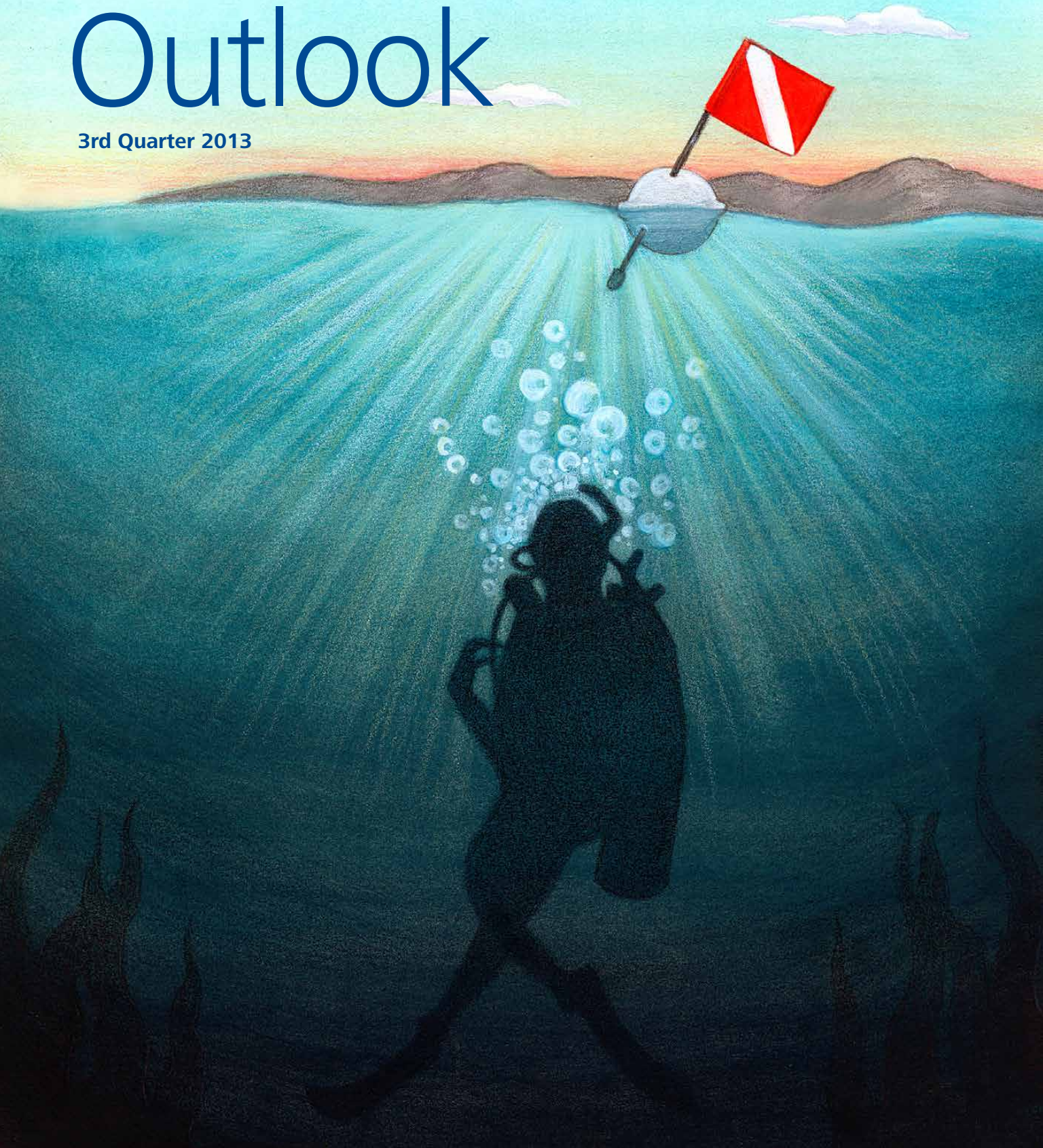


# Global Economic Outlook

3rd Quarter 2013

Deloitte  
University  
Press







Dr. Ira Kalish, chief  
global economist of  
Deloitte Touch  
Tohmatsu Limited

# Global Economic Outlook Q3 2013

**T**HE global economy continues to grow at a modest pace. Europe remains in recession, US growth remains subpar, and the major emerging markets face slower growth. Meanwhile, global financial markets have faced considerable volatility, owing to prospective changes in US monetary policy, a new policy in Japan, and instability in China's banking system. Indeed, Asia has been at the forefront of economic news in the latest quarter. Troubles in the Chinese financial system and volatility in Japan's financial system have been leading the headlines in recent months.

In this edition of the *Global Economic Outlook*, we examine the major issues confronting the global economy and discuss the likely outcome. We begin with my discussion about China. I explain the recent structure of the banking system, how the shadow banking system grew so rapidly, and the reasons why troubles emerged recently. I also discuss the response of the authorities and what must happen in the future in order to restore growth and financial stability.

In the next article, I discuss Japan's new economic policy, known as Abenomics, and the reasons why financial markets became quite volatile in June. I also discuss how the economy appears to be performing better in the aftermath of the new policy. I also look at the outlook for the Japanese economy and the conditions that must be met in the long run in order for the new policy to succeed.

In our next article, Patricia Buckley attempts to explain Ben Bernanke's attempt to explain his policy intentions. Bernanke's recent comments on the possible future path of monetary policy set off a rather notable round of financial volatility. Patricia examines the impact of monetary policy and the likely outlook for the US economy. She also discusses the impact of fiscal policy.

In his review of the Eurozone outlook, Alexander Boersch notes the difference in performance between European financial markets and European economic growth. Financial market health has improved, in large part due to ECB policy. Yet the economy remains mired in recession. Alexander says that Europe's economy is too dependent on exports, especially to emerging markets, and must have other sources of demand in order to generate sustainable growth.

Next, Alexander focuses on the long-neglected European consumer and the role that consumers will play in the outlook for the Eurozone economy. Alexander suggests that the European consumer remains hobbled by debt and continues to engage in deleveraging. As such, it is unlikely that they will play a major role in economic recovery. Rather, other sources of growth, including investments and exports, will be required.

In his article on the British economy, Ian Stewart suggests that Britain may be turning the corner. He notes that the consumer sector and the corporate sector have both shown unexpected strength. Ian notes that an aggressive monetary policy has provided the fuel for consumer wealth, consumer spending, and better credit market conditions. On the other hand, he says that the economy continues to face substantial headwinds from global weakness, tight fiscal policy, and global financial market volatility.

In her article on India, Rumki Majumdar says that, while the old challenges to India's economy continue, new challenges are emerging. The end result is that the outlook for growth is not good. Among the challenges are uncomfortably high inflation, a big budget deficit, a large external deficit, and capital flight, which resulted from actions by the Federal Reserve in the United States. Capital flight has contributed to currency depreciation, exacerbating inflation and constricting the ability of the central bank to ease policy.

In our next article, Akrur Barua provides a discussion about the Russian economy. He notes that the main strength of the Russian economy has come from the consumer sector. Increasing wages and consumer willingness to borrow have fueled spending growth. However, high inflation has led the central bank to tighten lending conditions. Moreover, muted global demand for commodities has had an adverse effect on growth. The outlook, therefore, remains uncertain.

Finally, Navya Kumar looks at the Brazilian economy, which is struggling to grow. The rapid shift from strong to weak growth has certainly taken a toll in terms of popular discontent. Mass demonstrations reflect frustration with poor infrastructure, corruption, and inefficiency. Sadly, the outlook is hampered by high inflation, weak overseas demand, and volatile and interventionist public policies that have hampered business investment.




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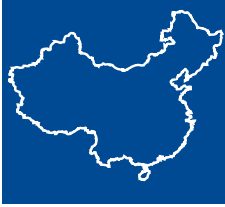
Brazil, one of the world's most promising emerging economies, is struggling to grow. Decelerating private consumption and demand for exports, as well as structural bottlenecks, are limiting Brazil's performance. Public protests that erupted in June have only added to the country's list of challenges.

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# China: A turning point?

by Dr. Ira Kalish

**T**HE Chinese economy appears to be faltering. At a time when the global economy is showing signs of very modest acceleration, China is shifting in the opposite direction. In the process, it is taking other countries such as Taiwan and South Korea in a negative direction as well. In June, a purchasing managers' index (PMI) for manufacturing, published by Markit, shifted into further negative territory, indicating that the critical industrial side of the Chinese economy is actually in decline.<sup>1</sup> A separate PMI for the services sector showed, at best, anemic growth.<sup>2</sup> While domestic demand continues to grow, it has benefitted from relatively loose credit market conditions that now face reversal. Indeed China's banking system is at a crossroads. It is going through a traumatic shift brought on by a government determined to alleviate financial imbalances, even at the temporary cost of slower growth. The new leadership has indicated that stimulus is not in the offing. Instead, fundamental issues will be addressed.

## Slowdown in manufacturing, slow growth in services

First, the industrial side of the economy is faltering. A PMI for the manufacturing sector published by Markit declined from 49.2 in

May to 48.2 in June.<sup>3</sup> A reading below 50.0 means a decline in activity. The lower the number, the faster the decline taking place. Hence, the June reading suggests deterioration in the manufacturing sector. This was the second consecutive month in which the PMI fell. There was a decline in new orders and an especially deep drop in export orders.

In addition, Markit published a PMI for the services sector.<sup>4</sup> This indicator increased modestly from 51.2 in May to 51.3 in June. Still, it remains low compared to recent months. New orders remained above 50.0, but were at the lowest level in 4.5 years. A sub-index for construction activity remained strong, but it declined nonetheless.

The weakness in economic activity reflects weak overseas demand—especially in Europe—and a slowdown in domestic spending on infrastructure and other forms of investment.





## Out from under the shadows

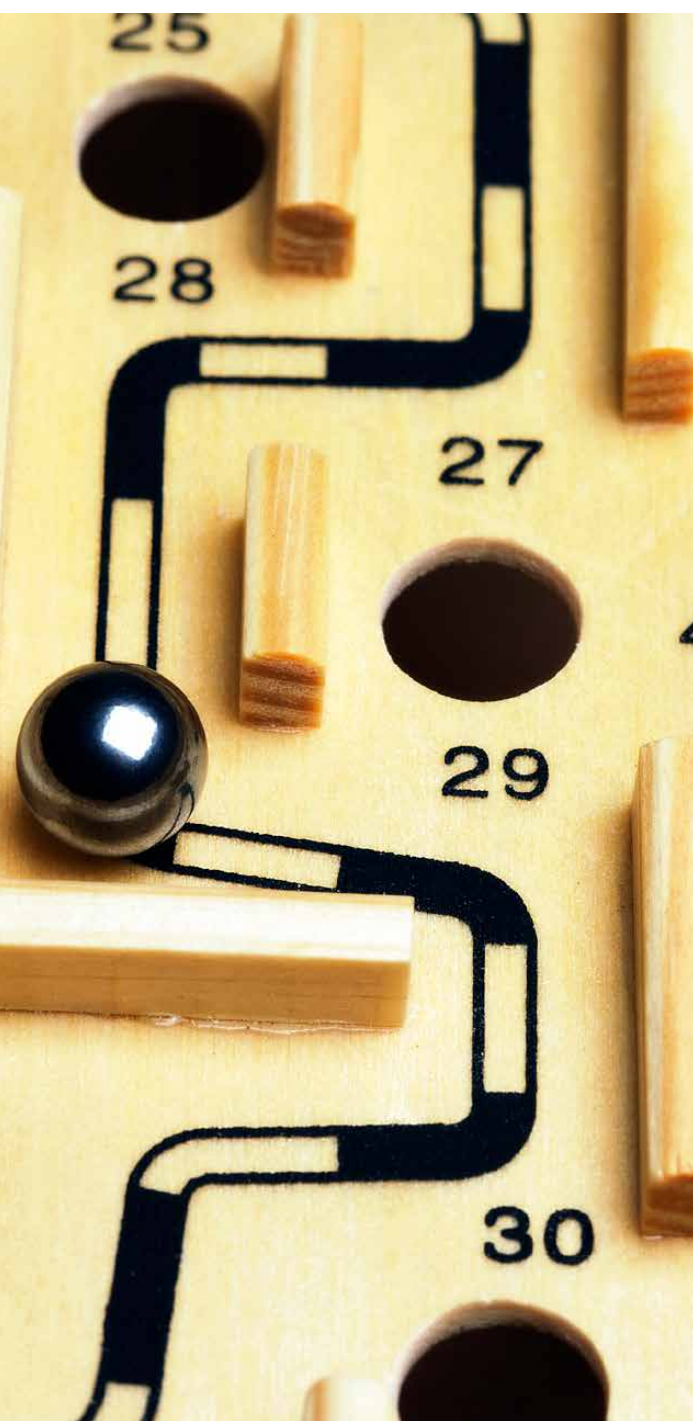
Interestingly, the economy is slowing despite the fact that credit is growing rapidly. Indeed Chinese authorities are concerned that credit growth is not translating into economic growth and that credit growth is creating risks to the economy. In the first quarter, credit was up 58 percent, but real GDP growth was a very modest 7.7 percent. The authorities are

worried that too much credit is flowing into things that contribute nothing to growth, including considerable speculative activity. As such, the central bank has taken steps to cool down credit markets. This includes cracking down on illegal capital inflows, tightening conditions in the mortgage market, and providing closer scrutiny of the shadow banking system.

It is the shadow banking system that has been at the center of attention. It has developed largely because of restrictions on commercial banks. They remain state-owned and face interest rate regulation. That is, the rate they pay depositors is capped, and the rate they charge borrowers is capped as well, providing the banks with a predictable and favorable profit margin. Their borrowers are mainly state-owned enterprises (SOEs) and local governments that get cheap credit and, as a consequence, invest excessively. Everyone else—including private sector businesses and households— lacks substantial access to bank credit.

In order to profit from the excess demand for credit, banks have bundled loans into Wealth Management Products (WMPs) that are essentially securitized assets. They sell these WMPs in order to shift assets off the books and raise funds that can be loaned at higher interest

The weakness in economic activity reflects weak overseas demand—especially in Europe—and a slowdown in domestic spending on infrastructure and other forms of investment.



For now, it appears likely that the economy will grow slowly, that credit growth will slow down, and that the authorities will seek ways to gradually shift the financial system away from dependence on non-traditional forms of financial intermediation.

rates through off-balance-sheet vehicles known as trust companies. The result has been an explosion of credit outside normal banking channels and outside the purview of regulators. Moreover, this has enabled the banks to maintain a very low non-performing loan ratio even if many of the loans they have made (especially to local governments) have actually gone bad.

The WMPs are like bonds in the sense that they have a maturity date, usually in less than three years, sometimes as little as six months. When they come due, banks must pay back the investors. If the loans behind the WMP have failed, the banks must somehow raise funds to service the WMPs. This has generally meant issuing new WMPs, often at even higher interest rates. To grease this market, much interbank lending has been taking place. WMPs are not the only part of the unsupervised shadow banking system, but they are the most noteworthy. The WMPs tend to be bought by wealthy individuals who want a better return than can be obtained through banks. In any event, the whole system exists because of interest rate regulation. Absent this, there would be little need for a system outside normal banking channels.

Default on a WMP would mean that individual investors would lose their money. Yet this is hardly desirable. As such, the banks

continue to fund the WMPs, often borrowing from one another to raise short-term funds needed to pay owners of WMPs.

### How did we get to this point?

One of the things that recently enabled a dramatic increase in credit has been continued growth of the money supply. This was partly due to the need to monetize inflows of capital. Such inflows were fueled, in part, by the illegal practice of faking export invoices. Exporters would do this in order to borrow overseas and bring money into China to invest, all the while falsely treating these inflows as export revenue. This “carry trade,” if not monetized, would have put upward pressure on the currency. To avoid currency appreciation, the People’s Bank of China (PBOC), China’s central bank, purchased foreign currency, thus maintaining the exchange rate and boosting the money supply. When the government recently cracked down on fake invoicing, capital inflows slowed dramatically. This, in turn, meant that the central bank was no longer providing as much liquidity, but the demand for interbank lending continued apace. Without support from the PBOC, interbank lending rates started to rise. When the PBOC initially failed to intervene



to suppress rates, investors panicked, thereby driving rates up to unusually high levels.

Ultimately, the PBOC intervened lest any banks fail. Yet the episode offered a glimpse at government thinking. The new leadership has spoken publicly about getting the shadow banking system under control. Clearly the recent events suggest that they are trying to find a way out of the current situation. However, unless they allow free movement of interest rates, the situation could worsen. Moreover, the lack of transparency in the system means that potential risks may be hidden and could explode at any time. While a Lehman type event is unlikely given that the government owns the banks, a serious credit crunch is possible, which would have negative ramifications for economic growth.

Most analysts expect that the government will bail out banks and absorb losses, should the need arise. They would probably place restrictions on credit growth, but not too much

lest they dramatically slow the economy. The result could be continued growth of credit, fueling the continuation of economic growth through investment in infrastructure. This means an increasingly distorted economy with huge financial imbalances, rising investment, and declining GDP growth. It would be better, of course, to liberalize financial services and create a more efficient system. The problem is that the transition to a market-driven system will involve a transition that would be challenging to implement. A market system would mean less credit growth, higher returns on bank deposits, higher costs of borrowing from banks, less investment by SOEs, and a gradual shift toward a consumer-driven economy.

For now, it appears likely that the economy will grow slowly, that credit growth will slow down, and that the authorities will seek ways to gradually shift the financial system away from dependence on non-traditional forms of financial intermediation.

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## Endnotes

1. Markit Economics, "Press releases," <http://www.markiteconomics.com/Survey/Page.mvc/PressReleases>, accessed July 17, 2013.
2. Ibid.
3. Ibid.
4. Ibid.



# Japan: Real progress with volatility

by Dr. Ira Kalish

**I**N Japan, it now appears that Abenomics is bearing some fruit in terms of a boost to economic activity. On the other hand, Abenomics has also created a far more volatile financial environment. Yet the improvement in economic performance can only be considered temporary as it is driven by movements in asset prices and a boost to business and consumer confidence. Longer-term improvements in economic performance will require real economic reforms—something that remains somewhat uncertain until there is a change in the political landscape.

## The real economy

The most positive economic news came from Markit's monthly purchasing managers' indices (PMIs), which can provide a forward-looking indication of economic conditions. In June, the PMI for the manufacturing sector reached 52.3, the highest level in nearly 2.5 years. A reading above 50.0 indicates increasing activity. A higher number means faster growth. The sub-index for new orders was up strongly to the highest level in three years. However, new orders for exports were up only modestly, likely due to the continuing

recession in Europe. Japan's manufacturing PMI was also one of the highest among major economies. On the other hand, Markit reports that Japanese manufacturers face a profit squeeze because of rising import prices—itsself the result of a declining yen.<sup>1</sup> Markit's PMI for the services sector was 52.1 in June, down from a record high of 54.8 in May.<sup>2</sup>

There was other good news recently: The government reported that industrial production increased 2.0 percent from April to May, shipments of capital goods were up 1.7 percent (suggesting a rebound in business investment), the inventory-sales ratio declined, retail sales increased 1.5 percent from April to May, and consumer prices stabilized after declining for six months. One reason for the stabilization of prices is that, with a declining yen, prices of imported energy rose.

Business sentiment is improving as well. Japan's Tankan survey of business sentiment





increased strongly in June, with the manufacturing survey rising to its highest level in more than two years. Evidently, despite increased financial volatility in the past month, Japanese business executives are confident that the new economic policy will bear fruit. The fact that the yen remains well below the peaks it reached last year has already had a positive impact on export competitiveness.

Finally, although consumer spending growth has decelerated from its rapid pace in the first quarter, spending on big-ticket items such as home-related products and automobiles continues to be strong. Consumer confidence is up considerably, and job market conditions have improved.

And although nominal wages continue to fall, worker bonuses are up considerably, thereby contributing to increased demand for large expenditures.

Overall, it appears that Abenomics is bearing some fruit. A lower yen boosted competitiveness, an aggressive monetary policy boosted expectations of inflation, and a radical shift in policy boosted confidence. Yet for longer-term success, more reform legislation will need to be passed. Recent polls show that Prime Minister Abe remains quite popular. Shinzo Abe successfully consolidated his power in elections for control of parliament's upper house, setting the stage for Japan's first politically-stable government since the popular



former prime minister Junichiro Koizumi left office in 2006. This means that the government can forge ahead on a range of issues and can more easily pass reform legislation.

One potential area of trouble for the government is the national sales tax. Based on legislation passed during the previous government, the national sales tax is set to increase next year. The tax will rise from 5 percent to 8 percent during the second quarter of 2014. This could have a severe negative impact on economic growth. It is meant to improve the country's long-term fiscal position, setting the stage to pay for the rising cost of pensions and healthcare. Indeed, the tax is set to rise again to 10 percent in 2015. A senior government official now says that the government may consider boosting spending next year in order to offset the negative economic consequences of the tax hike.

## A volatile June

Abenomics has a considerable impact on financial markets. Initially, the yield on Japanese government bonds dropped sharply as the government engaged in substantial purchases of bonds. The drop in supply meant that the price of the bonds increased (the yield declined). Recently, however, the yield bounced back when markets became concerned about actions by the Federal Reserve. Specifically, the Fed hinted that it will soon decelerate the pace of asset purchases. Consequently, US bond yields increased quickly, leading global investors to shift toward US bonds and away from non-US assets. In addition, investors started to anticipate higher inflation in Japan as a result of the Bank of Japan's policy of asset purchases. This meant that investors required a higher return on bonds to offset expected inflation. Still, the increase in bond yields was not sufficient to offset the rise in expected inflation. As

such, the real bond yield (nominal rate minus expected inflation) may have actually declined.

In addition, Abenomics initially led to a sharp increase in equity prices and a sharp drop in the value of the yen. Both had positive effects on economic activity and business confidence. Yet both were reversed in June during a period of volatility. Still, despite turmoil, equities remain well above the level prior to the election of Shinzo Abe, and the yen remains far lower.

One effect of the rise in Japanese bond yields has been a boost in mortgage interest rates. Interestingly, this rise in rates has coincided with a substantial increase in home buying as consumers decide to take advantage of relatively low mortgage rates before they get even higher. The rate on a fixed rate 35-year mortgage has increased from 1.8 percent in April to 2.0 percent in May. This is still very low. By comparison, the rate on a 30-year fixed rate mortgage in the United States is now 3.98 percent. The result of the increased demand for homes has been a rise in housing starts (up at the fastest pace since 1996), a rise in home prices, and a rise in land prices. Home buyers are particularly interested in fixed rate mortgages in order to lock in low rates. If rates rise much more, however, there could be a drop-off in home buying.

Financial market volatility in Japan has led to questions about whether the Bank of Japan will adjust policy or simply stay the course. After initially saying that nothing will change, BOJ Governor Haruhiko Kuroda said that the bank could add to the volume of asset purchases if economic conditions warrant. This is the first time he acknowledged that the policy is flexible.<sup>3</sup> He had previously suggested that the policy was fixed and would not change based on changing economic circumstances. Specifically, Kuroda said that he doesn't plan to change policy in the next two years, but he's

amenable to making changes if the country's economic or financial situation deteriorates or if it becomes apparent that the policy is insufficient.

### What next?

There are two important unknowns regarding Japan's economy. First, we don't know what specific reforms will be enacted as part of

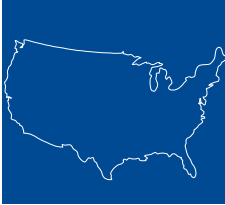
the third "arrow" of Abenomics (the first two being fiscal stimulus and aggressive monetary policy). Clarity about the reform agenda will help determine whether the progress so far is ephemeral or sustainable. Second, we don't know what impact a radically new monetary policy will have on asset prices. Already, bond yields, equities, and the currency have been on a roller-coaster. But the general direction of these asset prices has been positive.

Overall, it appears that Abenomics is bearing some fruit. A lower yen boosted competitiveness, an aggressive monetary policy boosted expectations of inflation, and a radical shift in policy boosted confidence.

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#### Endnotes

1. Markit Economics, "Press releases," <http://www.markiteconomics.com/Survey/Page.mvc/PressReleases>, accessed July 17, 2013.
2. Ibid.
3. Kihara, Leika, "BOJ's Kuroda says will shift policy of economy changes," *Reuters*, 2013, <http://www.reuters.com/article/2013/06/19/us-japan-economy-boj-idUSBRE95I04U20130619> accessed July 19, 2013.



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# United States: Working toward a recovery that can stand on its own

by Dr. Patricia Buckley

**T**HE path that will transform a currently anemic economic expansion into a more robust recovery has been bumpy, but the United States continues to make progress.

The unwelcome news that the United States only grew by 1.8 percent in the first quarter of 2013, rather than the 2.4 percent growth that was previously estimated, is a reminder that 2013 is a year of transition. We do not expect sustained higher growth levels until 2014, as the economy needs time to adjust to the tax increases that went into effect at the beginning of the year and the cuts in federal spending that began in March. However, even with

these challenges, the outlook for the United States has improved to the point where attention is now on the timing of Federal Reserve's reduction and discontinuation of asset purchases and its plan for interest rates to rise to more normal levels.

## A weaker start to the year

Based on new and revised data, the estimate of first quarter





GDP was adjusted sharply downward in June as estimates for growth in consumer spending, business investment, imports, and exports were reduced (see figure 1). The largest downward revision was in consumer spending, where the revisions were concentrated in service purchases—especially legal services, personal care services, and health care spending. The estimate for the contribution from consumer

spending on goods actually increased.

Another sizable change was the downward revision to fixed business investment that was primarily accounted for by a larger decline in investment in structures; the contribution from equipment and software held steady, albeit at a low level.

## Unintended turmoil from the Fed

For the remainder of the year, the United States should continue to experience slow-to-moderate growth with a slowly improving employment situation, setting the stage for a stronger 2014.

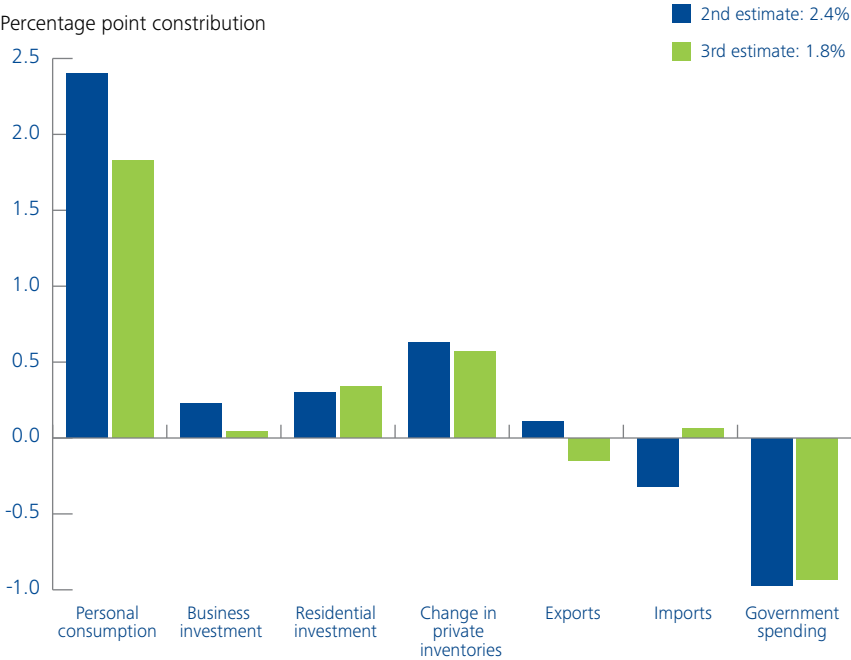
Given the continued improvement in the economy, the Federal Open Market Committee (FOMC) of the Federal Reserve Board (FED) signaled in May and again in June that if unemployment continues to fall, it will consider whether to begin to decrease the rate of asset purchases (known as QE3), which is currently running at \$85 billion per month. The FOMC also stated that if conditions began to deteriorate, it would consider increasing asset purchases. Neither of these statements reflected a change in policy, but some market analysts reacted as if the FOMC was about to cease all asset purchases and raise the federal funds rate target in the near future, and the stock and bond markets went on a roller coaster ride.

In order to clarify the FOMC position, Chairman Bernanke gave a press conference on June 19 where he stressed the following points:

- The Fed has three tools that it is currently using to “support a stronger economic recovery and to help ensure that inflation, over time, is at the rate most consistent with its dual mandate.”



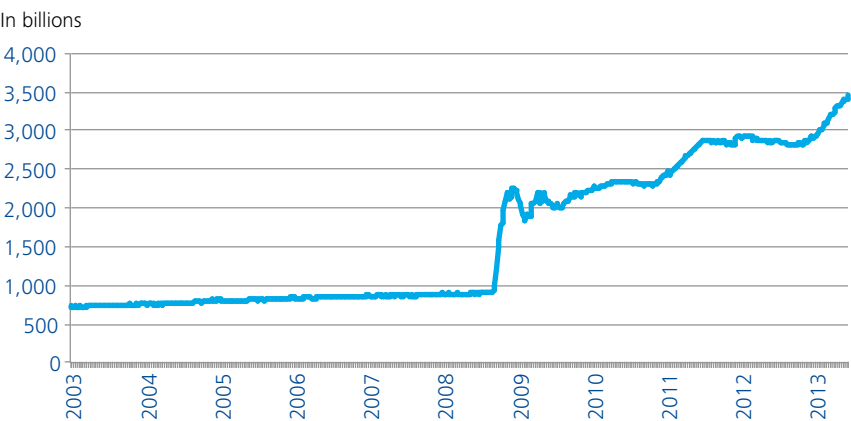
**Figure 1. Contributions to percent change in first quarter real GDP**  
**Change from 2nd estimate to 3rd estimate**



Source: US Department of Commerce, Bureau of Economic Analysis

Graphic: Deloitte University Press | DUPress.com

**Figure 2: Total Federal Reserve Board assets**



Source: Federal Reserve Board

Graphic: Deloitte University Press | DUPress.com

- Setting the target federal funds rate at 0.0–0.25 percent to foster low near-term interest rates
  - Communicating that it plans to keep the target very low during the midterm
  - Stimulating prices by purchasing Treasuries at the rate of \$45 billion per month and purchasing agency mortgage-backed securities at the rate of \$40 billion per month. The rate of asset purchases can be reduced or increased as conditions warrant.
- When considering the individual economic forecasts of the members of the FOMC, it is conceivable that unemployment could fall to 7.0 percent by the end of this year. If this were to occur, the FOMC would consider whether it should slow the rate of asset purchases.
  - When unemployment reaches 6.5 percent, the FOMC will consider whether to discontinue further asset purchases and will look for signs of strength that would cause the committee to consider a gradual increase in the federal funds rate.

It was clear that Bernanke was not setting a timeline and that he was discussing thresholds where changes should be considered in light of current economic conditions, not triggers that would result in automatic changes in policy.

Prior to a financial crisis that nearly resulted in financial collapse, the Fed maintained a balance sheet that grew slowly over time. All of that changed in October 2008 when the Treasury and Fed began to pull every lever at their disposal, as well as create new ones, in order to shore up the financial system. In a bid to provide liquidity, the Fed began to rapidly expand its balance sheet. As seen in figure 2, this shift was large and rapid. Between the end of October and the end of November 2008, the Fed's balance sheet

**Asset purchases were never intended to be an ongoing feature of monetary policy, and eventually—most likely over a period of years—the Fed will begin to reduce its balance sheet to levels more in line with historical levels.**

expanded by a third. Just prior to the beginning of the latest round of asset purchases in September 2012, the Fed's balance sheet tripled in size from its pre-crisis level. Recognizing that the Congress and the Administration were not going to act to speed the recovery, the Fed embarked on its latest round of asset purchases. As of June 2013, QE3 has resulted in an additional 23 percent increase in the Fed's balance sheet.

As the Fed sees the economy strengthen, it will taper off purchases of new assets. Asset purchases were never intended to be an ongoing feature of monetary policy, and eventually—most likely over a period of years—the Fed will begin to reduce its balance sheet to levels more in line with historical levels. The stock of assets is itself stimulative, holding up prices of Treasuries and mortgage-backed securities by reducing the supply. When growth strengthens sufficiently, the Fed's focus will shift; when growth strengthens sufficiently, the Fed's focus will shift to maintaining price stability, and interest rates will be allowed to rise from their current exceptionally low levels. The FOMC is extremely mindful that all these adjustments will need to be done gradually, with a close eye on economic conditions.



## Fiscal policy: Cost with little benefit

There is little doubt that the disappointing growth experienced in the first quarter of the year is, at least partially, attributable to the expiration of certain tax policies, most notably the temporary two percentage point reduction in payroll tax and the Bush tax cuts for high income earners. The automatic spending cuts that took effect in March will provide further drag for the remainder of the year. The Congressional Budget Office estimates that these two policy moves will reduce real GDP growth by about 1.25 percent this year. So what did we get in return for this lower rate of growth?

- A lower deficit this year: For fiscal year 2013 as a whole, CBO now estimates that the budget deficit will shrink to \$642 billion, the smallest shortfall since 2008. Relative to the size of the economy, at 4.0 percent of GDP, the deficit this year will be less than half as large as the shortfall in 2009, which was 10.1 percent of GDP. However, only part of this is attributable to higher tax rates; higher employment and an increase in payments to the Treasury by Fannie Mae and Freddie Mac were also major contributors.





- A lower deficit over the next two years: Because revenues are projected to rise more rapidly than spending in the next two years, CBO projects that annual deficits will continue to shrink, falling to 2.1 percent of GDP by 2015. Stronger growth might have approached a similar result.
- But no real fix for our long-term problems, as an aging population and rising health care costs will cause the deficit as a percent of GDP to rise again.

It is difficult to see how this Congress and the Administration can work together to make the hard choices necessary to provide long-term solutions, but we do know that the longer they wait, the harder the fix will be.



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# Eurozone: Exporting its way out of the recession?

by Dr. Alexander Börsch

**T**HE good news for the Eurozone in the first two quarters of 2013 was that things did not get worse. The bad news was that they did not get better. Currently, the divisions in the Eurozone are not only between relatively well-performing countries and countries in deep recession, but also between financial market sentiment and the real economy. Investors continue to trust the safety net of the European Central Bank, but the fairly optimistic views in the financial markets do not spill over to the real economy, at least not yet. The recession in the Eurozone continued in the first quarter and very likely also in the second. This means that the Eurozone has been in recession for more

than six quarters now, the longest recession in its 14-year history.

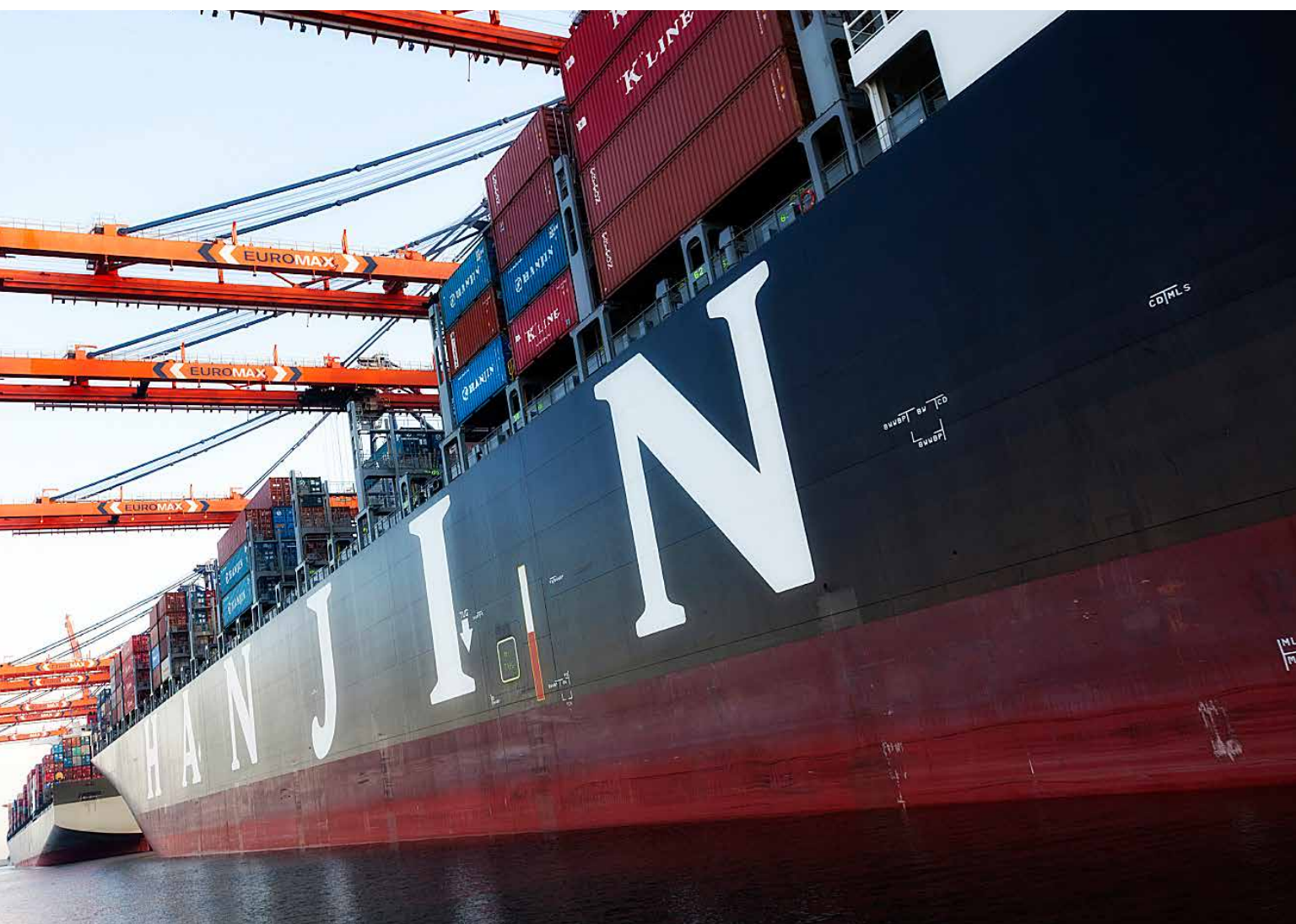
## Where can growth come from?

A return to growth in the Eurozone naturally requires growth in the main GDP components: private consumption, government expenditure, investments, and net exports.

Private consumption trends in the Eurozone, the subject of a separate article in this issue, are not favorable. Private consumption remains suppressed as household deleveraging has been ongoing and disposable income falling.







Governments in the Eurozone, on the other hand, mostly do not have the capacity to increase expenditure. Governments in the crisis countries are in the process of repairing their balance sheets, with no room to increase expenditure. Meanwhile, the northern European countries are reluctant to increase expenditure substantially, not least because the fiscal brake prevents higher deficits, and the northern European governments are already above the debt limits of the Maastricht Treaty.

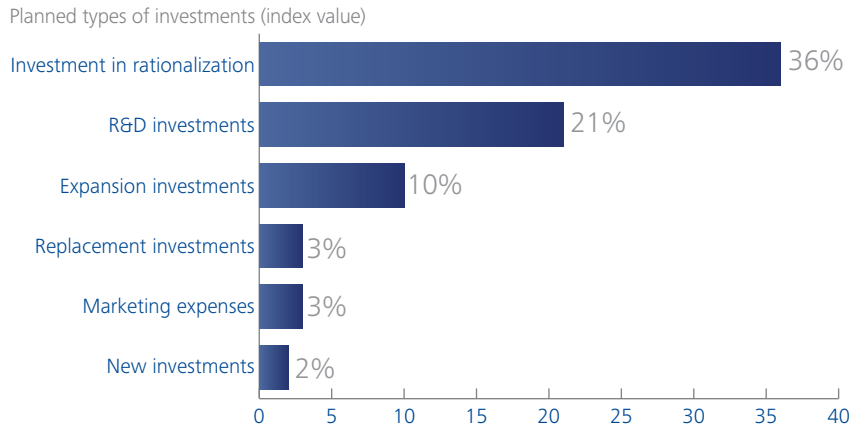
Investment activity in the Eurozone has been extremely weak. Since 2007, private investments have fallen from 21.8 percent of GDP to currently 18 percent.<sup>1</sup> This investment gap seems unlikely to be closed in the near

future. Even in Germany, firms remain reluctant to invest. The latest Deloitte CFO Survey indicated that an increase in investments is very low on the agenda of big German companies compared to other strategic activities such as cost cutting or increasing cash flow. In addition, the investments that are planned are defensive in nature and focus on rationalization rather than on growth (figure 1).

This means that three out of four GDP components fail to contribute to growth. Therefore, the hopes for growth in the short term hinge critically on exports. However, there are profound changes underway in the Eurozone's export sector that will have an

**Figure 1. Investment plans of German firms for the next 12 months**

**Question:** How will the following investment types of your company change over the next 12 months in Germany?



Legend: The index value is the net balance of positive (increase) respondents and negative (decrease) respondents.

Source: Deloitte Germany, CFO Survey, May 2013

Graphic: Deloitte University Press | DUPress.com

**Figure 2. Growth in intra- and extra-Eurozone exports (%)**



Source: Eurostat

Graphic: Deloitte University Press | DUPress.com

impact on the likely success of an overwhelmingly export-oriented strategy.

## The Eurozone's changing export structure

The Eurozone is a highly export-oriented economy. Very open economies such as the Netherlands export more than 70 percent of

their GDP. After the financial crisis in 2009, which implied a deep slump in exports, the Eurozone's exports recovered and have been growing quite strongly, at 7.9 percent on average from 2010 to 2013 according to Eurostat. The trade balance is strongly positive and, according to projections of the EU Commission, will amount to €196 billion in 2013. Germany runs by far the biggest surplus (€194 billion), followed by the Netherlands (€53 billion) and Ireland (€45 billion).<sup>2</sup>

The export structure of the Eurozone is changing substantially, especially in terms of destinations. While intra- and extra-Eurozone exports grew roughly at the same pace before the crisis, this has been changing since then. Exports outside the Eurozone have been growing much faster, and the growth gap between intra- and extra-Eurozone exports has been widening (see figure 2). In 2012, intra-EU exports stagnated, while extra-EU exports grew by 9 percent.

## New export destinations

The fastest-growing export destinations are the BRIC countries, which account for the bulk of the growth. After the financial crisis, Eurozone exports to the BRIC countries grew by more than 20 percent annually (figure 3).

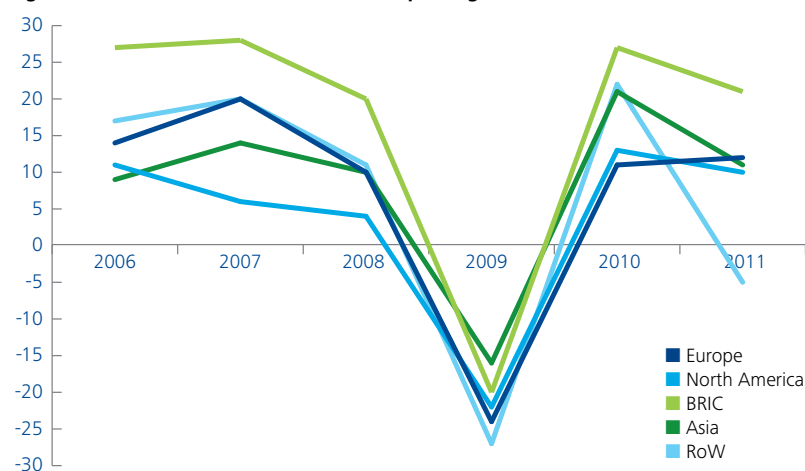
Not surprisingly, China has seen the biggest increases in Eurozone exports. Especially for German firms, China has become a market of crucial importance. Data and projections of

the German Council of Economic Experts show that China increased its share in German foreign trade from 2 percent in 1993 to 6 percent in 2010, and it will further increase it to 9 percent in 2016. This would imply that Germany will export more to China than to the United States in 2016, and that China will be very close to France, the second-most important market for German firms.<sup>3</sup>

Exports to China and emerging markets in general are one crucial factor that explains a good deal about German economic performance, and why such an export-driven economy as Germany could prosper despite the recession in the Eurozone. Between 2008 and 2011, the latest year for which data are available, Germany could increase its exports to China from €49 billion to €91 billion. The difference in growth rates in relation to the other Eurozone countries is huge. The rest of the Eurozone could increase its exports to China from a similar level (€47 billion) to only €66 billion, less than half as much.

So far, it seems that the German economy, in particular, has benefitted from the rise of the emerging markets and especially China. To achieve large-scale recovery, however, the Eurozone as a whole needs to strengthen its footprint in emerging markets to generate the export growth it needs. While there are encouraging signs that rising price competitiveness in the Eurozone can support higher exports—Spain is a good example—it remains

Figure 3. Destinations of extra-Eurozone exports (growth in %)



Source: Eurostat (2011 latest year available)

Graphic: Deloitte University Press | DUPress.com

to be seen whether the strategy can work for the Eurozone as a whole.

## Implications

The reliance on export performance to escape the recession makes the Eurozone very dependent on developments in the rest of the world, especially emerging markets. This might turn out to be a successful strategy, but it requires constant growth in the emerging markets, which cannot be taken for granted (see the article on China in this issue). An export-led recovery makes sense for the open Eurozone economies, but putting all the eggs only in the export basket makes the Eurozone vulnerable. A more balanced strategy that also focuses, for example, on jumpstarting investments in the Eurozone might be less risky.

## Endnotes

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## Special topic

# Consumers and the recession: Trends in Eurozone consumer spending

by Dr. Alexander Börsch

**E**UROPEAN consumers have been confronted with tough economic conditions for more than half a decade now due to three crises: the financial crisis, the euro crisis, and the recession. The prospects for a recovery in Europe critically hinge on consumer behavior and how it will develop as it represents the largest part of GDP in the Eurozone.

With considerable differences between the member countries, individual consumption accounts for around 70 percent of GDP in the Eurozone.<sup>1</sup> What distinguishes the current recession from cyclical recessions is not only the length and depth, but also the unusually high economic uncertainty and its negative impact on consumption.

Among the four big Eurozone economies—Germany, France, Italy, and Spain—consumers deal very differently with this situation. This is mainly due to two reasons. First, disposable income patterns have been diverging after the financial crisis. Second, private consumption has been influenced not only by disposable

income, but by very different levels of household deleveraging.

## Disposable income and consumption trends

Consumption critically hinges on the dynamics of disposable income. In the Eurozone as a whole, disposable income stagnated in the financial crisis and then started to grow moderately after 2009 (see figure 1). While Germany and France saw stronger increases, Italy and Spain have experienced a double dip in disposable income. After negative dynamics in the first part of the crisis, a short-lived recovery set in, but after 2011, both countries saw a fall in disposable income again.





The developments before and after the crisis diverge significantly. Before the crisis, there were considerable differences in disposable income growth, especially between Spain and the other countries, but the trend proceeded in a quite uniform way across the bigger Eurozone economies. After the crisis, the divergence between France and Germany on

the one hand and Spain and Italy on the other has been growing significantly.

During the recession, private consumption in the Eurozone largely followed the development of disposable income (see figure 2). In the case of Spain, the story is different. While disposable income declined continuously after 2009, private consumption recovered and grew shortly, before it fell again quite sharply.

The reason is very likely that Spanish consumers hoped for a short-lived recession and increased consumption in anticipation of better times ahead. Now that the recession is still around, consumption is falling again. Private consumption in Italy shows a similar pattern; however, in Italy the drop during the financial crisis was much milder than in Spain.

In a recession, consumers cut their expenses not across the board, but tend to focus their cuts on durable goods, such as cars or furniture (see figure 3). This is especially the case when the recession is accompanied by great economic uncertainty that suggests a wait-and-see strategy for expensive and non-essential goods.

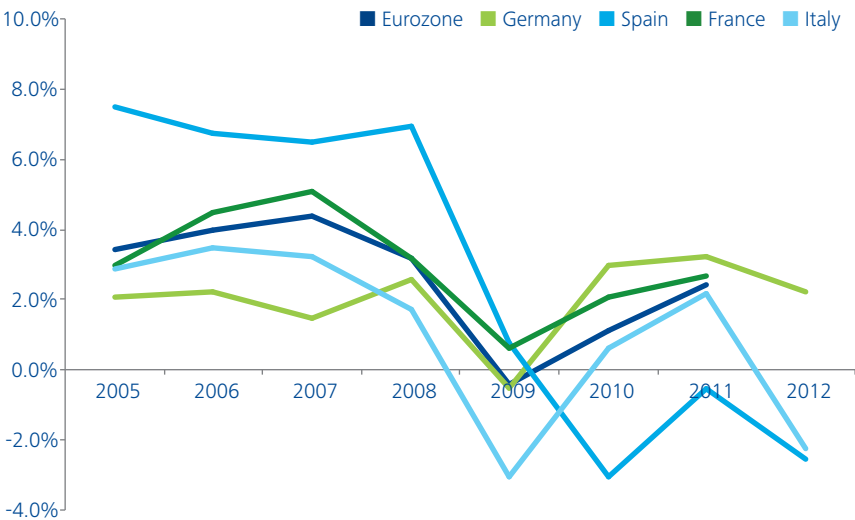
This pattern is clearly visible in the reaction of European consumers to the recession. The consumption of durables fell the sharpest in 2009 and took the longest to recover. The decline in durable goods was even sharper in Spain, where they dropped by more than 9 percent. Data are only available until 2011, but the general consumption trends outlined above would suggest a reversal of the upward trend that set in after 2009.

## Saving trends

Generally, saving rates tend not to change much in the short-term as they are influenced by culture and factors such as home-ownership, access to credit, or the design and generosity of pension systems. And indeed, in the Eurozone, as a whole the saving rate has not changed much. However, country-specific



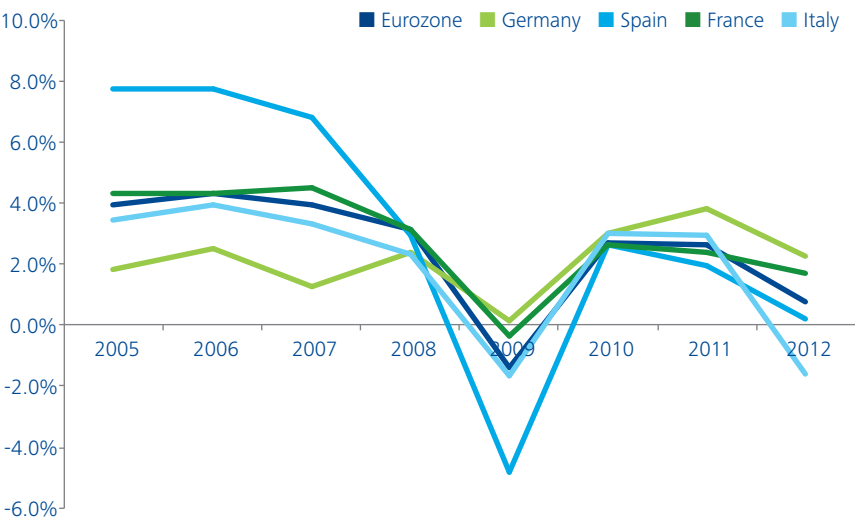
Figure 1. Development disposable income (change in %)



Source: European Commission, Economic & Financial Affairs, AMECO

Graphic: Deloitte University Press | DUPress.com

Figure 2. Development of private consumption (change in %)



Source: European Commission, Economic & Financial Affairs, AMECO

Graphic: Deloitte University Press | DUPress.com

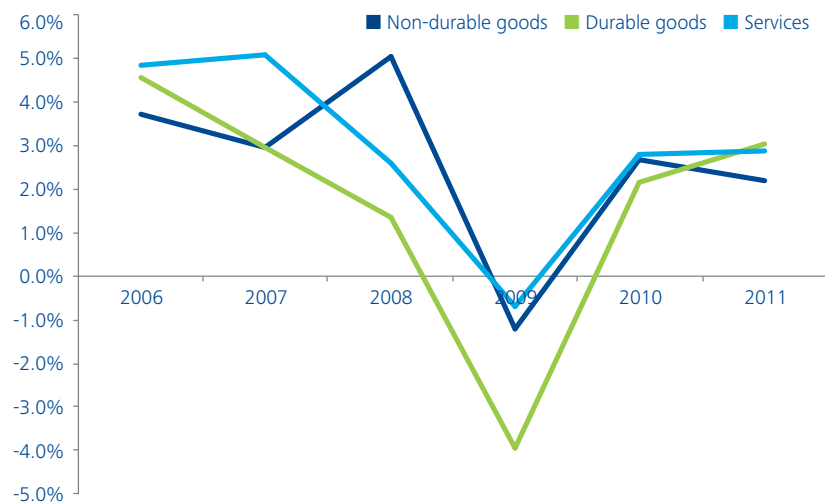
## What distinguishes the current recession from cyclical recessions is not only the length and depth, but also the unusually high economic uncertainty and its negative impact on consumption.

developments vary widely around the average (see figure 4). Consumers can react to an economic downswing in two ways. Either they increase their savings, motivated by precautionary motives or they lower their savings to uphold consumption.

In a way, some countries did both, but at different stages of the crisis. Consumers in countries with a high saving rate—Germany and France—slightly increased or at least held it constant. Italian consumers continually lowered their saving rate. Spanish consumers, which had a low saving rate in pre-crisis times, dramatically raised it, explaining the sharp decline in Spanish consumption. Precaution was certainly a dominating motive for the increase. After 2009, the Spanish rate fell drastically and to deeper levels than before the crisis.

It seems as if Spanish consumers tried to build up buffers in the first phase, which they had to dissolve in the second phase. The key reason for this development is certainly the ongoing deleveraging process among Spanish households after the bursting of the real estate bubble. At around 80 percent of GDP in 2011, Spanish households were much more indebted than their German or Italian counterparts and

**Figure 3. Consumption of durable goods, non-durable goods and services (Eurozone)**



Source: European Commission, Economic & Financial Affairs, AMECO

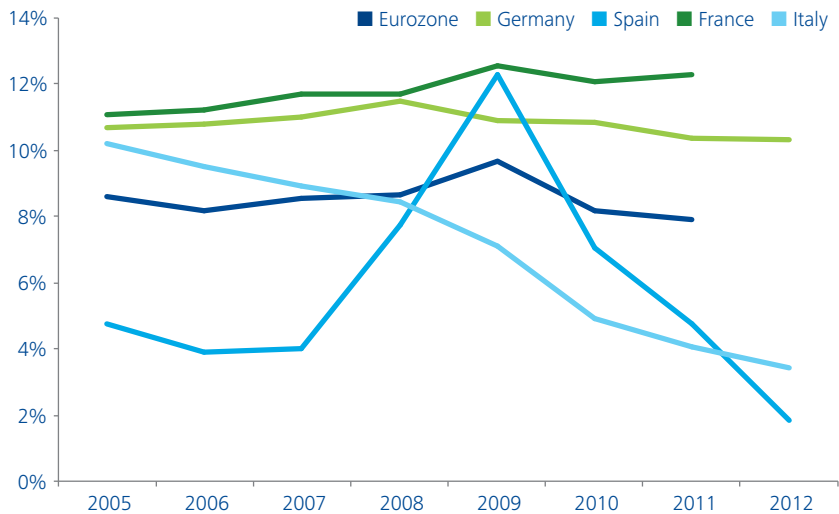
Graphic: Deloitte University Press | DUPress.com

at a similar level as the United States or the United Kingdom.<sup>2</sup>

### Outlook: No turnaround in sight

The outlook for consumer spending for the next year is not encouraging. Survey consumer data show that households are strongly pessimistic about their financial prospects. Not surprisingly, Spanish and Italian consumers are most pessimistic; German consumers are modestly optimistic. German consumers consider it likely that they will save in the coming year, while French, Spanish, and Italian consumers

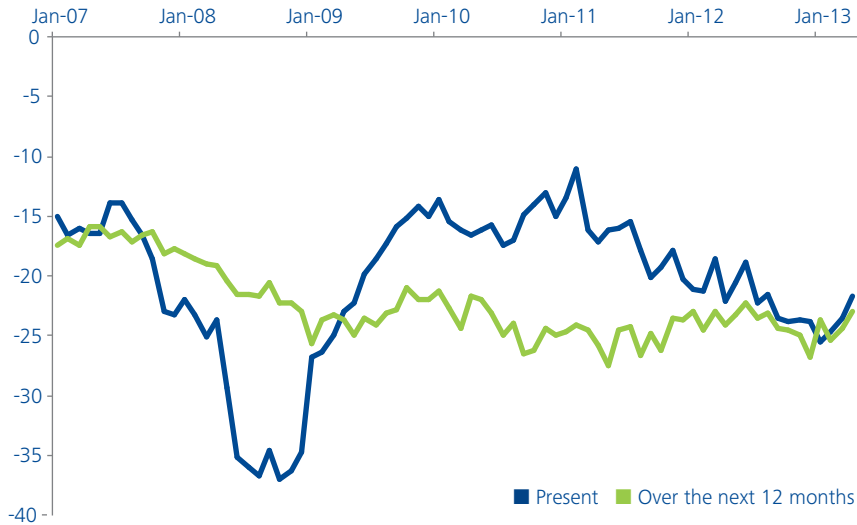
Figure 4. Saving rate (% of disposable income)



Source: European Commission, Economic & Financial Affairs, AMECO

Graphic: Deloitte University Press | DUPress.com

Figure 5. Plans for major purchases (Eurozone)



Source: European Commission Consumer Survey

Graphic: Deloitte University Press | DUPress.com



do not think they will save although they think it would be recommendable.

As a consequence, the propensity of European consumers for major purchases continues to be negative (see figure 5). The plans of Eurozone consumers to make major acquisitions now and in the coming 12 months are strongly in negative territory.

Interestingly, there are huge gaps between actual and future consumption inclination in all countries. While German consumers are bullish for current consumption, the reverse is true for future consumption, while the tendency for French consumers is exactly the opposite. These gaps indicate the high level of uncertainty Eurozone consumers are exposed to.

## Conclusions

There are several dynamics at work in the Eurozone's consumption expenditure. The first dynamic is closely correlated to, positive or negative, trends in disposable income. The second dynamic is heavily influenced by the need for households to deleverage and it reinforces the negative trends in disposable income due to the recession, which is happening in Spain.

The still-pessimistic outlook of European consumers makes it very unlikely that consumers will buy the Eurozone out of the recession. The impulse for Economic recovery needs to come either from enterprises and their investments or from the export side; in the interest of a balanced recovery, it should come from both.

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### Endnotes

1. Christine Gerstberger and Daniela Yaneva, Statistics in focus: Economy and finance, Eurostat, 2013, [http://epp.eurostat.ec.europa.eu/cache/ITY\\_OFFPUB/KS-SF-13-002/EN/KS-SF-13-002-EN.PDF](http://epp.eurostat.ec.europa.eu/cache/ITY_OFFPUB/KS-SF-13-002/EN/KS-SF-13-002-EN.PDF), accessed July 15, 2013. The figure includes final consumption of non-profit institutions serving households as well as 'individual' government expenditure such as public education and public healthcare. Without these items, household final consumption amounts to 56.5 percent of GDP.
2. "Economic Surveys: Spain," OECD, Paris, 2012.



Ian Stewart, chief economist,  
Deloitte UK

# The United Kingdom: Turning the corner

by Ian Stewart

UK growth stalled in the second half of 2012, hit by a deterioration in the outlook for the world economy and UK exports, weaker-than-expected investment, and the effects of continuing crisis in the euro area. The United Kingdom is likely to show modest growth for the rest of 2013, but signs are growing of a gradual pickup in activity in 2014. Loose monetary policy, a stronger global economy, and a reduced level of risk in global financial markets have all played a part. Yet the legacy of the financial crisis means that the recovery is likely to remain weak by past standards, with growth not forecast to return to above-trend rates until 2015.

Household spending accounts for over 60 percent of GDP and has been hard hit by the

financial crisis and falling real incomes.

A turnaround in this sector would significantly contribute to growth, and the latest news suggests the worst is past. Household spending has picked up in recent quarters (as illustrated in figure 1), and car sales are on an upward path, one of the few bright spots in an otherwise contracting European car market. UK unemployment has edged lower in the last two years, and private sector job creation is outpacing job losses in the public sector. While the outlook is far from rosy for UK consumers, as credit conditions begin to normalize and real wages start to recover, the hope is that household spending could prove a driver of growth over the next year or so.





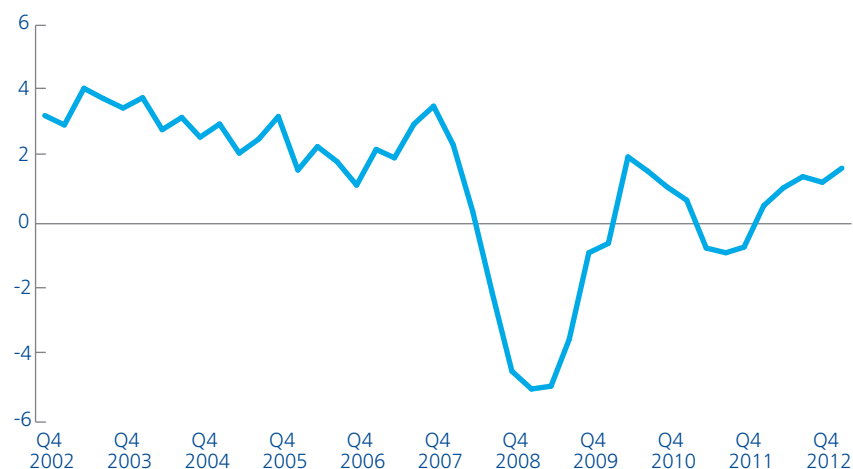
A period of sharply higher taxes and high inflation is coming to an end. Seventy percent of the coalition government's planned tax rises have already taken affect. Inflation

has more than halved since its peak in 2011. With average earnings forecast to pick up, the scene looks set for a modest rise in consumer spending power.

The United Kingdom is likely to show modest growth for the rest of 2013, but signs are growing of a gradual pickup in activity in 2014. Loose monetary policy, a stronger global economy, and a reduced level of risk in global financial markets have all played a part.

**Figure 1. UK household spending showing signs of improvement**

Percentage of annual change in quarterly household expenditure, adjusted for inflation

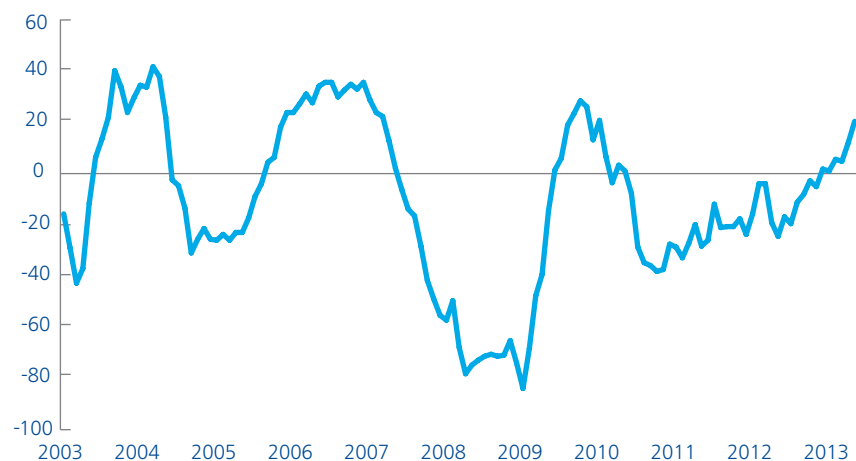


Source: Office for National Statistics, 2013.

Graphic: Deloitte University Press | DUPress.com

**Figure 2. House price expectations on the rise**

Percentage of surveyors reporting a rise in price expectations over the next three months, net balance



Source: Thomson Reuters Datastream

Graphic: Deloitte University Press | DUPress.com

Rising equity markets have boosted consumer wealth. Comparing consumer debt with financial assets shows that balance sheets are in better shape than at any time in the last 10 years. Falling levels of mortgage arrears and

write-offs of consumer credit fit with a picture of a healthier consumer sector.

There are signs, too, that the long credit freeze may be starting to thaw. The Bank of England's latest Credit Conditions Survey found that mortgage availability in the fourth quarter improved at the fastest rate since early 2008. Meanwhile the government has introduced a series of schemes to improve the flow of mortgage finance to households, and these appear to be having some effect.

Easier credit conditions are also supporting house prices and housing activity. Most measures of house prices have shown some increase in recent months, and the government's independent forecaster, the Office of Budget Responsibility, is forecasting strong growth in housing transactions. Investors and property professionals certainly see better times ahead for the UK house-building industry. Chartered surveyors are now more optimistic about house prices than they have been in over two years (see figure 2), and shares in house-building companies have doubled over the last year.

Elsewhere in the economy, there are signs of activity. In recent months, numerous surveys show a broad-based rise in business confidence. The latest Deloitte CFO Survey, carried out in June, indicates a further rise in business sentiment, a sharp decline in



perceptions of macrouncertainty, and a marked fall in concerns about a euro area breakup.

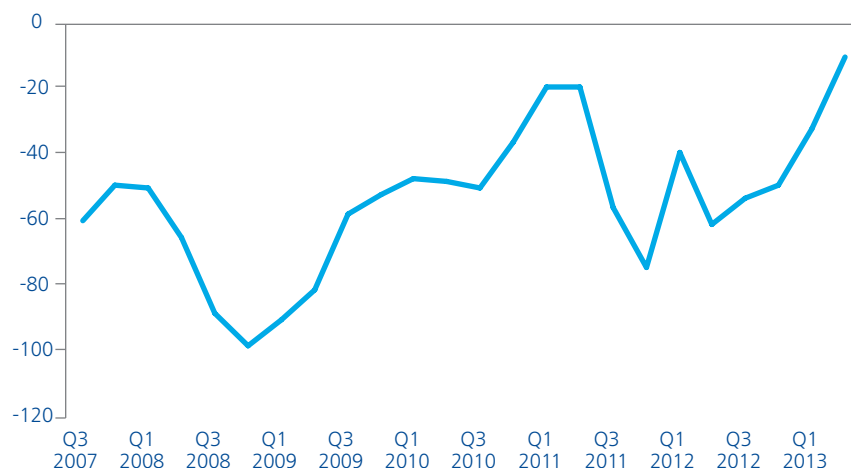
Corporate risk appetite, one of the key determinants of corporate activity, has risen to its highest level in 5.5 years (see figure 3). And in a sign of reduced levels of defensiveness, CFOs are focusing less on cutting costs and more on expansionary policies, including bringing out new products or services, expanding into new markets, and undertaking M&A.

The combination of stronger consumer and corporate sector activity should provide a boost to the UK economy. But for a highly internationalized and open economy such as

the United Kingdom, much will depend on events beyond these shores. The main risks to the United Kingdom lie in the global economy, particularly from renewed weakness in the euro area. At home, continued fiscal consolidation, which stretches five years ahead, represents a further headwind for recovery. But assuming the global environment does not deteriorate, the UK economy seems likely to show gradual but assuming the global environment does not deteriorate, the UK economy seems likely to show gradually stronger activity through the second half of 2013 and into 2014.

**Figure 3. Corporate risk appetite at 5.5-year high**

Percentage of CFOs who think now is a good time to allow greater risk in their balance sheets



Source: Deloitte LLP, Deloitte CFO Survey, June 2013

Graphic: Deloitte University Press | DUPress.com



Dr. Rumki Majumdar is a manager at Deloitte Research, Deloitte Services LP

# India: A long, winding road to growth

by Dr. Rumki Majumdar

**T**HE Indian growth story is turning out to be unique and perplexing. The economy is facing new challenges, while old ones persist. The question is how the economy will grow amid so many hurdles. The path to recovery is similar to Indian roads—full of pot holes, which not only slow down progress but also make maneuvering difficult.

## Disappointing growth and outlook

After a disappointing growth of 5 percent in the calendar year 2012, the lowest growth reported in a decade, 2013 started with a weak recovery of 4.8 percent year over year in Q1

2013 compared to the previous quarter, primarily due to weak domestic demand. Private final consumption expenditure growth, which has experienced a sharp decline since Q2 2012 (figure 1), was a mere 3.8 percent in Q1 2013 due to poor consumer sentiments. Private capital formation declined as well due to the high cost of financing, infrastructure bottlenecks, poor investor sentiment, and weak domestic and global demand. However, it was government expenditure that declined the most in the past two quarters,



owing to the expenditure reforms initiated in September 2012. Expenditure grew marginally by 0.6 percent in Q1 2013.

The latest monthly data on industrial production and PMI manufacturing indicate very modest growth in the FY Q1 2013. According to the April data, capital goods output rose 1 percent year over year, and the manufacturing sector grew 2.8 percent year over year. On the

other hand, the mining sector contracted 3 percent year over year.

India's economic growth is slowing down more than expected. The International Monetary Fund's recent downward revision of growth in 2013 from 5.9 percent to 5.7 percent signals that the economy now needs stronger government policies and more reforms. However, the government's hands are tied, given the challenges that the economy is currently facing, and there is not much room for maneuvering fiscal and monetary policies.

## Inflation is a concern

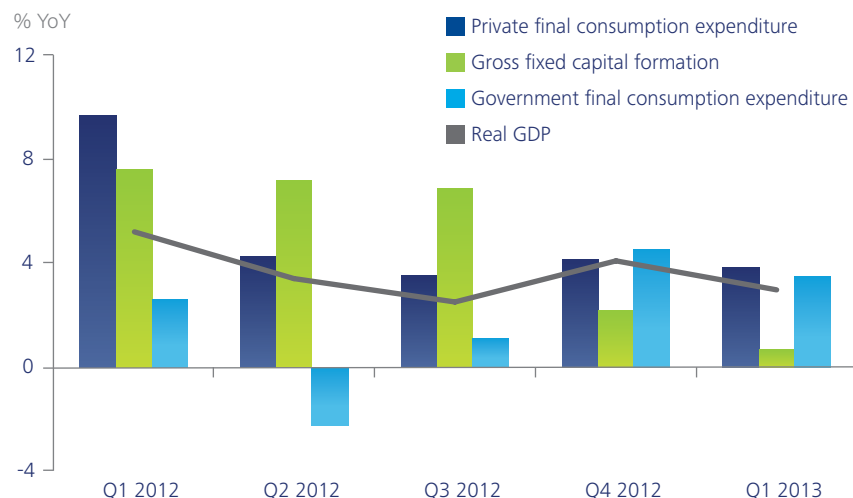
Despite the low growth, inflation has continued to remain high, with consumer price inflation (CPI) hovering above 10 percent year over year for most of 2013. Supply constraints, particularly in food and infrastructure, the resulting food price rise, and high dependence on fuel imports have kept inflationary pressures high. The past few months have seen some respite in inflation due to a fall in food and international crude oil prices. As shown in figure 2, wholesale price inflation (WPI) has come down from 7.3 percent in February to 4.7 percent in May, while CPI (which has been higher than WPI) has declined to about 10 percent in April. However, the fall may soon reverse due to a reduction in fuel subsidy (leading to a rise in administered prices), persistent supply-side shortages (due to infrastructure bottlenecks), and the recent depreciation of the Indian rupee. The success of the monsoon in the next three months will also be an important determinant of inflation.

## The challenge of twin deficits

The government's strategy of fiscal consolidation has repeatedly gone off course since 2008 due to a series of unfavorable



**Figure 1. Disappointing growth due to poor domestic demand is evidence of fiscal drag**



Source: Q1 refers to calendar year. Source: CSO India, Bloomberg, 2013

Graphic: Deloitte University Press | DUPress.com

**Figure 2. Inflation has eased down lately, though inflationary pressures remain high**



Source: CSO India, Ministry of Statistics and Programme Implementation, Bloomberg, 2013

Graphic: Deloitte University Press | DUPress.com

due to the reforms have helped the government report better-than-expected fiscal performance, as suggested by the recent revisions (4.9 percent of GDP in FY 2012–13) shown in figure 3, the deficit is still wide enough to weigh on investors' confidence. The FY 2013–14 budget emphasizes measures to control the deficit further, with a target of 4.8 percent. Further, fiscal consolidation by the government, if it happens, may impact expense quality and result in necessary expenditure being deferred, adversely impacting long-term growth prospects.

On the other hand, the current account deficit in FY 2012–13 was the largest ever. The fall in external demand for exports (both merchandise and services) and the rise in fuel and gold imports resulted in a record-high current account deficit in 2012. Thanks to the recent fall in international crude oil and gold prices, the preliminary estimate of trade deficit in Q4 of FY 2012–13 came down to 3.6 percent of GDP, compared to a historical high of 6.7 percent in the previous quarter. This helped contain the current-account deficit to 4.8 percent of GDP in

developments. Faced with prospects of a sovereign rate cut and the crowding out of private investments in the economy, the government has undertaken a series of reforms, including fuel subsidies and rail fares, starting in September 2012. While cuts in expenditure

the past FY, lower than the earlier estimate of 5 percent.

However, the past three months data indicate that the trade deficit has bounced back to high levels in the first quarter of FY 2013–14. The fall in gold prices has only served



to reinforce Indian consumers' appetite for purchasing gold as a hedge against inflation and uncertain equity returns. This has boosted demand for gold imports. A fast-depreciating currency has also led to an increase in the import bill for fuel, partly shaving off the advantage of a fall in international crude oil prices. Higher chemical and fertilizer imports too have increased in May. On the other hand, growth in exports remains sluggish due to poor external demand. In other words, there is strong evidence that suggests that the trade deficit is likely to widen in the short term, posing by far the biggest risk to the deteriorating current account deficit.

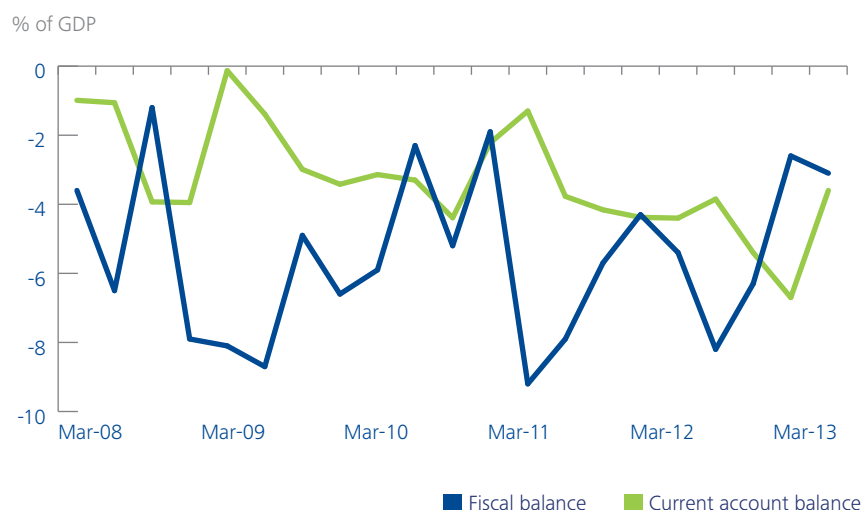
### Emerging external and domestic challenges

One recent challenge that India has been facing is the reversal of capital inflows in the past few months. In the past, foreign investors have brought capital into the Indian stock market due to high global liquidity, interest rate differentials between advanced and emerging nations, and better growth prospects relative to the advanced economies. However, lower-than-expected growth, macroeconomic imbalances that include fiscal and current account deficits, poor investment conditions

and corporate earnings, and a volatile currency have led to a reversal of the trend. Institutional investors are turning into net sellers in the Indian equity market. The market expectation of an improvement in the US economy and the hint of a possible exit by the US Federal Reserve this year have also contributed to the reversal of capital inflows. In a recent monetary policy review meeting, the Reserve Bank of India (RBI) expressed apprehension of a sudden stop and reversal of capital inflows from emerging markets, including India.<sup>1</sup>

Foreign direct investments picked up in the calendar year Q3 2013 after the government's announcement of reforms in the retail and the aviation sectors and the establishment of a ministerial panel to fast-track industrial

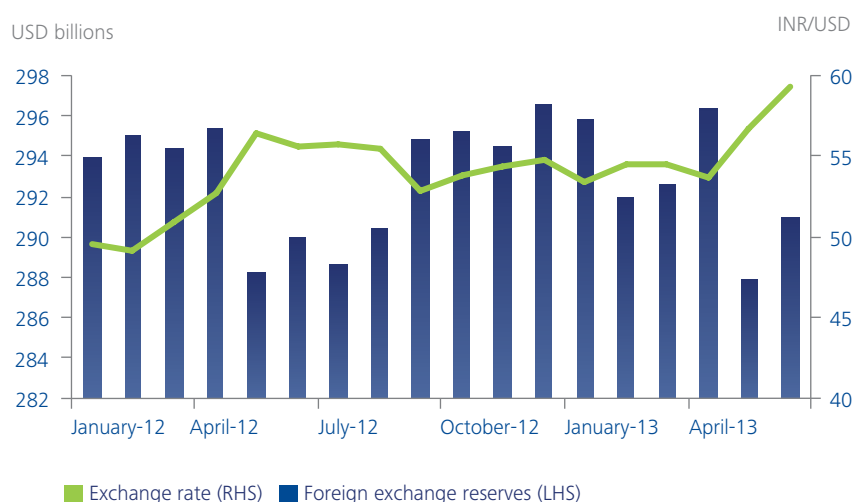
**Figure 3. The fiscal and current account deficits**



Source: Oxford, Reserve Bank of India, 2013

Graphic: Deloitte University Press | DUPress.com

The fall in external demand for exports (both merchandise and services) and the rise in fuel and gold imports resulted in a record-high current account deficit in 2012.

**Figure 4. Currency volatility and movement in foreign exchange reserves**

Source: Bloomberg, 2013

Graphic: Deloitte University Press | DUPress.com

projects. These factors helped improve investors' confidence and thus capital inflows. However, the growth in direct investments has lately been slowing due to government inefficiencies, the regulatory burden, and a lack of competition in the economy.

The steep currency depreciation in the past few months has been another cause of concern, in particular, the risk it poses to the current account deficit. The currency depreciated more than 14 percent against the US dollar in 2012 (figure 4), primarily due to the widening of the current account and fiscal deficits. The fall had briefly reversed until April 2013. However, in the past three months, the currency steeply depreciated, about 10 percent, due to a combination of domestic and global factors, a widening trade deficit, and the sudden reversal of capital inflows (due to growth concerns and the possibility of the US Federal Reserve's exit from the monetary policy stimulus program). While policy makers have emphasized that the recent currency weakening is temporary, there are significant downside risks to the further weakening of the currency in the coming year.

The reversal of capital inflows and widening of the trade deficit have led to a sharp fall in the foreign exchange reserves in FY 2013–14. While India's position is still comfortable, with an import cover of more than six months, under circumstances of unexpected external uncertainties, further weakening of the currency, and increased capital outflows, reserves may fall below sustainable levels.

Also, the persistent fall in capital goods production and poor industrial activity reflect depressed investment conditions in the economy. A

sustained revival of growth requires a continuous growth of investment in the economy. However, investments have remained subdued due to poor business profitability, a slowdown in private consumption demand, poor governance and regulatory hurdles, and tighter credit conditions. On the other hand, unwillingness to lend to businesses stems from fears of erosion of asset quality, deteriorating cash-flow situations of borrowers, and heightened risk premiums.

## Policies amid challenges

The combination of the previously mentioned challenges has severely restricted the flexibility of both monetary and fiscal policies in the economy. High fiscal and current account deficits restrict the government's ability to undertake proactive government stimulus programs to boost the economy. The recent austerity measures to consolidate the fiscal position have led to a fall in government expenditure and resulted in a fiscal drag on growth, as evident in the past two quarters.

On the other hand, widening current account deficits, currency depreciation, and inflationary pressures limit the RBI's ability to ease monetary policy. The industrial sector has been pushing for further monetary easing, which will likely encourage the fresh investments necessary to pull the economy out of the slowdown. However, the RBI prefers to wait until it sees sufficient evidence of further declines in CPI and inflation expectations, as well as currency stability. The RBI kept interest rates unchanged in its June meeting, after cutting rates thrice in its previous policy reviews. The cash reserve ratio has been held steady since the February policy meet to keep a check on liquidity.

### Exploring more options to boost investments

Short-term risks to global financial stability have come down considerably compared to the past year. However, the uncertainty in the international environment still remains. The need of the hour is to boost investment in the economy, which in turn will likely help improve the labor market and consumer confidence. The issues in India are more structural, where supply factors (such as labor market bottlenecks), poor infrastructure, and domestic policy factors (such as policy uncertainty and regulatory obstacles) have contributed

to the fall in investments. These issues cannot be addressed merely by monetary and fiscal policies.

The pace of reforms is slow as governance concerns and delay in approvals continue to weigh on business confidence. There is a need for some institutional mechanism that removes bottlenecks to stalled projects, especially in key sectors such as coal, power, steel, and roads. Policy efforts should bring enduring improvements in productivity and competitiveness to the economy. At the same time, the efficiency of the Indian banking system has to be improved, with a focus on managing systemic risks to banks emanating from the external environment, as well as on recent domestic macroeconomic risks.

The government is considering further opening up the Indian economy, including raising the cap on foreign investment in rupee-denominated government debt by up to \$5 billion, reducing taxes on such investments, easing access to foreign funds for Indian companies, and reducing curbs on foreign investment in sensitive sectors such as defense, telecommunications, and media. India's finance minister has been pushing for more foreign investments in the country. Nevertheless, the pace of reforms will likely remain gradual. India holds elections in May 2014, and, until the next elections, the probability of significant reforms being announced is low.

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#### Endnote

1. Reserve Bank of India, "Mid-Quarter Monetary Policy Review: June 2013"  
<<http://rbidocs.rbi.org.in/rdocs/PressRelease/PDFs/IEPR2109MR95261038C8.pdf>>



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# Russia: The bear slows down

by Akrur Barua

**R**USSIA is entering a new phase of economic uncertainty. GDP growth is slowing, and extraction industries are suffering a decline due to muted global demand for their commodities. Russia's continued dependence on commodities has come at the expense of other sectors where both domestic and foreign investments have suffered. Meanwhile, to counter the slowing economy, any fiscal response has been complicated by a probable deterioration in the budget balance in Q1 2013. In such a scenario, monetary policy easing would have helped, especially when businesses are complaining about the high cost of financing. Unfortunately, with inflation high, any immediate rate cut is not likely. The only silver lining for the economy is the strength in

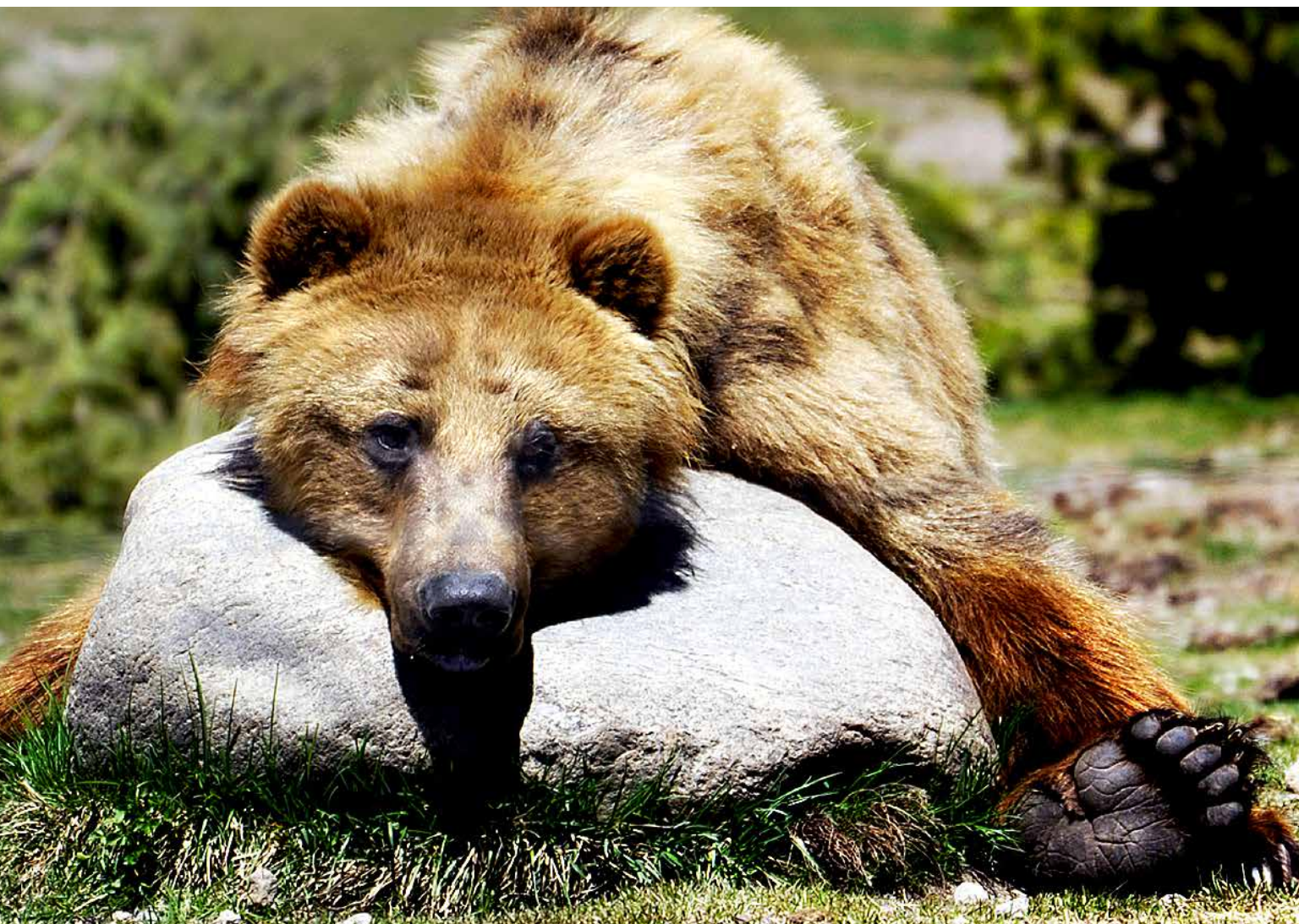
private consumption expenditure, which has been boosted by low unemployment, rising incomes, and access to consumer credit.

## Commodities and investments have been a drag on the economy

Russia's dependence on commodities has proved to be a bane this year, especially with slowing demand from key markets. Commodity prices have fallen as Eurozone weakness continues, US recovery is muted, and growth falters in key commodity-importing emerging markets—primarily China and India.







For example, Urals crude, the country's main export blend, averaged a little less than \$111 a barrel in Q1 2013, about 5 percent down year-over-year (see figure 1).

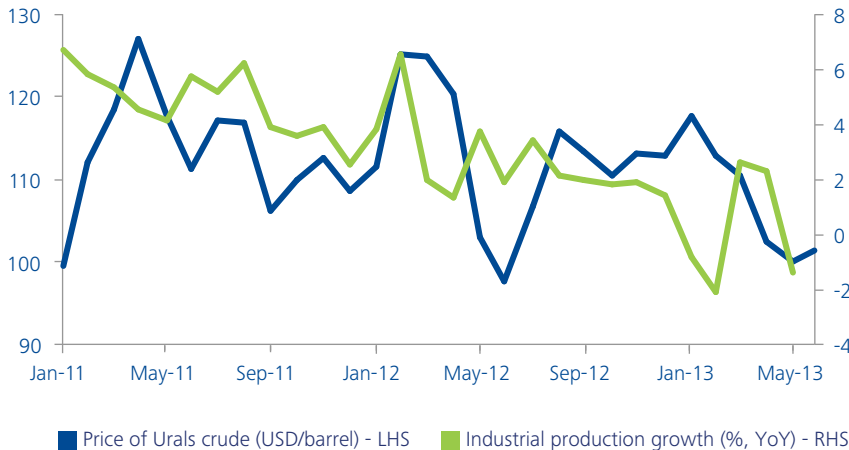
No wonder then that resource extraction—oil, gas, coal, and metals—was the key drag on the economy in Q1 2013, declining 4.9 percent

year-over-year. This in turn dragged down real GDP growth during the quarter to 1.6 percent year-over-year, the worst performance since Q4 2009 and much lower than the annual 3.4 percent growth reported in 2012 (see figure 2).

Growth in gross fixed investments has fallen sharply since Q1 2012; it was a mere 0.4

**Russia's continued dependence on commodities has come at the expense of other sectors where both domestic and foreign investments have suffered.**

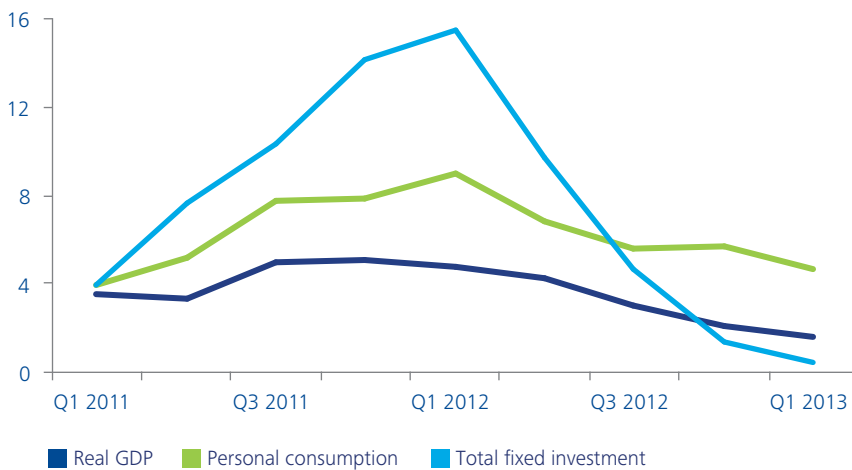
**Figure 1. Crude oil price and industrial production growth**



Source: Bloomberg, 2013

Graphic: Deloitte University Press | DUPress.com

**Figure 2. Growth in real GDP, personal consumption, and total fixed investment (% YoY)**



Sources: Bloomberg, 2013, Oxford Economics

Graphic: Deloitte University Press | DUPress.com

preparations for the 2014 Sochi Winter Olympics nearly concluded, construction activity has slowed, thereby weighing on fixed capital formation.

Private consumption will yet again be the key driver of economic growth this year

Private consumption was the key driver of GDP growth in 2012 and is likely to be so this year as well. It grew 6.8 percent in 2012, and was up 4.7 percent year-over-year in Q1 2013. Consumers have benefited from a host of factors, including strong labor markets, rising incomes, and easy access to credit. Unemployment fell to 5.2 percent in May 2013, one of the lowest levels ever, and it is likely to remain low in the short term. Incomes have increased by about 12.5 percent year-over-year in the first five months of 2013, with real wage gains of over 5.0 percent. Meanwhile, low household debt (about 12.0 percent of GDP) has encouraged consumers to take recourse to credit for spending. Consumer lending swelled in Russia by about 40.0 percent in the

past year; credit card loans were up by about 80.0 percent.

However, the pace of lending is likely to slow as the central bank has been urging banks to cut consumer lending, given the risks that

percent year-over-year in Q1 2013. Slowing external demand has prompted companies, including those in the extraction industry, to scale down investment plans. High borrowing costs have not helped either. Meanwhile, with

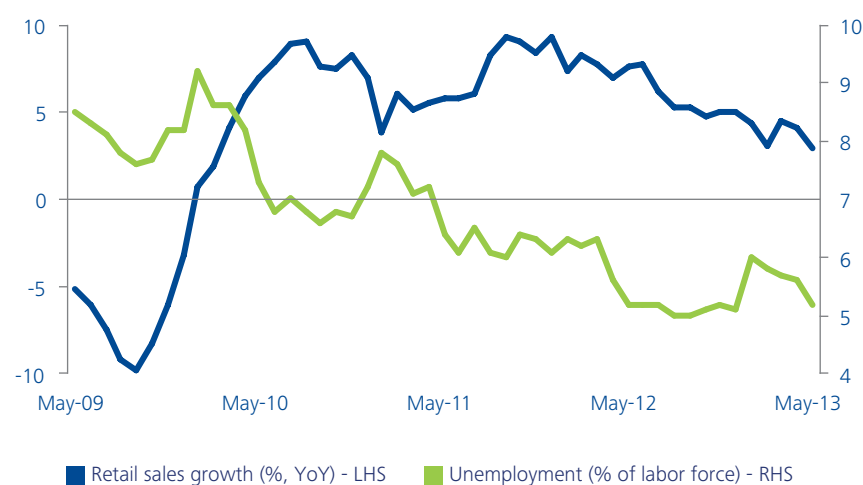
such fast-paced lending pose. This is likely to marginally weigh on consumer spending growth this year. The other problem for consumers is high inflation, which is likely to dent growth in real wages, thereby weighing on consumer purchases. The impact of these and a slowing economy on private consumption is partially evident from a dip in retail sales growth (see figure 3). Sales grew 2.9 percent year-over-year in May 2013, down from 4.1 percent in April and 4.4 percent in January. Nevertheless, consumers are not likely to reduce their spending, and total private consumption growth is likely to be 4.4–4.6 percent this year. This will drive overall GDP growth of 2.2–2.4 percent in 2013.

### Any sharp easing of monetary policy not likely given high inflation

The Bank of Russia (BOR) kept its key interest rate unchanged at 8.25 percent for the ninth straight month in June 2013. The BOR has been hesitant to cut rates to stimulate the economy, given high inflation and strong growth in consumer credit. Inflation has been edging up since 2012 due to a rise in food prices (courtesy of a poor harvest) and strong growth in consumer demand. In May 2013, inflation accelerated to the fastest pace in 21 months to 7.4 percent, up from 7.2 percent in April, way above the central bank's target range of 5.0–6.0 percent. Meanwhile, consumer credit and broad money (M2) growth have also been edging higher this year. M2 growth was

15.2 percent year-over-year in April, up from 11.9 percent in December 2012.

Figure 3. Retail sales growth and unemployment



Source: Bloomberg, 2013

Graphic: Deloitte University Press | DUPress.com

High price pressures notwithstanding, a partial loosening of monetary policy is likely in the latter part of the year. Inflation is expected to ease in the second half of 2013 due to a high base effect and a better harvest (see figure 4). This would enable the BOR to cut rates by a total of 25–50 basis points (bps) in the second half of 2012. If inflation falls below the BOR's upper limit of 6.0 percent, another 25 bps cut cannot be ruled out. Meanwhile, a change of guard at the BOR has raised expectations of a move away from inflation bias in monetary policy. However, Elvira Nabiullina (the new chief) has reiterated that any rate cut would depend on movement in price pressures in the short term. She is also not expected to entertain calls to intervene in the currency market to make the ruble more competitive. Instead, it would be better if she focuses on formalizing an inflation targeting mechanism for monetary policy, reducing concentration



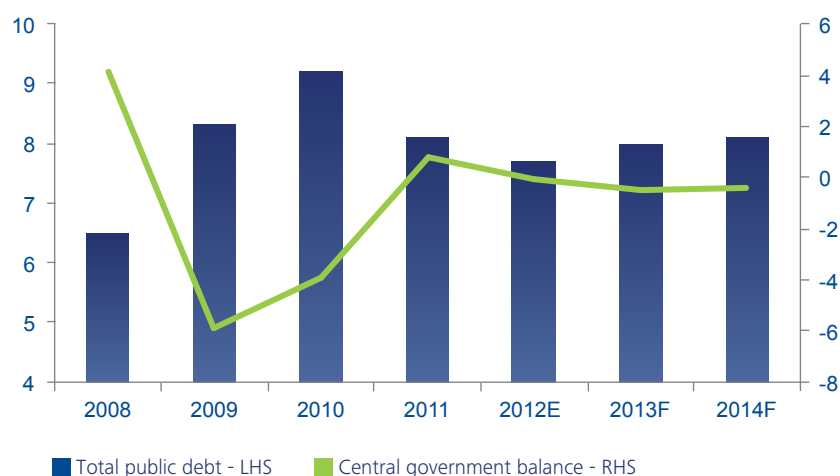
Figure 4. Inflation and broad money (M2) supply growth



Source: Bloomberg, 2013

Graphic: Deloitte University Press | DUPress.com

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



Source: EIU

Graphic: Deloitte University Press | DUPress.com

of big banks, increasing regulatory supervision of non-banking financial companies, and improving information symmetry on risks and credit practices.

## Toward greater fiscal prudence

Fiscal consolidation is likely to remain a key theme over the next couple of years, with the government aiming for a balanced budget by 2015. Although the budget is likely to have been in a small surplus in 2012 (0.1 percent of GDP), slowing revenue flows due to dipping GDP growth and lower commodity prices are likely to push it into deficit this year (see figure 5). Of more concern is, perhaps, the non-hydrocarbon deficit, which was at 10.6 percent of GDP when the year started, much worse than the 5.0 percent medium-term target recommended by the World Bank and the International Monetary Fund. To achieve this target, the government has to find ways to cut spending, especially in the medium-to-long term. Encouragingly, the federal government has already initiated a more realistic way of budgeting spending by using the long-term average oil price, rather than the forecasted oil price. The long-term average oil price is the average price for the past five years, and this

would be raised to ten years by 2018. However, this in itself is not enough to bring the non-oil deficit to a more manageable level.



## Tapping reserves to boost growth

With economic growth faltering, President Vladimir Putin, in a recent speech, announced plans for \$43.5 billion of investments, most of it directed to infrastructure. Of this, \$13.6 billion would be in the form of loans from its National Welfare Fund (Russia's sovereign wealth fund) for three key infrastructure projects—modernizing the Trans-Siberian Railway, constructing a 500-mile high-speed rail line between Moscow and Kazan (capital of the Tatarstan region), and building a superhighway ringing Moscow. Private investments would also be invited into these projects with government guarantees to minimize risk. Although this would be a welcome boost to the economy, sustainable growth is not possible without better investment climate, economic diversification, and productivity growth. The investment plans also set a dangerous precedent of digging into the Welfare Fund, especially at a time when the government is moving toward greater fiscal prudence.

## Need to improve the business climate, diversify the economy, and enhance productivity

Investor perceptions have suffered in recent years, following the seizure of large and medium businesses due to alleged economic crimes. Although the president's recent

announcement of amnesty to many of those convicted of white collar crimes would help to improve the business climate, investors are likely to wait for developments on the ground. To attract foreign investment, progress is also required on deregulation and improving transparency in business, including better corporate governance rules. Interestingly, moves to diversify the economy away from oil and gas would also boost investments into myriad sectors across manufacturing and services. A strong non-hydrocarbon economy supported by a highly skilled workforce and state-of-the-art technology is crucial for sustainable growth and healthy public finances.

Technology and skills enhancement are also important for achieving the productivity gains the country needs to stave off risks from a declining working population. Russia's working-age population will decrease at a steady pace of 0.9 percent every year up to 2020. Combined with an already-high participation ratio, it would mean a rise in the burden of pension and health care costs on future workers, businesses, and the government. This is not possible without strong productivity gains, especially given that potential GDP growth is also likely to edge lower due to a declining labor force.



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# Brazil: Problems mount

by Navya Kumar

**B**RAZIL, one of the world's most promising emerging economies, is struggling to grow. Decelerating private consumption and demand for exports, as well as structural bottlenecks, are limiting Brazil's performance. As a result, in June 2013, Standard & Poor's cut the outlook on the country's sovereign debt from "stable" to "negative," citing Brazil's low growth prospects, weakening fiscal balances, and loss of standing among investors. Public protests that erupted in June have only added to the country's list of challenges.

## Lackluster private consumption and exports weigh on economic growth

Brazil's economy grew just 0.9 percent in 2012, and it is unlikely to experience a robust recovery this year. Given decelerating private

consumption and weak export demand, Q1 GDP growth of 1.9 percent year-over-year fell short of an expected 2.3 percent. Consumer purchasing power has been restricted by high inflation, which has exceeded 6.0 percent since the beginning of this year. Meanwhile, exports have been adversely affected by a slowdown in major markets such as China and Europe (see figure 1). Given slowing demand—both domestic and external—there has been a 2.9 percent year-over-year increase in the number of business bankruptcies in the first five months of 2013. Sentiments about business prospects in the short term are not very optimistic either; the manufacturing purchasing



managers' index hit 50.4 in May, its lowest level in seven months.

To help revive private consumption, in June 2013, the government announced BRL 18.7 billion worth of subsidized loans to low-income families to purchase furniture and home appliances. This follows a BRL 2.2 billion tax cut announced in April 2013 to boost car sales. Policymakers are also expected to allow

the Brazilian real to weaken against the dollar to support exporters. However, these measures may not be sufficient since private consumption is only projected to grow by 2.8 percent in 2013—the slowest in a decade. Meanwhile, exports are expected to grow a modest 1.3 percent this year. As a result, Brazil's GDP growth forecast for 2013 dropped to 3.0 percent—down from the International Monetary Fund's initial estimates of 4.6 percent.

**Brazil's GDP growth forecast for 2013 dropped to 3.0 percent—down from the International Monetary Fund's initial estimates of 4.6 percent.**

### Inflation to remain high despite monetary tightening

Inflation has been edging up since mid-2012, and in March 2013, it breached the upper limit of the Central Bank of Brazil's target range of 4.5–6.5 percent (see figure 2). The stubborn inflation is being propped up in part by rising wages, pushed up by workforce shortages and labor regulation rigidities. In the past three years, real wages have increased an average 5.4 percent annually. Furthermore, labor shortages have adversely affected the non-export-oriented segment of Brazilian agriculture, increasing food prices sharply. Continued double-digit credit growth is also likely driving up inflation.

To curb inflation, the Central Bank has embarked on monetary tightening, raising the benchmark interest rate to 8.0 percent in May 2013 from 7.25 percent in March 2013. The tightening cycle will continue with the rate now likely to reach up to 9.0 percent by the end of the year. Meanwhile, to stem price rise, the





government announced BRL 7.4 billion worth of tax breaks on food and other staple goods in March. However, in the absence of structural changes in the labor market, price pressures are not likely to ease with inflation expected to average 6.3 percent this year.

### Volatile and interventionist public policy threaten Brazil's economic strength

At a sector level, government intervention in bank lending has resulted in a shrinking market share for private banks, as public sector banks aggressively expand credit in line with federal directives. In the oil and gas sector, increasing government control

of resources and delays in settling a royalty sharing dispute among states has hampered new investments. Auctions held in May 2013 for oil and gas block rights were the first in five years. Similarly, delays in mining reforms have reportedly resulted in companies deferring \$20–75 billion in investments for the 2012–2016 period.

At the macroeconomic level, while government stimulus is unlikely to significantly increase private consumption, it may be stoking price rise. On the other hand, the tax breaks to stem rising prices may not dramatically lower inflation in 2013, but they would contribute to a higher fiscal deficit of 2.8 percent of GDP in 2013, up from 2.4 percent in 2012. Meanwhile, even though the government is content to allow the real to depreciate,





this might not be enough to boost exports. Instead, a falling real would raise import costs, thereby pushing up inflation and denting the current account. The current account deficit for 2013 is projected at 3.0 percent of GDP, up from 2.4 percent in 2012.

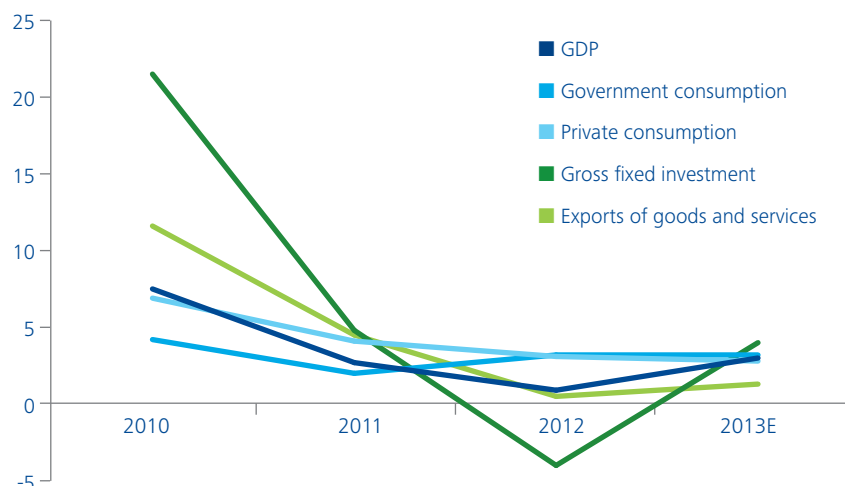
### Addressing long-term challenges: Infrastructure and the labor market

Transportation bottlenecks as well as a tight and rigid labor market are limiting Brazil's competitiveness across sectors. To improve transportation, the government plans to increase investments in areas such as ports, roads, railways, and airports. However, attracting private investors to these projects has been tough, given the low rate of returns initially offered by the government. In addition, the projects have been facing political delays. Brazil also continues to face a shortage of adequately skilled workers.

This, in addition to rigid labor laws, has been lowering competitiveness in various sectors.

Public dissatisfaction over the state of affairs in the country, including deteriorating public services, increasing corruption, and rising prices took the form of widespread street protests in June 2013. To placate the public, President Dilma Rousseff promised to

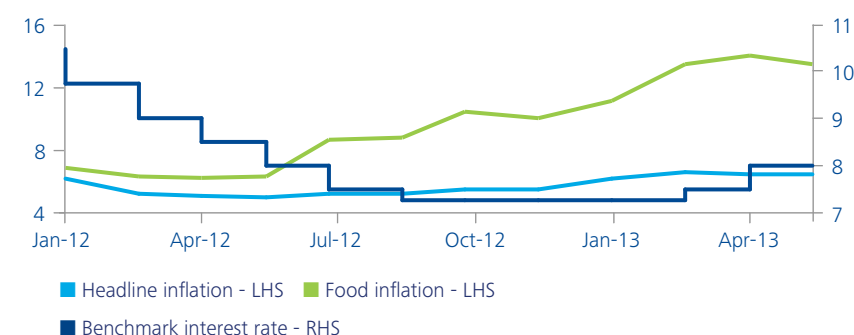
**Figure 1. Change in real GDP, private consumption, fixed investment, and exports (% YoY)**



Source: Economist Intelligence Unit

Graphic: Deloitte University Press | DUPress.com

**Figure 2. Inflation and interest rates (%)**



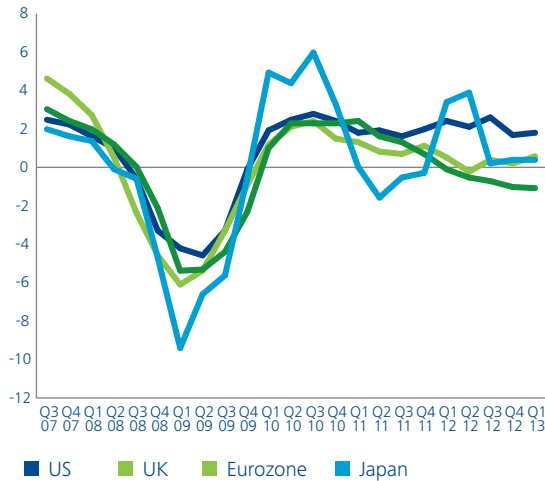
Source: Central Bank of Brazil

Graphic: Deloitte University Press | DUPress.com

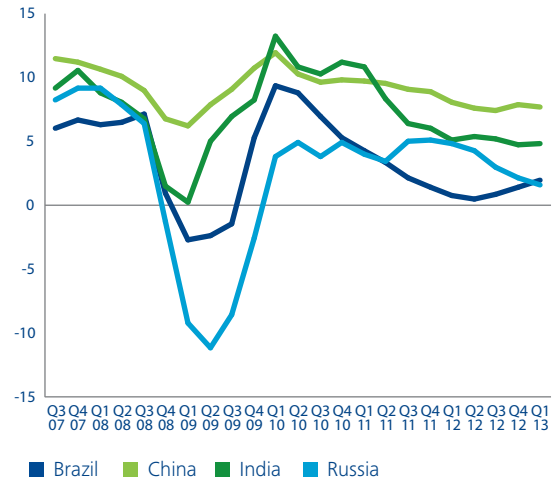
enhance public transportation, use oil royalties to improve education, and draft doctors from overseas to boost health care. However, protests continue, albeit at a smaller scale, over corruption issues. This is probably indicative of the larger challenge for Brazil, where immense economic potential is limited more by internal weaknesses than external factors.

# Appendix

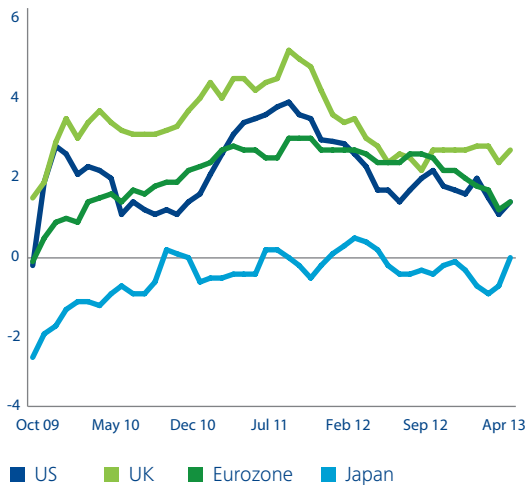
**GDP growth rates (YoY %)\***



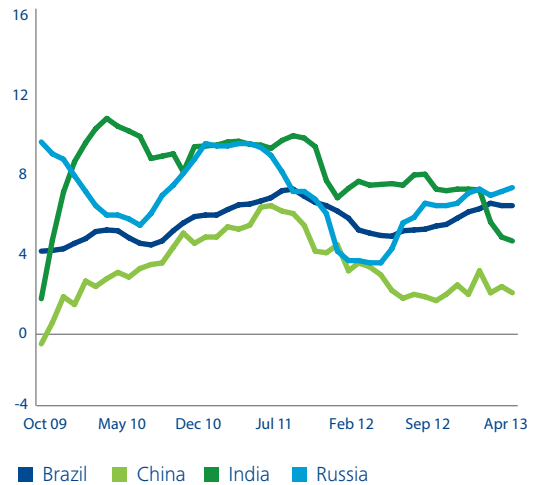
**GDP growth rates (YoY %)\***



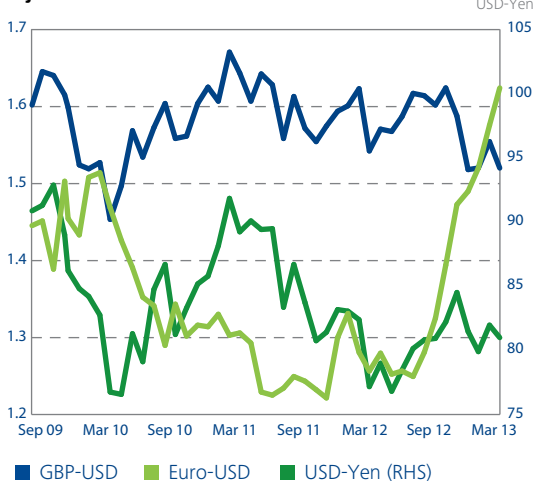
**Inflation rates (YoY %)\***



**Inflation rates (YoY %)\***



**Major currencies vs. the US dollar\***



\*Source: Bloomberg

Graphic: Deloitte University Press | DUPress.com

## Yield curves (as of June 24, 2013)\*

	US Treasury bonds & notes	UK gilts	Eurozone govt. benchmark	Japan sovereign	Brazil govt. benchmark	China sovereign	India govt. actives	Russia‡
3 months	0.04	0.41	0.04	0.09	7.90	2.80	7.42	6.14
1 year	0.13	0.37	0.22	0.10	9.15	3.41	7.48	6.23
5 years	1.44	1.63	0.87	0.35	11.24	3.39	7.70	7.68
10 years	2.54	2.53	1.81	0.88	11.21	3.54	7.51	8.37

## Composite median GDP forecasts (as of June 21, 2013)\*

	US	UK	Eurozone	Japan	Brazil	China	Russia
2013	1.9	0.9	-0.6	1.7	3	7.7	2.8
2014	2.7	1.6	1	1.5	3.4	7.65	3.5
2015	3	2.05	1.3	1.1	3.5	7.5	3.4

## Composite median currency forecasts (as of June 21, 2013)\*

	Q3 13	Q4 13	Q1 14	Q2 14	2014	2015	2016
GBP-USD	1.51	1.49	1.49	1.52	1.51	1.54	1.5
Euro-USD	1.28	1.27	1.27	1.27	1.25	1.3	1.26
USD-Yen	103	105	107	106	110	107	98
USD-Brazilian Real	2.07	2.05	2.05	2.12	2.07	2.16	2.09
USD-Chinese Yuan	6.13	6.1	6.08	6.07	6	6.03	5.85
USD-Indian Rupee	55.5	55	54	55.9	52.5	51	51.5
USD-Russian Ruble	32.05	31.89	31.49	32	31.88	32.39	32.78

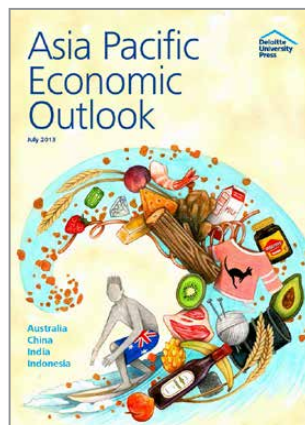
## OECD composite leading indicators (amplitude adjusted)†

	US	UK	Eurozone	Japan	Brazil	China	India	Russia Federation
Jun 11	100.71	100.07	101.14	100.21	99.96	101.31	99.92	102.38
Jul 11	100.33	99.83	100.86	100.15	99.49	101.19	99.74	102.27
Aug 11	99.93	99.63	100.58	100.11	99.06	101.04	99.61	102.21
Sep 11	99.56	99.55	100.32	100.09	98.72	100.88	99.53	102.22
Oct 11	99.27	99.60	100.12	100.12	98.48	100.69	99.52	102.28
Nov 11	99.12	99.76	99.99	100.18	98.33	100.51	99.58	102.38
Dec 11	99.08	99.98	99.91	100.26	98.35	100.34	99.64	102.46
Jan 12	99.13	100.19	99.88	100.34	98.48	100.24	99.63	102.50
Feb 12	99.20	100.33	99.85	100.38	98.74	100.22	99.57	102.41
Mar 12	99.27	100.38	99.81	100.36	98.99	100.18	99.44	102.11
Apr 12	99.33	100.37	99.75	100.29	99.19	100.07	99.29	101.58
May 12	99.40	100.30	99.65	100.16	99.34	99.95	99.10	100.95
Jun 12	99.51	100.23	99.54	100.02	99.48	99.85	98.86	100.38
Jul 12	99.68	100.19	99.44	99.89	99.60	99.77	98.55	100.00
Aug 12	99.88	100.22	99.36	99.81	99.67	99.70	98.28	99.82
Sep 12	100.09	100.31	99.32	99.79	99.70	99.65	98.10	99.75
Oct 12	100.30	100.44	99.34	99.84	99.67	99.63	97.96	99.77
Nov 12	100.46	100.57	99.42	99.95	99.58	99.65	97.79	99.82
Dec 12	100.56	100.70	99.56	100.13	99.48	99.69	97.63	99.85
Jan 13	100.63	100.82	99.72	100.35	99.40	99.73	97.48	99.79
Feb 13	100.68	100.92	99.88	100.61	99.36	99.72	97.33	99.57
Mar 13	100.72	100.99	100.01	100.87	99.35	99.70	97.27	99.13
Apr 13	100.77	101.04	100.12	101.11	99.37	99.71	97.29	98.54

\*Source: Bloomberg    ‡MICEX rates    †Source: OECD

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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