Global Economic Outlook

4th Quarter 2013

Deloitte University Press

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PREFACE

Dr. Ira Kalish is chief global economist, Deloitte Touche Tohmatsu Limited

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THINGS have certainly changed since our last report three months ago. Europe appears to be coming out of recession, China appears to be stabilizing, and the United States appears to be going back to square one. That is, after several months in which markets anticipated a shift in monetary policy, nothing actually happened. The Fed left policy unchanged. In Japan, the burgeoning success of Abenomics is juxtaposed against an impending tax increase. Finally, emerging markets, having seen a sizable slowdown in growth, and attacks on their currencies have been given a brief reprieve by the US Federal Reserve. Still, the short-term growth outlook remains modest at best.

In this issue of the *Global Economic Outlook*, we begin with Patricia Buckley's take on the US economic situation. While acknowledging that the Federal Reserve was probably correct to view the US recovery as too weak to shift policy, Patricia offers hope that a rebound in residential construction might be the spark that ignites stronger growth in 2014. She worries, however, about the potential impact of congressional failure to provide a stable and predictable fiscal policy.

Speaking of Federal Reserve action, or inaction, Navya Kumar and Akrur Barua offer a perspective on the impact that expectations of Fed action already had on emerging markets. In addition, they discuss the likely outcome for emerging markets once the Fed ultimately moves to slow the pace of asset purchases. Navya and Akrur consider whether the current situation is similar to that of 1997, when emerging markets in Asia faced a financial crisis. They conclude that the situation is quite different and that, today, emerging markets are much better prepared to withstand external financial shocks. Navya and Akrur conclude that, while short term challenges exist, long-term prospects for emerging markets remain attractive.

Next, Alexander Börsch celebrates the end of the Eurozone's long recession, but notes that growth remains less than spectacular. Alexander suggests that given various risks and obstacles, it is likely that Eurozone growth will remain "slow and bumpy." He notes that among the risks to Europe, are a slowdown in emerging markets, continuing troubles in Europe's credit markets, and persistently high unemployment—the latter potentially undermining political stability.

In our next article, I offer my point of view on Japan. So far, Japan's economic performance in the wake of the new economic policy has actually been quite good. Growth has been strong, and various economic indicators are hopeful. Among them are increased equity prices, a lower yen, increased inflation, and the strength of exports. Yet I also note the risk stemming from the impending increase in the national sales tax, and I discuss the various policy options that the government might implement to offset the negative impact of the tax increase.

On China, I discuss the various economic indicators that suggest a stabilization of Chinese growth after a period of deceleration: strong industrial production, exports, and rebounding credit creation. On the other hand, I discuss the risk of credit expansion, the tools that the government might use to improve bank safety, and how the property price bubble has been exacerbated by the failure of the financial system to offer good investment opportunities for savers. The end result, of course, is that banking reform is critical, an issue that will be top of mind when the leadership meets in November to discuss a reform agenda.

Next, the chief economist for Deloitte UK, Ian Stewart, provides his assessment of the outlook for the British economy. Ian notes how much things have changed in recent months and how the British economy appears to be on the mend. Indeed, there is now concern that the housing market is exhibiting signs of a bubble. Ian says that positive external factors have played a role. These include an easing of economic stress in Europe and recovery in the United States. He concludes that "cheap money and the absence of big external shocks are working their magic."

Our examination of the remaining BRICs begins with India. Rumki Majumdar says that economic growth continues to decline, inflation remains too high, fiscal discipline is declining, the external deficit is widening, and business confidence is poor. Moreover, a new central bank governor is focusing first on inflation and financial stability rather than growth. The result is that the best path forward for India involves structural reforms that have yet to be legislated or implemented. However, Rumki notes that the recent Federal Reserve decision to postpone a shift in policy provides India with a bit of breathing room. On the other hand, Rumki worries that significant reform will wait at least until after the election in 2014.

As Navya Kumar notes in our next article, Brazil also faces the challenge of slow growth, excessive inflation, and a deteriorating external balance. She says that, despite a rebound in growth in the second quarter, the outlook remains troubling. Despite slowing growth, the central bank has tightened monetary policy in order to stabilize the currency and fight inflation. Plus, the government is tightening fiscal policy in order to maintain fiscal probity. The main hope for better performance rests with prospects for freer trade, especially with the EU.

Finally, Akrur Barua examines the Russian economy. Like many other emerging markets, Russia faces a difficult time. Growth has been slowing in recent quarters, with investment weakening and exports performing poorly, owing to weakness abroad. Moreover, excessive reliance on hydrocarbons means that falling energy prices are harmful to growth. With inflation running relatively high, the central bank is not likely to significantly loosen policy. Plus, fiscal policy is likely to be tightened. Finally, foreign direct investment has dried up, and funds are flowing out of the country. Thus, the outlook appears troubling.

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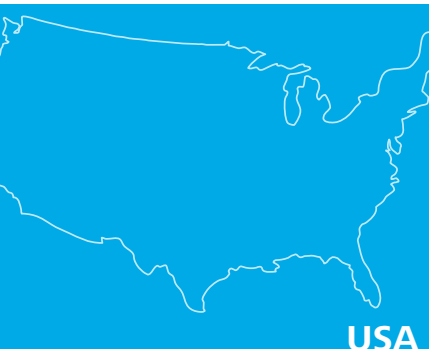

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United States: Over four years into the recovery—where are the jobs?

By Dr. Patricia Buckley

The US Federal Reserve Board holds steady on asset purchases in the face of disappointing job growth as we continue to wait for the pickup in economic growth that remains stubbornly "just around the corner." Unfortunately, not even the continuation of a highly accommodative monetary policy can overcome the drag inflicted by Congressional brinkmanship over the federal budget and financing the nation's debt.

WHEN the Federal Open Market Committee (FOMC) of the Federal Reserve Board met in September, they shocked most economic pundits by deciding to keep the Fed's rate of asset purchases steady at the $85 billion per month level set exactly a year earlier when they launched the current round of quantitative easing—QE3. They had concluded that the available data did not indicate the "substantial improvement in the outlook for the labor force" that they set as the standard that would let them begin ratcheting down the rate of purchases. Although financial markets reacted to the announcement by pushing stock indices to record or near-record levels, the FOMC analysis was correct: Notwithstanding recent declines in the unemployment rate, US labor market conditions are only improving at a moderate rate. So what will be the trigger that unleashes stronger job growth? One possibility can be found in the sector that triggered the crisis initially—residential construction.

The continuing lackluster recovery

Since the recovery began in June 2009, the US economy has been growing 2.2 percent on average with no emerging pattern of acceleration. In fact, growth over the first half of this year—at an annualized rate of only 1.8 percent—has been even slower than average. Given the severity of the 2007–2009 recession, this rate of growth has not been sufficient to recover the jobs lost during that period. Employment has increased by 6.8 million since the low point reached in early 2010, but the United States still has 1.8 million fewer jobs than it did prior to the downturn (see figure 1).

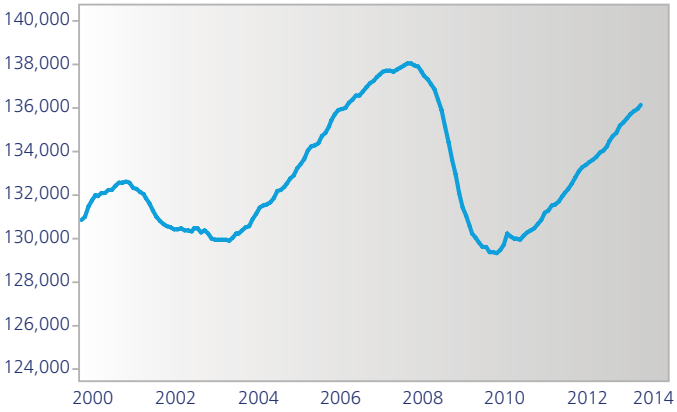
Unemployment has been steadily declining, but at 7.3 percent, it is well above pre-recession levels. In addition, several other factors point to a less-than-robust employment situation:

- Although labor force participation has been falling over most of the past 15 years, the pace of decline has been more rapid over the course of this recession and recovery, and at 63.2 percent, it is at levels not seen since the late 1970s. Some of the causes of declining labor force participation, including a growing number of retirees and increasing numbers of young people in college, are not negative, but at least some portion of the decline is due to people dropping out of the labor force because they do not think they can find a job.

- Long-term unemployment remains elevated. Those unemployed for 27 weeks or longer make up 38 percent of the total 11.3 million people who are currently unemployed—a high proportion by historical standards. The longer people are unemployed, the more difficult it is to find employment and the less likely it is to find employment with earnings comparable to their prior earnings.

Figure 1. Total nonfarm employment

Thousands of employees



Source: Bureau of Labor Statistics

Graphic: Deloitte University Press | DUPress.com

Since the recovery began in June 2009, the US economy has been growing 2.2 percent on average with no emerging pattern of acceleration.

- The broadest measure of unemployment—total unemployed, plus all persons marginally attached to the labor force, plus total employed part time for economic reasons as a percent of the civilian labor force, plus all persons marginally attached to the labor force—remains a very high 14.0 percent.

- Youth unemployment—young people between the ages of 16 and 19 who are looking for a job—is 22.7 percent.

So where are the jobs being created?

Figure 2 shows a comparison of employment levels at the overall employment peak of January 2008 with the most recent estimates from August 2013. Health care is the most anomalous of the sectors as it is the only major sector that did not lose jobs during the recession. Its employment level is currently 1.7 million or 11.1 percent above its January 2008 level. Several sectors have overcome the losses they experienced during the recession and have passed their prerecession employment peaks. These include accommodation and food service (640,000 or 5.5 percent above the prior peak), private education services (340,000 or 13.3 percent), and professional and business services (571,000 or 3.4 percent). These sectors should continue to be drivers of employment growth in the economy as they continue on a trajectory consistent with their prerecession paths.

Other sectors remain substantially below their prior peaks, including manufacturing (−1.8 million or −12.8 percent) and construction (−1.7 million or −22.4 percent). Given the large size of these job losses, it is worth considering the potential of these sectors to contribute to employment growth going forward.

Manufacturing—Manufacturing employment peaked at 19.5 million in 1979, and during the 1980s and 1990s, it fluctuated around the 17 million mark. Leading into the 2001 recession, manufacturing employment began a deep slide that moderated rather than reversed in the recovery that followed. During the most recent recession, the decline in manufacturing employment was even steeper, and 12 million jobs were lost during the recession and its immediate aftermath. Since the February 2010 low point, the manufacturing sector has recovered 500,000 jobs. During the first eight months of 2013, manufacturing employment has remained flat (see figure 3).

When manufacturing employment first started rising in 2010, it was hailed by some observers as the beginning of a renaissance in US manufacturing. Indeed, manufacturing output has staged a remarkable recovery—after falling by

Figure 2. Employment levels by sector

Source: Bureau of Economic Analysis

Graphic: Deloitte University Press | DUPress.com

just over 20 percent during the recession, output is now only 4 percent below its prerecession peak. However, as mentioned earlier, even with the recent recovery, manufacturing employment remains 12.8 percent below its prerecession level as productivity increases in the manufacturing sector are substantially higher than for the economy as a whole.

The recovery in autos and auto parts, a subset of manufacturing, is noteworthy, given the taxpayer investment and government-sponsored reorganization that turned around two of the big three US automakers. In 2011 and 2012, all three companies made profits for the first time since 2004. Even though employment in auto and auto parts accounts for less than 7 percent of manufacturing employment, this subsector accounted for 31 percent of the 503,000 manufacturing jobs created since manufacturing employment's low point in February 2010.

As the manufacturing sector continues to recover and expand, it should be able to continue generating jobs; falling energy prices and a large consumer market make the US an attractive place to manufacture. However, high productivity will limit the size of employment growth in this sector.

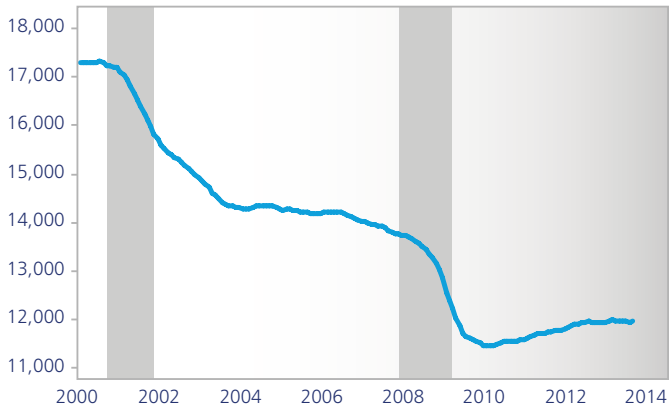
Construction: The collapse of the housing market led the way into the 2007–2009 recession, and employment in this component of the construction sector peaked well in advance of the start of the recession in April of 2006 at almost 3.5 million workers (see figure 4). The low point for this series came in January 2011; a year and a half after the official end of the recession, employment in residential construction shed 1.5 million jobs or 42 percent of its prerecession peak. Employment recovery for all the construction components has been slow.

Data on residential construction spending is following the same pattern of slow recovery, but this is a trend that should reverse soon and bring more construction jobs with it. Consider:

- Existing-home sales in August reached their highest level in 6.5 years, while the median price shows nine consecutive months of double-digit, year-over-year increases.[1]

Figure 3. Manufacturing employment

Thousands of employees

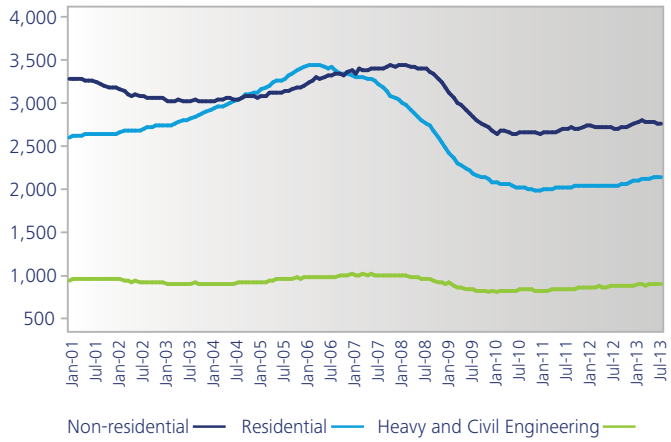


Source: Bureau of Labor Statistics
Note: Shaded areas indicate areas of US recession.

Graphic: Deloitte University Press | DUPress.com

Figure 4. Construction employment type

Thousands of employees



Source: Bureau of Economic Analysis

Graphic: Deloitte University Press | DUPress.com

- Inventories of houses for sale are very low—just 4.6 months' worth of existing homes were available for sale in August.[2]
- The population has kept growing, but the pace of household formation has lagged, indicating substantial pent-up demand for housing.
- Household net worth has passed its prerecession peak.
- Even though mortgage rates have increased (in part, due to the Fed signaling that the end of QE3 was closer than it now appears to be), they are still very low by historical standards.
- Although job creation has been slow, employment is still increasing—2.2 million jobs have been created in the last 12 months alone.

Since construction is the first step in a process that generates demand for many types of goods and services (appliances, furnishing, lawn care, etc.), a pickup in construction employment could quickly build employment momentum. We have worked through the housing overhang, reducing excess inventory from the system. When we finally see acceleration in construction employment, it should be viewed as the signal that the acceleration of the US growth rate that has been "just around the corner" for too long has finally arrived.

And now the bad news

We continue to expect stronger growth in 2014 than we will have in 2013—not an especially high bar given the damage that will be reflected in the fourth quarter from the 16-day government shutdown and the loss of consumer and business confidence from the threat of default. However, we cannot be completely sanguine about US growth prospects, particularly for the early part of next year, since the current budget agreement only funds the government through January 15 and extends the debt ceiling until February 7. Although we are hopeful that our elected leaders will act responsibily and put the US economy on a sustainable growth path rather than precipitating another crisis, recent events have given us reason to be skeptical.

Endnotes

1. National Association of Realtors, press release, September 19, 2013.
2. Ibid.

COMPREHENSIVE REVISION TO GDP

With the initial estimate of second quarter 2013 GDP in July, the Bureau of Economic Analysis (BEA) of the US Department of Commerce incorporated major changes in how business investment is reported and the way pensions are accounted for in the National Income and Product Accounts. These changes were made as part of a comprehensive revision that generally occurs every five years and are consistent with the 2008 update to the international guidelines for national economic accounts. In addition, the revisions incorporated the results of the 2007 economic census and the benchmark input-output accounts as well as other data improvements (including improved measures of banking services). The entire time span dating back to 1929 was open for revisions.

This benchmark revision includes major conceptual changes:

- Capitalization of research and development
- Capitalization of entertainment, literary, and artistic originals
- Change to accrual treatment of defined benefit pension plans
  - Accrual accounting better reflects the retirement benefits an employee earns and thereby improves measures of compensation by more closely aligning the accrual of retirement benefits with the employee's work. Accrual accounting is also consistent with business accounting standards.
  - Under the prior current cash accounting approach, sporadic cash contributions made by employers to the pension funds result in volatility in the measure of compensation that did not accurately reflect the relatively smooth manner in which benefits are earned by the employee.

As a result of the changes to capitalize R&D and artistic efforts, BEA now publishes three categories of business fixed investment:

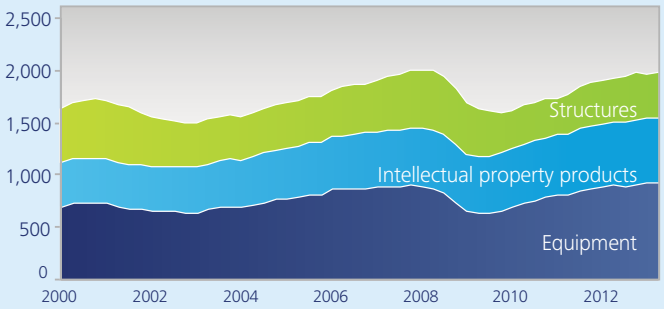
- Business fixed investment in structures
- Equipment (no longer including software)
- Intellectual property products
  - Software (currently included with equipment)
  - Research and development
  - Entertainment, literary, and artistic originals

In real terms, business investment has almost returned to its prerecession peak, with equipment making up 46 percent of the total, followed by intellectual property at 32 percent and structures at 22 percent (see figure 5).

The results from the revision are shown in figure 6. The largest change in the recent history was an upward revision in 2012, where GDP growth is now estimated to have been 2.8 percent rather than 2.2 percent. The increase in the 2012 annual growth rate came from a significantly stronger Q1. The other quarters in 2012 were revised downward.

Figure 5. Business investment by type

Billions of chained (2009) dollars

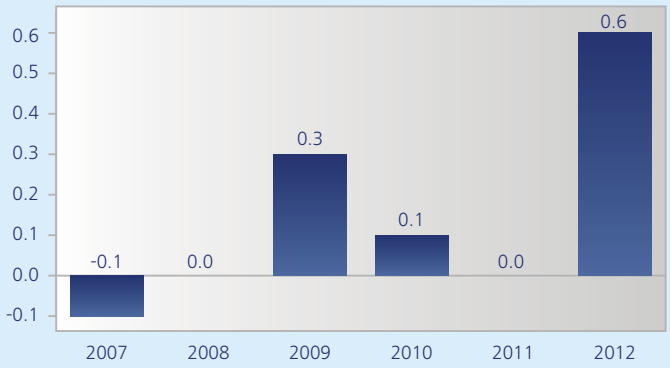


Source: Bureau of Economic Analysis

Graphic: Deloitte University Press | DUPress.com

Figure 6. Real gross domestic product

Revision in percentage change, 2007–2012



Source: Bureau of Economic Analysis

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SPECIAL TOPIC

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The impact of Fed tapering on emerging economies: Struggling with the ebb

By Navya Kumar and Akrur Barua

ON September 18, 2013, the US Federal Reserve (Fed) surprised the world by deferring the planned winding down of its quantitative easing (QE) program. The announcement brought some respite to capital, currency, and commodity markets across the globe. Since May, when the Fed first hinted at a gradual winding down of QE starting later this year, markets have been hit by sharp capital outflow from emerging economies, rising interest rates, and uncertainty about the impact of QE tapering on US economic growth. Emerging economies have been the worst-affected, especially those with large current account deficits, high external borrowings relative to reserves, and weak public finances.

Ominously, the sharp fall in currency and capital markets in emerging economies has provoked comparisons with the Asian financial crisis of the 1990s. Economists worry that a swift tapering by the Fed could produce a similar scale of fund outflow from emerging economies, impacting banking sector health, currency stability, and the wider economy. Although some of these concerns are well founded, the situation today is different from the 1990s. Economies now have larger foreign reserves, better capital controls, and lower banking sector risks with less exposure to external wholesale funding.

Policymakers in emerging economies have also proactively countered the current dip in currencies, equities, and bonds. Luckily for them, the Fed's latest decision will give them a bit more time to fine-tune policy, but they might encounter higher volatility in the short term due to uncertainty over tapering. Nevertheless, with long-term growth prospects still strong, the current adversity will hopefully nudge these economies to focus more on reforms aimed at enhancing competitiveness and removing structural bottlenecks.

Economies now have larger foreign reserves, better capital controls, and lower banking sector risks with less exposure to external wholesale funding.

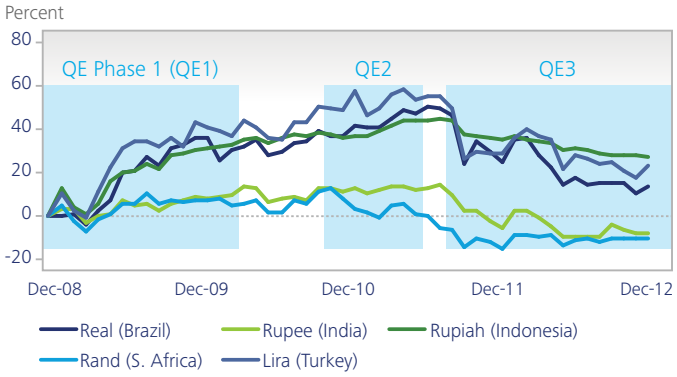
Emerging economies' face-off with QE: Not a new phenomenon

Having to bear the brunt of the Fed's announcement in May, central bankers in emerging economies have urged the Fed to be cognizant of global implications before enacting any change to its current asset purchase program. Ironically, this is not the first time that emerging economies are seeking greater cooperation from the Fed. In 2009–2010, after the Fed's launch of QE, emerging economies witnessed a flood of inflows of cheap money. This propped up equity, currency, and bond markets in these economies (see figures 1 and 2). In some economies, money flowed in despite lower growth prospects and structural deficiencies. For example, in 2009, the Brazilian real appreciated by almost 36 percent, and the equity market nearly doubled even though real GDP fell 0.3 percent, compared to growth of 5.3 percent in 2008. In fact, the real continued to appreciate against the greenback well into 2010, prompting the country's finance minister to accuse the Fed of unleashing a currency war.

Impact of the Fed's hint of tapering on emerging economies

Speculation about a possible tapering by the Fed has propped up interest rates in the United States, thereby reducing the yield differential on debt instruments that emerging economies were enjoying before the announcement. At the same time, improving economic data in the United States have ensured that equities there have outperformed their emerging-market counterparts. This has paved the way for a reverse flow of funds back into the United States. No wonder then that the Fed's statement in May has led to a hammering of emerging market currencies, stocks, and bonds (see figures 3, 4, and 5). For example, by September 1, 2013, the Indian rupee and the Brazilian real had fallen by more than 15 percent each since the Fed's announcement in May. In

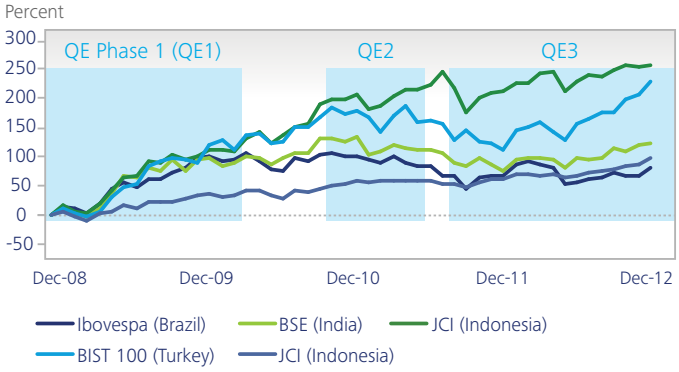
Figure 1. Emerging economies' currency returns versus the US dollar since the start of QE till early 2013



Source: Bloomberg, September 2013

Graphic: Deloitte University Press | DUPress.com

Figure 2. Emerging economies' equity index returns since the start of QE till early 2013



Source: Bloomberg, September 2013

Graphic: Deloitte University Press | DUPress.com

equity markets, Indonesia's Jakarta Composite Index and Turkey's BIST 100 shed nearly 20 percent each during this period. In debt markets, 10-year government bond yields in Turkey have shot up by nearly 370 basis points (bps) since May 1; the corresponding rise in Indonesia was about 290 bps.

It is noteworthy that for a number of emerging economies, including South Africa, Turkey, and India, much of the current turmoil is also due to deterioration in economic fundamentals, primarily high current account deficits, entrenched inflationary pressures, and deteriorating public finances. Concerns about the Fed tapering off can be considered a trigger for the outflows, but not the sole reason for them. However, the impact of tapering concerns extends even to economies with relatively better fundamentals. For example, the Philippines, which has better growth prospects, public finances, and external position, has taken a significant hit to its currency, equity market, and bond yields. From May 1 to September 1, 2013, the peso depreciated 8 percent, stocks fell 16 percent, and 10-year government bond yields went up 28 basis points.

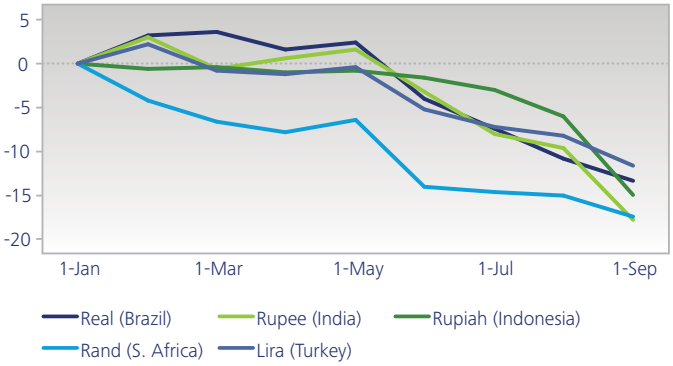
It is noteworthy that for a number of emerging economies, including South Africa, Turkey, and India, much of the current turmoil is also due to deterioration in economic fundamentals, primarily high current account deficits, entrenched inflationary pressures, and deteriorating public finances.

Definitely not a rerun of the Asian financial crisis

The sudden dip in emerging market currencies, equities, and bonds have led some to draw parallels with the Asian financial crisis of 1997 when Indonesia, Malaysia, Philippines, and Thailand saw their currencies plummet with massive capital outflows. The crisis left these economies tending to scores of bankruptcies and requiring bailouts from the International Monetary Fund. A repeat of such a crisis will be debilitating to the global economy, especially when it is still recovering.

But is the situation today really as dire as in 1997? It would appear not (see figures 6–9). Compared to the 1990s, emerging economies today hold nearly five to ten times more foreign exchange reserves, giving them substantial resources to protect their currencies. In addition, countries at the heart of the crisis in 1997, including Malaysia, Philippines, and Thailand have vastly improved current account balances, which place them in a position of strength. Significantly lower levels of external debt also bolster the countries' standing. Furthermore, the banking systems of most major emerging economies are more robust today and more likely to withstand shocks. Hence, it may be safe to say that we will likely not witness a repeat of the Asian financial crisis. However, pockets of concern remain such as the wide current account deficits and external debt positions of South Africa and Turkey. India too needs to bridge its yawning current account gap.

Figure 3. Emerging economies' currency returns versus the US dollar since January 2013 (%)



Source: Bloomberg, September 2013

Graphic: Deloitte University Press | DUPress.com

Figure 4. Emerging economies' equity index returns (%)

Source: Bloomberg, September 2013

Graphic: Deloitte University Press | DUPress.com

Figure 5. Change in 10-year government bond yields of emerging economies since May 2013 (basis points)

Source: Bloomberg, September 2013

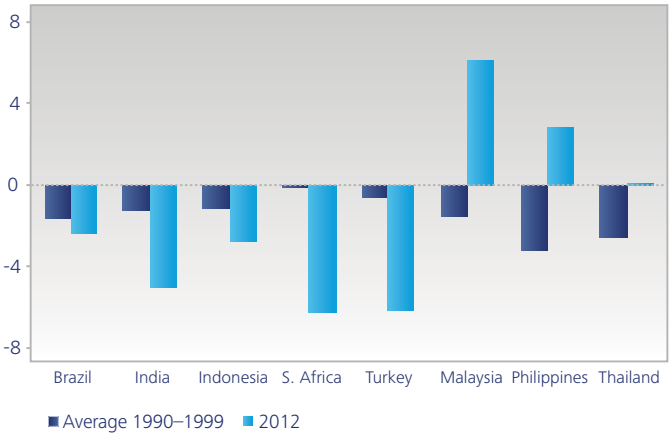
Graphic: Deloitte University Press | DUPress.com

Figure 6. Foreign reserves ($ billion) excluding gold

Source: Bloomberg, September 2013

Graphic: Deloitte University Press | DUPress.com

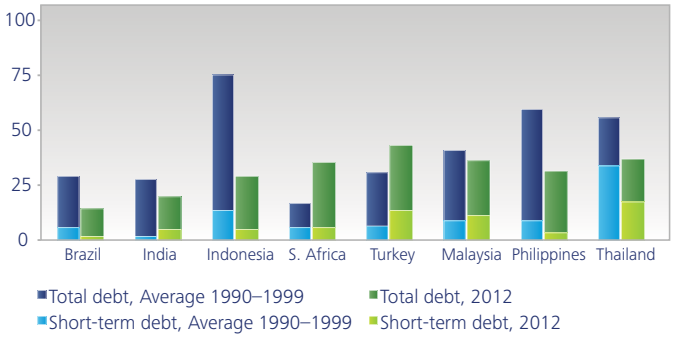
Figure 7. Current account balance (% of GDP)



Source: Oxford Economics, September 2013

Graphic: Deloitte University Press | DUPress.com

Figure 8. External debt (% of GDP)



Source: Oxford Economics, September 2013

Graphic: Deloitte University Press | DUPress.com

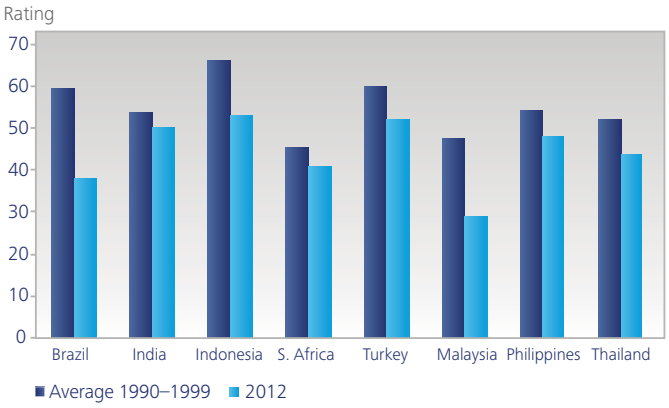
Leaving no stone unturned to shore up currencies

Central banks have stepped in aggressively to dent sharp currency depreciation and thereby counter imported inflation. The central banks of Brazil, India, and Indonesia have raised their respective policy interest rates (see figure 10). Countries are also pressing their foreign exchange reserves to action. For instance, India is selling dollars via swap agreements to major state-owned petroleum importers. In August 2013, Brazil also announced a $60 billion currency intervention program involving swaps and repurchase agreements with businesses requiring dollars. Bilateral currency swap agreements with frequent trade partners are also being explored. In September, India identified seven emerging economies with whom it plans to trade in rupees. Indonesia is also trying to establish two swap agreements worth nearly $30 billion and may extend an older agreement with China.

India and Indonesia are also cutting imports to stem their current account deficits and boost their currencies. India aims to lower its gold imports bill by hiking duties. Indonesia has targeted luxury car imports and is mandating higher biodiesel usage to cut oil imports. In addition, policy changes to boost FDI and boost exports are also being used. For example, Indonesia has announced tax incentives for investments in agriculture and metal. India is seeking to encourage FDI by easing restrictions in key sectors like telecommunications. In addition, India has increased deposit rates on select dollar-denominated deposits for Indians residing overseas. Brazil and India are also attempting to boost their respective currencies through changes in capital controls. In June 2013, Brazil removed several capital controls, including taxes on foreign portfolio investments. India, on the other hand, restricted overseas investments by Indian companies and citizens beginning mid-August.

Meanwhile, just sitting the storm out appears to be another option, at least for Turkey and South Africa. Turkey's central bank has sold $6–8 billion in foreign currency auctions since June 2013, but it has not been able to substantially stem the lira's fall. Hence, it is likely that it will pause for a while. South Africa's central bank, on the other hand, has mostly maintained a non-interventionist approach, favoring a market-determined exchange rate. However, there is a step that even South Africa is taking to shield the rand from a long-term perspective. In September, South Africa joined Brazil, Russia, India, and China in plans to establish a $100 billion foreign exchange fund, which will likely begin operations by 2015. Members may be able to draw a specified amount from the pool to stabilize their currencies. The efficacy of such a fund remains to be seen, given a similar fund established by the Association of Southeast Asian Nations, China, Japan, and South Korea in 2010 has not yet been drawn upon.

Figure 9. Banking sector risk with a score of 100 as most risky

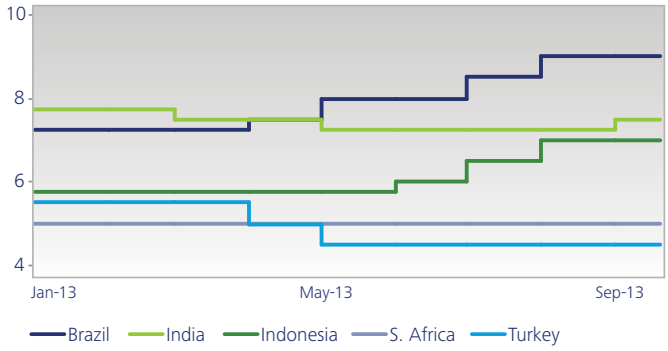


Source: Economist Intelligence Unit, September 2013

Graphic: Deloitte University Press | DUPress.com

The delay in tapering provides a breather to the emerging economies, acknowledged by the immediate exuberance of equity and currency markets.

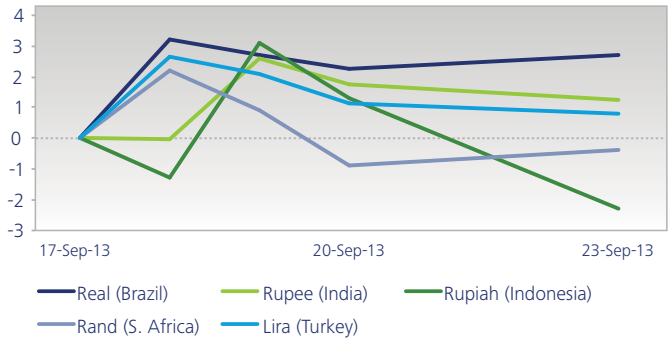
Figure 10. Benchmark interest rates in 2013 (%)



Source: Respective central banks' websites, September 2013

Graphic: Deloitte University Press | DUPress.com

Figure 11. Emerging economies' currency returns versus the US dollar since September 17, 2013 (%)



Source: Bloomberg, September 2013

Graphic: Deloitte University Press | DUPress.com

Darkest before dawn

In view of the Fed having deferred the tapering, perhaps by a few months, the impact on emerging economies will be interesting to note. The delay in tapering provides a breather to the emerging economies, acknowledged by the immediate exuberance of equity and currency markets. However, soon after, stock markets and foreign exchange rates returned to trend, affirming that fundamental factors related to the individual countries will still drive currencies, equity markets, and bond yields (see figures 11 and 12).

Policy challenges, high inflation, wide current account and fiscal deficits, and slowing growth are challenges that may discourage foreign investments in markets such as Brazil, India, South Africa, and Turkey, irrespective of the Fed's latest action. In addition, given the Fed's decision in September not to start tapering, anticipating the timing of a future move by the Fed will increase volatility and uncertainty. Furthermore, with valuations in less risky equity markets of Europe looking attractive, fund flows into emerging economies' equities may remain adversely affected in the short term (see figure 13).

However, long-term prospects for emerging economies remain attractive, as growth rates are expected to exceed those of the United States and other major developed economies (see figure 14). As a result, funds are expected to flow back to emerging economies in the medium term. Moreover, with the Fed making it clear that its actions will be governed by US interests only, it may be just the trigger for some emerging economies to wake up from their policy slumber and move ahead with critical reforms to restore economic confidence.

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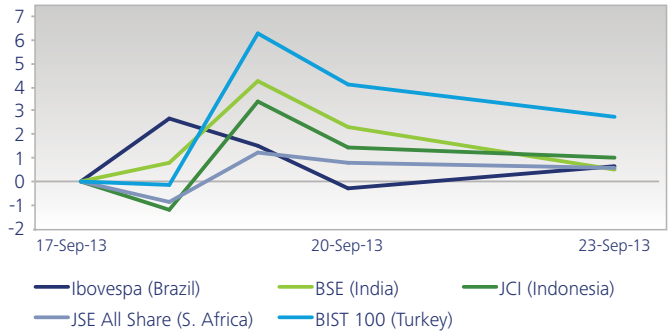
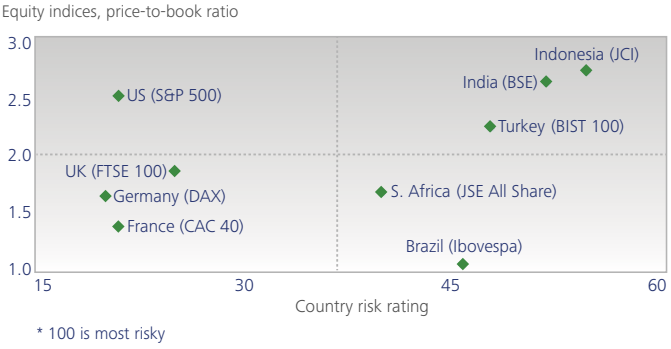
Figure 12. Emerging economies' equity index returns since September 17, 2013 (%)



Source: Bloomberg, September 2013

Graphic: Deloitte University Press | DUPress.com

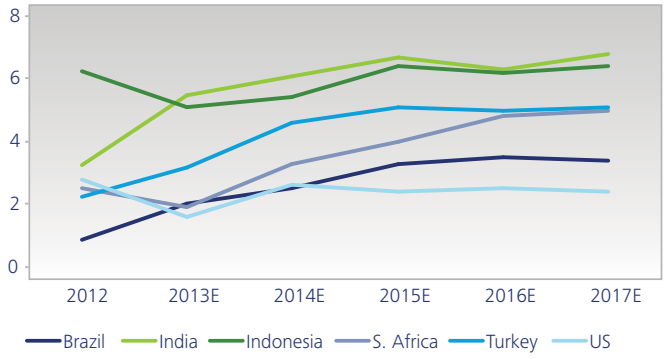
Figure 13. Current risk and valuations in equity markets in emerging and developed economies



Source: Bloomberg, Economist Intelligence Unit, September 2013

Graphic: Deloitte University Press | DUPress.com

Figure 14. Emerging economies' real GDP growth (%) will surpass developed economies



Source: Economist Intelligence Unit, September 2013
Note: E = estimates

Graphic: Deloitte University Press | DUPress.com

Dr. Alexander Börsch is head of research, Deloitte Germany

Eurozone: A bit of a recovery

By Alexander Börsch

THE second quarter of 2013 brought long-awaited good news to the Eurozone. It grew for the first time since autumn 2011, bringing the end of the longest-lasting recession since the Eurozone's inception within reach. The growth rate, in itself, was not spectacular. But the hopeful sign was not only that the Eurozone grew at all, but that its second-quarter growth was broader-based than anticipated. Contributing further to a better economic climate, early indicators developed better than expected and have been on the rise for several months. The main questions for the Eurozone are therefore twofold: What are the chances that this growth signals the beginning of a sustained recovery? And if it does, what will such a recovery look like?

Is the recession ending?

The Eurozone economy grew by 0.3 percent in Q2 on a quarter-over-quarter basis. Growing at 1.1 percent, Portugal showed exceptional performance. As a whole, the recessionary tendencies in the crisis countries weakened substantially. Taken together, these countries shrank by 0.1 percent, but compared with their substantial contraction in the first quarter (–0.5 percent), moderate change for the better seems underway.

Growth was mainly driven by the two big Eurozone economies, Germany and France. Both showed stronger growth than expected (Germany grew by 0.7 percent). The main drivers were catch-up effects from construction and an upswing in industrial production. France followed not far behind (growing by 0.5 percent). Spain and Italy still showed negative growth rates, but at -0.1 and -0.2 percent, both economies are stagnating more than shrinking.

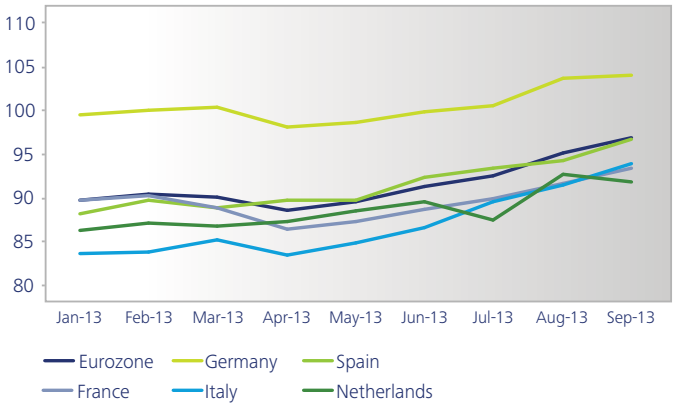
The main early indicators also outperformed expectations. For the Eurozone as a whole, all components of the economic sentiment indicator—industry, services, consumer, and retail trade—improved except for construction. A look at the big Eurozone countries confirms a clear upward trend in expectations (figure 1). Since April, economic sentiment has improved across the board; it has come much closer to the

The main questions for the Eurozone are therefore twofold: What are the chances that this growth signals the beginning of a sustained recovery? And if it does, what will such a recovery look like?

threshold of 100, which separates negative from positive expectations and which Germany has already crossed. Also, the purchasing manager index reached positive territory, recording its second straight month of expansion and the fastest rate of growth in two years.

The better-than-expected performance of the crisis countries and the positive early indicators raise hopes that most of the crisis countries could return to growth next quarter. This would imply that the Eurozone as a whole will grow in a broad-based way during the second half of the year, potentially beating most current forecasts, which expect growth of 0.1 and 0.2 percent for the coming two quarters. That said, there is no reason to cheer. For the entire year, the Eurozone will still record negative growth rates. The consensus view expects its growth to be in the vicinity of –0.6 percent.

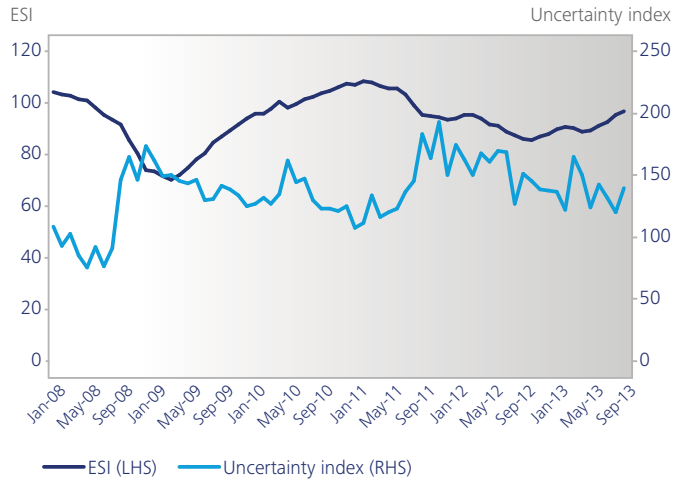
Figure 1. Economic sentiment indicator (ESI)



Source: European Commission

Graphic: Deloitte University Press | DUPress.com

Figure 2. Economic sentiment indicator (ESI) and economic policy uncertainty index



Source: European Commission

Graphic: Deloitte University Press | DUPress.com

Drivers of growth

The Eurozone's most recent growth was based on increases in consumption, investments, and exports. Exports grew most strongly, by 1.6 percent (after falling by 1.0 percent in the first quarter). Investments increased by 0.3 percent, which is an encouraging sign after a fall of –2.2 percent in the preceding quarter.

As described in the previous issue of *Global Economic Outlook*, the Eurozone's current growth strategy is based on export growth to non-Eurozone countries. Balanced growth needs a reversal of the sharp drop in investment that has been ongoing since the outbreak of the financial crisis. The slight increase in investment could be a first weak signal that European firms are more bullish regarding investments.

One major factor that supports increased investment activity is that, after the Cyprus crisis in the beginning of the year, the euro crisis has been fading into the background. While there were no major political decisions regarding the future shape of the Eurozone—not least due to the German federal elections in September—turbulence has not re-emerged. The acute phase of the euro crisis seems to be over.

Whether this is a permanent easing of the crisis is far from certain. Even less certain is whether the crisis has gone from an acute to a chronic one. Nevertheless, the uncertainty that has dragged on Europe's growth and investments has been declining lately. Figure 2 tracks two indexes from January 2008 through September 2013. The European sentiment index reflects business climate and expectations; the economic policy uncertainty index measures the level of political uncertainty. While the correlation between the two is not perfect, it confirms the intuition that high uncertainty affects business climate and lowers the propensity to invest.

Besides a smaller fiscal drag, another factor supporting the notion of a recovery is simply that the recession has lasted for so long; at some point, it can be argued, the recession must hit bottom, after which a countermovement sets in. Empirically, the turnaround point depends on the type of recession. Normal recessions last for about a year. They last longer when associated with an oil shock or an external demand shock. The worst recessions are associated with a big financial crisis; in these cases, the recession lasts between six and seven quarters.[1]

This timeframe seems to fit the developments in the Eurozone nicely, as growth has returned after six quarters of recession. This empirical match supports the view that the early indicators signal not only a transitory break, but the beginning of the end of the recession.

Tailwinds: The known unknowns

Notwithstanding the above, a technical economic rebound will not be enough to sustain a recovery. There are several risk factors that could interfere with the trend toward recovery.

First, capital flight from emerging markets following the Fed's announcement of ending the quantitative easing program endangers emerging markets' stability as well as their growth rates (see "The impact of Fed tapering on emerging economies: Struggling with the ebb" in this issue of *Global Economic Outlook*). Given that emerging markets have become the main export engine for the Eurozone, further instability could severely strain European exports.

Second, the recovery takes place against a background of a relaxation in the Euro crisis. But as many of the reasons for the Euro crisis and the recession are not solved yet—unstable banking systems, over-indebtedness, the architecture of the Eurozone, and difficult access to credit in southern Europe—it is far from impossible for the Euro crisis to return. For example, while borrowing costs have been falling in the Eurozone's crisis countries, the gap between their financing costs and Germany's remains substantial.

Third, political risk factors still exist. The most important one remains the high unemployment rate in Southern Europe, which might result in political instability and a threat to the integrity of the Eurozone (for example, if it brings anti-European governments into power). In order to substantially reduce unemployment, much higher growth rates are needed. Because southern European labor markets are highly regulated, there is no straight relationship between growth and employment. Therefore, growth must be substantial before it spills over to the labor markets.

Research undertaken by Deutsche Bank suggests that in Italy, for example, a GDP increase of 1 percent leads to employment growth of only 0.1 percent, while the crisis countries generally need GDP growth between 0.7 and 1.3 percent just to keep employment constant.[2] Labor markets and the unemployment situation are thus likely to remain the Eurozone's principal Achilles' heel. Given ongoing labor market reforms, these thresholds might be lowered in the near future so that even modest growth will have an impact on the labor markets. But until that happens, or until growth reaches substantially higher dimensions, political tensions will remain.

Shape of the recovery: L meets U

Pessimists interpret the quarter's tentative growth as a short intermezzo in the ongoing deep recession. Optimists think that it was a strong positive sign and a turning point toward a sustainable recovery. Consequently, the pessimists expect not a real recovery, but stagnation at best. In this scenario, the recovery would take the form of an L. The optimists expect a rebound in the form of a U.

If one or several of the above-mentioned risk factors materializes, the first camp could end up being right. In a more upbeat scenario, risks will not materialize, and the more positive current expectations would spill over to investment and consumption.

Given the still-shaky state of the Eurozone's economy and politics, the safest bet is that the Eurozone will work itself out of the recession in a rather slow and bumpy way. Uncertainties in the Eurozone are currently receding, but they still exist and will put a strain on the recovery. The recovery is likely to proceed in a stop-and-go fashion, driven by domestic and European politics and volatile financial market expectations. The result will probably be something like a combination of an L and a U.

Endnotes

1. International Monetary Fund, "Crisis and Recovery," *World Economic Outlook*, April 2009.
2. Deutsche Bank Securities, "Will the Euro area recovery be strong enough?," *Global Economic Perspectives*, September 6, 2013.

Japan: Early signs are positive

By Dr. Ira Kalish

IT appears that Abenomics is working fairly well—at least so far. Economic growth in the first two quarters of 2013 was strong. Specifically, real GDP increased at an annual rate of 3.8 percent in the first quarter and 4.1 percent in the second quarter. The strong growth was led by a boost to business investment, itself the result of strong profitability and improved confidence. The likely cause of this acceleration in growth was the expectation of and implementation of the dramatic shift in monetary policy earlier this year. This is the second arrow of Abenomics, the others being fiscal stimulus and deregulation. As for the monetary policy shift, the Bank of Japan began a program of unlimited purchases of assets aimed at boosting liquidity, creating inflation, and suppressing the value of the yen.

So far, this policy has had a notable impact. The growth of the money supply has accelerated (see figure 1); the value of the yen has declined, thereby boosting export competitiveness; equity prices have risen considerably, boosting consumer wealth and potentially having a positive impact on spending (see figure 2); and consumer price inflation is finally positive, which should have a positive impact on the willingness of consumers to spend (see figure 3). Plus, positive inflation lowers the real interest rate, thus boosting investment. Indeed, growth in the first half of the year involved strength in exports, investment, and consumer spending.

Moreover, the third quarter is starting to look strong. In August, Japanese exports increased 14.7 percent from a year earlier—the fastest such growth since 2010. Still, this was not sufficient to reverse Japan's trade deficit. The latter persists because of rising energy costs—especially as Japan

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must import energy to offset the continued loss of nuclear power. Exports increased to the United States and China, demonstrating the power of a declining yen. The yen is down roughly 20 percent from a year ago. Other positive signs for the third quarter include strong growth of industrial production and an increase in the purchasing manager's index (PMI) for manufacturing. On the other hand, one worrisome sign is that wages have not yet budged. If prices continue rising without commensurate increases in wages, then real consumer purchasing power will decline,

Figure 1. Japanese money supply growth: % change year over year

Source: Trading Economics

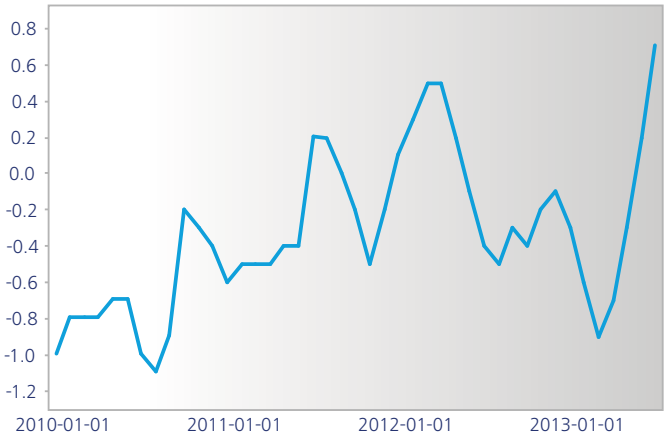
Graphic: Deloitte University Press | DUPress.com

Figure 2. Japanese equity prices: Nikkei 225 Index

Source: Trading Economics

Graphic: Deloitte University Press | DUPress.com

Figure 3. Japanese inflation: Consumer price index, % change year over year



Source: Trading Economics

Graphic: Deloitte University Press | DUPress.com

thereby hurting consumer spending. Indeed, retail sales declined in July from a year earlier, disappointing those who expected continued improvement in the consumer sector.

Why worry?

Despite signs of modest strength, there is a widespread viewpoint that the actions taken so far, while helpful, are not sufficient to generate sustained strong growth. Providing liquidity stimulates spending, but does little to ease bottlenecks and improve productivity. Rather, the third arrow of Abenomics, deregulation, will be needed to truly change the longer-term economic outlook. Yet, that must await specific proposals from the government, which are expected to be announced soon. Although the governing party has a majority in both houses of Parliament, the ability to pass politically difficult legislation is still not certain.

Meanwhile, even the short-term economic outlook is considered uncertain because the national sales tax is set to rise from 5 percent to 8 percent early in 2014. This is due to a law passed prior to the election of the current government. The tax increase, which is set to be followed by another increase from 8 to 10 percent in 2015, is meant to fix the long-term deficit of the country's pension system. The goal is to address the impact of an aging population and, in the process, stabilize the country's sovereign debt, which has grown rapidly in recent years. However, there is concern that the tax increase will stymie consumer spending and cause the economic recovery to stall. The last time the sales tax was increased, in 2007, there was a substantial negative impact on consumer spending following the tax increase. Prior to the increase, consumer spending accelerated in anticipation of the tax increase. That could happen in the months ahead.

Some political leaders called for a delay or gradual implementation of the tax increase. They feared that the increase would cause the recovery to stall. Others, however, said that a delay would spook financial markets, leading to higher bond yields and lower equity prices. Moreover, they said that the economy will be strong enough to absorb the shock of a tax increase. Their argument was that the huge increase in equity prices over the past year, by boosting household wealth substantially, will stimulate increased consumer spending. Finally, many political leaders called for offsetting tax reductions and spending increases in order to avoid the negative consequences of the tax increase. Just before we went to press, the government announced it would allow the tax increase to take effect, but it will implement temporary measures aimed at easing the impact. The tax increase is expected to yield about 8 trillion yen in annual revenue. The offsets announced are expected to cost about 5 trillion yen. Among the offsets are early repeal of temporary taxes that were implemented to finance earthquake reconstruction, increased spending on infrastructure, tax incentives for investment and hiring, and tax cuts for lower-income households. In addition, the Bank of Japan has indicated that it is prepared to accelerate asset purchases should the economy show signs of weakening as a result of the tax increase.

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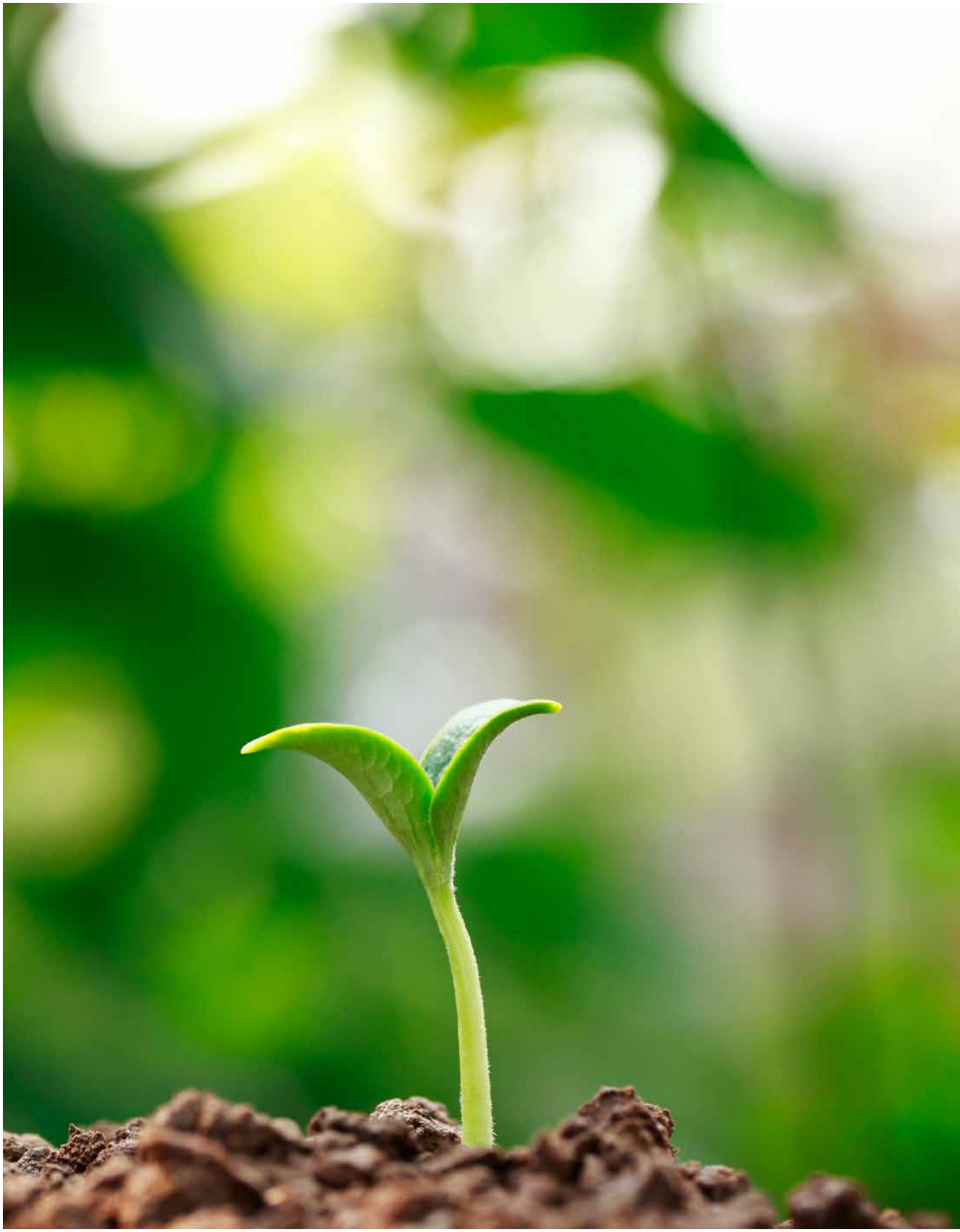


China: Stable for now

By Dr. Ira Kalish

THE economic slowdown in China appears to be over—at least for now. China's government has provided modest stimulus aimed at stabilizing growth, and there are indications that it is working. The stimulus included extra spending on infrastructure and easing of credit conditions. Consider that China's industrial production was up 10.4 percent in August versus a year ago. This was the fastest rate of growth in 17 months. This is consistent with other recent data that pointed to a recovery in China's growth, including exports. In August, China's exports were up 7.2 percent from a year earlier. This was better than expected. Exports to the United States and the EU were up. Exports to Southeast Asia were up a staggering 30.8 percent. Exports to Japan, however, were down for the seventh consecutive month, reflecting political tensions between Asia's giants. On the other hand, Chinese imports were weak in August, rising only 7 percent (below market expectations) and suggesting weakness in domestic demand. The result of these indicators was an increase in the trade surplus.

There were other positive indicators as well. First, Markit's purchasing manager's indices (PMI) for both manufacturing and services improved in August. The PMI for manufacturing went from 47.7 in July to 50.1 in August. This was a significant shift. A reading below 50.0 indicates declining activity while a reading above 50.0 indicates expansion. The August reading was the first indication of expansion in four months. Still, a reading of 50.1 suggests slow growth. Also, the sub-index for export orders was in negative territory for the fifth consecutive month, boding poorly for a continuation of strengthening exports. As for services, the PMI went from 51.3 in July to 52.8 in August.

Second, retail sales in August were up 13.4 percent from a year earlier. This was the fastest rate of growth this year. Third, credit growth took place after four months of decline. While this may be worrisome in the longer term, it boosts economic activity in the short term. Specifically, bank lending increased by 711 billion yuan in August while total social financing, a measure that includes bank lending as well as non-bank credit creation, increased by 1.57 trillion yuan in August. On the other hand, growth in property investment decelerated slightly in August.

The fact that bank lending accounted for less than half of the growth of credit is cause for longer-term concern. It means that the unregulated and unsupervised part of the credit industry (including the issuance of wealth management products) is expanding once again,

The fact that bank lending accounted for less than half of the growth of credit is cause for longer-term concern.

thereby possibly setting the stage for troubles down the road. It means that the credit squeeze of June is clearly over and that the government is now being accommodative in order to keep the economy growing. Indeed, the broad money supply accelerated in August as well. The government is caught in a difficult spot. On one hand, if it tightens credit conditions, growth will most likely falter. On the other hand, if it allows non-bank credit to continue growing rapidly, it could face crises in the future that emanate from the creation of bad debt. The challenge for the leadership will be to reform the financial system in a way that avoids a disruptive financial crisis.

Dealing with banks

Worried about the stability of China's financial system, the government is looking for ways to boost bank safety. As such, the government is encouraging banks to raise capital from the private sector. The government wants Chinese banks to meet the requirements of Basel III. Just a decade ago, the government was forced

to bail out troubled banks by setting up asset management companies to take over bad assets. The government would like to avoid doing this again. Recently, the government said that banks can issue non-tradable preferred shares as a way to boost capital. The government specifically noted the US experience of having AIG issue such shares in order to restore capital. One problem for the government is that it is not clear to what extent Chinese banks are at risk because they have securitized many loans into Wealth Management Products (WMPs). These loans, whether performing or not, are no longer counted as part of bank assets. Thus, the non-performing loan (NPL) ratio for banks is roughly 1.0 percent. Yet it is widely believed that if banks wind up covering the losses of WMPs, the potential liability of Chinese banks could be substantial. Hence, there is a need for more capital. And if the banks fail to cover the losses of WMPs, there will be many unhappy wealthy and influential individuals who have purchased these securities.

Worries about the housing bubble

Among the worries vexing China's leaders is the continuing rise in house prices. Savers are putting money into housing for lack of good investment alternatives. With equity prices stagnant, bank deposit rates fixed, the bond market under-developed, and few opportunities for overseas investment, the property market is one of the few places where people can put their money and expect a decent return. In July, new home prices were up 10 percent from a year earlier. Equity prices during that same period were down 10 percent. The problem is that house prices could fall if and when the central bank tightens monetary policy. This could set off the financial crisis that has been feared for some time. On the other hand, it could be argued that the housing market in China does not possess the attributes of a bubble. The rise of the middle class, combined with a lack of satisfactory housing choices, warrants a rise in prices. Thus, prices reflect true supply and demand conditions rather than a speculative bubble. Still, the well-publicized existence of massive ghost cities suggests that a degree of over-building has taken place.

What to expect in November

At the Communist Party Plenum in November, the government is expected to announce the details of its economic policy going forward. It is widely anticipated where this will be the occasion for commencing the process of reform. Indeed, Premier Li said that his focus is on reform rather than stimulus. He recently said that an "important part of economic-system reform is financial reform. It is because it is such a complicated systematic project it indicates China's reform has entered a deep-water zone, or the most difficult phase." This will, of course, be critical to shifting the economy away from dependence on investment and toward growth based on consumer demand. It will also be important in avoiding a financial crisis. Of particular importance will be liberalization of interest rates. However, financial reform is only one part of the equation. It is also anticipated that the government will announce reforms involving internal migration, social services, investment in human capital, and environmental issues.

The problem is that house prices could fall if and when the central bank tightens monetary policy. This could set off the financial crisis that has been feared for some time.

Ian Stewart is chief economist, Deloitte UK

United Kingdom: Optimism returns

By Ian Stewart

THINGS certainly have changed for the United Kingdom in the last six months. Financial markets now believe that a gathering recovery will force the Bank of England to raise interest rates in 2014, far earlier than had been expected at the start of this year. The previously moribund UK housing market has strengthened so much that there is growing talk of a housing bubble (see figure 1). It is a sign of the times that in late September the Financial Times ran an editorial entitled, "Osborne wins the debate on austerity," which argued that a run of strong economic data had vindicated the UK chancellor's deficit reduction program and confounded his Keynsian critics.

After years of downside shocks, the UK outlook is looking brighter. UK GDP rose by 0.7 percent in the second release, the fastest rate in more than three years and with activity fairly broadly based (see figure 2). GDP forecasts for 2014 have nudged higher since March. The nearly universal assumption is that growth in the industrialized world will bounce back in 2014 led by accelerating activity in the United Kingdom, the euro area, and North America.

The mood in the United Kingdom has been boosted by a perceived reduction in risks in the global economy. The world financial system seems to be on a gradually improving path. Fears that the Eurozone would break up have eased, and reform in the

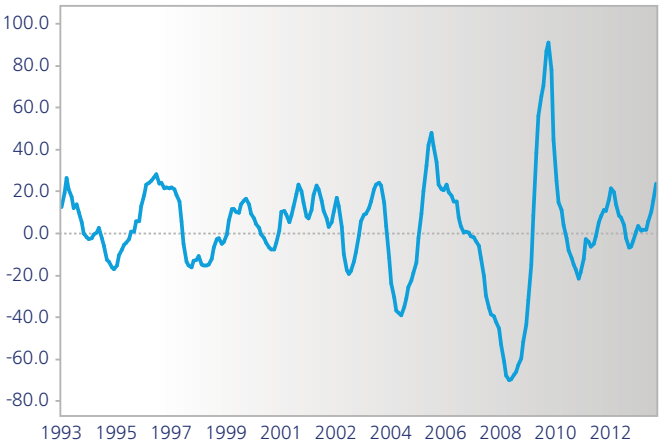
After years of downside shocks, the UK outlook is looking brighter.

periphery of the euro area is delivering improvements in competitiveness. The US recovery is eroding America's vast budget deficit. In the United Kingdom, financial markets are worrying less about economic weakness and more about the risk of early interest rate rises.

In early August, the new governor of the Bank of England, Mark Carney, sought to counter an involuntary tightening of UK monetary policy caused by Ben Bernanke's "tapering" speech in May. Mr Carney announced that UK interest rates would stay at their current level of just 0.5 percent until unemployment falls below 7.0 percent. With the jobless rate at 7.6 percent, and the bank not expecting it to fall below 7.0 percent until late 2016, the message to consumers and business was that low interest rates are here to stay for three more years.

Markets are not convinced, even after the US Fed's rate-setting committee rowed back from an early slowing of bond purchases at their September meeting. UK base rates stand at 0.5 percent, and the day after the Fed announcement, on September 20, financial markets were betting

Figure 1. UK mortgage approvals (volume, 3 month % change)



Source: Bank of England

Graphic: Deloitte University Press | DUPress.com

Figure 2. UK GDP growth: Actual and forecast (%)

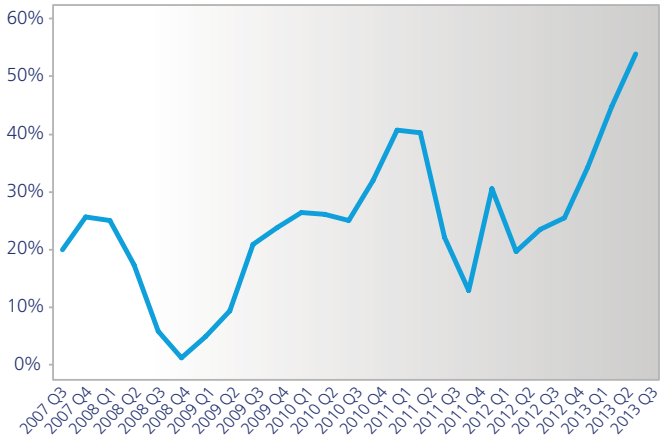
Source: ONS, consensus forecasts from *The Economist* and Deloitte calculations

Graphic: Deloitte University Press | DUPress.com

on UK rates rising to the 0.75 percent mark by late 2014 to 1.5 percent by the end of 2015 and to 2.25 percent by the end of 2016.

Cheap money and the absence of big external shocks are working their magic. In the last few months, survey indicators of activity and confidence have picked up across the United Kingdom. The composite purchasing managers index, covering services, manufacturing, and construction, has risen to its highest level since 1997. The third quarter Deloitte CFO Survey shows a sharp drop in perceptions of macro uncertainty, and risk appetite has risen to an all-time high (see figure 3). Optimism about the outlook for growth in the United Kingdom, the rest of Europe, and the United States rose sharply, and longstanding optimism about emerging markets dimmed somewhat. Our index of corporate defensiveness—based on the weight CFOs place on cost cutting, building up cash, and deleveraging—has dropped sharply. It is clear that the defensive balance sheet strategies that marked the recession are in the back seat.

Figure 3. Risk appetite: Percentage of CFOs who think this is a good time to take greater risk onto their balance sheets



Source: Deloitte CFO Survey Q3 2013

Graphic: Deloitte University Press | DUPress.com

This is unlikely to be the perfectly balanced recovery so fervently hoped for by UK policymakers. Some of the hallmarks of previous lopsided recoveries are already starting to emerge: lower consumer savings, rising credit growth, and higher house prices. The reality is that the control that policymakers exercise over the economy is very limited and imperfect. As a result, policymakers will doubtless take the view that while balanced growth is better than unbalanced growth, either is far better than no growth.

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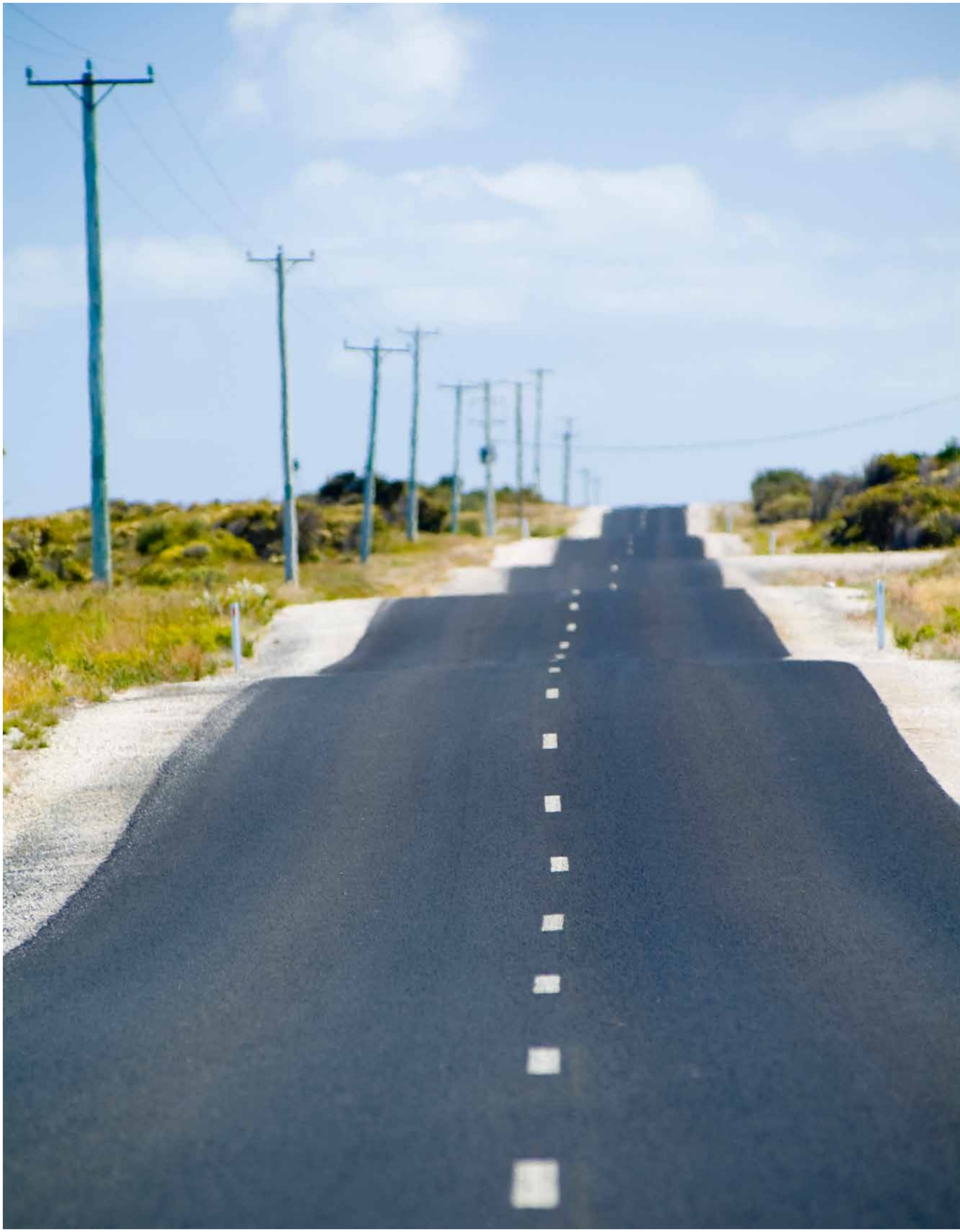

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India: Domestic strength tested by intensifying global uncertainty

By Dr. Rumki Majumdar

INDIA'S economic growth is testing new lows with every passing quarter. The economy grew at its slowest pace in more than four years during the first quarter of fiscal year (FY)[1] 2013–2014, and unfortunately, this may not be the bottom. Domestic economic activities are showing signs of weakness, exposing internal challenges that could compromise the economy's ability to grow. At the same time, global macroeconomic uncertainties are aggravating India's internal troubles. The US Federal Reserve's (Fed's) announced intention to taper its purchasing program sooner than expected on May 22, 2013 led to a series of events that adversely impacted India's equity market, currency, and capital account balance. Thanks to the recent Fed announcement to continue its pace of buying Treasuries and mortgages securities at the current rate, India's equity market could breathe a sigh of relief. However, optimism due to reduced Fed policy uncertainty was short-lived. Two days after the Fed's announcement, the Reserve Bank of India (RBI) delivered an unexpectedly hawkish statement to raise the policy rate (the repo rate) by 25 basis points to control high inflation in the economy.

The RBI's policy announcement is a gentle reminder that India has few reasons to cheer and many reasons to be concerned. A mere hint by the Fed to taper its bond purchases unnerved investors and aggravated India's recent economic woes. Sooner or later, the Fed will eventually reduce its unsustainable extraordinary monetary policy. Is India prepared to fight its way out of its domestic economic challenges, which will likely be exacerbated by global policy uncertainties?

Fundamental domestic challenges

India's economic performance has been weaker than expected, resulting in a downward revision of the country's growth forecast for FY 2013–2014. Slower growth, high inflation, and

Domestic economic activities are showing signs of weakness, exposing internal challenges that could compromise the economy's ability to grow.

rising fiscal and trade deficit are posing significant challenges to its troubled economy.

Growth: India's GDP grew at a disappointing rate of 4.4 percent year over year[2] in Q1 FY 2013–2014; poor growth is attributed to a broad-based slowdown in domestic demand. Private consumption expenditure, which has been on a downward trend, grew at a mere 1.6 percent. Growth in gross fixed capital formation turned negative to −1.2 percent despite the efforts of the Cabinet Committee on Investment, which was instituted by the government this year to fast-track and reduce bottlenecks of key projects. Modest GDP growth was helped by a 10.5 percent rise in government expenditure in Q1 FY 2013–2014.

Sector-specific contribution to growth remained modest in Q1 FY 2013–2014. An early and good monsoon had a huge positive impact on sowing activity and helped boost agricultural output, but poor growth in the services and manufacturing sectors weighed upon total growth in the first quarter. Growth in industrial production declined by 4.5 percent in Q1 FY 2013–2014; all

While India holds 91 percent of its total outstanding debt internally, the share of external debt is rapidly increasing, and the country holds a majority of this debt in foreign currency.

its constituent sub-sectors, barring consumer non-durables, experienced a contraction. In the first quarter of the fiscal year, the index of mining, manufacturing, and electricity registered growth of –4.6 percent, –1.2 percent, and 3.5 percent, respectively. Industrial production experienced an unexpected rebound in July due to positive growth in capital goods. However, the overall pace of expansion was anemic. Growth in consumer durables has remained negative for four consecutive months this fiscal year, which implies that overall consumption spending is weak and may pose significant risk to the sustainability of growth in the capital goods sector.

Both consumer and business sentiments on economic conditions have been experiencing a decline. What is worrisome is that none of the survey participants[3] were optimistic about the economic developments for the next six months during the time these surveys were conducted.

Growth outlook: Most of the leading indicators point to weak growth in Q2, while sentiments are waning. By July, India's government ran up a fiscal deficit of 62.8 percent of the budget target deficit. If the government is committed to limiting its fiscal deficit to its target of 4.8 percent of GDP this fiscal year, government spending will not contribute to growth for the rest of the FY14. In such a scenario, the above trends suggest that growth may remain stagnant or even decline in the current quarter, while the economy may expand by 4.5–5.3 percent in FY 2013–2014.

Inflation: For India, the economic challenge doesn't end with falling growth; stability of growth has also been in question for the last few years. India has one of the highest consumer price inflation (CPI) rates among all emerging nations. It averaged around 10.2 percent in FY 2012–2013. Inflation—including headline and consumer prices—fell briefly for three consecutive months until May 2013 due to a fall in international oil and gold prices. The fall reversed in June, and CPI (IW)[4] averaged 11.2 percent in June–August 2013. The pickup was primarily due to food inflation, while fuel and non-food inflation declined.

Inflation outlook: A good monsoon this year may ease pressure on food prices, which will likely help reduce CPI. But a hike in administered fuel prices by the government to reduce the fuel-subsidy bill, the depreciating rupee, and supply-side shortages will keep inflationary pressures high. A survey by the RBI[5] indicates that the inflation expectation for the next three months is very high, and around 71 percent of respondents expect prices to rise faster than the current rate.

Fiscal balance and debt: India's fiscal balance, which measures the government's ability to manage its finances, is already showing signs of deterioration. After registering a deficit of 4.9 percent of GDP in FY 2012–2013, there are indications that fiscal deficit might widen further this fiscal year. In the first four months of FY 2013–2014, India's deficit already reached 62.8 percent of the budgetary provision for the full year, and expenditure on major subsidies reached 51.3 percent.

Outstanding public debt, which accounts for approximately 43 percent of GDP, increased by 5 percent quarter over quarter in Q1 FY 2013–2014. While India holds 91 percent of its total outstanding debt internally, the share of external debt is rapidly increasing, and the country holds a majority of this debt in foreign currency. At the same time, the share of total outstanding government debt held by foreign institutional investors

(FIIs) is trending upward. The share increased from 0.9 percent to 1.8 percent since March 2012 and contributed to the government's increased vulnerability to market speculations. This is also evident from the fact that 10-year government bond yields rose by 1.4 percent from May to August 2013, primarily triggered by selling pressure from FIIs on fears of tapering quantitative easing in the United States and a possible war in Syria.

Fiscal outlook: To prevent the deficit from surpassing its target of 4.8 percent this fiscal year, the government needs to cut discretionary spending and restructure deficits for the next eight months. That said, a recent initiative to pass the food security bill and an impending election in less than eight months indicate that the country's budgetary target will be very challenging, if not impossible, to achieve. If the fiscal deficit widens beyond 5 percent of GDP in FY 2013–2014, which is probable, it could adversely impact investors' sentiments, raise debt liability, and increase government bond yields. A high debt burden will limit the government's fiscal flexibility and its ability to respond to future shocks, as well as restrain investment in India's social and physical infrastructure.

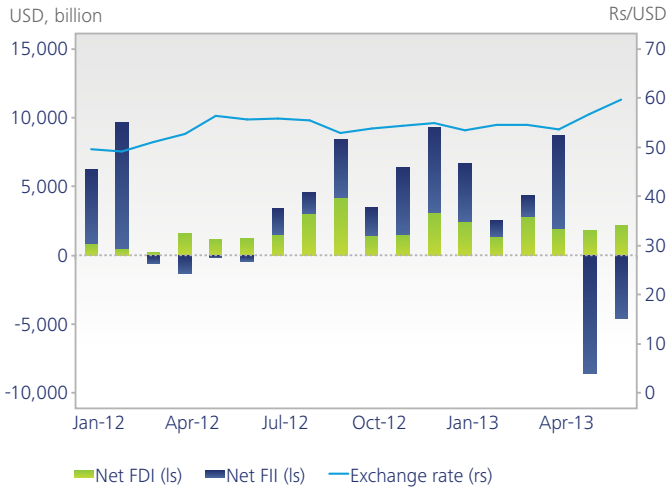
External account: India's external sector imbalance persisted above sustainable levels in Q1 FY 2013–2014 after a record high current account deficit of 4.8 percent in 2012–2013. The trade deficit of 10.1 percent of GDP in FY 2012–2013 widened to 11.5 percent of GDP in the first quarter due to deteriorating export performance and increasing imports of gold and crude oil products, including petroleum, oil, and lubricants.

The announcement by the US Federal Reserve Bank to taper its quantitative easing and tensions over Syria led to a sharp capital outflow from most of the emerging nations, including India. Net portfolio investment turned negative in June and July as FIIs withdrew $13.2 billion from the Indian market in these two months. India's currency, which has been under pressure for more than two years, fell 23 percent against the US dollar during April–August 2013. The currency, however, gained back some ground in the next two months.

By August, high trade imbalance, currency depreciation, and rapid capital outflows depleted India's foreign exchange reserve by 7 percent since the start of this fiscal year (see figure 1).

Trade outlook: India's currency is expected to remain weak in the coming months. Exports are expected to benefit from a weaker currency, which is evident from the first two months' data in Q2, but it is unlikely that growth will be sustained. Relatively high inflation, high cost of imported raw materials for production, tax structures, and infrastructural deficits are expected to raise the costs of production and, hence, compromise the advantage of a depreciating currency.

Figure 1. Currency depreciates as institutional investors withdraw funds



Source: RBI bulletin, Reserve Bank of India; Bloomberg

Graphic: Deloitte University Press | DUPress.com

Figure 2 briefly summarizes the risks to India's economy. It is evident that both real and the financial economies are facing challenges, and the outlook is not very encouraging either.

The countering monetary policy actions

The RBI promptly instituted several measures after May[6] to contain the exchange rate volatility and current account deficit. The objectives of these measures were to contain gold imports, check speculation in the currency market, and tighten liquidity in the economy. Prompt as they

Figure 2. A summary of the economy and future outlook

Real economy				
Variables/quarterly data	Q1 FY 2012-13	Q4 FY 2012-13	Q1 FY 2013-14	Monthly avg of Q2 FY 2013-14
GDP, % y-o-y	5.4	4.8	4.4	↓
Real private consumption expenditure, % y-o-y	4.3	3.8	1.6	↓
Total fixed investment, % y-o-y	-2.2	3.4	-1.2	↔
Industrial production, % y-o-y	-3.8	3.7	-4.5	2.1
CPI-inflation, % y-o-y	9.9	11	9.6	11.8
Trade balance, % y-o-y	-10.3	-9.6	-11.5	↔
Variables/fiscal years	2010-11	2011-12	2012-13	2013-14
Fiscal deficit, % GDP	-4.8	-5.7	-4.8	↓
Current account deficit, % GDP	-2.8	-4.2	-4.8	↔
Financial economy				
Variables/quarterly data	Q1 FY 2012-13	Q4 FY 2012-13	Q1 FY 2013-14	Monthly avgs of Q2 FY 2013-14
10-yr yield, %	8.7	7.9	7.5	8.4
INR/USD	49.8	54.1	56.7	63.3
Equity index, % y-o-y	-10	10.1	15.3	8.1

Source: RBI Bulleting, Reserve Bank of India; Press Information Bureau, Government of India; Ministry of Statistics and Programme Implementation, Government of India, Oxford Economics; Bloomberg;

Notes: Downward arrow represents downside risks; Downward arrow represents expected downside risks; two-way arrow represents no further deterioration expected (in cases where data for Q2 FY 2013–14 is not available).

Green, yellow, and red are the outlook indicators; green refers to low risk while red refers to high risk.

Graphic: Deloitte University Press | DUPress.com

were, these monetary measures failed to contain the fall in currency, and a significant funds were withdrawn by FIIs as the Fed's September policy meeting closed in.

Raghuram Rajan, who took over as the new governor of RBI on September 4, 2013, announced plans in his introductory speech to emphasize currency stability, strengthen the bank's monetary policy framework, and generate financial development and inclusion. He highlighted improving competition between banks by granting new licenses to banks and increasing participation of foreign banks. Besides, he stressed greater independence of banks in decision making, encouraged banks to clean up balance sheets, reduced the requirements of banks to invest in government securities, and improved efficiency in priority sector lending requirements. His speech was well received by the market, and subsequently, the pressure on currency eased. Within two weeks of taking over, he has already implemented full liberalization of bank branching; and other measures are underway.

RBI's hawkish move: In his first policy announcement on September 20, 2013, Rajan surprised the market by taking a bold step by hiking the repo rate by 25 basis points and focusing primarily on containing rising inflation. At the same time, he also announced scaling back some of the emergency measures that were taken recently to prevent currency depreciation (mentioned above) to ease liquidity. His policy review clearly indicates that while the key concerns would be inflation and currency stability, RBI will closely monitor economic conditions and may undertake mid-course corrections and adjustments outside usual policy dates, if required. His actions to correct the national balance sheet and growth agenda are expected to improve investors' confidence.

However, if viewed dispassionately in the current economic scenario, India needs more than just monetary policy to correct its course. There has to be more action to manage fiscal accounts, and Rajan cannot turn the tide alone.

Reforms fall short

The Indian government has undertaken reforms in the last few months in an attempt to revive foreign direct investment: raising the limits on foreign investments in sectors that include insurance and defense, a cap raised to 100 percent in telecommunication, and relaxing investment norms in multi-brand retail to give more clarity and space to investors. Several other important bills were passed during the monsoon session of parliament: the company bill to enhance transparency in company operations, the food security bill to ensure nutritional security and thus improve living standards for the poor, and the land acquisition bill to ensure fair compensation to farmers.

Nonetheless, the government's effectiveness in undertaking reforms has been widely criticized. Frequent protests by members of parliament over various issues disrupted the reform process. In

addition, the government's efforts to undertake meaningful reforms have been followed by disappointing implementation. In the past, reforms have been repeatedly watered down, which continues to frustrate the business fraternity and impact investor sentiments.

Furthermore, recent bills pertaining to food security and land acquisition have been criticized as populist reform measures to appease voters before the approaching election. It is feared that such bills could raise the cost of business and delay investments. Additionally, the food security bill is expected to increase government spending on subsidies, which could make it harder to contain the country's deficit to 4.8 percent of GDP this fiscal year. Political uncertainty, poor progress in reforms, and signs of widening fiscal deficit suggest that the Indian government may not be prepared to respond to unexpected shocks that could arise from domestic as well as global uncertainties.

India still has time to correct its course

The US Fed's monetary policy uncertainty and speculations by institutional investors have certainly aggravated India's recent economic woes, but high current account and fiscal deficits are probably the biggest reasons for the diminishing confidence on India's slowing growth. High trade imbalance, currency depreciation, and rapid capital outflows are depleting India's foreign exchange reserve, while high fiscal imbalance and a rising debt burden are making India less attractive in the eyes of its investors. The postponement of tapering by the Fed gives India some time and opportunity to correct its course. There are three strategic priorities that could help India improve its economic performance:

1. Restore investors' confidence. India is suffering from a crisis of confidence, so restoring the confidence of the global business community should be the top priority. Monetary actions can provide the first line of defense, but India needs immediate and credible action to correct its external and fiscal balance. The government needs to effectively communicate its policies to contain its current account deficit and inflation. It also needs to rapidly implement reforms without watering down the process. Policies should focus on strategies that improve export competitiveness by taking advantage of the depreciating currency. At the same time, measures should be taken to curb gold and fuel imports by imposing restrictions, removing subsidies on fuel products, and encouraging the use of alternate and environment- friendly sources of energy. Rising food inflation can be tackled by addressing inefficiency in public distribution systems and supply-side shortages.

2. Address structural weaknesses. In India, structural weaknesses are hindering long-term growth prospects. The bottlenecks in infrastructure and manufacturing investments have to be addressed and promptly removed. Tax issues concerning some of the industries need to be resolved while public investment in sectors like coal, power, roads, and railways needs to find a place on the fast track. The Cabinet Committee on Investments (CCI), which has been set up to fast-track key projects, should be closely monitored by the government as well as the business sector to maximize its effectiveness.

3. Ensure stability in the financial system. Policy actions in advanced economies will continue to pose risks to India's financial and banking systems; they need to be prepared for spells of high volatility and uncertainty. Deteriorating asset quality and liquidity in the market, which primarily contributes to the instability of the banking system, have to be closely monitored. In addition, measures should be taken to improve the efficiency of banks by increasing competition and access to markets with proper supervision.

While India's current vulnerability to external uncertainty is similar to most of the other emerging economies, fundamental domestic challenges to growth are making the country's economy extremely susceptible to external shocks. A recent fall in the world ranking on the global competitive index[7] places India below most of its competing emerging nations, and India cannot afford to neglect that. Impending elections cannot be an excuse for policy paralysis, and if India delays its actions until the elections in May 2014, it might lose an opportunity to improve its economic situation and the confidence of its investors.

Endnotes

1. Fiscal year in India begins on April 1 of the year referred.
2. Hereafter, all growth percentages mentioned in the article are measured as year over year unless otherwise specified.
3. The consumer confidence survey is conducted by the Reserve Bank of India (RBI) and the business sentiment survey is conducted by the Federation of Indian Chambers of Commerce and Industry (FICCI). Both the surveys were last published in June 2013.
4. IW refers to Industrial Worker and refers to retail prices of fixed basket of goods and services being consumed by the target group—an average working class family. http://labourbureau.nic.in/Special%20Art%20CPI%20IW%20NS%202006.pdf
5. The Inflation Expectations Survey of Households for the April–June 2013 quarter (32nd round) captures the inflation expectations of 4,960 urban households across 16 cities for the next three-months as well as the next year.
6. These measures were made to counter the impact of Fed's first announcement of tapering monetary stimulus on May 22, 2013 and contain market volatility.
7. The Global Competitive Index published by IMF ranks India 60, its lowest ranking so far, and places it 31 ranks below China. India is now placed below China, Thailand, Indonesia, Turkey, South Africa, Mexico, and Brazil and is barely above Russia.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Brazil: One quarter does not a year make

By Navya Kumar

IN Q2 2013, the Brazilian economy experienced its fastest growth in eight quarters, but the outlook for the year continues to deteriorate. Amid internal and external challenges, the government and the International Monetary Fund (IMF) have repeatedly cut growth forecasts for 2013 . However, despite slowing growth, the central bank had to employ monetary tightening to counter inflation and a sharp depreciation in the currency (see figure 1). While the government also plans spending cuts to improve fiscal balance, the country is looking to spur growth by boosting trade. Brazil is looking to enter a free-trade agreement (FTA) with the European Union (EU), and although both parties appear favorable, major roadblocks remain.

Q2 glimmer quickly fades

Brazil's GDP expanded at 3.3 percent year over year in Q2 2013, compared to 1.9 percent in Q1 2013. Double-digit growth in agriculture and capital goods production, along with a rise in exports of manufactured products, drove the performance. Subsidized loans and tax cuts by the government in the first half of the year appear to have aided the economy, but their impact was limited by rising unemployment and inflation. Unemployment averaged 5.9 percent in Q2 2013, up from 5.6 percent in the previous quarter, while inflation went up to 6.6 percent from 6.4 percent in the same period. These were the highest rates of unemployment and inflation in nearly 12–18 months. Consequently, private consumption recorded the second-slowest growth in 17 quarters in Q2, rising a mere 2.0 percent year over year. Another low point for the Brazilian economy in the second quarter was persisting weakness in the mining sector. Extraction fell an average 6.7 percent in Q2 2013 due to tepid demand as well as production challenges.

The overall economic scenario for the rest of the year appears even less promising, with the government and the IMF recently cutting full-year growth forecast by 50 basis points to 2.5 percent. Industrial production data for July backs the lack of optimism, registering just 1.1 percent year-over-year growth compared to the 3.3 percent average for Q2 2013. A decline in intermediate goods

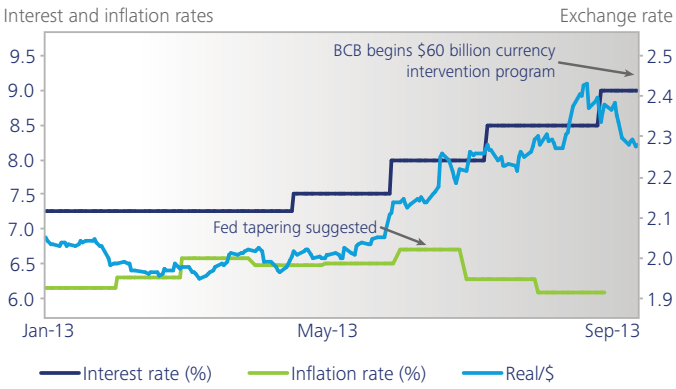
Amid internal and external challenges, the government and the International Monetary Fund (IMF) have repeatedly cut growth forecasts for 2013.

and significant slowdown in consumer goods has weighed on industrial activity. Exports have also been hit by soft demand from European markets, and for the full year, they are expected to grow a modest 1.5 percent, compared to 0.5 percent in 2012. In addition, private consumption growth for 2013 is forecast at the lowest level in a decade, due in part to cooling real wages. These weak internal and external factors are reflected in deteriorating business sentiments, with the purchasing managers' index for July as well as August dipping below 50 after nine consecutive months in expansionary territory.

Tightening purse strings despite slowing growth

From March to June 2013, Brazil's inflation rate hovered at or exceeded the Banco do Brasil's (BCB's) upper limit of 6.5 percent, driven in part by a double-digit increase in food prices. In addition, in the past four months, the Brazilian real has depreciated nearly 19 percent against the dollar. This was triggered by the US Federal Reserve's hinting on May 22 at a winding down of its quantitative easing program (Fed tapering) and could stoke imported inflation.

Figure 1. Monetary tightening to target price rise and currency depreciation



Source: Bloomberg, Banco do Brasil, 2013

Graphic: Deloitte University Press | DUPress.com

To counter these challenges, the BCB has hiked its key interest rate four times since April 2013 by a total of 175 basis points, to bring it to 9.0 percent in August. On August 22, the BCB also launched a $60 billion currency intervention program including swaps and repurchase agreements with businesses that need dollars. The host of steps seems to have stemmed both price rise and currency depreciation to some extent. Inflation declined to 6.1 percent in August, while the real strengthened by 6.1 percent against the US dollar since August 22.

After significant stimulus spending earlier in the year, the government is now looking to curb spending to cool inflation and bolster the country's fiscal balance. To this end, in July, the government announced plans to cut its expenses by 10 billion reals. This follows an announcement in May to cut spending by 28 billion reals. With these cuts, the government seeks to achieve its 2013 primary budget surplus target of 2.3 percent of GDP. However, a primary surplus of only 1.5 percent of GDP appears within reach for the year, given spending for economic stimulus and improving public services. Nevertheless, the expenditure incurred on public services has boosted President Dilma Rousseff's public approval ratings, which took a beating during the widespread street protests in June. As a result, President Rousseff is likely to remain ahead of rivals before campaigning for the October 2014 election begins.

Paving trade routes for growth

The EU accounts for a fifth of Brazil's exports, and forging an FTA with the EU has acquired an immediate urgency for Brazil. The urgency arises from Brazil's recent classification by the World Bank as an upper-middle income country, which makes the country lose the EU's preferential trade status in 2014. Brazil paid lower duties on its exports under the EU's preferential status, which covers several less developed and developing economies. Given a deteriorating current account balance, it becomes even more important to boost trade with the EU, with whom net exports have favored Brazil for nearly a decade.

The only remaining hurdle for Brazil is its trade alliance with Argentina, Paraguay, Uruguay, and Venezuela—the Mercosur trade bloc. The trade bloc has been unsuccessfully trying to negotiate an FTA with the EU since 1999, and Brazil will now need a waiver from other Mercosur members to negotiate its separate deal. While Argentina and Venezuela's positions remain doubtful, Brazil may receive support from Uruguay. Uruguay has also been seeking flexibility from the Mercosur to pursue individual FTAs.

The situation calls for Brazil to tread carefully. While waiting for a Mercosur-EU deal may be in vain given Argentina's protectionist stance, alienating a sizeable market such as the Mercosur, which accounted for 10 percent of Brazil's exports in 2012, would also be unwise.

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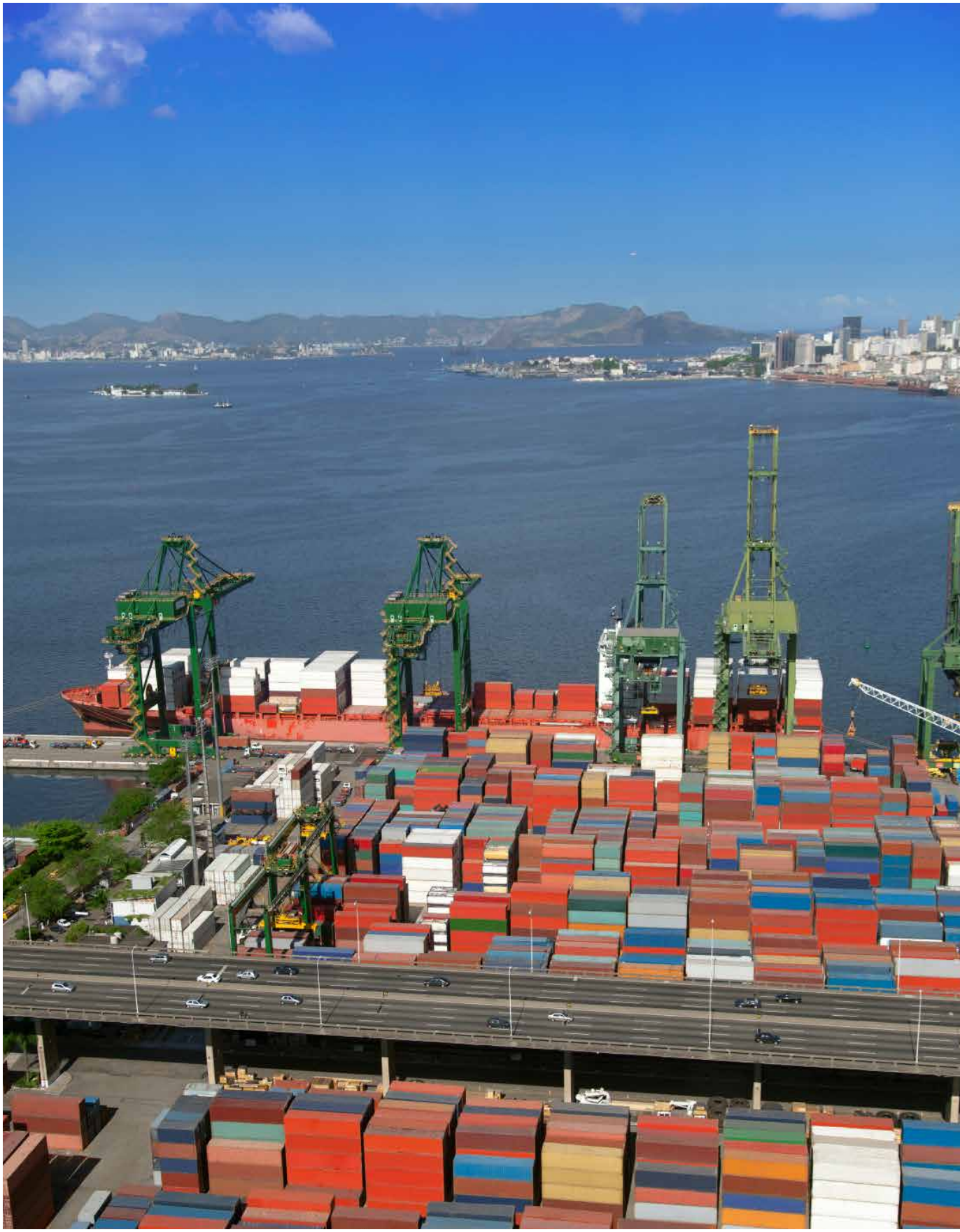
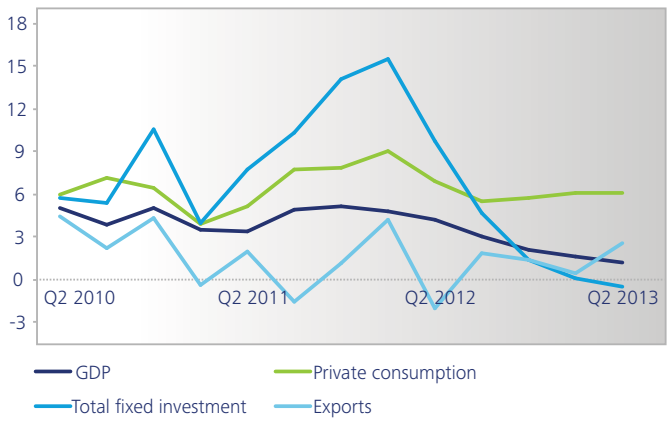


Russia: Deeper into the woods

By Akrur Barua

RUSSIA'S economy continues to stagger under the weight of subdued investment, a weak manufacturing sector, and lack of a strong reform agenda that addresses long-term productivity concerns, population decline, and overreliance on hydrocarbons. It was therefore not surprising that Q2 2013 GDP growth dipped to 1.2 percent year over year from 1.6 percent in Q1 (see figure 1). This was the sixth straight quarter of slowing growth, and it would have been worse had it not been for strong resilience in consumer spending. Meanwhile, exports continue to face pressures from a muted recovery in Europe even as slowing growth in emerging markets dent the prices of hydrocarbons, Russia's key export item.

Figure 1. Growth in real GDP and key components (%, YoY)



Source: Oxford Economics, September 2013

Note: Q2 2013 figures (except real GDP) are estimates by Oxford Economics

Graphic: Deloitte University Press | DUPress.com

Given these trends, Russia's Economy Ministry has lowered its GDP growth forecast for 2013 to 1.8 percent from April's projection of 2.4 percent. Although the ministry expects economic growth to improve to 2.8–3.2 percent in 2014, the figure is way below President Vladimir Putin's ambitious 5 percent target.

Investments continue to be a drag on the economy

The slowdown in investments this year shows no signs of abating. Total fixed investment fell by an estimated 0.5 percent year over year, down from a paltry 0.1 percent rise in Q1 and way below the 9.7 percent expansion in Q2 2012. Private sector investment has been hampered by high interest rates. Demand conditions also remain challenging due to restricted fiscal spending, reduced demand from Europe, and slowing trends in the consumer durables segment. For example, car sales fell 10 percent year over year in August; this sixth straight month of decline was worse than the 8 percent dip in July.

Meanwhile, industrial output eked out a marginal 0.1 percent year-over-year rise in August (see figure 2). Manufacturing also fared poorly during the month; the purchasing managers' index recorded a second straight month of contraction. Worryingly, although new orders gained

Russia seems to be moving away from the radar of foreign investors. In addition to a slowing economy, foreign firms are faced with an elevated level of political and regulatory risk.

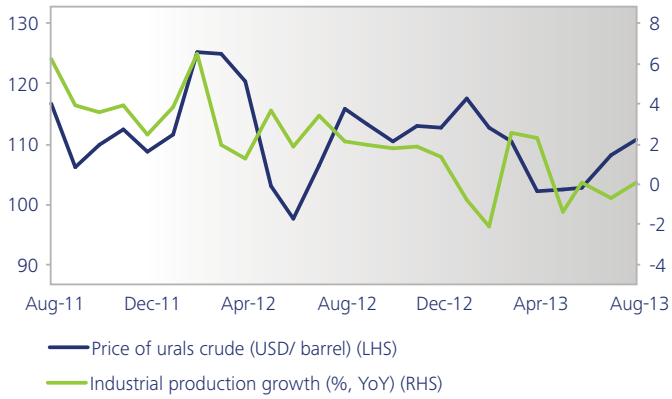
during the month, the rise was marginal. This does not augur well for Russia's manufacturing sector in the short term.

Furthermore, Russia seems to be moving away from the radar of foreign investors. In addition to a slowing economy, foreign firms are faced with an elevated level of political and regulatory risk. In Q1 2013, Russia recorded a net foreign direct investment outflow of $26.5 billion, the worst figure since the breakup of the Soviet Union. Under such a scenario of slow domestic and foreign interest, fixed investment is not likely to record any growth this year. This is despite a possible loosening of monetary policy in Q4 2013 as the lagged effect of lower interest rates will not filter in before 2014.

Private consumption yet again rescues the economy in Q2 2013

Private consumption will continue to be a key driver of economic growth this year. The segment expanded 6.1 percent year over year in Q2 2013, almost the same as in Q1. A tight labor market has ensured gains in wages with a slowdown in inflation in the coming months also likely to benefit Russian consumers. Inflation has been edging lower since the peak of 7.4 percent in May, with August recording a figure of 6.5 percent. A possible easing of food prices due to a good summer harvest is likely to push inflation down further, thereby benefitting consumers. This is partially evident from an uptick in retail sales growth since May; sales rose 4.3 percent year over year in July, up from 3.5 percent in June and 2.9 percent in May (see figure 3).

Figure 2. Crude oil price and industrial production growth



Source: Bloomberg, OPEC, September 2013

Graphic: Deloitte University Press | DUPress.com

Figure 3. Retail sales growth and unemployment

Source: Bloomberg, September 2013

Graphic: Deloitte University Press | DUPress.com

Nevertheless, upbeat consumer demand is not enough to propel Russia to a higher growth trajectory. With the segment having grown steadily in the past year, the base effect is likely to work against the segment in the next 2–6 quarters. At the same time, wider concerns about the slowing economy are likely to weigh on consumer

sentiment. The central bank's efforts to stem unsecured consumer credit will also act against private consumption growth in the short to medium term.

Monetary easing in sight: Bank of Russia moves in to curb unsecured retail lending

Both consumption and investment are likely to find support from a probable lowering of policy rates by the Bank of Russia (BOR). Although inflation is still above the central bank's upper target of 5–6 percent, and the ruble has edged lower since indications of a tapering of quantitative easing in the United States, BOR looks set to ease monetary policy to stimulate the economy (see figure 4). Analysts expect BOR to cut its policy rate by a total of 25–50 basis points (bps) in Q4 2013, followed by cuts of 75–100 bps in 2014.

A concern for the central bank is the sharp growth in unsecured retail lending. So far, BOR's measures have helped bring down the pace of expansion of unsecured loans to about 40 percent this year from more than 60 percent in 2012. However, the central bank wants to bring this down further to a more manageable 10–15 percent by 2016. A spike in unsecured consumer credit with subsequently high interest costs does not bode well for consumers and banks. According to the National Bureau of Credit Histories, Russia's leading credit bureau, the credit health of Russian consumers fell to a three-year low in July 2013. Moody's has also warned of rising credit risk due to a sharp rise in unsecured consumer loans, including credit cards. This could dent banks' asset quality and force banks to infuse more capital, record greater loss provisions, and post lower profits in the coming years.

In September, BOR directed banks which issue loans at annualized interest rates of 45–60 percent to set aside a reserve fund of 300 percent of that loan's principal—higher than the previous reserve requirement of 170 percent. This directive comes on the heels of another one in July that had hiked reserve requirements for banks that hand out consumer loans with annualized rates higher than 25 percent. BOR is also debating about whether or not to set a maximum rate that banks can charge for consumer loans.

A few baby steps to improve public finances

On the fiscal side, Russia's overreliance on oil and gas continues, with the non-hydrocarbon deficit in 2012 at about 10.6 percent of GDP. Overall, the federal deficit is small (0.1 percent of GDP in 2012) and will likely remain close to that figure this year as well. On the negative side, hydrocarbon revenues are likely to be dented by lower crude prices this year due to slowing growth in emerging markets. The average price of Urals crude for the first eight months of 2013

was 4 percent lower than in the same period a year before.

In positive news, the country has taken a few encouraging steps to spruce up public finances (see figure 5). Tighter budget rules, including limiting the federal budget deficit to 0.5 percent of GDP in 2014–2016, have been implemented. The government is also likely to postpone some of the expenses related to the country's $700 billion defense modernization plan. The finance ministry has also called for reforms in healthcare and pensions. As a first step, it has suggested that the growing deficit of the pension fund, which is covered by federal budget, be adjusted by raising employers' mandatory social security contributions.

In reducing its dependence on hydrocarbons, Russia could perhaps take a cue from Mexico, where President Peña Nieto has made efforts to raise the share of taxes on GDP, reform social programs, and seek private investments in the oil sector. However, Russia faces less urgency than Mexico to reduce oil dependency, given that the former's oil and gas reserves are significantly higher than the latter. Also, political opposition to expanding reforms in the oil and gas sector is higher in Russia. In fact, reforms that go any further than the ones already enacted in social security, health, defense, and privatization are likely to face strong opposition from the Kremlin.

Ukraine's EU ambitions dent Russia's Eurasian project

For some time now, Russia has been trying to prevent Ukraine from moving toward European Union (EU) accession. Instead, Russia wants Ukraine to join a Eurasian customs union that consists of former Soviet states. With energy sops failing to sway Ukraine, Russia responded in August with tough trade restrictions on Ukrainian exports. The use of harsher measures points to Russia's increasing fears about losing influence in the region. To Russia's dismay, Ukraine seems unperturbed. In September, the country took one more step toward EU integration by agreeing to sign a number of trade agreements with the EU. This is a blow to Russia's Eurasian ambitions, and it has implications for the region.

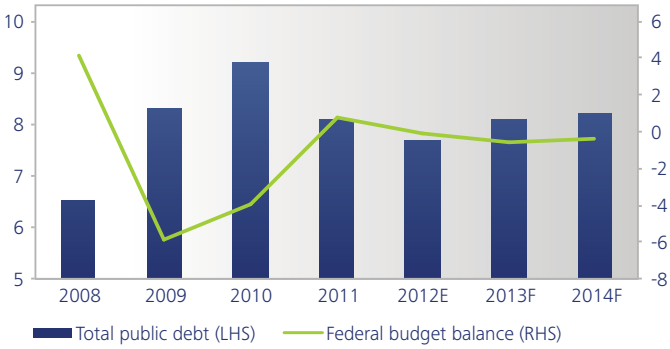
Meanwhile, a spat between Russia and close ally Belarus has had a more global impact. In September, Uralkali—a Russian potash company—withdrew from a cartel (with Belarus) for potash, a key ingredient in fertilizers. Belarus reacted by inviting Uralkali officials for talks and then arresting the company's Chief Executive Officer. This angered Russia, and it has retaliated with a number of trade-related measures. Interestingly, breakdown in cooperation between Belarus and Russia has led to a dip in global fertilizer prices. The longer it takes for any compromise to emerge, the better it is for farmers across the world.

Figure 4. Inflation and broad money (M2) supply growth

Source: Bloomberg, September 2013

Graphic: Deloitte University Press | DUPress.com

Figure 5. Public debt and federal government balance (% of GDP)

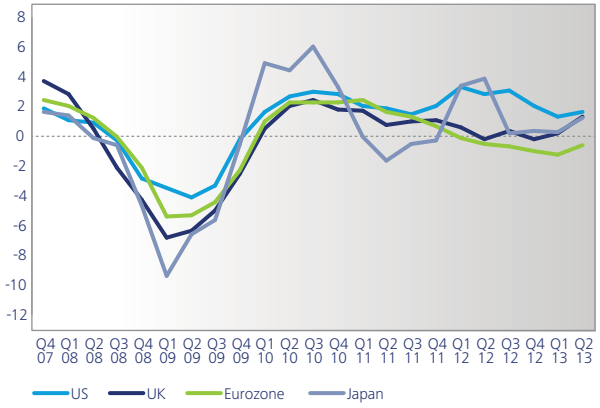


Source: Economist Intelligence Unit, September 2013
Note: F = forecasts, E = estimate

Graphic: Deloitte University Press | DUPress.com

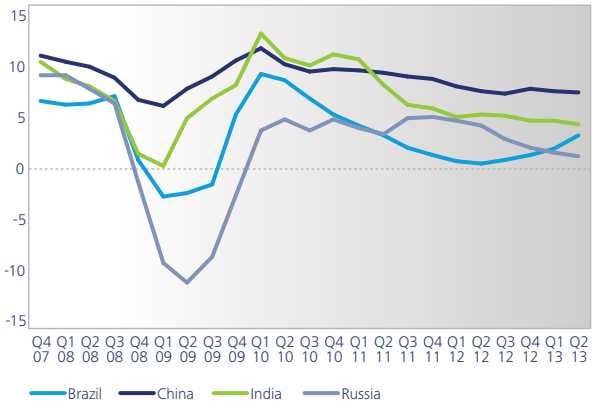
Economic indices

GDP growth rates (YoY %)



Source: Bloomberg
Graphic: Deloitte University Press | DUPress.com

GDP growth rates (YoY %)



Source: Bloomberg
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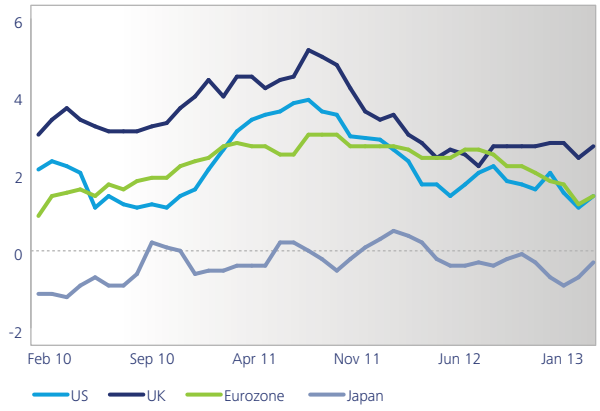
Inflation rates (YoY %)



Source: Bloomberg
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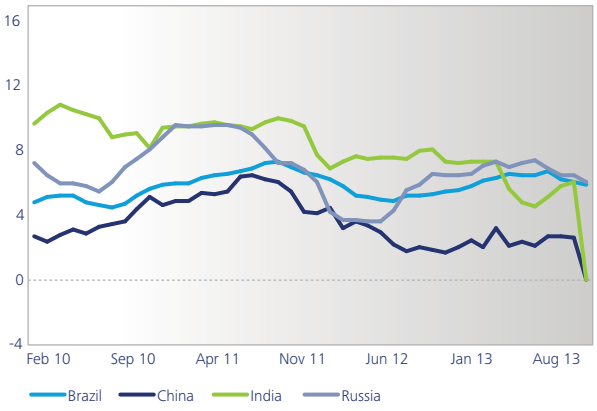
Inflation rates (YoY %)



Source: Bloomberg
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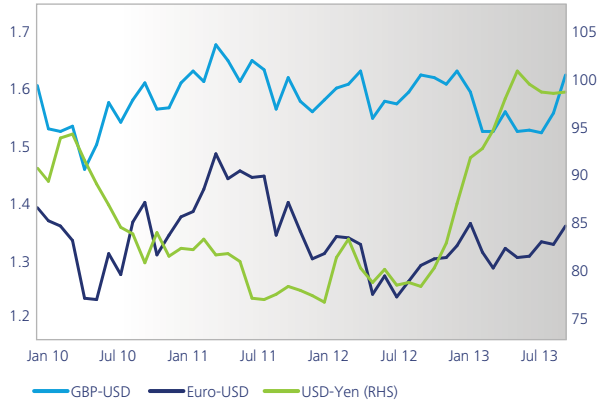
Major currencies vs. the US dollar



Source: Bloomberg
Graphic: Deloitte University Press | DUPress.com

Yield curves (as of October 11, 2013)*

	US Treasury bonds & notes	UK gilts	Eurozone govt. benchmark	Japan sovereign	Brazil govt. benchmark	China sovereign	India govt. actives	Russia‡
3 months	0.08	0.40	0.07	0.06	9.59	3.59	8.83	5.81
1 year	0.13	0.39	0.17	0.08	10.10	3.53	8.91	5.98
5 years	1.41	1.54	0.85	0.23	11.44	3.88	8.43	6.81
10 years	2.65	2.72	1.85	0.66	10.88	4.05	8.48	7.66

Composite median GDP forecasts (as of October 11, 2013)*

	US	UK	Eurozone	Japan	Brazil	China	Russia
2013	1.6	1.3	-0.3	1.9	2.4	7.6	2
2014	2.6	2.2	1	1.6	2.4	7.4	2.8
2015	3	2.4	1.4	1.2	3.1	7.15	3.1

Composite median currency forecasts (as of October 11, 2013)*

	Q4 13	Q1 14	Q2 14	Q3 14	2014	2015	2016
GBP-USD	1.57	1.56	1.55	1.54	1.55	1.56	1.53
Euro-USD	1.32	1.3	1.29	1.27	1.26	1.28	1.28
USD-Yen	101	103	104	107	110	110	102
USD-Brazilian Real	2.3	2.33	2.35	2.35	2.35	2.45	2.4
USD-Chinese Yuan	6.1	6.09	6.07	6.05	6.03	6	5.93
USD-Indian Rupee	63	62.67	62.5	61.97	62	58	56
USD-Russian Ruble	32.76	32.54	32.95	32.88	32.92	33.21	34.36

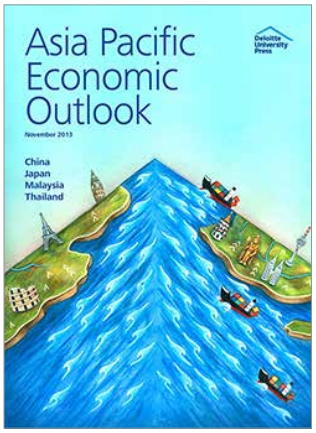
OECD composite leading indicators (amplitude adjusted)†

	US	UK	Eurozone	Japan	Brazil	China	India	Russia Federation
Oct 11	99.44	99.09	100.04	100.07	98.66	100.39	99.87	102.91
Nov 11	99.59	98.92	99.89	100.10	98.53	100.16	99.96	102.84
Dec 11	99.79	98.87	99.81	100.15	98.56	99.97	100.04	102.71
Jan 12	99.98	98.91	99.77	100.20	98.71	99.87	100.05	102.52
Feb 12	100.11	98.97	99.74	100.23	98.98	99.88	99.99	102.25
Mar 12	100.15	99.03	99.69	100.22	99.25	99.88	99.88	101.85
Apr 12	100.12	99.07	99.61	100.16	99.46	99.82	99.72	101.32
May 12	100.03	99.13	99.51	100.07	99.63	99.77	99.53	100.75
Jun 12	99.95	99.23	99.39	99.95	99.79	99.74	99.30	100.24
Jul 12	99.90	99.39	99.27	99.83	99.93	99.75	99.05	99.87
Aug 12	99.90	99.57	99.18	99.75	100.02	99.80	98.86	99.61
Sep 12	99.98	99.77	99.13	99.71	100.06	99.85	98.76	99.43
Oct 12	100.08	99.95	99.14	99.72	100.04	99.92	98.70	99.28
Nov 12	100.20	100.09	99.21	99.79	99.95	100.01	98.62	99.15
Dec 12	100.32	100.17	99.34	99.93	99.83	100.07	98.53	99.05
Jan 13	100.44	100.21	99.49	100.13	99.72	100.08	98.39	98.98
Feb 13	100.55	100.24	99.65	100.37	99.64	99.98	98.19	98.96
Mar 13	100.64	100.28	99.80	100.59	99.53	99.81	97.97	98.97
Apr 13	100.73	100.35	99.93	100.79	99.40	99.62	97.74	99.01
May 13	100.82	100.46	100.08	100.92	99.24	99.44	97.49	99.06
Jun 13	100.89	100.64	100.25	100.98	99.07	99.31	97.25	99.14
Jul 13	100.93	100.90	100.42	100.99	98.93	99.26	97.06	99.26
Aug 13	100.94	101.21	100.60	100.96	98.83	99.28	96.95	99.39

*Source: Bloomberg ‡MICEX rates †Source: OCED

Note: A rising CLI reading points to an economic expansion if the index is above 100 and a recovery if it is below 100. A CLI which is declining points to an economic downturn if it is above 100 and a slowdown if it is below 100.

Additional resources



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