



What's Ahead for the Global Economy in 2008? Reports from the Knowledge@Wharton Network

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Though the subprime mess and rising oil prices slammed the U.S. economy during much of 2007, other emerging markets -- especially China and India -- seem to be on a roll. China's growth rate of more than 11% is likely to continue, and India, too, should be able to sustain a high rate of GDP growth, even if it slows from last year's 9%. Latin America, meanwhile, is cautiously optimistic but could see a moderate decline in 2008. The Knowledge@Wharton Network sites -- including Universia Knowledge@Wharton, China Knowledge@Wharton and India Knowledge@Wharton -- spoke with Wharton faculty and other experts about what to expect during the coming year.

U.S. Economy and Financial Markets: Uncertainty Reigns

How best to describe the outlook for the U.S. economy and financial markets in 2008? Uncertain at best.

High oil prices and fallout from the subprime mortgage debacle continue to threaten the economy and financial markets, according to several Wharton faculty members. Although none think a recession is guaranteed, all agree that even if a recession is averted, economic growth will be agonizingly slow. "There are a lot of unknown unknowns out there," says management professor [Marshall W. Meyer](#).

Perhaps surprisingly, none felt the U.S. presidential campaign will have much effect on the markets. As finance professor [Jeremy Siegel](#) put it, none of the candidates save John Edwards has a strongly anti-business platform, and the former North Carolina senator appears less and less likely to become the Democratic nominee. None of the others "are significantly anti-market. The market could live with Hillary or Obama, and of course it could live with any of the Republicans," he notes.

Siegel is more optimistic than many experts, thinking that the U.S. economy will slow during the first half of the year but will avert a recession and start to rebound in the second half. The chief threat, he says, is high oil and food prices, rather than the housing slowdown. "We've adapted pretty well to \$3 [per gallon] gasoline, but \$4 would be quite difficult," Siegel says.

"Forecasters are split about 50-50 on whether there's going to be a recession or not," he adds. "I think there's some predominance among professionals that there isn't [going to be a recession]. I'm in that optimistic group."

Siegel expects gross domestic product to grow at an annualized rate of 1% to 2% during the first half of the year, and perhaps 3% in the second half. "I'm predicting that we could rise to 3% in the second half of the year because I think that by the middle of this year, housing will hit bottom," he notes, adding that the economy could fall into recession if rising oil and gasoline prices dampen consumer spending.

As for the credit crisis, "Once this subprime crisis is sorted out, it will not be as bad as the market fears," Siegel says, predicting that the number of foreclosures and the losses in mortgage-backed securities will be smaller than many forecasters expect. "There is tremendous fear in the market today about what those losses are," he suggests. He thinks the market has overestimated the number of securities that will default on payments promised to investors.

Siegel did note that the financial markets were jarred by a recent report that unemployment in the U.S.



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had risen in December to a two-year high of 5%, but he doesn't think the situation will get worse, adding that the number of people with jobs had continued to rise. "The unemployment rate seems very anomalous to me. It's not likely to stay that way next month.... You've got to do some smoothing on that [statistic]. My feeling is it will go down to 4.9% or 4.8% once we get the January data."

Siegel adds he is "fairly optimistic" about the stock market, predicting a 10% to 12% return for broad market gauges like the Russell 3000 and Standard & Poor's 500.

Home Prices

According to Wharton finance professor [Franklin Allen](#), home prices and the cost of oil will be key factors in the U.S. economy and financial markets. "The key thing ... is what happens in the property market -- the housing market -- and how far prices will go down," he says. The severity of the situation may depend on which geographical regions are hit hardest. "That will determine what happens in the credit markets and if there is any spillover into the rest of the economy. That will drive what happens in the stock markets."

As for his prediction on housing prices, "I think they will fall for quite a while," he says, adding that "It's been a speculative market for quite a while. No one was sure how much speculation was there, but I think what we are finding out is that there was a fair amount.... There were people who were buying because they just thought prices would keep going up."

Speculators are putting homes that cannot be sold onto the rental market, depressing rental rates so far that they do not cover the speculators' carrying costs, he notes. When it becomes much cheaper to rent a home than to buy one, there are fewer buyers and home prices drop even further, he adds, warning that property prices could fall until the cost of owning is closer to the cost of renting.

Allen also suggests that with oil having recently climbed above \$100 a barrel, energy costs could play a big role in the economy and financial markets this year. "That's an interesting issue -- just how high the price of oil will go," he says. "I don't think it will go down significantly in the mid-term. I will think it would stay where it is and possibly go somewhat higher."

Allen predicts that stock-market performance will be heavily influenced by the prospect of recession, which will largely depend on the severity of the housing crisis. "The longer these house prices keep falling, the more likely it is that there is going to be a recession." At current prices, stocks will be "significantly overvalued" if there is a recession, causing share prices to fall substantially.

Meanwhile, the Federal Reserve is in a poor position to deal with the threat of recession because the standard remedy, cutting interest rates, could spark inflation, which is a looming risk because of high oil and food prices, Allen says. "With inflation picking up, the Fed has limited tools for dealing with the problem."

The behavior of long-term interest rates, which are set by the marketplace rather than the Fed, is something of a mystery, he adds. Normally, long-term rates drift upward as the Fed raises short-term ones, but this did not happen in the Fed's most recent tightening. "It's a fascinating question. I don't think we understand properly why [long-term rates] are so low." One possibility is a "flight to quality" as nervous investors move money from risky stocks to safer bonds, such as U.S. Treasuries, he suggests. The high demand pushes bond prices up, causing yields to fall.

This could change, he adds, if inflation picks up, causing long-term rates to rise. That could undermine economic growth by increasing the cost of borrowing, and it could exacerbate the housing crisis by making it harder for homeowners to get fixed-rate loans to pay off high-cost adjustable-rate mortgages. Rising interest rates, Allen says, "would be very negative for the housing market and everything else."

On the question of the U.S. trade deficit, Allen suggests that while some experts worry the trade deficit will cause a rise of protectionism in the U.S., he thinks the falling dollar may offset that tendency by strengthening U.S. exports. "Because the dollar has fallen so much, it's likely that won't be such an issue."

And while it may be too soon to speculate on how the presidential election could influence the markets, or whether Washington will impose new regulations, Allen says he would not be surprised to see new

regulations if the subprime mortgage situation evolves into a broader banking crisis. He says there may be pressure to tighten control of the ratings agencies, which many believe failed to see the risks inherent in the securities based on risky home loans.

When China Sneezes...

According to Meyer, the Chinese economy will be one of the biggest factors to influence the financial markets and world economy this year. China's huge demand for oil, metals and other commodities has pushed commodity prices up around the world. But Chinese officials are now taking unprecedented steps to slow their economy to control inflation, Meyer says. That should stop the spike in commodity prices, but it also will likely cause a slowdown in growth worldwide in 2008.

"The price of pork went up 70% last year," he says. "That's a bellwether number.... The average household in China is being squeezed." Historically, social unrest increases when the Chinese feel prices are too high, and incidents of unrest have risen dramatically in the past two years, Meyer says, adding that "the central government is adamant about restraining credit and, where they can, restraining prices, because the failure to do so creates social dynamite."

To stem inflation, Chinese officials have moved to tighten credit. Regional bank branches, which have long operated with great autonomy, are being put under stronger central control to assure that money is lent only to borrowers likely to pay it back. In addition, in a move meant to deflate the Chinese stock-market bubble, regulators have told Chinese mutual fund companies to stop buying Chinese stocks. "I can imagine that, informally, many other measures are being taken," Meyer notes.

The government, for example, is likely to stop subsidizing gasoline and diesel fuel. If prices for these fuels rise, demand will fall, helping to curtail the worldwide rise of oil prices. "It's inevitable that this will happen," Meyer says. "If you slow down the Chinese economy, you are going to slow down and reverse galloping petroleum and metal prices [worldwide]. I think we are coming close to the end of the commodity boom.... If this happens, people are going to be a little shaken, because the assumption has been that global growth will be driven by China and India." Meyer says he can't predict a recession in the U.S., "but I can see a slowdown in global growth because of the tightening in China."

He also contends that in the U.S. "greater taxation is inevitable," regardless of who becomes the new U.S. president, because Washington will have no choice but to tackle the federal budget deficit. "I doubt you'll see, for example, zero estate tax," he says, referring to the current law that will eliminate the estate tax in 2010.

As for his take on the credit crisis, Meyer predicts that uncertainty arising from the subprime mortgage collapse will continue to plague the financial markets. Currently, it is not possible to place a correct value on securities backed by mortgages and other forms of debt, such as corporate debt. Worries about this may continue to erode the balance sheets of banks and other financial institutions, he says, adding that there may be more bad news still to come.

Tax Cuts to the Middle Class

Wharton finance professor [Richard Marston](#) believes the U.S. economy will slow significantly, primarily because of the credit crisis arising from the subprime debacle. He believes Washington should step in with a stimulus package providing tax cuts to the middle class.

"At this point, the economy looks bad enough that it almost doesn't matter whether we satisfy the technical requirements of a recession," he says. "We are in a big slowdown.... Why has this slowdown occurred? The first ingredient is housing, but that alone would not have sunk the economy.... No, we needed the financial disruption that started with subprime loans."

A year ago, Marston warned that the market was underestimating risk, noting that investors were demanding very little extra yield for taking on the risk inherent in junk bonds and emerging-market bonds. Many financial institutions took on too much risk and in recent months they have suffered huge losses as prices have fallen on risky securities like those tied to subprime mortgages. "Add one more ingredient -- an oil price approaching \$100 [a barrel] -- and no wonder we are slowing down," Marston says.

He believes the securities markets have not fully accounted for the economic slowdown, suggesting stock prices could fall. "If the slowdown is here, then investors need to take heed," Marston says, predicting that riskier stocks, such as those investing in small companies, are likely to suffer the most.

Cautious Optimism in Latin America and Spain

Latin America's overall growth rate in 2008 will most likely face a moderate decline in 2008, according to economists, who add that their forecasts are the most optimistic for the Southern Cone countries (Argentina, Uruguay, Chile), and the least optimistic for Mexico and the Caribbean.

The region was expected to grow by an average of about 5% in 2007. However, because of the subprime mortgage crisis in the U.S., the expansion rate will be about 4.25%. Mario Ricardo López Ramírez, a professor at the University of Medellín in Colombia, predicts that South America's GDP will come in at 5.6% in 2007, slightly below the 5.8% recorded in 2006. He expects the trend to continue during 2008. This slowdown, he says, "can be explained by the risks associated with the decline in external demand and continued increases in international interest rates."

In Argentina, he adds, the prediction is for "6% growth in 2008, below the 7.5% recorded in 2007, and for 5.5% growth in Chile. He expects growth of 5.5% in Uruguay, 3.5% in Paraguay, 7.3% in Peru, 4% in Bolivia, 3% in Ecuador, 4.3% in Brazil and 5.8% in Colombia. In Venezuela, he projects growth of 7% as a result of large salary increases and high governmental spending. He also forecasts that Mexico and Central America will suffer a drop in their growth rate to 4%, "as a result of a slowdown in external demand related to the behavior of the American economy, as well as to declining domestic demand and restrictive monetary policy."

Despite such mixed forecasts, confidence in the economic progress of the region still exists. "Latin America continues to be in a very favorable economic cycle, which we believe will continue next year," says David Tuesta Cárdenas, a professor at the Catholic Pontifical University in Peru. He ascribes the situation to the structural reforms that began during the 1990s and which improved the competitiveness of the region through such measures as tariff reductions and trade agreements, the arrival of international investors, and the fact that "emerging nations such as China and India continue to lead the way in global growth and are the prime source of demand for [Latin American] raw materials. This situation seems to be continuing despite economic conditions on the global level."

At the same time, the region will be put to the test because of a possible deterioration in the external environment. Wharton management professor Mauro Guillén, head of the school's Lauder Institute, believes that "the impact [of the current crisis] will be small." Nevertheless, he warns that if there is a recession, "Mexico and Central America will suffer a great deal." Tuesta also stresses the important role that conditions in the U.S. will play in Latin America, although he notes that the region generally depends a lot less on demand from the U.S. than it did in the past.

Experts agree that it would be more troublesome if raw material prices dropped precipitously, but they predict that this won't happen unless there is a more abrupt decline in global growth. In addition, there is a negative side to high raw material prices. Although rising prices "favor growth in the region, they also generate excessive liquidity and increase expectations about inflation," notes Rafael Pampillón, a professor of economics and analysis at Spain's Instituto de Empresa. "The CPI [Consumer Price Index] can be quite upsetting for the economies of the region and it can force central banks to opt for higher interest rates. That, in turn, would put a brake on economic growth," he says.

Continued high prices for petroleum, which reached the \$100 per barrel mark at the start of 2008, will also increase inflationary pressures, according to Anita Kon, professor at the Catholic Pontifical University of São Paulo (PUC/SP) in Brazil. One saving grace, she notes, is that "since Brazil is self-sufficient in petroleum production, its import requirements are declining. In addition, the upward revaluation of the country's currency [the real] against the dollar promotes [Brazilian] imports." In 2008, the government of Brazil plans to begin exploring for oil in new basins, with an eye toward increasing the country's reserves.

Moreover, Kon says, Brazilian companies are very aware of what can happen as a result of a decline in the availability of global credit. "These financial blockades tend to have repercussions on the country's

growth rate, on its financial markets and on infrastructure investments." She predicts that the repercussions will be significant and negative in 2008 "because Brazil is taking in a growing volume of foreign direct investment in order to stimulate more growth, which is necessary because internal savings are scarce."

Another historic factor is political risk. The growing populism in the region is being watched closely by foreign investors and, according to Pampillón, presents a serious danger that populist governments in Venezuela and Ecuador "will proceed with excessive public spending programs and attempt to control prices and markets."

Spain's Housing Slowdown

Spain, on the other side of the Atlantic, shares its culture and language with Latin America. It also maintains close economic relationships with the region. In 2008, Spain's growth rate is expected to slow to about 3%, compared with 3.8% in 2007. Yet Altina Sebastián González, a professor of finance at the Complutense University in Madrid, believes that the current situation is "a storm but not a hurricane. While the percentage of bad loans in the U.S. has shot up, the situation appears to be under control in Europe. Credit differentials have increased, but not insolvencies." Sergio R. Torassa, a professor of finance at ESCI-Pompeu Fabra University, predicts that "corporate profits will continue on their same course, with an estimated growth rate of 10% in 2008. Spanish banking is enjoying strong solvency ratios; there are practically no bad loans, and the banking sector is highly efficient. Perhaps the only weakness is its dependence on foreign financing, which is becoming scarcer and more and more expensive day by day."

Given this environment, the forecasts from Sebastián and Torassa are cautiously optimistic. In 2008, notes Sebastián, "the Ibex 35, the main index on the Spanish stock exchange, will rise to about 17,000 points; the stars on the exchange will be the big companies -- electricity companies, banks, construction and telecommunications. Those companies that are better positioned to take advantage of a difficult situation are the ones that have size and liquidity, and are well diversified."

Regarding the liquidity crisis, "there are reasonable doubts about whether the worst has passed or it is about to come, and we'll get some answers when companies report their results for the third quarter," notes Torassa. In the international arena, "the credit crunch will come to an end when companies are able to determine the true scale of the problem and its victims. Meanwhile, suspicions will spread to all financial institutions, which will be paying for the sinners."

The main problem for 2008 is to figure out how far the repercussions will spread from the slowdown in the housing market, which has been the principal engine of Spanish economic growth in recent years. "If the decline in the volume of activity in Spain does not lead to any deterioration in the labor market beyond a net loss of 210,000 jobs," says Sebastián, "then it will be possible to recover."

For all that, the first week of 2008 brought data that is not very encouraging. Spain's inflation rate was about 4.3% in December, the highest rate in a decade. In 2007, unemployment increased to 5.2% over the previous year, and the consumer confidence index fell to historic lows. Pampillón warns that these numbers can generate what is known as the "savings paradox." When there is slower growth and more unemployment, "people consume less and save more, preparing themselves for bad times. This decline, in turn, depresses the economy; families spend less and companies sell less and produce less. They also get rid of workers to compensate for the decline in sales and production. Things get worse as a result of this supposedly virtuous behavior." In that kind of situation, it's no wonder that the consensus forecast for growth in Spain in 2008 is about 2.8%, Pampillón notes.

As for the political arena, Spain will hold its general elections in March. "Two of the big issues will be [low] productivity and the lack of competitiveness," Torassa notes. "Regardless of which party wins the election, the Spanish government will have to make these topics a priority on its agenda."

China: No Signs of Cooling Down

China is hot, and shows no significant signs of cooling down in 2008. Its growth rate clocked in at 11.5% for the past year and its stock market has been one of the world's best-performing markets over the past 12 months, with an average price/earnings ratio of 50.

"The U.S. recession next year is almost a done deal," suggests Andy Xie, an independent economist and former managing director of Morgan Stanley's Asia/Pacific economics team, in a recent speech in Beijing about China's economy in 2008. Though many commentators stick to the old adage that "when the U.S. sneezes, the rest of the world catches a cold," Xie believes that the outlook for emerging markets remains robust despite a potential recession in America. Thanks to Alan Greenspan, he adds, emerging economies nowadays are flush with cash.

What are the economic consequences for China's export-led economy? "The Chinese are going to suffer," Xie predicts. "Whereas in the past, the U.S. used to absorb Chinese savings and products, it will now want to turn the tables and export to China. "It's going to be an enormous challenge for us. Next year is the first year of this new world."

Meanwhile, increasing trade with emerging markets has been a "godsend" for China, Xie says, noting that China's exports to the West are already winding down. He predicts a 10% to 15% growth rate in these exports over the next year compared to a growth rate of more than 20% in recent years. This trend is partly due to market saturation, he says, and partly due to the loss of some cost advantage to countries like Vietnam and Bangladesh.

Emerging market trade, by contrast, already accounts for half of China's trade growth, says Xie. These economies export precisely what China needs -- commodities such as oil, copper and iron ore. In return, they buy cheap Chinese-made consumer products and capital goods. "In the short term, this is going to be a huge cushion for China," says Xie. "Next year, exports will continue to grow."

For Xie, this blossoming South-South trade represents "the dawn of emerging market development." He predicts that the large foreign exchange reserves in places such as India, Russia, Dubai and even Africa will have "very important implications for what happens next year," because these economies will continue to be able to spend despite the U.S. recession.

Scott Chu, head of strategy and business development for Pioneer Investment, paints a similar picture. "I don't think that the downturn in the U.S. will have any impact on China," Chu says. "China has shaken off its dependence on the growth of the U.S. economy. Consider the recent number of exports. In the third quarter of 2007, the U.S. economy slowed down while China still has robust growth in its exports, which grew faster than the exports of any other country. And if you look further, the fast growth destinations are the Middle East, Africa, Vietnam and Indonesia. China's exports will gradually relocate to the euro area, Middle East and South East Asia."

How much will the yuan's appreciation impact China's exporting? Not much, and the impact is positive, suggests Chu. "When the yuan gradually appreciates, those low-margin, labor-intensive, heavily polluted and low-value-added industries will be forced out of China, and enterprises will start upgrading themselves into high-value-added businesses while also trying to improve their efficiency. That's why in recent months, you see that China's trade surplus number is actually going up instead of going down."

Chu also sees "real estate consumption -- the biggest item for the Chinese and one that is driving all the related spending, including house renovation, electronics, furniture and life-style spending -- going up steadily. In short, China's consumption, exports and investments are all healthy, which suggests a 10% or above growth for 2008."

Adds Xie: "My hunch is that next year is okay," but he cautions that it would be an altogether different story if the U.S. falls into a deep recession, with 2% or 3% negative growth for the year."

A Bubble That Will Get Bigger

The upbeat export picture is not the only factor likely to bolster China's performance next year. "I believe the hot money story is going to become bigger next year," says Xie. Following the subprime crisis, money that would have flowed to the U.S. will instead come to China, he predicts. "Wall Street financiers, including my ex-colleagues, are leaving their jobs without waiting for their non-existent year-end bonuses, arming themselves with funds and taking aim at China. My phone has been busy. So the asset bubble you are seeing here is probably going to become bigger" next year.

This is despite the central government's efforts to cool investment in real estate. Property prices will only fall when the U.S. dollar strengthens and liquidity starts to flow out of China, according to Xie.

Meanwhile, Chu, when asked whether the P/E ratio is too high for China's listed companies, notes that "in certain periods of emerging markets, concurring currency appreciation and excessive liquidity, it's common to see a high P/E ratio. You can't simply compare China to Japan, the U.S. or Hong Kong, since the capital flow in those mature markets is free and is looking for the lowest P/E ratios with the highest profit growth companies. But in China, it's a different story because the country has relatively tight regulation on foreign exchanges and there are limited choices for investment."

In general, he concludes, China's stock market is more expensive than those in the U.S. and Europe. But there is logic behind it. "First, it's an indicator of high growth. For example, China's banks have strong profit growth and [significant] middle market business potential, and the commissions they charge are much higher than in other countries. Some companies in China are in a monopoly position and therefore it's understandable to see high P/E ratios.

"From the perspective of demand," he continues, "you can see that with an inflation rate of 6% to 7%, the ordinary Chinese people are moving their bank deposits to the assets market. As long as the actual interest rate is negative and the yuan keeps appreciating, the money from both home and abroad to buy these assets will keep on growing, and growing fast."

Chu suggests taking a cautiously optimistic approach to China's A share market in 2008. "It will be very good if you have a return of between 10% and 30% next year. My view is that after the first quarter of 2008, the market will have a deep correction."

Meanwhile, in early December, China's government announced a "tougher" economic policy for 2008, which is a rare and significant change in its official stance. Chu says that the biggest risk for China now is inflation. "The actual inflation rate is far exceeding the official number of 6.7%. If inflation expands to a certain point, it will be a disaster for the whole economy and the stock market as well."

Zhou Qiren, an economics professor at Peking University, noted in a speech in Beijing in early December that the main challenge China's economy faces comes from its currency. "Excessive liquidity is reshaping the price level and pushing up all the [basic] costs." Adds Zhou: "It's unprecedented in the history of [mankind] that labor, information, technology and capital can be flowing freely and be re-organized around the globe. This forms the basis for a big transformation. China has experienced tremendous growth in the past three decades. But I see 2008 as a major turning point for its economy."

India: Shipshape at Home, Even If Global Tides Ebb

The Indian economy is likely to face pressures in 2008, and its 9% growth rate of recent years will feel the pain of a U.S. slowdown, according to economists and investment managers who spoke to Knowledge@Wharton. Led by rapid growth in Asia, India's fortunes are certainly getting increasingly "decoupled" from the U.S. economy, but the country faces other challenges. Inflationary pressures loom, but opinion is divided on whether that could force interest rates to rise. The increasing cost of capital is already beginning to sap retail and corporate borrowing appetites around the country.

"India has a 50% chance of suffering a painful downturn in 2008-09, a 30% chance of a mild downturn and only a 20% chance of continuing with rapid 9% growth," says Swaminathan S. Anklesaria Aiyar, a well-known Indian economist and columnist. Aiyar says he limits the chance of a painful downturn to 50% because, like many other advocates of the so-called "decoupling" theory, he sees a U.S. slump impacting India to a lesser extent now than it might have in earlier years.

Aiyar cites the International Monetary Fund's World Economic Outlook (October 2007), which has marked down its global growth projection for 2008 by almost half a percentage point to 4.8%, while that for the U.S. is down a full percentage point to 1.9%. It is less harsh on prospects this year in Asia, where it says "growth may moderate somewhat;" in 2007, China and India posted 11% and 9% rates, respectively.

But "it could be extremely painful" if India were to slow from 9% to 7% this year, says Aiyar. He recalls how a similar two-percentage point drop in India's growth rate in the years following the 1994-1997

Asian financial crisis flattened industrial growth. "Exports collapsed, any number of plants set up with a view to exporting in effect went bust, and the banks lending to them went bust." However, he sees Indian companies much more resilient to a downturn these days, with lower borrowing costs and healthier debt-equity ratios.

Ruchir Sharma, the New York City-based head of global emerging markets at Morgan Stanley Investment Management, says he doesn't buy the theory that India's growth rate could dip by two percentage points. He is "bullish on India" this year because he sees "quite a large opportunity" in investing there relative to his capital pool. Sharma oversees equity investments totaling some \$35 billion in emerging economies, of which India accounts for a little less than \$5 billion.

In terms of absolute allocations, India shares second place along with Russia and Brazil in Morgan Stanley's emerging market investments, after China, says Sharma. On the question of increasing allocations to India this year, he says his fund is already "overweight" on India with more than a tenth of total funds invested there.

Indian finance minister P. Chidambaram has also fueled optimism by hinting at income tax cuts when he unveils his annual budget in February. Chidambaram is encouraged, says Aiyar, by the dramatic growth in direct tax collections. They jumped 40% in 2006, and are expected to be 42% higher in 2007, or by Rs. 90,000 crore (\$24 billion).

Interestingly, the higher tax collections are driven not just by better compliance and improved tax administration, says Aiyar. He is convinced that many businesses are bringing onto their books a lot of "black" money -- or funds that are not accounted for -- with the lure of initial public offerings. "The IPO price is a certain multiple of the book profits," he says.

A "Sticky Wicket"

Aiyar, however, sees danger on the inflation front led by higher wheat prices. He says Indian wheat prices are half the prevailing global level of about Rs. 20 a kilo (53 cents). "In a relatively open global economic system, you can't keep this up for very long," he says. In fact, he notes, it makes sense for the ruling Congress-led alliance to call for mid-term elections this year; it may face "a sticky wicket in 2009" when the next general elections are due, he adds.

Sharma believes that inflation triggered by higher food prices could puncture the promise of rapid economic growth continuing in India. "If the central bank were to raise interest rates more aggressively to curb food inflation, that would concern me a lot," he explains.

The asset growth of India's banks could be constrained in 2008, largely because of a deceleration in mostly retail credit demand, says Abheek Barua, chief economist at HDFC Bank in Mumbai, adding that interest rates on retail loans like mortgages and auto finance have risen an average three to four percentage points during the past year. "The interest rate signals we continue to get from the Reserve bank point to a tight policy."

Sharma, however, believes that "there is scope for monetary policy to ease." He says most other central banks in developing economies are facing pressures to either increase interest rates or stop cutting rates. India has already had its "inflationary scares" in early 2007, he notes.

But Barua sees growth plans and capacity expansion at Indian companies facing challenges in accessing overseas credit with "the very large-scale credit contraction in the Western markets." He says he notices "significant levels of risk aversion from banks in the developed world." But he sees respite in "institutional changes" such as a policy commitment to develop India's corporate bond market.

Aiyar is encouraged by progress elsewhere, such as with rural telecom penetration and a government program to connect India's villages with motor-friendly roads. "You have to create conditions where entrepreneurship and new business can prosper, and that requires connectivity, which at long last is coming," he says.

Arindam Sengupta, resident editor of *The Times of India* newspaper in New Delhi and an avid watcher of the political scene, says he is worried about "uneven growth" in the medium and long run. He says the

central Indian states of Madhya Pradesh, Uttar Pradesh and Bihar have seen less growth than others. "There are swathes of the population that have been left out of the success story and that leads to social tensions," he says. "This expresses itself in Naxalism [a radical left-wing political ideology] and insurgency."

Sengupta says international investors no longer need to be worried by the dynamics of India's coalition politics that sometimes see the Leftist parties strike discordant notes. He reads intermittent objections from the Left to market-friendly proposals as a "branding exercise" that the Left needs to secure its identity. "Overall, there is no argument on that front," he says. "India is on the path of the market economy, and the Left has agreed."

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