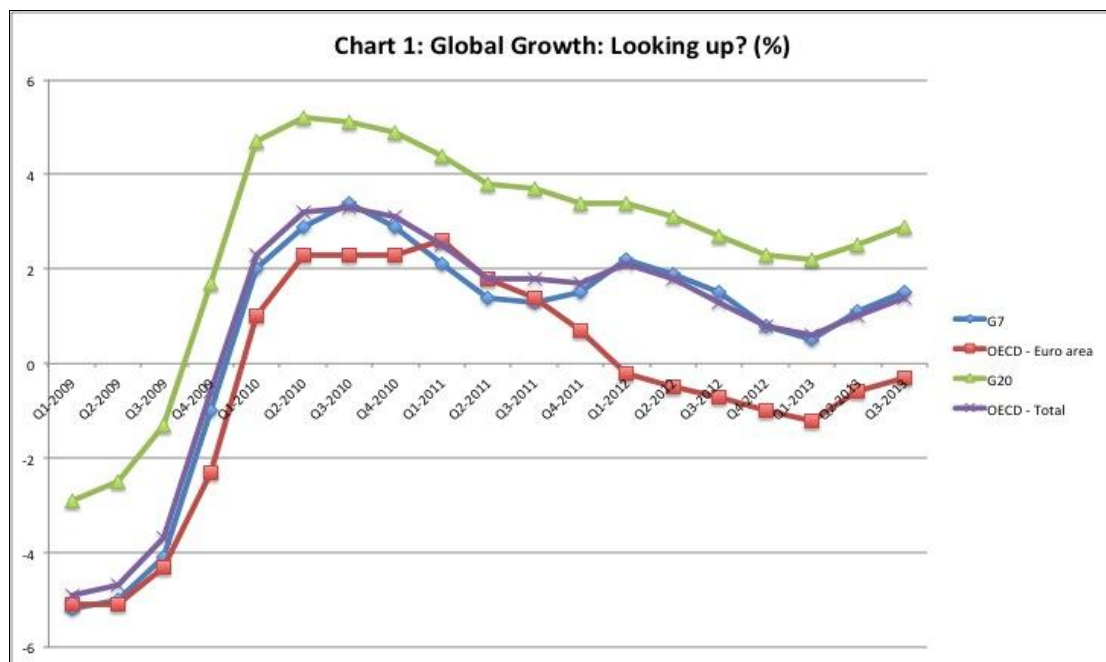


Search for Recovery

C.P. Chandrasekhar

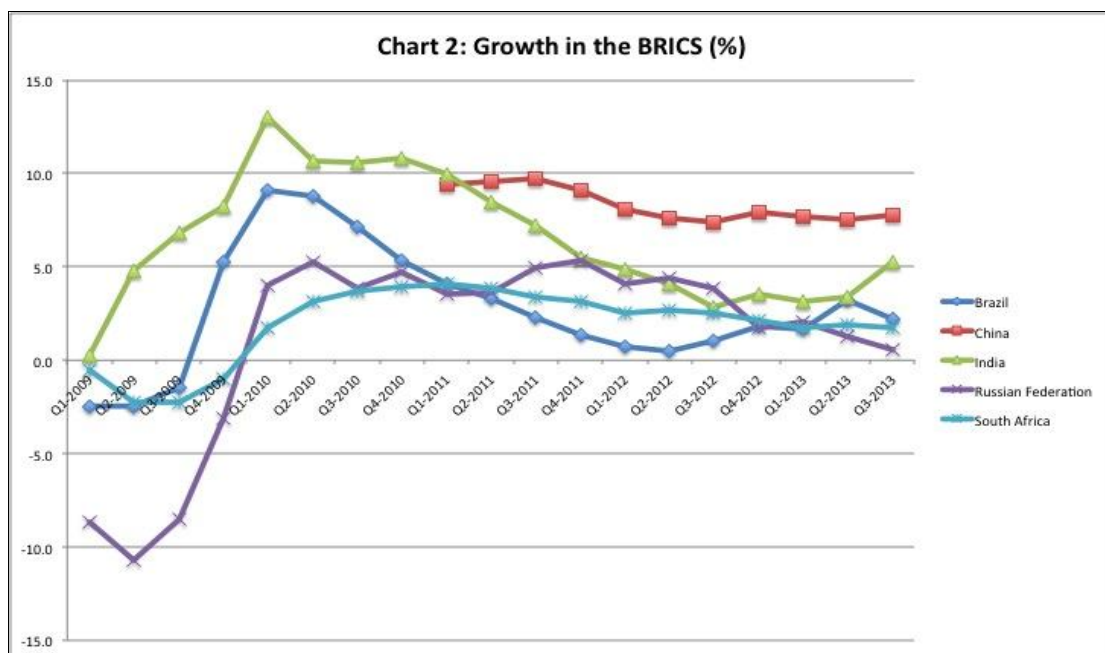
Even as the progress of the taper triggers capital flight from emerging economies, disrupting their markets and depressing their currencies, the World Bank and the IMF have held out hopes of a recovery. A growth rebound in the US, signs that the recession has bottomed in Europe, and expectations that growth would revive in developing countries other than China seem to underlie the optimism. But, as the Chief Economist at the World Bank, Kaushik Basu, in an effort to protect the organisation against the likelihood of its projection proving wrong, put it: “one does not have to be especially astute to see there are dangers that lurk beneath the surface.”

The reasons for this caution are obvious. First, as of now, every significant country/region of the world is either still in the midst of stagnation or growth deceleration (Chart 1). The ‘recovery’ is largely because of a minor upturn in a bent graph (Chart 1), from still low levels. Hope, therefore, currently rests on predictions. But, as the [Financial Times](#) recently noted: “For the past four years, analysts have predicted an imminent acceleration in the US economy, and got it wrong. The mediocre record is growth of 2.5 per cent in 2010, 1.8 per cent in 2011, 2.8 per cent in 2012 and something around 2 per cent in 2013.”



The second is that interest rates in Japan, the US and the Eurozone are either near zero or extremely low. This implies that monetary policy to stimulate growth, in the form of a reduction in interest rates, has run its course there without much impact. On the other hand, the space for fiscal activism is seen as restricted. Getting a recovery going is, therefore, even more difficult.

Finally, in countries like China and India, besides other emerging markets, the growth slowdown is accompanied by a rise in inflation rates. That makes addressing the slowdown through demand stimulation that much more difficult. India's central bank has just “shocked” markets by [raising the policy repo rate](#) by 25 basis points to 8 per cent. This, the third increase in six months, was a declaration that fighting inflation must take precedence over stimulating growth.



Though RBI governor Raghuram Rajan has explained the policy in terms of domestic compulsions, especially the high retail inflation rate, the evidence is clear that across emerging markets central banks are under pressure to raise interest rates despite slowing growth for external reasons (Chart 2). The principal reason is that the ‘taper’ or the gradual reduction in the Federal Reserve’s bond purchase policy is expected to push up interest rates in the developed countries. This is forcing emerging markets to maintain high and rising interest rates in the hope that they can withstand the hit from what Brazil’s central bank governor, Alexandre Tombini, has termed the “vacuum cleaner”—high developed country interest rates that would suck out capital from emerging markets.

Evidence of that likely hit is not lacking. In the week ending January 24 and the week that followed [emerging country stock indices fell sharply](#) and currencies depreciated because of capital flight, necessitating an emergency response by Argentina and Turkey to stem the fall of the peso and the lira. Besides the taper, these investor jitters seem linked to the expectation that the world economy is headed for another downslide. Besides the loss of momentum in China and India, those fears stem also from the threat of deflation in the developed countries. Even as the International Monetary Fund raised by 0.1 percentage point its 3.6 per cent global growth projection for 2013, the IMF has warned of the dangers of deflation in the US and Europe. In Europe too, the European Central Bank’s President Mario Draghi has said that he is in favour of finding ways to package bank loans to the private sector that would allow the ECB to buy into them and stall the collapse of bank lending.

Put together these developments and responses, the signal we get is that the world economy is not just still caught in a trough, but that the possibility of the “bottom” of that trough giving way for a further dip is all too real. Seen in that context the recent growth projection exercises by the Bank and the Fund appear to be more a way of talking up markets and persuading governments and central banks to act rather than a confident prediction that the worst is over.

(This article was originally published in The Hindu on January 28, 2014)