

Global Economic Prospects, June 2012

The current concern

Europe is significantly affecting the global growth outlook today and given that China is already weak, further deterioration in the Euro zone crisis could tip the global economy into a recession. The US is doing relatively well, although mixed trends are observed in macro-economic data - employment and consumer spending keeps market sentiment and economic outlook uncertain. Spain is already in trouble as yields continue to climb with the 10-year yield touching a high. The same holds for Italian bonds as yields on both short and long term government debt are rising around the euro area. Further, distortions that may be caused by say a Greek exit (indicators will be available after 17th) from the euro could be enormous.

The other major concern is the potential fiscal burden of bail-outs. The Spanish bank rescue is a plan to lend the Spanish sovereign money, adding to its debt burden and potentially pushing private creditors farther down the payment priority list. While Italy's banks are also not in good state, markets are worried that the list of countries in need of rescuing may soon outpace the list of "safe" countries. Unless the central bank is clearly standing as lender-of-last-resort behind bank and sovereign guarantees, a fiscal death spiral could result. This fear is reaffirmed by downgrades in sovereign ratings of Euro-zone countries by global rating agencies that have cited poor fiscal strength and weakness in banking system as the prime reasons for deterioration in economic health in this region. Gross domestic product in the euro zone stagnated in the first quarter of 2012, following a decline of 0.3% in the final three months of 2011. There are 11 countries in the EU that are now judged to be in recession, including Greece and Spain.

After last month's election failed to produce a governing coalition, Greek voters will return to the polls this Sunday, along with France entering the election phase as well. The concern in a political game is that anti-austerity politicians will win enough seats in Parliament to derail the bailout program Greece secured earlier this year. That would put the nation in jeopardy of being forced out of the euro currency union.

What has the World Bank got to say now?

According to the World Bank, global GDP is projected to increase 2.5% in 2012, with growth accelerating to 3.0% and 3.3% in 2013 and 2014. High income nations' GDP is expected to expand by 1.4% this year weighed down by banking sector deleveraging and ongoing fiscal consolidation. As these pressures ease in 2013 and 2014, high-income country GDP growth is projected to firm to a modest 1.9% and 2.3% in 2013 and 2014.

Table 1: GDP growth expectations (%)

	2010	2011	2012	2013(f)	2014(f)
World	4.1	2.7	2.5	3.0	3.3
High income	3.0	1.6	1.4	1.9	2.3
Euro	1.8	1.6	-0.3	0.7	1.4
USA	3.0	1.7	2.1	2.4	2.8
Japan	4.5	-0.7	2.4	1.5	1.5
Developing	7.4	6.1	5.3	5.9	6.0
China	9.7	8.3	7.6	8.1	7.9
India	8.4	6.5	6.9	7.2	7.4
Russia	4.3	4.3	3.8	4.2	4.0
Brazil	7.5	2.7	2.9	4.2	3.9
S Africa	2.9	3.1	2.7	3.4	6.6

Source: World Bank
(f) stands for World Bank forecast

GDP in developing countries is projected to expand 5.3% in 2012. GDP growth in developing countries is however set to decelerate in 2012, amid volatile global economic forces. The main driving forces would be:

- Increased market jitters,
- reduced capital inflows,
- fiscal and banking-sector consolidation

These drags on growth are expected to ease somewhat, and global growth strengthen during 2013 and 2014, although both developing-country and high-income country GDP will grow less quickly than during the pre-crisis years.

An important point here is that the forecast for India, which is made post our FY12 performance of 6.5%, is still steady at 6.9%. This is lower than Ministry of Finance number of 7.6% and almost the same as RBI of 7%.

Main worries

- The Bank warns that a sharp deterioration in financial market tensions cannot be ruled out. And while the precise nature of such a scenario is not known in advance, developing countries could be expected to take a large hit. Simulations suggest that their GDP could decline relative to baseline by more than 4% in some regions, with commodity prices, remittances, tourism, trade, finance and international business confidence all mechanisms by which the tribulations of the high-income world would be transmitted to developing countries.
- The other issue is that European banks' deleveraging will erode developing country capital flows. European banks started to reduce their loan books in the second half of 2011 as they were faced with rising borrowing costs, increased country-party risk assessments, deteriorating bank-asset-quality, and concerns over the adequacy of capitalization. Indeed, the quantity of cross-border syndicated bank lending to developing countries organized and led by European banks fell by almost 40% during the 6

month period October 2011-March 2012 compared with the same period a year earlier. Nearly all developing regions were affected, with the sharpest percentage declines among projects in South Asia (down 72%), partly reflecting a deterioration of investment conditions in India. Lending by European banks to Russia and Turkey also dropped by 50% and 56%, respectively.

- Capacity utilization may become a binding constraint in major developing countries. Developing countries have been important engines of global growth in the post-crisis period, generating about 50% of the increase in global import demand and GDP growth. While they are expected to continue to play an important role, many of the larger and faster growing economies are close to or above potential which suggests that they will not be able to provide as much an impetus to global growth as before.
- The situation in the Euro Area and high government debt and deficit levels in the United States and Japan remain central elements that will shape global prospects over the next several years. With inconclusive elections in Greece, changes of government in France and the Netherlands; banking downgrades and nationalizations elsewhere in the Area, uncertainty and financial market tensions have increased sharply yet again — with financial markets openly discussing the possibility and implications of a Greek exit from the Euro Area and the need for a bailout of some Spanish banks.
- Financial indicators have deteriorated markedly. Credit Default Swap (CDS) rates throughout the Euro Area have increased, recouping almost all (90%) of the earlier declines. CDS rates in most non-European high-income countries (and developing Europe and Central Asia) are also up, reaching between 60% and 90% of their earlier highs. CDS rates in most developing countries have risen by about 30% and 50% of earlier declines. Spreads on long-term bonds of Spain have reached 555 basis points, a record high. Those of Portugal, Ireland, and Italy have also risen by 276, 158, and 68 basis points, respectively, but remain below earlier peak levels. It is too soon to observe the impact of the recent resurgence in financial market turmoil on the real -side of the economy, but it is almost certain to be negative — particularly in high-income Europe. How negative is extremely uncertain? As of early June, financial market uncertainty in high-income Europe (as proxied by CDS rates) was about the same level as in the fall of 2011.

Capital flows to developing countries: What is the impact?

Table 2: Projected capital flows to Developing countries

\$ bn	2010	2011	2012	2013	2014
Capital inflows	1131	1038	818	995	1198
Equity	634	649	533	647	775
FDI	506	625	518	594	685
Portfolio	128	25	16	53	90
Private creditors	426	340	242	306	377
Bonds	111	109	114	120	109
Official	71	50	43	42	46

Source: World Bank

An interesting observation here is that there has to be a distinct slowdown in capital inflows from 2012 onwards. In 2011 too, while FDI increased, portfolio investment had declined to just \$ 25 bn. Against this background, the flows to India based on Government and SEBI data were 27.6 bn FDI and \$ 7.9 bn portfolio investment, share of 4.5% and 31.6% respectively in 2011. The shares in 2010 were 4.2% and 31%, which is almost the same.

Based on our share in these flows, the scenario for 2012 does not appear to be too bright as the global flows would be much lower on both scores. While FDI will pick up in 2013 and 2014, the same would be still lower in case of portfolio flows.

Concluding observations

Growth prospects for 2012 would be under a shadow as there are too many imponderables in suspension. Conditions are expected to improve subsequently in 2013 and 2014, though admittedly, it is difficult to take a call that much ahead. World Bank has a stable growth outlook for India, which is encouraging, though capital flows, which have helped significantly to steady our external account will be under pressure and since our current account deficit will improve only marginally based on movements in crude oil price, the rupee would continue to be under pressure based on fundamentals.

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