Financial turmoil in global markets

CASTING DARK SHADOWS ON EMERGING ECONOMIES

The fear of yet another recession is making the rounds the world over. And if this financial tsunami hits again, emerging countries like India also stand to lose enormously. Growing inflation has already exerted its impact on various industries, including paints and coatings, in the country as far as labour, raw material and logistics costs are concerned. It is time to act decisively, taking cue from the lessons of the past.

■ Dr Mosongo Moukwa

The predominant sentiment in the financial markets today is that the world is coming to an end. Some analysts actually believe that a new global recession is coming. This double dip, as seen by the markets' fear-tinted lenses, looks ominous indeed. There is an apprehension that banks will fail, governments will not be able to cope, and the recession will deepen.

In Western countries, the recovery has been slow and the financial challenges daunting, but that should not be surprising. These nations are tangled in nets of excessive public and private debt, which limit their room for economic mobility. A new recession, more accurately, a prolongation of the old one is always likely.

The crashing of world market has also hit the corporate sectors of India. If the economic situation of the US and European countries does not improve, the problem of Indian economy will get aggravated. If this happens, the growth rate of India will be adversely affected, and thereby impacting the growth of the paints and coatings industry. Previously, when global recession cropped up owing to economic slowdown in the US and European countries, India faced the situation bravely. This time, however, the situation is different. Like all countries, India stands to lose if a slowdown hits the developed nations. An emerging market like India needs a healthy global economy to maintain its own growth. If the developed world's economies slip, India may tumble.

Reasons for the fear

There are a number of explanations to the fear of a new recession. The first one is the collapse of confidence in credit. Just recently, in August 2011, Standard & Poor (S&P) degraded the US credit rating. The Euro zone's credit crisis and the concern that there is no money to bail out all those governments that may need help, only add to the fear contagion. This crisis of confidence can drive an even bigger sell-off in government bonds. And yet, treasury bonds have been one of the safest places to hide since S&P's downgrade.

A second explanation is that this is a continuation of the crisis that peaked after the fall of Lehman Brothers in 2008. The evidence lies in the astonishing fall in bank shares for global banks. The recession from 2008 was plainly driven by the shock administered to the economy when the financial sector suddenly withdrew credit. The extreme fall in bank stocks reflects a fear that such an event could occur. Judged in isolation, the financial sector continues to get better, albeit slowly. This scenario is mildly positive for the economy.

However, this time the problem appears to be the effect of the economy on the banks, rather than the other way round. Banks, like most businesses, are exposed to the economic cycle at the best of times. But this one is more serious than others. If the economy takes another slide, many of the loans sitting on their books will have to be written down. Renewed recession in the US could be the final straw for mortgages taken out at the peak of the US housing boom in the last decade.

Greek style recession in other Euro zone countries is another case. This could have an awful effect on default rates for other large European banks, which are still in the process of steady recovery. So, the spasm for bank stocks appears to be driven by alarm at the slowing down of the world economy, which includes China, nucleus of all hopes, as well as Europe and the US. Investors think the banks are particularly exposed.

Coatings sector in Asia-Pacific

Not too long ago, industry players were optimistic of double-digit growth again in Asia-Pacific region. This was primarily because of the demand from end-user industries such as steel, automotive, furniture and construction. The paints and coatings sector depends heavily on the end-user industries it serves and positive growth is generally expected in many of those segments. Countries such as China, India, Vietnam and Indonesia have been identified as high-growth countries where there are more opportunities for the development of the paints and coatings market. However, the specific high-growth segments vary between countries.

In India, the paints and coatings market has increased by approximately 15 per cent since 2009, reaching a market size of $ 3.8 billion in 2010. It was expected to continue to exhibit double-digit growth between 2011 and 2013. But, the current global economic situation may change this picture. Decorative and industrial coatings account for 65 per cent and 35 per cent of the total Indian paints market, respectively. Industrial coatings are generally expected to witness a higher growth rate compared to decorative coatings, owing to the increasing number of industrial facilities in India.

In India, the growing middle-class population and increasing sale of premium paints (mainly in urban areas) have been driving the demand for quality products. Huge foreign investments from multinationals such as Dutch group Akzo Nobel and Japan's Kansai have led to the expansion of facilities (due to low operating costs), boosting the industrial sector. The local government has also played an important role in increasing construction activities to accommodate the large population.

A global downturn: Setback for developing countries

A severe recession in the developed world would only slow, not stop, a more rapid growth in the emerging countries. According to Deutsche Bank, a 3 per cent decline in the gross domestic product of the European Union and the US over the next year would reduce China's economic growth rate by only 2 percentage points, to a still impressive 7 per cent.

Financial analysts are projecting that the hottest markets can fall the hardest when a global correction sets in. As of August 2011, the Nasdaq has fallen 11.7 per cent, the S&P 500, 10.7 per cent. Only Canada, rich in resources, has logged a smaller decline, 10.3 per cent. India has been a big loser this year. The 'Barclays iPath India' exchanged traded note has plunged 26.3 per cent in 2011 through August 2011.

India in perspective

India is growing fast – registered 7.7 per cent in the quarter to the end of June – but is rapidly becoming more costly. It has fast-climbing interest rates, and the highest inflation rate of any large emerging market. Food prices, in particular, look almost uncontrollable. Its companies are investing abroad rather than at home. Much of India's inflation was induced by soaring food costs, which in turn, were caused by weather damage.

Surging raw material cost (54 per cent) is a major concern. The top three effects of inflation experienced by the businesses are increases in labour, logistics and raw material costs. The impact is much greater for large companies, which are experiencing a lower demand for their products & services, and increase in raw material & labour costs. Tough economic situation affect the end-user industries such as steel, automotive and furniture, and construction, which the paints and coatings industry serves and depends on heavily.

The Reserve Bank of India (RBI) is closely monitoring all key indicators and is assessing the impact of global developments on Rupee & foreign exchange liquidity and macroeconomic stability. The RBI said its immediate priority was to ensure that adequate Rupee and forex liquidity is maintained in domestic markets to prevent excessive volatility in interest rates & exchange rates. The volatility of petroleum and raw material prices & exchange rate instability are major threats for the industry players.

A prolonged monetary tightening is having a greater effect on the economy. It squeezes investments and brings down growth to a rate that economists say will not be enough to pull millions out of poverty and spur consumption.

Morgan Stanley has revised its 2012 Indian economic growth forecast from 7.8 per cent to 7.2 per cent. They have noted India's big stock market losses and had warned those declines will hurt the economy. According to Morgan Stanley, "Reflexivity is at work – lower share prices are affecting growth and vice versa."

Buckling up for the future

Although the chemical industry has recovered strongly from the crisis, a potential double-dip recession still frightens even the greatest optimists. Further exacerbated by unstable economic conditions, emerging markets and shifting political power relations, decision makers in the chemical industry are preparing their companies for 2012.

There is some good news. Judged as a reaction to the economy, August 2011 seems a gross over-reaction. Purchasing managers suggest that growth is still positive. Demands for commodities appear robust. But, there is still the volatility of petroleum, and raw material prices & exchange rate instability remain major concerns. While growth is anaemic and fitful, history teaches that this is the best we could hope for after a major financial crisis. It is not yet clear whether the developed world has fallen into a fresh recession.

It may, however, be noted that in the worst phase of the previous global financial crisis, the Indian economy grew by 6.8 per cent, suggesting high resilience emerging from domestic factors. ■

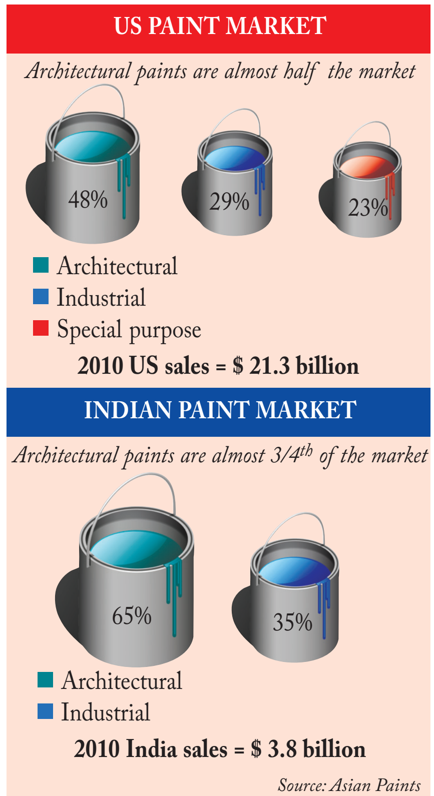

Figure 2: Paint market in the US and India

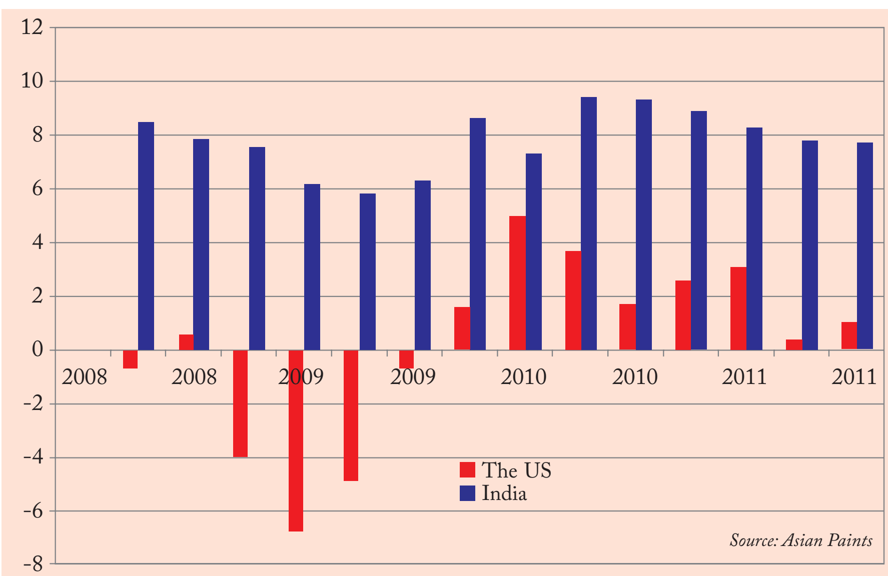

Figure 1: GDP growth rate (%) of the US and India

Dr Mosongo Moukwa is Vice President (Technology), Asian Paints Ltd, Mumbai. He was Vice President (Global Technology), Reichhold, North Carolina. He holds a PhD from the Universite de Sherbrooke, Quebec, Canada and an MBA from Case Western University, Cleveland, Ohio. He is a member of the American Chemical Society, the Commercial Development and Management Association and the Licensing Executive Society. Email: mosongo.moukwa@asianpaints.com