government.
- *Net Exports:* This component is the net of exports and import in the country for the year under study. High net exports is a healthy sign, as it helps in driving business activity on the back of demand, over and above the domestic one, earning valuable foreign exchange and enhancing money supply.

India vis-a-vis current global scenario

India, being an emerging economy with strong fundamentals, is currently better placed than the developed nations. However, among the champions of economic growth – the BRIC nations, its position is the weakest.

Exports of Goods

India maintains significant exposure to US and Japan in terms of export profile, with almost 40% of its exports being directed to these two nations. The statistics by Ministry of Commerce and Industry say that exports in October 2008 declined to USD 12.8 billion compared to USD 14.6 billion last year. With IMF's economic outlook indicating recessionary trends in US (0.1% projected growth) and Japan (0.5% projected growth), further contraction in trade is expected to come in 2009. Although, due to falling imports, the current account deficit situation is not likely to worsen from the present levels. The exports to US form only about 4% of the GDP. Therefore, such trade contraction is not likely to have a direct severe effect, but carries the risk of other allied repercussions like a surging unemployment in the export sector.

Unemployment

According to the Federation of Indian Export Organizations (FIEO), the highly job intensive export sectors of Indian economy have shown as much as 70% of negative growth. These include handicrafts (-70%), oil meals (-50%), carpets (-32%), tea (-20%), yarns (-17% to -19%), and marine produce (-19%). The export sector has lost almost 500,000 jobs in a single quarter (October-December 2008). The rise in unemployment rates is not limited to the export sector - the unemployment rates have been rising across the board. The Dun & Bradstreet Optimism Index for Employees stood at 21% for January-March 2009 quarter, a dip of 12 percentage points over October-December 2008 quarter.

Exports of Services

Despite the bleak scenario in the goods export, Indian IT-BPO sector continues to register growth, though at a lower rate of 22%-25% as compared to 36% CAGR of boom period. In FY 2009 (April 2008 to March 2009), the industry has grown by 12% to hit USD 71.7 billion mark in aggregate revenues. Of the total, export sales contributions stand at 66%. Export of software and IT-BPO services account for 99% of the total exports.

Financial System

Traditional ways of lending and banking still form the backbone of Indian Financial System. This remains a big contributory in safeguarding the system from the worldwide financial turmoil, due to limited exposure to the US markets.

Government Measures to Contain the Damage

Ever since, the aftermath of the global crisis began to manifest itself on India, the Indian Government has come up with various incentives, apart from measures by Reserve Bank of India, like reduction in benchmark lending rate and cash reserve ratio (CRR), along with easing lending norms for commercial banks to provide boost to the housing sector lending. To provide a stimulus to export sector, the RBI has enhanced the credit period for exporters from 6 months to 9 months.
The Government, in its turn, plans to reduce sales tax by 4%, to be funded through USD 4 billion of Government spending. In the introductory speech (dated February 26, 2009) of the Commerce and Industry Minister on the announcement of Trade Facilitation Measures, following measures to combat the economic slowdown were discussed:

- Interest subvention of 2% till December 31, 2009, for certain employment intensive sectors
- Additional funds of INR 1,200 Crore for Central Sales Tax/ Terminal Excise Duty/ Drawback refunds
- Extension of Duty Entitlement Pass Book Scheme (for saving on Customs Duty) up to December 31, 2009
- Restoration of Duty Entitlement Pass Book rates for all items at rates prevailing prior to November, 2008,
- Increase in Duty Drawback Rates on certain items effective September 1, 2008
- Around INR 2,300 Crores have been provided through various existing schemes for cushioning the adverse impact of declining exports

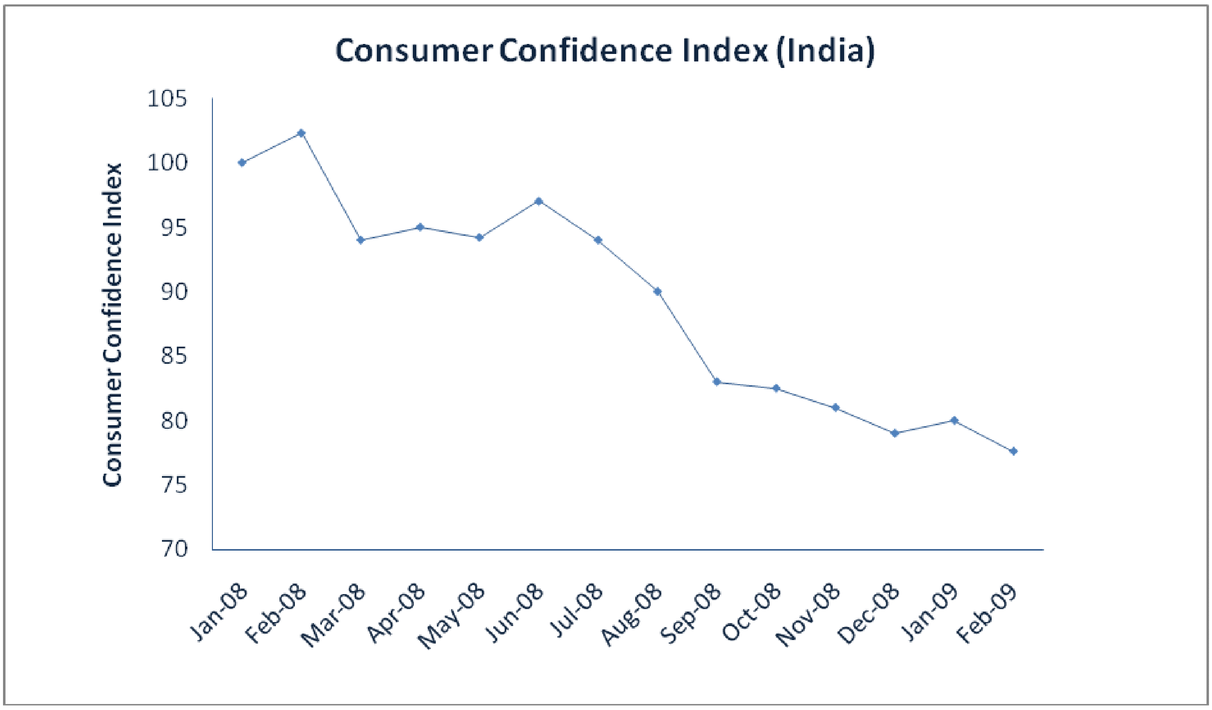
Since, the fiscal and monetary measures take approximately 8-12 months to bring about the desired effects by September 2009 onwards a turnaround on the back of these measures could be seen.

Risks to the Indian Economy

Despite a fundamentally strong economy, India is plagued by certain inherent risks to its health, which are discussed below.

Consumer Confidence and Consumption

According to the comprehensive Consumer Confidence Index by Boston Analytics and CNBC-TV18, the consumer confidence has reduced by 3% from January 2009 to 77.6 for the month of February 2009. This index becomes all the more important, since it is an average of the Current Situations Index and the Future Expectations Index. This is a clear signal for the Indian policy-makers that regaining the lost consumer confidence can pose a serious challenge in the time to come. Following diagram illustrates a year of fluctuating consumer confidence.



Source: Boston Analytics

Consumer confidence is an indicator of trends in consumption. Falling confidence has translated into a definite impact on consumption, which is showing signs of a slowdown. According to *Deloitte Global Economic Outlook for first quarter of 2009,* the consumption in July-September 2008 quarter grew by only 5.5%, as compared to 7.9% in April-June 2008 quarter.

Business Sentiment and Economic Activity

Adversely impacted by decrease in demand and other factors, The Dun & Bradstreet Composite Business Optimism Index for first quarter of 2009, slid to its lowest levels in last seven years to 95.7. On a Q-o-Q basis, this represented a steep fall of 31.1% and on Y-o-Y basis, a fall of 43%. The sagging business sentiment is a dangerous sign for any economy – developed or developing. Due to plunging demand and consequent lower capacity utilization, the manufacturing industries are feeling the pressure on their margins, on account of higher burden of overheads. To add to the plight of the industry, the access to foreign funds for business investment is constantly decreasing. As per an estimate by *Deloitte Global Economic Outlook for first quarter of 2009,* approximately, 40% of investment spending by the corporate was sourced from foreign borrowing and through issue of new equity capital. The crash of the stock markets and future predictions of their entry into a long bearish phase puts another damper on the economic growth.

Inflation Rate

Over the last one year, the inflation rates (Consumer Wholesale Price Index) in India have fluctuated over a wide range – from the historic levels of 12.91% in August 2008 to a 14-year low of 0.44% in the week of March 7, 2009. This is an indicator of the vulnerability of Indian Economy to outside disturbances.

The above three major factors are cumulatively pointing towards the impending danger of deflation and its allied consequences. Dipping consumption reduces the business initiative, leading to a reduction in production and other economic activities, which pushes up the unemployment rates. This further, leads to reduced demand and a vicious cycle sets. Interestingly, the inflation related to all major food items in India, still remains high, which again, is an alarming signal. In an attempt to check the sliding inflation through increase in money supply, RBI has reduced the CRR by 350 basis points to 3.5%. In addition, it has reduced its benchmark interest rate from 9% to 6.5% between October and December 2008.

Outlook

Despite some inherent weaknesses, India, along with other emerging economies, will continue to be the growth engines for the world economy.

In the medium term, Indian is expected to be driven by consumer demand from its large population and its growth potential. With negative sentiments prevailing among the consumers currently, the thrust area for the Government in the coming time will be to provide enough stimuli to boost demand. Further, the demand is eventually expected to pick up, as the essential consumer expenditures cannot be postponed indefinitely.

Emerging economies have suffered heavily from the flight of invested foreign capital back to their home countries, as a direct result of the credit freeze in western markets. But domestic savings have been largely unaffected by this. In fact, in India, there has been a shifting trend from consumptions to savings, by the population with enough purchasing power in hand. More and more people are looking at safer investments like treasury, banks, and post offices, rather than investing in the capital markets. Therefore, the bearish trend in the capital markets, at present, is not a definite indicator of weakness in the economic fundamentals. Sectors, like telecom, automobiles, and IT-ITES are expected to grow in the year 2009, though at lower rates than in previous years. However, sectors like construction, real estate, and retail are likely to feel the heat, and are poised for negative growth rates in year 2009.

India remains a good investment destination, more so when other options are losing sheen. According to the *IMF World Economic Outlook for 2009,* India is poised for a growth rate of 5.1% in 2009. Although, this is a steep decline from growth rates of 9.3% in 2007 and 7.1% in 2008, Indian growth estimates are among the highest in the World, next only to China. Further, the opinions on the growth prospects of the Indian economy remain divided, with *Centre for Monitoring of the Indian Economy (CIME)* projecting a GDP growth rate of 6.5% (2009) in its latest published report. The developed nations are in for a negative growth trend and other emerging economies are estimated to grow at much lower rates (1.1% to 3.9%), making India a preferred destination for investment in the longer term. In addition, domestic savings, along with NRI capital inflows, are expected to accelerate the economic activities, and overall growth in the medium term.