Publication: The Hindu Business Line

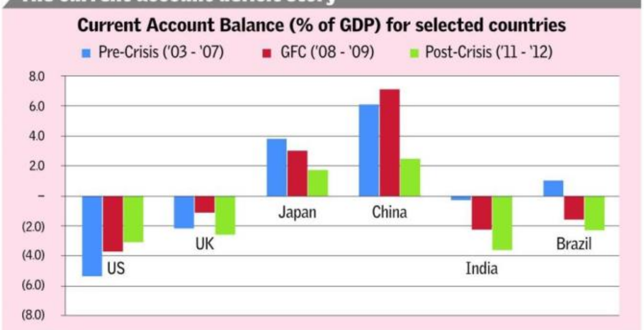
Page no: 09	Date: April 24, 2013

US got it right after 2008

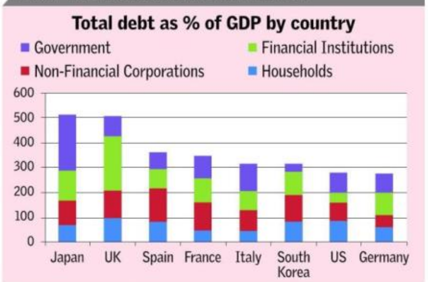
AJAY SRINIVASAN

As against Europe, US recapitalised banks and got its economy moving. BRICS, hit by a slump in global demand, are focused on internal reforms.

The current account deficit story



How the debt cookie crumbles



Source: McKinsey Global Institute

Ajay Srinivasan

Four years since the financial crisis, the global economic landscape offers some very interesting insights.

The US, the centre of the financial crisis, is the only major economy to have returned to pre-crisis growth levels. Not only Europe, with 0.5 per cent growth in 2011-2012, but also the UK with 0.2 per cent growth in the last two years, are both looking increasingly "Japanese" from an economic standpoint.

At the other end of the spectrum, BRICs, the much-touted economic engines of the world in the pre-crisis era, all seem to have undergone structural changes with almost a 200-400 basis points deceleration in GDP growth since the financial crisis.

There are at least three interesting key questions that arise from this economic picture. First, why has the economic recovery in the US been so strong, especially when compared with other advanced economies such as Europe and the UK? Second, is the growth story of the BRIC nations still alive, or has something fundamentally changed for these emerging economies? Third, what do these economic trends imply for India and its growth path, going forward?

WHAT US DID RIGHT

Let's start with the relative strength of the US economic recovery. Given that excessive leverage was the primary driver of the financial crisis and the current economic problems in advanced economies, a good starting point is to evaluate the aggregate debt to GDP for different industrial economies.

As the following chart reflects, total debt to GDP for most European countries is not that different from that of the US. Thus, factors other than aggregate leverage levels are responsible for the different economic paths that the US and Europe are travelling on post the GFC.

The answer, therefore, probably lies in the various steps undertaken by US policymakers since the financial crisis to fight the underlying de-leveraging trends.

A key learning of the Japanese deleveraging process in the 1990s and 2000s was that Japan let the NPA problems in its banking sector linger for too long. In contrast, the US took a number of decisive initiatives such as TARP (Troubled Asset Relief Program) and rigorous stress tests to force the US banks to firstly, recognise the real magnitude of embedded balance sheet losses and then, to recapitalise themselves.

In fact, the US Government funded almost $245 billion of equity investments into various financial institutions to ensure their solvency. Clearly, this proactive re-capitalisation of the financial sector was an important step to ensure funding channels remained open for the productive sectors in the economy.

Another important step taken by US policy makers was to force banks to help under-water home buyers through the Home Affordable Modification Program (HAMP). A key feature of this policy was to help home buyers with an outstanding loan amount higher than their house value by reducing mortgage interest and some principal forgiveness.

Moreover, quantitative easing programmes by the Federal Reserve have lowered the cost of capital for both consumers and businesses and thus lowered their interest burdens. One of the key concerns after the 2008 crisis was that US consumers would enter into an extended period of de-leveraging and thus cut back on spending. In fact, US personal consumption at 71 per cent of GDP in 2012 is close to all-time highs of the last 30 years and even investment has moved up since the crisis.

This is a testament to the proactive steps taken by US policy makers. No wonder, US equity markets are close to all-time highs and even the US housing market seems to be picking up.

RISK-AVERSE EUROPE

A very stark comparison to the US is Europe. Most global investors still remain sceptical about the Euro Zone economy as policymakers have not taken bold steps to either re-capitalise the banking sector or to resolve concerns regarding high debt to GDP for countries such as Italy and Spain.

As a result, most banks in Europe remain risk-averse. Bank lending to both households and non-financial corporates has been declining in Europe in year-on-year terms.

As a result, nominal personal consumption is growing at a much lower rate in Europe as compared with the US. Another key difference between the US and Europe is that while US unemployment rate peaked in 2010 and has started coming down, EU unemployment rate continues to go up.

No wonder, the Euro Zone economy is expected to be in recession in 2013 again after contracting by 0.4 per cent in 2012.

The longer Europe delays the tough steps required to deal with its debt problems, the more likely it faces a tough economic future.

The key point here is that the US and Europe are travelling on two very different paths despite their similar leverage problems. And, the difference is arguably the right policy framework.

EMERGING ECONOMIES

Let's turn to the economic performance of emerging markets. Why has growth slowed down so dramatically in China and India?

Yes, slower growth in advanced economies post-GFC is certainly a factor. But the bigger reason is probably lack of sufficient structural reforms.

Post-GFC, investment rate has fallen across all advanced countries (EU, US, UK, Japan) as a result of excess capacity — one of the reasons all the money printing by Western central banks is not resulting in inflation, at least not in Western economies.

China is an exception that implemented an "investment stimulus" in 2008-09 to offset the sharp drop in exports during the GFC. China continues to focus largely on an investment driven model with investment as a share of GDP close to 50 per cent in the last two years.

Interestingly, the current account deficit (CAD) has deteriorated across a number of Asian economies and Brazil as they have shifted to an internal-demand-focused economic model after the financial crisis. China, which had a current account surplus falling from 10 per cent in 2007 to 2.3 per cent in 2012, is a prime example.

Unfortunately, this increase in internal demand in China is a result of pick-up in investments rather than consumption as reflected in the steady rise in gross capital formation as a percentage of GDP.

Again, the US has managed to reduce its CAD in a world where others are seeing a deterioration.

India, with growth down at 5-5.5 per cent in FY13, arguably needs structural reforms in all factors of production i.e. land, labour and capital. Perhaps, the most important is capital.

INVESTMENT CLIMATE

It is ironic that for a capital- and supply-shortage nation like ours projects worth almost 10 per cent of our GDP are stuck due to regulatory and environmental clearances.

The Finance Minister needs to be commended for re-starting the reforms process by deregulating diesel prices and opening sectors such as multi-brand retail and aviation to FDI investment.

But, there is a long path ahead of us. India has to dramatically reform its infrastructure to compete with China and other export-focused South Asian countries.

We need to get manufacturing back on a sustainable growth path, and get investments and employment going once again.

We need to open up for foreign capital so that we can fund our CAD through FDI. And we need to invest in supply chains so that we don't end up in the position we are currently in — large supplies of foodgrains in our warehouses even as food inflation persists.

Most people will agree that India remains the best structural growth story in the world. But as the last few years have shown, growth is not our birthright. We need to accelerate the current reforms process.

(The author is CEO, Financial Services, Aditya Birla Group)