

## Global Economic Prospects 2010-11

*The global economy is transitioning from a rapid, bounce-back phase of recovery, towards a slower, more sustainably paced phase. This in essence is the World Bank's take on the world economy in its 'Global Economic Prospects'.*

It has estimated that global GDP has expanded by 3.9% in 2010 being driven mainly by strong domestic demand in developing countries. Growth is expected to be lower at 3.3% in 2011, before picking up to 3.6% in 2012. These predictions are based on easing of restructuring activities in developed countries.

The developed countries would be showing a recovery of 2.8% in 2010 after a negative growth of 3.4% in 2009. However, growth will be subdued at 2.4% in 2011 with marginally higher growth of 2.7% in 2012. This is significant as the World Bank indicates stable economic conditions in this part of the world with a downward bias. *A conclusion that could be drawn is that monetary policy will continue to be easy in these regions as central banks will be focusing on growth.*

Growth in 2010 has been brought about by developing countries in particular (7%) which has been supported by recovery in domestic demand. These nations have contributed to around 46% of the total growth that has taken place. Growth is however projected to come down to 6.0% and 6.1% respectively in 2011 and 2012.

### **Issues going forward**

Restructuring and right-sizing in the banking and construction sectors, combined with necessary fiscal and household consolidation, will continue to drag growth in many high income economies and developing Europe and Central Asian countries. At the same time, growth is projected to slow in other developing countries due to capacity constraints.

### **Risks galore**

The main short term risks are: (a) Debt sustainability in Europe, (b) continued low interest rates in high income countries, and (c) rising food prices.

Longer-term risks center on the possibility that countries fail to shift focus from short-term crisis management to addressing structural issues that contributed to the crisis such as (a) Putting in place credible plans for restoring fiscal sustainability by emphasizing more on fiscal measures that facilitate re-employment of displaced workers, (b) Programs to improve longer-term competitiveness, (c) Completing the re-regulation of the financial sector, (d) Pursuing policies that permit exchange rates to gradually adjust in line with relative fundamentals and (e) Reducing the volatility of major reserve currencies in order to sustain confidence in them

#### **Contacts:**

Madan Sabnavis, Chief Economist  
91-022-67543489

Anuja Jaripatke, Associate Economist  
91-022-67543552

Going forward, the recovery will be characterized by close to potential growth rates among those countries that were least directly involved in the excesses of the pre-crisis boom period. *India's GDP in constant terms for 2010 (fiscal) would be 8.7% with an upward bias of 9.0% for FY12. The current account deficit however, is expected to be high at 3.6% of GDP this year.*

*India's growth in line with our own expectations*

## Trade flows

There was a rebound in the volume of goods traded, which regained pre crisis level by mid 2010 with 50% of the global increase in import demand emanating from the faster growing developing countries. Although overall activity in high-income countries remains relatively depressed, by October 2010 their export volumes had regained 98% of their August 2008 levels. Developing country exports were some 16% higher than pre-crisis levels as of November.

*Developing countries aid growth in trade*

While the recovery from pre-crisis levels is encouraging, trade volumes remain well below their earlier peaks and the level that might have been expected to prevail had trade continued to grow at pre-crisis rates. In fact global trade is expected to slow down to 8.3% in 2011 from 15.7% in 2010.

*Trade will moderate further*

## Capital flows

The low interest rate regimes in the western developed countries were responsible for the large flow of capital to the other markets. Total capital flows to the developing countries increased from \$ 598 bn to \$ 826 bn, which was however much lower than that in 2007 before the crisis set in. Private flows dominated accounting for 90% of the total (\$ 753 bn). Within this group equity was more important accounting for 75% (\$ 563 bn). *And within this group of equity 72% was as FDI (\$ 410) and the balance as FII (\$ 153).* The debt flows were in the form of short term (\$ 86 bn) and medium to long term (\$ \$ 104 bn).

*Threat to external stability  
Is real*

## The Indian story

### Flow of funds to developing countries

Billion \$	World		India		Indian share	
	2009	2010	2009	2010	2009	2010
FDI inflows	354.1	409.6	54.33 (28.79*)	22.33*	15.3	5.5*
FDI outflows	153.9	210	14.1 (11.68)	12.8*	9.2	6.1*
Net portfolio equity inflow	108.2	153.4	17.63	29.32	16.3	19.1
Net debt flow- ECBs/ Private creditors	52.8	104.1	16.54 (15.04#)	20.35#	31.3	19.5

*India gains in FII flows but loses direction in FDI*

Source: World Bank, RBI

\* data till October, #Up to November

The table above shows that India has been a preferred destination for FII funds in 2010 as against FDI. Our markets have absorbed almost 20% of total flows in 2010. Indian companies have also been busy in the ECB market. *The lower share of FDI this year is however a concern, and has to be addressed by more aggressive proactive foreign investment policy as well higher credibility of the systems to ensure that these flows come in larger numbers.*

## Polices pursued across the Globe

Taxation	FX Accumulation
<p><b>Brazil</b> increases tax from 4 to 6% on bond inflows</p> <p><b>Thailand</b> imposes 15% tax on interest income and capital gains by foreign investors</p>	<p><b>Mexico</b> goes for reserve accumulation, sells dollar put options of \$ 600 mn/month</p> <p><b>Turkey</b> increases daily forex purchases limit to \$ 140 mn</p> <p><b>South Africa</b> intervenes directly to build reserves</p> <p><b>Columbia</b> purchases \$ 20 mn daily in spot market</p> <p><b>Other measures</b></p>
Counter measures	
<p><b>Turkey</b> reduced short term rates</p> <p><b>Columbia</b> reduced tariffs to encourage imports</p> <p><b>Korea</b> caps size of banks' FX derivatives</p>	<p><b>Chile</b> introduced administrative measures to reduce exporters' transactions costs</p> <p><b>Columbia</b> eliminates tax exemption on foreign borrowing</p> <p><b>China</b> eased restrictions on foreign banks' investments in Yuan denominated Chinese bonds held offshore</p>

*Prices continue to rise*

*QE2 may just exacerbate the situation*

## Tackling capital inflows

Capital inflows, while good for developing countries run the risk of getting too volatile and reversing when times change thus causing turmoil in forex markets. It is for this reason that large capital inflows especially those caused due to imbalances in the structure of interest rates across the globe are a threat for domestic central banks. Theoretically these are the alternatives. To begin with currencies can be allowed to appreciate. Such policy prevents capital from adding to inflationary pressures but also exposes the country to the risk of causing long-term damage to their export and import-competing sectors. The other option is to accumulate reserves. Here one runs the risk of increasing money supply which has to be countered through sterilization measures. The third alternative is to encourage outflows or introduce some kind of capital controls. The table alongside illustrates some options chosen by countries.

## Commodity prices and inflation

The sharp rise in the dollar prices of internationally traded grains in the 2nd half of 2010 induced fears of a repeat of the 2008 food crisis. The real concern lies in the possibility that prices may continue to rise, either because energy prices increase as they did in 2008 or because further negative supply shocks result in a second year of bad crops. In such circumstances, prices could continue strengthening and become once again a major source of increased poverty. And while global developments ultimately are critical determinants of the long-term trend of local prices, in the shorter-run they are one of many influences.

There are also concerns that the US\$600 billion quantitative easing announced by the US in November may induce higher commodity price volatility as some of the "new money" may find its way to commodity futures exchanges through hedge and investment fund activity. As of mid-

2010, \$320 billion were invested in commodities (more than half in energy), representing about 1 percent of the assets of global pension and sovereign wealth funds.

The dollar price of commodities continued to rebound in 2010 from the post-financial crisis lows, with price changes varying from a relatively small increase in energy to larger gains in metals and agriculture.

- Oil prices have been stable on opposing forces of supply cuts and strong demand versus surplus capacity and high stocks.
- Base metals prices have risen 43% since December 2009 supported by relatively strong demand in emerging markets buttressed by recovery in developed countries. Although the downturn in industrial production during the 2<sup>nd</sup> half of 2010 slowed the momentum prices rose due to strong demand in China and tightening supplies in the medium term.
- Agriculture prices were up 17% in 2010, with some commodities rising much higher on extreme weather events. The severe drought in Russia and surrounding countries led to a sharp rise in wheat prices. Corn and soybeans prices followed with expected competition for acreage. Heavy rains in Asia affected some tropical commodities and drought concerns in South America.
- The USD appreciated almost 10% against the euro from 1.46 \$US/euro in December 2009 to 1.32 \$US/euro in December 2010 amid considerable volatility. However, it appreciated much less against other major currencies and against the broader group of trading partners.

*Supply pressures to complement demand requirements*

*Dollar remains whimsical*

### **Where are prices headed?**

There are long-term upside risks for some commodities, especially those in the extractive industries as strong developing country growth would mean that demand for some commodities may be entering into a phase during which commodity prices will continue to rise as supply growth struggles to meet demand.

- Base metals prices are expected to rise by 15% on continuing strong demand by China, falling stocks, and supply constraints. The metals intensity of China's GDP is well above average. China's copper and aluminum intensity was 1.8 and 4.1 kgs per \$1,000 of real GDP for 2007-09, compared with world averages of 0.4 and 0.7, respectively. This has been put in the context of the commodity super-cycle.
- Energy prices are expected to strengthen in 2011, despite slower demand growth and large surplus capacity as OPEC now prefers a wider price range of \$70-90/bbl.
- Agricultural commodities are expected to decline 8% assuming a return to normal crops and rebuilding of stocks. Large declines are expected in beverages (11%) and grains (5%).

*Metals up*

*Longer band for crude*

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