

Global Economic Outlook

3rd Quarter 2015

P0475119

Deloitte
University
Press



Contents

Introduction | 2

By Dr. Ira Kalish

In the third-quarter outlook for the global economy, Deloitte's far-flung economists offer their views on the economic situation and the outlook for the near and longer term.

United States: Another negative start—or was it? | 4

By Dr. Patricia Buckley

For a second year in a row, the first-quarter GDP estimate indicated a contracting economy—a fact many economists find disconcerting, since employment growth remained strong and wage growth finally started to pick up.

Eurozone: Combining crisis and recovery | 10

By Dr. Alexander Börsch

Beneath the surface of the intensifying Greek crisis, the recovery in the Eurozone has continued, and there are even signs that it is broadening. European corporates are moderately optimistic about their prospects.

China: Uncharted territory | 16

By Dr. Ira Kalish

After a lingering slowdown, the Chinese economy has begun to show some signs of possibly bottoming out. The country is in the midst of an equity market boom—or possibly a bubble.

Japan: Slow liftoff | 20

By Dr. Ira Kalish

The economy is having trouble taking off; areas of concern include slowing exports, consumer and industrial sectors, and retail sales. First-quarter GDP growth provides hints on the path of the economy.

Russia: The slide continues | 24

By Akrur Barua and Lester Gunnion

Russia is in the throes of a recession. A contraction in the first quarter is likely to be repeated as the effects of low oil prices and Western sanctions continue to dent the economy.

United Kingdom: Good growth ahead | 32

By Ian Stewart

Growth unexpectedly eased in the first half of 2015. Poor productivity, in part the flip side of increasing employment, seems to have weighed on exports. Yet the fundamental drivers of growth are generally supportive.

India: Different stories from the same book | 36

By **Akrur Barua**

Economic activity picked up during Q1—in fact, India’s GDP growth was higher than China’s. Yet, apart from GDP numbers, other economic indicators have been rather subdued, leading to concerns about growth.

Brazil: No escape from a contraction | 44

By **Akrur Barua**

This year was never going to be easy. It started with a fiscal austerity overdrive, and, with the labor market deteriorating and pessimism rife among consumers and businesses, the stage is set for a potential recession.

Economic indices | 54

GDP growth rates, inflation rates, major currencies versus the US dollar, yield curves, composite median GDP forecasts, composite median currency forecasts, OECD composite leading indicators.

Additional resources | 57

About the authors | 58

Contact information | 59



Introduction

By Dr. Ira Kalish

As we go to press with the third-quarter outlook for the global economy, it must be noted that events are happening that are in flux and might change considerably in the days and weeks ahead. These include Greece's role in the Eurozone, asset market conditions in China, the price of oil, the values of major currencies, and expectations about monetary policy in the United States. Despite these uncertainties, some important statements can be made with some confidence: The Eurozone economy is on the mend; the Brazilian and Russian economies are in recession; the US economy is rebounding from a bad first quarter; and the Chinese economy is growing relatively slowly. In this issue of the *Global Economic Outlook*, our far-flung economists offer their views on the economic situation and the outlook for the near and longer term.

First off, Patricia Buckley comments on the critically important US economy. She discusses how the decline in real GDP in the first quarter was possibly due to more than simply bad weather. Rather, she suggests that the government's method of measuring GDP might be flawed in a way that suppresses first-term GDP. Patricia also notes that another indicator of the economy, employment, suggested greater strength in the economy than did the GDP numbers. Based on her analysis, Patricia says that "the United States should experience stronger growth in the second half of the year."

Second, Alexander Börsch provides an analysis of the Eurozone economy. He says that the recovery in the economy continues, albeit in an "unspectacular manner." Going forward, Alexander points to various measures of business confidence as boding well for accelerated growth.

Of particular note is Deloitte's European CFO Survey,¹ in which there are notable differences in sentiment by country, with a high level of optimism in Spain, pessimism in France, with Germany somewhere in between. The survey also indicates that CFOs see national government structural reforms as most likely to cure what ails the Eurozone.

In our next article, I discuss the Chinese economy. I discuss how, after a series of moves easing monetary policy, there are now signs that the economy is, at the least, starting to stabilize rather than decelerate. On the other hand, China's export sector continues to suffer the effects of a strong currency and weak overseas demand. In addition, I look at the recent debt-driven surge in equity prices in China and the risks this might pose to the economy.

Fourth, I examine the Japanese economy. Despite the Bank of Japan's very aggressive program of quantitative easing, it appears that the economy is having trouble taking off. For example, despite a cheap Japanese yen, exports have not surged as expected. Likewise, domestic demand has disappointed, with the consumer sector remaining dormant as real wages decline and the lagged effect of last year's tax increase continues. On the other hand, Japanese corporate profits have soared, potentially setting the stage for a rebound in wages.

In their article on Russia, Akrur Barua and Lester Gunnion discuss the current downturn. They note that, although many factors have made Russia's situation worse, monetary policy has been largely successful in stabilizing the currency and reversing the trend toward higher inflation. Although a rebound in oil prices will help the economy, Akrur and Lester

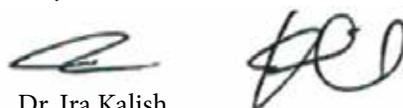
discuss the fact that Russia's expected growth over the coming decade is the lowest of the major emerging markets. This reflects a declining labor force, excessive dependence on oil and gas, a relatively high level of state involvement in the economy, and inadequate investment.

The United Kingdom is our next country of focus, with an article by Ian Stewart that takes a notably optimistic view of the outlook, despite the recent slowdown in growth. Ian notes that economic fundamentals are currently quite good, boding well for a rebound in growth. Plus, although productivity growth has been poor recently, Ian offers some reasons to expect a resurgence in productivity in the coming years that will help to maintain strong growth. Finally, he suggests that it is more likely than not that, following an expected referendum, the United Kingdom will remain in the European Union.

In our next article, Akrur Barua returns with an analysis of India, an economy that appears to be growing faster than China. Akrur notes, however, that aside from headline GDP figures, other economic indicators "have been rather subdued." Thus, it is not entirely surprising that, with inflation decelerating, the central bank has eased monetary policy.

Going forward, Akrur suggests that monetary policy alone will not be sufficient for growth, or even for boosting credit market activity. As such, he discusses the prospects for financial market reforms that could play a role in better utilizing India's savings and unleashing its entrepreneurs.

Finally, our last article looks at Brazil. Akrur Barua finds that Brazil is most likely already in recession. He notes the poor economic performance of the first quarter, the exception being the relative strength of exports. Moreover, economic fundamentals point to further troubles ahead. A cut in government subsidies led to higher electricity prices, boosting inflation, in turn preventing the central bank from easing monetary policy. A weak currency has played a role as well. The result is a combination of tight monetary and fiscal policy that, while beneficial in the long run, will suppress activity this year. Therefore, don't expect a recovery until at least 2016.



Dr. Ira Kalish
Chief global economist of
Deloitte Touche Tohmatsu Limited

Global Economic Outlook

published quarterly by
Deloitte Research

Editor-in-chief

Dr. Ira Kalish

Managing editor

Aditi Rao

P04751198

Contributors

Dr. Patricia Buckley
Dr. Alexander Börsch
Dr. Rumki Majumdar
Akrur Barua
Lester Gunnion

Editorial address

350 South Grand Street
Los Angeles, CA 90013
Tel: +1 213 688 4765
ikalish@deloitte.com

Endnotes

1. For more information on the CFO Survey, including the participating member firms, see <http://www.deloitteresearchemea.com/>.

Another negative start—or was it?

By Dr. Patricia Buckley

FOR the second year in a row, the first-quarter GDP estimate for the United States indicated a contracting economy—a fact that many economists find disconcerting, since during the same period, employment growth remained strong and wage growth finally started to pick up. The focus is now on whether the GDP accounting needs improvements.

GDP's first-quarter 0.2 percent contraction left us scratching our heads, just as when the first quarter of 2014 showed a contraction of 2.1 percent, on how an economy that by many measures appears to be growing actually shrunk. True, both of these first quarters experienced abnormally cold weather, and some factors in early 2015 negatively impacted exports, including a labor issue at the West Coast ports, a relatively high US dollar, and slower growth among some of our trading partners. But even with these headwinds, these contractions seem out of sync with reality, leading to the question: Is there a problem with how the government's statisticians calculate US GDP?

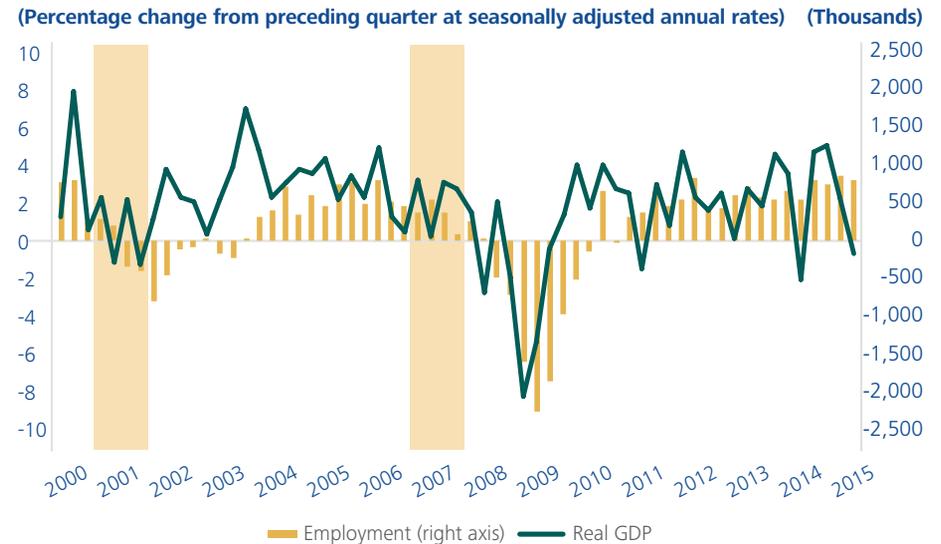
Researchers quickly closed in on the “seasonal adjustment” process as the most likely culprit. The government publishes most official statistical series with the impact of regularly occurring patterns removed to show changes in the underlying trends. For example, the Census Bureau adjusts automotive production in July as factories shut down to retool for new models, and it adjusts heating oil production to account for the regularly observed September increases in anticipation of the winter heating season.¹ The Bureau of Labor Statistics (BLS) adjusts the individual components of the consumer price index for a wide variety of factors that can cause seasonal variation in prices, such as changing climatic conditions, production cycles, model changeovers, holidays, and sales events. As an example of a regularly occurring pattern, BLS points to oranges, which can be purchased year-round but whose prices are significantly higher in the summer months, when the major sources of supply are between harvests.²



In constructing the GDP estimate, the Bureau of Economic Analysis (BEA) draws on data from many sources, much of which each collecting agency seasonally adjusts, with the BEA seasonally adjusting the remainder if the time series is sufficiently long. Both the BEA and the source data agencies review and update their seasonal adjustment procedures regularly, but even with regular reviews and updates, there are several ways in which uncorrected seasonal patterns can remain in the GDP estimate. These include seasonal patterns in the aggregates, not apparent in the individual components; patterns at the quarterly level not present in the underlying monthly data; and patterns that appear in the deflated estimates and that are not apparent in the nominal estimates or the prices.³

The impact of this “residual seasonality” on the quarterly estimates may be substantial. A recent study by researchers at the Federal Reserve Bank of San Francisco applied a second round of seasonal adjustment to the published real GDP data and concluded that analysts have underestimated first-quarter GDP since the late 1990s—and that the underestimation has risen in recent years to about 1.5 percentage points. Therefore, according to this analysis, first-quarter GDP should have shown weak, but firmly positive, growth.⁴

Figure 1. GDP growth and employment change



Source: Bureau of Economic Analysis; Bureau of Labor Statistics; Deloitte Services LP economic analysis.

Graphic: Deloitte University Press | DUPress.com

The **pickup in wage growth** was another signal that the first quarter of 2015 was **stronger than the GDP estimates portray**.

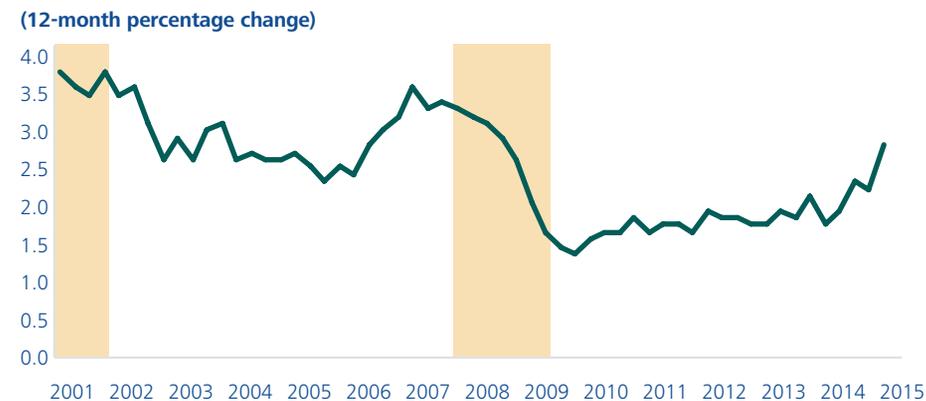
GDP and the labor market

Figure 1 illustrates the seeming mismatch between the quarterly GDP estimates and another indicator of economic health: employment. As the US economy entered recession in early 2001 and again at the end of 2007, employers reacted quickly to reduce headcount. Even when output began to rise as the economy shifted into expansion, employment continued to fall, giving rise to the concept of the “job-less recovery.” But eventually employment began to increase in both of these expansions. Where the first quarters of 2014 and 2015 stand in stark contrast to expectations is in the strength of employment growth, even as GDP apparently contracted or stalled.

The pickup in wage growth was another signal that the first quarter of 2015 was stronger than the GDP estimates portray. Much attention is generally given to the monthly changes in average hourly wages published alongside BLS’s monthly employment estimates. However, changes in the average hourly earnings mask changes in industry and occupational shifts; another BLS series, the quarterly Employment Cost Index (ECI), corrects for this by measuring the change in labor cost, free from the influence of employment shifts among occupations and industries.

The ECI tracks the two major components of labor costs: wages and salaries (approximately 70 percent of compensation costs) and benefits (the remaining 30 percent). As shown in figure 2, the ECI for wages and salaries has accelerated in recent quarters after remaining relatively constant for most of the recovery.

Figure 2. ECI for wages and salaries of private industry workers



Source: Bureau of Labor Statistics; Deloitte Services LP economic analysis.

Graphic: Deloitte University Press | DUPress.com

Figure 3. Trade in goods and services, selected countries

Q4 2014–Q1 2015, nominal percentage change, seasonally adjusted			
	Goods and services	Goods	Services
Total	-4.2%	-6.5%	1.0%
Canada (1)	-7.9%	-9.0%	-2.5%
Mexico (2)	-1.3%	-2.1%	5.4%
China (3)	-6.6%	-10.1%	3.5%
Japan (4)	-1.2%	-1.0%	-1.5%
United Kingdom (5)	-1.4%	-4.7%	1.4%

Source: Bureau of Economic Analysis; Deloitte Services LP economic analysis.

The combination of a **strong dollar** and **slower growth among some US trading partners** caused exports to decline in both real and nominal terms.

So what did happen in the first quarter?

Even if some unaccounted-for residual seasonality depressed first-quarter GDP, it was still a weak quarter. Although the labor market remained strong, other indicators—such as the large decrease in exports—constrained growth. The combination of a strong dollar and slower growth among some US trading partners caused exports to decline in both real and nominal terms. Figure 3 shows the percentage change in nominal exports during the first quarter of 2015. Overall, exports declined 4.2 percent, with the decrease more than accounted for by the drop in goods exports. Indeed, services exports actually increased. On a country basis, the five largest US export markets, accounting for 45 percent of total exports, all declined. The declines were particularly large in goods, with only Japan showing a higher percentage drop in services.

Other weaknesses in the first quarter include consumers who did not take advantage of lower gas prices and higher incomes to spend more—instead, they paid credit card debt and increased savings, although they did take out more in auto and student loans. Mortgage debt, the largest debt category, remained unchanged from the fourth quarter.⁵ Business investment also slowed, as declines in structural investment overwhelmed the increased spending on equipment and intellectual property (primarily software, and research and development). Residential investment still appears to be sputtering along, with no new upward shift in trajectory.

Although factors causing the first-quarter weakness (whatever its magnitude) may spill over into the second quarter of 2015, the United States will likely experience stronger growth in the second half of the year. The Federal Open Market Committee of the Federal Reserve Board continues to monitor conditions, looking

to judge the correct point to begin to raise interest rates. There are no major imbalances present—at least imbalances within US borders. Unfortunately, there is no shortage of external situations that might spiral out of control and disrupt world growth.

After the BEA issues its regular annual revisions in July, which may include a change to some of the underlying seasonal adjustments, we might have a clearer idea of where we have been—a necessary prerequisite to better contemplating future US prospects.

Endnotes

1. Bureau of the Census, “Manufacturing and construction division FAQs on seasonal adjustment,” <http://www.census.gov/const/www/faq2.html>, accessed June 26, 2015.
2. Bureau of Labor Statistics, “Fact sheet on seasonal adjustment in the CPI,” March 13, 2015, <http://www.bls.gov/cpi/cpisaqanda.htm>.
3. Bureau of Economic Analysis, “Accounting for seasonality in GDP” May 20, 2015, <http://blog.bea.gov/2015/05/20/accounting-for-seasonality-in-gdp/>.
4. Glenn D. Rudebusch, Daniel Wilson, and Tim Mahedy, “The puzzle of weak first-quarter GDP growth,” Federal Reserve Bank of San Francisco, May 18, 2015, <http://www.frbsf.org/economic-research/publications/economic-letter/2015/may/weak-first-quarter-gdp-residual-seasonality-adjustment/>.
5. Federal Reserve Bank of New York, “Household debt and credit report,” May 2015, <http://www.newyorkfed.org/microeconomics/hhdc.html>.

Combining crisis and recovery

By Dr. Alexander Börsch

THE second quarter in the Eurozone was dominated by escalating political tensions around the modalities of the Greek bail-out program, discussions about the future of Greece in the Eurozone, and the future of the Eurozone itself. However, beneath the surface of the intensifying Greek crisis, the recovery in the Eurozone has continued, and there are even signs that it is broadening. In the medium term, European corporates are moderately optimistic about their prospects. A possible Greek exit (or “Grexit”) from the Eurozone continues to be a risk for the Eurozone, the possible impact of which will depend to a large degree on investor perceptions.

The economic situation

Available data for the second quarter suggest that the recovery in the Eurozone continues. It does so in an unspectacular manner, in line with the trend of the last few months. From a positive viewpoint, the recovery has become more solid.

Overall economic sentiment indicators, such as the European Commission’s Economic Sentiment Index, are stable and in positive territory. Other economic climate indicators for the Eurozone even report an eight-year high.¹ Also, consumer-related early indicators such as car and

Available data for the second quarter suggest that **the recovery in the Eurozone continues.**





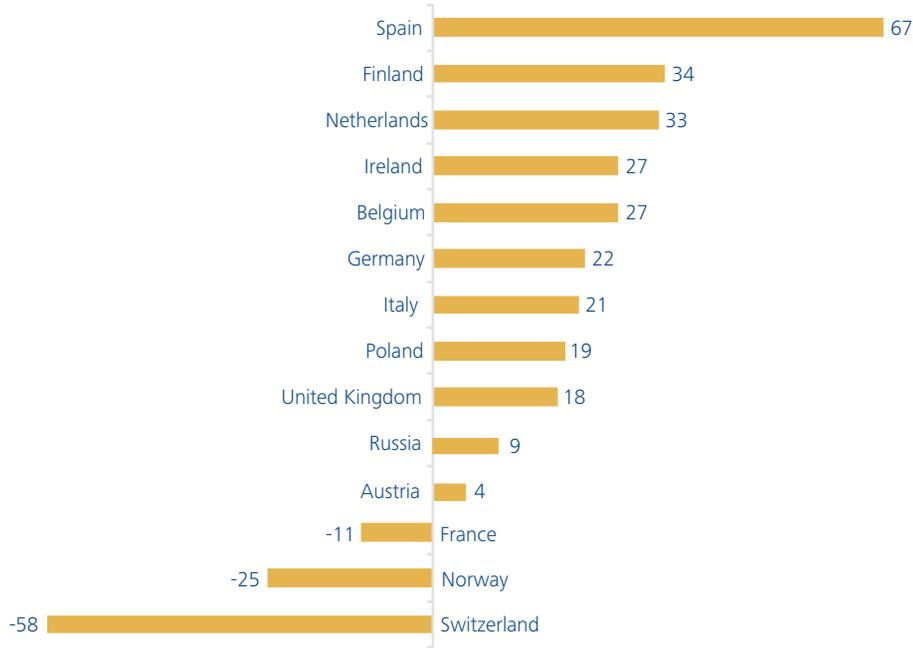
retail sales are pointing upward. At the same time, the fears of deflation that dominated the headlines earlier in the year are beginning to disappear as inflation rates have picked up. Core inflation was at a low of -0.6 percent in January but went up to 0.3 percent in May.

Similarly, investments, which have been the sorrow child of the recovery for a long time, show encouraging signs. They have been growing, albeit modestly, for the third quarter in a row. This suggests that businesses are becoming increasingly confident about the recovery. Even if it is too early to proclaim a trend reversal for corporate investments, it speaks for a broader-based recovery.

From a country perspective, Spain has been the fastest-growing economy in the Eurozone in the first quarter (behind Cyprus), showing signs of a strong recovery for the rest of the year.

Figure 1. Corporate sentiment in Europe

Question: Compared with three months ago, how do you feel about the financial prospects of your company?

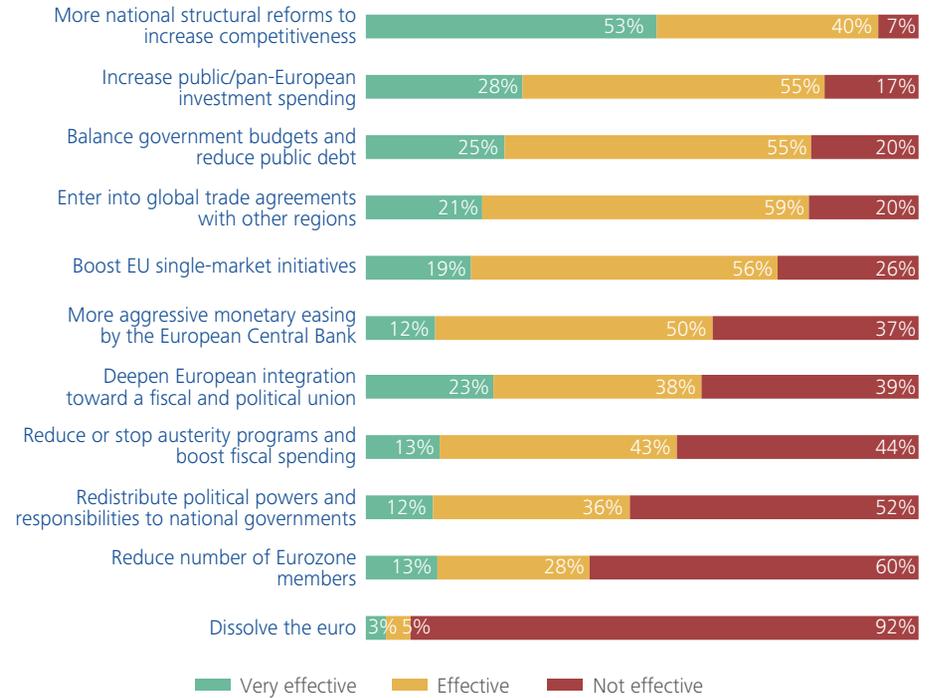


Source: Deloitte European CFO Survey, Q1 2015, www.deloitteresearchemea.com.

Graphic: Deloitte University Press | DUPress.com

Figure 2. European CFO assessment of approaches to overcoming growth crisis

Question: How effective do you think the following policies would be in resolving the current EU/euro area growth crisis?



Source: Deloitte European CFO Survey, Q1 2015, www.deloitteresearchemea.com.

Graphic: Deloitte University Press | DUPress.com

The corporate outlook

General corporate sentiment in Europe for the next 12 months is characterized by modest optimism (figure 1). According to the Deloitte European CFO Survey, which is conducted among CFOs in 14 European countries, the overall sentiment is positive, even if there are wide country-specific differences.²

Regarding their own financial prospects, Spanish corporates are currently the most optimistic, which speaks for the strength of the ongoing recovery. On the other end of the spectrum, French, Norwegian, and Swiss CFOs are the most pessimistic. The pessimism of the latter two can be attributed mainly to the fall in oil prices and the strong appreciation of the

Swiss franc. German CFOs' sentiment lies in the middle of a cross-country comparison, but it recovered sharply relative to last autumn, when the Ukraine crisis was at its height.

Regarding the euro crisis, European CFOs have a fairly strong consensus on how it can be solved and how the Eurozone should look going forward (figure 2). They see national structural reforms as by far the most important measure to escape the growth crisis: 93 percent see them as effective or very effective to overcoming the growth crisis. Strengthening pan-European investment spending comes in as the second-most important measure.³

On the other hand, European CFOs strongly resist radical ways to solve the Euro crisis.

Almost no CFO from a Eurozone country considers dissolving the Eurozone as helpful, and only a few prefer reducing the number of Eurozone members. European CFOs from outside the Eurozone (United Kingdom, Switzerland, and Russia) are much more inclined to recommend these measures. The possibility of deeper European integration is welcomed to very different degrees in Eurozone countries. While Italian and Spanish CFOs are strong supporters, German and Dutch CFOs are more hesitant. This implies that there is strong unity among European businesses about the desirability of the common currency but considerably less consensus on how the euro can be made stronger.

Regarding the euro crisis, European CFOs have a fairly strong consensus on how it can be solved and **how the Eurozone should look going forward.**



The Greek crisis reloaded

After the second bail-out program for Greece was extended by four months with difficulty in February, the implementation of the attached conditions has turned out to be even more difficult. The extension was conditional on the implementation of reforms in Greece. However, no mutual understanding, let alone a consensus, of reform necessities and priorities between the Greek government and its creditors has emerged. Consequently, the last tranche of the program, with the condition that Greece needs to fulfill its obligations, was not paid until the end of June. The increasing tensions and growing doubts resulted in massive capital flight from Greece, which the banking system could withstand only due to the European Central Bank's emergency cash program, Emergency Liquidity Assistance.

At the time of writing, it is unclear whether there will be a last-minute agreement between the creditors (Eurogroup, European Central Bank, and International Monetary Fund) and Greece. If there is no agreement, Greece faces the prospect of a sovereign default and of potentially leaving the Eurozone, even if there is no formal provision in the treaties for such an exit.

Whatever the final outcome of the negotiations, the financial-market consequences of a possible Grexit will hinge on two factors. First, if investors are surprised by a Grexit, it could, in principle, lead to substantial unrest in financial markets. However, given the length of the crisis, which is now in its sixth year, it is doubtful that investors would be completely surprised. Second, the consequences would depend on whether investors

perceive Greece as a special case or as the start of a broader restructuring of the Eurozone. If the latter perception prevails, contagion is a danger. If investors expect other former crisis countries to be stable and continue their current growth trajectory, consequences would be more limited.

On the other hand, if Greece stays within the Eurozone and receives the last tranche of the second bail-out program, its financing needs will only be covered in the very short term, but not long after. While the servicing costs of Greek debt as a share of GDP are lower than in many other Eurozone countries thanks to exceptionally low interest rates and long maturities, Greece will need access to external finance to guarantee repayment. If capital markets are unwilling to provide financing, a third bail-out package will very likely come up in the political agenda.

Endnotes

1. Ifo Institute, "Ifo economic climate in the euro area improves significantly," May 6, 2015, <http://www.cesifo-group.de/ifoHome/facts/Survey-Results/World-Economic-Survey/Economic-Climate-for-the-Euro-Area/Archive/2015/Economic-Climate-Euro-Area-20150506.html>.
2. For results of the Deloitte European CFO Survey, see www.deloitte.com/emea/research.
3. Ibid.

Uncharted territory

By Dr. Ira Kalish

Economic conditions

After a lingering slowdown, the Chinese economy has begun to show some signs of possibly bottoming out. The government reports that several indicators improved in May, suggesting that the central bank's three recent interest rate reductions might finally be bearing fruit. However, there are some negative signs as well. Here is what we know:

- Industrial production increased 6.1 percent in May vs. a year earlier, an improvement from the 5.9 percent gain in April.¹
- Retail sales increased 10.1 percent in May, slightly better than the 10.0 percent increase in April.²
- Fixed asset investment was up 11.4 percent in the first five months of the year vs. a year earlier, a bit slower than the 12 percent gain for the first four months of the year.³ Decelerating investment is not necessarily a bad thing, as China desperately needs to shift away from investment-driven growth and toward consumer-driven growth.
- Credit creation accelerated in May vs. April, indicating that the easing of monetary policy is having a positive effect. On the other hand, we do know that much credit expansion has been channeled into the frothy equity market, which continues to exhibit the attributes of a speculative bubble.⁴ Given excess capacity in housing and heavy industry, the easing of credit conditions may boost asset prices rather than investment.

- After a first-quarter slump, housing sales rose 5.1 percent in the first five months of 2015 vs. a year earlier—still a slow pace but potentially encouraging: It appears that the easing of mortgage market regulations is having a positive impact on housing activity, which may help to stabilize housing prices.
- Inflation eased in May. The consumer price index was up 1.2 percent in May vs. a year earlier, slower than in April. Consumer prices were down 0.2 percent from April to May, the third consecutive month of declining prices. In addition, producer prices were down 4.6 percent in May vs. a year earlier. All this means that the excess capacity in industry continues to be a problem.⁵

The one unambiguously negative batch of economic data concerns trade. China's imports declined sharply in May, down 17.6 percent from a year earlier and even bigger than the 16.2 percent decline in April. This decline is seen as reflecting deteriorating domestic demand and evidence of further economic weakening. Indeed, imports of iron ore fell sharply, indicating weak plans for investment in infrastructure and construction. It may also reflect weak export demand because many imports into China are reprocessed into exportable products. Indeed, May exports were down 2.5 percent from a year earlier. The result was

a widening of China's trade surplus. Exports to the United States were up 7.8 percent, while exports to the European Union were down 6.9 percent. The Chinese currency has risen considerably in value against the euro, which partly explains the weak exports to Europe. The poor trade numbers for both April and May bode poorly for GDP growth in the second quarter—and increase the likelihood that the government will soon take new measures to stimulate a relatively moribund economy.⁶

Equity bubble and potential problems

China is in the midst of an equity market boom—or possibly a bubble—with prices on the Shanghai Exchange up more than 120 percent from a year ago. Moreover, the amount of money traded each day has increased commensurately, providing further evidence that this might be a bubble. Yet not everyone is convinced: Some people have noted that the price-earnings ratio of Shanghai listed stocks is not especially high and is well below the ratio seen during China's last stock market surge in 2007—which ended in a massive rout. Still, the amount of money traded now is far higher than in 2007; moreover, much of the money traded today is borrowed. Until recently, much of that money was going into the property market.

Yet with huge excess capacity in that market, investors are shifting their demand to equities, adding risk to the financial system.

The surge in share prices has been largely fueled by loans to margin traders. Millions of ordinary citizens, many without formal education, have flooded the equity market to take advantage of the boom. This came despite a slowdown in China's economy, excess capacity in industry leading to declining wholesale prices and weaker profit margins, and a cutback in investment growth and growing capital outflows. In other words, the equity market boom has defied logic—a hallmark of an unsustainable bubble. In any event, a January decision by brokerages to crack down on margin trading may reflect pressure from concerned regulators. A recent drop in prices, if sustained, could lead more investors to sell in an attempt to secure

the profits they have made. A further drop in share prices would likely lead to margin calls, creating a vicious cycle of declining prices and share redemptions. Ultimately, many investors could find themselves unable to service the debts they have accumulated, thus leading to sizable losses for the banks that have extended credit to brokerages. One irony of this situation is that China's central bank has been easing monetary policy in order to boost credit market activity and revive economic growth. Yet rather than fueling investments in tangible assets, for which there is already excess supply, the easier monetary policy appears to have contributed to an asset price bubble.

A debate is emerging about the possible consequences of a bursting of China's frothy equity market bubble—if and when it eventually comes. Some analysts worry that, because

debt financed so much of the recent increase in share prices, a reversal of share prices would lead to financial troubles for a large number of households, as well as for some banks. On the other hand, other analysts note that equity market capitalization remains a relatively low share of GDP compared with developed economies. And while share ownership has increased considerably, it remains a low share of total household net worth. Therefore, the consequences of a drop in share prices would be manageable. In addition, given the government's penchant for intervening in the market, it is possible that the government would attempt to ease the impact of an equity market collapse by injecting liquidity into the market. The reality is that the current situation is new territory for China, and the impact of a sudden reversal of equity prices is hard to foresee.

A debate is emerging about the possible consequences of a bursting of **China's frothy equity market bubble**—if and when it eventually comes.

Currency valuation issues

For much of the past two decades, China's central bank purchased foreign currency in order to suppress the value of its currency, with the goal of maintaining the competitiveness of its manufactured exports. This was successful in driving economic growth through exports; it also led China to accumulate the world's largest bundle of foreign currency reserves. Yet it also resulted in complaints from other countries, especially the United States, that China was manipulating its currency to the detriment of the competitiveness of other countries' exports. It became a periodic ritual that US Treasury

secretaries would visit Beijing to complain about the renminbi's undervaluation.

Yet, in May, the International Monetary Fund (IMF) declared that China's currency is no longer undervalued. In recent years, Beijing has modestly liberalized the exchange rate and loosened capital controls, which has brought a sizable increase in the value of the renminbi. Recently, there has been a surge in outbound capital flows, actually putting downward pressure on the renminbi. In fact, so severe was that pressure that the central bank has been selling rather than purchasing foreign currency lest the renminbi decline too much. The IMF clearly believes that we have entered a new world—even if the US government does not yet see it

that way. As IMF Deputy Managing Director David Lipton put it: “While undervaluation of the renminbi was a major factor causing large imbalances in the past, our assessment is that the substantial real effective appreciation over the past year has brought the exchange rate to a level that is no longer undervalued.”⁷ The significance of the IMF view is that it will likely lead the organization to add the renminbi to the basket of currencies used to calculate special drawing rights (SDRs). While of no practical importance for China, having its currency as part of the SDR group has been a key goal of the government and represents China's arrival as a major financial power.

Endnotes

1. National Bureau of Statistics of China, “Industrial production operation in May 2015,” June 12, 2015, http://www.stats.gov.cn/english/PressRelease/201506/t20150612_1158161.html.
2. National Bureau of Statistics of China, “Total retail sales of consumer goods in May 2015,” June 12, 2015, http://www.stats.gov.cn/english/PressRelease/201506/t20150612_1158174.html.
3. National Bureau of Statistics of China, “Investment in fixed assets for the first five months of 2015,” June 12, 2015, http://www.stats.gov.cn/english/PressRelease/201506/t20150612_1158163.html.
4. People's Bank of China, “Financial statistics, May 2015,” June 24, 2015, http://www.pbc.gov.cn/publish/english/955/2015/20150624084057589826684/20150624084057589826684_.html.
5. National Bureau of Statistics of China, “Consumer prices for May 2015,” June 9, 2015, http://www.stats.gov.cn/english/PressRelease/201506/t20150609_1156702.html.
6. William Kazer, “China exports fall, as imports tumble,” *Market Watch*, June 8, 2015, <http://www.marketwatch.com/story/china-exports-fall-as-imports-tumble-2015-06-08>.
7. Tom Mitchell and Shawn Donnan, “China currency is ‘no longer undervalued’, says IMF,” *Financial Times*, May 26, 2015, <http://www.ft.com/cms/s/0/11e96e1e-03a7-11e5-b55e-00144feabdc0.html#axzz3dnzMMMyLR>, accessed June 22, 2015.

Slow liftoff

By Dr. Ira Kalish

THE Japanese economy is having trouble taking off. Observers note several areas of concern:

- The Bank of Japan's policy of quantitative easing (large purchases of government bonds) has substantially suppressed the value of the Japanese yen, but exports have not surged, as hoped. The exchange rate is now roughly 125 yen per US dollar, with the yen down about 20 percent from a year ago—the yen's lowest value in 13 years. Yet rather than exports shooting up, the government reports, May exports rose only 2.4 percent from a year earlier, slower than April's 8.0 percent increase. Indeed, exports declined 2.7 percent from April to May. Moreover,

export volume (exports adjusted for price changes) actually fell 3.8 percent in May from a year earlier. Many attributed the slowdown in exports, in part, to the weakness of the Chinese economy: May exports to China were up only 1.1 percent from a year earlier. In contrast, exports to the United States rose 7.4 percent from a year earlier, though this still represented a substantial slowdown from the prior month. Also, imports fell 8.7 percent in May from a year earlier, indicating weak domestic demand in the Japanese economy. The weakness of trade is likely to have a chilling effect on business investment; it also bodes poorly for economic growth in the second quarter.¹

The government hopes that **corporations will pass strong profits on to workers** in the form of higher wages, thus boosting spending, **but this has not yet happened.**



- Likewise, Japan's consumer and industrial sectors provide cause for concern. The government reported that, compared with a year earlier, in April, consumer spending declined 1.3 percent, industrial production fell 0.1 percent, and core consumer prices remained unchanged. Plus, although unemployment declined, that was entirely due to a sharp drop in labor force participation. Despite a highly aggressive quantitative easing program and a sharp drop in the yen's value, inflation has not yet rebounded. The governor of the Bank of Japan attributes the low inflation to the impact of lower energy prices; he sees this as temporary and expects to see a pickup in inflation.² In addition, overall demand in the economy remains very weak, as consumer purchasing power stagnates while businesses remain reluctant to invest. The International Monetary Fund says that Japan needs a new set of reform-oriented policies and should not simply rely on a lower yen to boost exports.³
- As for the consumer, retail sales in Japan rose 5.0 percent in April vs. a year earlier. This number sounds strong but actually reflects last year's plunging retail sales following a national sales tax boost. In fact, retail sales remain relatively weak. Moreover, sales were up only 0.4 percent from March



to April on a seasonally adjusted basis, suggesting that retail spending has nearly stalled. The government reports that spending on big-ticket items remains weak, indicating that the sales tax rise continues to negatively influence such spending. That increase caused last year's recession, and so far the rebound has been disappointing. The government hopes that corporations will pass strong profits on to workers in the form of higher wages, thus boosting spending, but this has not yet happened.

Evidence from the first quarter

First-quarter GDP growth provides hints about the path of Japan's economy. The economy actually grew strongly in the first quarter, with real GDP rising at an annualized rate of 2.4 percent—far better than the 1.6 percent growth in the Eurozone or the decline in output in the United States. However, much of Japan's growth stemmed from an accumulation of inventories; when this is excluded, real GDP grew at a rate of only 0.7 percent. Moreover, the massive growth of inventories in the first

quarter means that businesses may not boost production much in the second quarter. This bodes poorly for second-quarter growth. Thus, although Japan came out of recession in the fourth quarter of last year, growth since has been relatively anemic.

The government's GDP report contained positive and negative elements. Consumer spending and nonresidential investment both grew at a moderate rate of 1.4 percent, while residential investment soared 7.5 percent. Government spending grew modestly, even as government investment declined sharply. Interestingly, although exports grew at a blistering rate of 9.9 percent, imports grew even faster at a rate of 12.0 percent, meaning that

net exports actually made a substantial negative contribution to GDP growth. This report suggests that the drop in the yen's value initially paid dividends in terms of export competitiveness. Domestic demand, though, remains relatively weak, and the modest increase in business investment—the first rise in four quarters—is nevertheless disappointing.⁴

Another positive element concerns corporate profitability, which the yen's sharp drop has boosted: For the fiscal year that ended in March, 30 percent of large publicly traded companies reported record profits—the highest percentage since 2006—and total profits were up 6.7 percent from the previous year, hitting a record volume. The companies that

did especially well, benefiting from the cheap yen, were those with substantial export sales or overseas operations, as well as industrial companies, boosted by falling oil prices. On the other hand, rising import prices and weak domestic demand hurt many domestically oriented nonmanufacturing companies. The rise in overall profitability has led to a surge in dividend payments to shareholders, and the question now is whether strong profitability will boost investment, which, lately, has been relatively weak. The government also continues to hope that companies will elect to boost compensation, thereby stimulating increased consumer spending.

Endnotes

1. Toru Fujioka and Masaaki Iwamoto, "Japan exports rise less than forecast, headwind to recovery," *Bloomberg Business*, June 17, 2015, <http://www.bloomberg.com/news/articles/2015-06-17/japan-s-exports-rise-less-than-forecast-in-headwind-to-recovery>.
2. Chikako Mogi, Kazumi Miura, and Hiroko Komiya, "Kuroda inflation optimism winning over consumers, bond investors," *Bloomberg Business*, June 21, 2015, <http://www.bloomberg.com/news/articles/2015-06-21/kuroda-inflation-optimism-winning-over-consumers-bond-investors>.
3. Nicholas Spiro, "IMF a scrooge on Japan and Europe, but investors should watch out for complacency," *South China Morning Post*, May 28, 2015, <http://www.scmp.com/comment/insight-opinion/article/1811088/imf-scrooge-japan-and-europe-investors-should-watch-out>.
4. Economic and Social Research Institute, "GDP (expenditure approach) and its components," Cabinet Office, Government of Japan, January–March 2015, http://www.esri.cao.go.jp/en/sna/data/sokuhou/files/2015/qe151_2/gdemenua.html.

The slide continues

By Akur Barua and Lester Gunnion

RUSSIA is in the throes of a recession. A contraction in the first quarter is likely to be repeated as the effects of low oil prices and Western sanctions continue to dent the economy. Years of dependence on oil and gas have also prevented the creation of a strong non-oil domestic economy, which would have been helpful at a time like this. The fiscal response to the current crisis has been fuzzy at best, owing to the lack of a long-term economic strategy to tackle structural challenges prior to the crisis. Tensions with Ukraine and with the West are a distraction; the fiscal burden of the takeover of Crimea is another. So far, the sole bright spot in the economy, albeit a small one, appears to be the Bank of Russia's (BOR's) policy actions. The BOR hiked rates sharply late last year to prevent a currency crash, and therefore a spike in inflation, in response to the crisis. Due to this rate hike, a ceasefire in Ukraine's troubled eastern region, and a bout of carry trade for higher returns, the Russian ruble has recovered some ground this year. Moreover, inflation, despite being in double digits,

is starting to edge lower. But by no means does this bit of success mark an end to the bank's challenges. Monetary policy formulation is still a daunting task in the face of a weak economy, high inflation, and currency and banking sector risks.

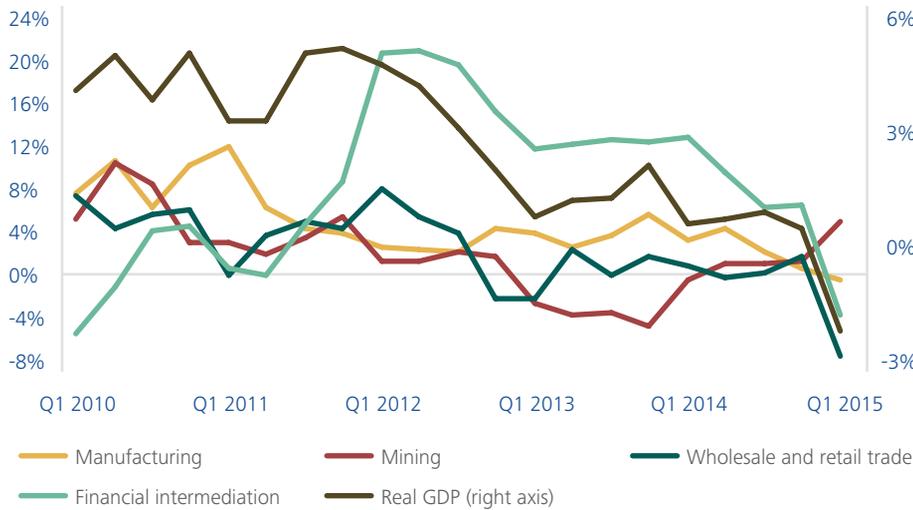
GDP decline in Q1 2015 was expected

The economy contracted 1.3 percent quarter over quarter in Q1 2015, the third consecutive quarterly contraction (figure 1). On a year-over-year basis, real GDP fell 2.2 percent in Q1; the drop was larger than the initial estimate of a 1.9 percent decline.¹ A host of sectors fared poorly, dragged down by declining domestic demand in the face of economic instability. Reflecting a tightening of household budgets, wholesale and retail trade fell 7.6 percent in Q1. Within services, the other major sector to suffer was financial services (-3.8 percent), which has been hit hard by Western sanctions, ruble weakness, and



Figure 1. As expected, economy contracted in Q1 2015

(Growth, year over year)



Source: Haver Analytics; Deloitte Services LP economic analysis.

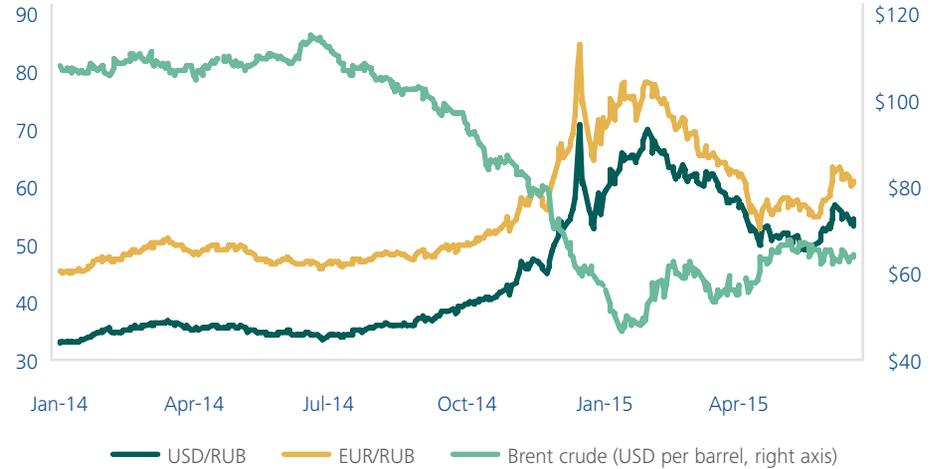
Graphic: Deloitte University Press | DUPress.com

economic contraction. Services, however, were not the only weak spot for the economy in Q1. Manufacturing and construction also did not fare well; while the former fell 0.6 percent, the latter contracted 4.1 percent.

The economy would have suffered more had it not been for a modest recovery in oil prices. For example, after slumping to below \$50 per barrel in mid-January, Brent crude has gone up about 38 percent since then (as of June 18,

2015). The impact of the oil price recovery is evident from the fortunes of the mining and quarrying sector, which expanded 4.9 percent year over year in Q1. A recovery in the ruble has also aided the economy. In fact, the ruble outperformed oil from February to mid-May (figure 2). The currency appreciated about 40 percent against the US dollar during the same period before weakening due to an intervention in the foreign exchange market by the BOR.

Figure 2. Ruble has recovered some ground against US dollar; oil prices up this year



Source: Haver Analytics; Deloitte Services LP economic analysis.

Graphic: Deloitte University Press | DUPress.com

Challenging times for monetary policy implementation

In May, the BOR announced its intention to bring foreign exchange reserves up to \$500 billion within the next five to seven years.² Toward this goal, the bank is purchasing foreign exchange worth \$100–200 million every day. Data reveal that the BOR purchased \$2.5 billion in May 2015, the largest monthly

forex purchase since April 2012.³ As a result, the ruble has weakened since mid-May. A weak ruble aids Russia’s fiscal health by boosting ruble revenues earned from oil sales denominated in dollars. Traditionally, exporters benefit from a weak currency. However, it is doubtful whether Russian firms, other than arms manufacturers, can corner global market share in the wake of declining competitiveness.

The BOR’s intervention in foreign exchange markets to dent the ruble’s rise is not without criticism. First, it contravenes the idea of keeping monetary and fiscal policies separate. Also, a rising ruble is important for curbing inflationary pressures; the sooner inflation goes down, the better it will be for real incomes. In April, real wages dropped 13.2 percent year over year (figure 3), the sharpest decline since August 1999. Real disposable income declined 4.0 percent during the same period, accelerating from a 1.8 percent decline in the previous month. Add to this a deteriorating labor market—unemployment went up to 5.7 percent in April from 4.9 percent in January—and the stage is set this year for a sharp contraction in household spending, a key growth driver for Russia in recent years.

As inflation heads lower, it will be easier for the central bank to ease monetary policy and shift its focus to growth. Luckily, the BOR has been able to ease policy this year as inflation has eased slightly. On June 15, the central bank cut its key policy rate by 100 basis points (bps) to 11.5 percent. This was the fourth rate cut in 2015, a gradual reversing of policy from December 2014 when the BOR had raised rates to 17 percent to defend the ruble and consequent high inflation. Price pressures appear to have eased a bit after hitting a peak of 16.9 percent in March; in May, inflation fell to 15.8 percent (figure 4). Nevertheless, inflation still remains high, and the BOR would have to tread cautiously before easing policy any further this year. A lot will depend on global oil prices, currency movements, and the West continuing sanctions. An earlier-than-expected rate hike by the US Federal Reserve would, of course, complicate matters for the BOR even more.

Figure 3. Real incomes have fallen, weighing on household spending

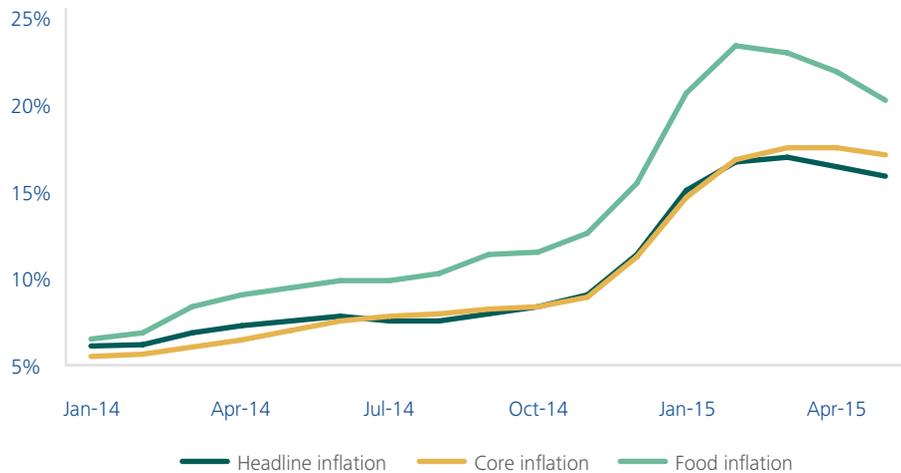
(Growth, year over year)



Source: Haver Analytics; Deloitte Services LP economic analysis.

Graphic: Deloitte University Press | DUPress.com

The economy would have **suffered more** had it not been for a **modest recovery in oil prices.**

Figure 4. Price pressures have reversed a bit after inflation peaked in March

Source: Haver Analytics; Deloitte Services LP economic analysis.

Graphic: Deloitte University Press | DUPress.com

Worries about the banking sector continue

At the heart of Russia's economic contraction is a weak banking sector. Challenges arising from sanctions, the rollover of external private sector debt, ruble volatility, and declining loan demand have dented the sector's performance. Nevertheless, troubles in the banking sector in Russia are not new. Challenges have been growing over the past few years, primarily due to a slowing economy; the current crisis has just made them worse. For example, after improvements during 2010–12, the ratio of nonperforming loans (NPLs) to total gross loans has been edging up (figure 5); in Q1 2015, the figure climbed to 6.9 percent.

Declining asset quality amid a weakening economy has hit earnings and profitability; both return on equity and return on assets nearly halved in 2014 from a year before. And this is likely to get worse as the economic downturn continues. In April 2015, for example, the banking sector incurred losses of \$400 million. Although the figure might be minuscule considering that the sector holds assets worth \$1.5 trillion (as of April 2015), it indicates the rough journey ahead.⁴ Challenges in the banking sector and high interest rates, in turn, have eroded confidence in banks in general. In a survey conducted by the National Agency of Financial Research in April, only 56 percent of respondents expressed trust in banks (either fully or mostly), down from 74 percent in a similar survey a year ago.⁵

Declining investments not only pose **risks for growth in the near term** but also threaten to pull down **potential GDP growth**.

The current scenario, however, offers an opportunity for major changes in the banking sector. For one, consolidation is important and should be encouraged by policymakers. Currently, there are more than 820 banks; as weak banks either go out of business or are acquired by healthier competitors, the sector will become stronger. Banks also need capital, especially given the current crisis. Encouragingly, the BOR has responded by announcing a \$35 billion anticrisis package, including a recapitalization package of 1 trillion rubles for the banking sector, in January 2015.⁶ Furthermore, the BOR's banking sector stress test in May revealed that capital adequacy will remain above the required 10.0 percent even in a "shock scenario" (GDP declining 7.0 percent, inflation at 16.0 percent, and oil at \$40 per barrel).⁷ It is, however, a bit early to judge the impact of the BOR's bail-out package.

Also, there is concern over Russian companies' external debt obligations, given the weak ruble relative to 2014 and the current sanctions regime. Russian companies have debt worth \$100 billion to be refinanced or repaid over the next two years.⁸ It is highly likely that the BOR and the government will have to extend assistance to indebted companies if the companies are to meet their debt obligations. However, the process of selecting beneficiaries (if any) for assistance by the government or the BOR is clouded by the lack of transparency surrounding Russia's public sector. Russia ranked 136 out of 175 nations on Transparency International's 2014 Corruption Perceptions Index, which measures the perceived levels of public sector corruption.⁹

Figure 5. Russian banks under pressure as NPLs rise

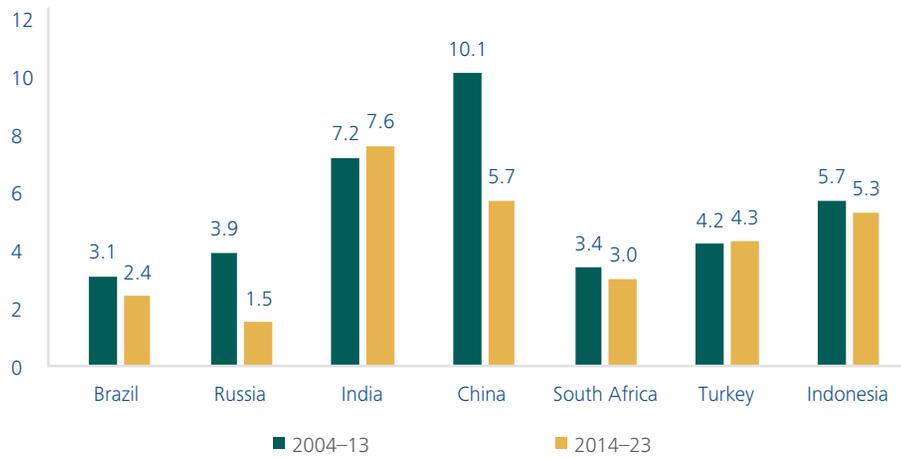


Source: Haver Analytics; Deloitte Services LP economic analysis.

Graphic: Deloitte University Press | DUPress.com

Figure 6. Russia needs to prop up potential GDP growth

(Average annual potential GDP growth, percentage)



Source: Oxford Economics, "Country economic forecasts," June 2015; Deloitte Services LP economic analysis.

Graphic: Deloitte University Press | DUPress.com

Amid deteriorating fundamentals, GDP concerns abound

Current trends indicate that the economy is set for a contraction this year. In April, Russia's monthly index of GDP growth fell 4.2 percent year over year, down from a decline of 2.7 percent in March. Then, in May, the contraction in industrial production and manufacturing activity accelerated. The BOR expects the economy to contract 3.2 percent in 2015.¹⁰ Any recovery next year would depend on oil prices. For example, according to the BOR, if oil prices average \$60 a barrel next year, the economy will contract 1.2 percent; instead, if prices rise to \$70 a barrel, GDP will grow about 0.7 percent.¹¹

Among key components of the economy, declining investments is arguably a more long-term concern. In 2014, total fixed investments fell 2.0 percent. This year, the contraction is likely to be worse. For example, production of machinery and nonelectrical equipment, an indicator of investment activity, fell 14.9 percent in May; this was the fifth straight contraction, and the largest this year. Declining investments not only pose risks for growth in the near term but also threaten to pull down potential GDP growth. According to Oxford Economics, potential GDP growth in Russia will average 1.5 percent per year between 2014 and 2023, much below that of key emerging-economy peers and less than half the country's figure for 2004-13 (figure 6).¹² With the working-age population set to decline at an annual rate of 1.0 percent between 2014 and 2023, a revival in investments is critical. Also needed is a push to upgrade technology and improve the quality of human capital, both of which have been in relative decline given the slow erosion of legacy assets from the erstwhile Soviet Union.

Finally, not much can be achieved without a thriving private sector economy with credible institutions in place. Russia fares poorly in both areas. State intervention in the economy has been rising and has dented efficiency. It is estimated that state ownership of the economy is up to 50 percent of GDP, much higher than the international average of 30 percent.¹³

Similarly, in the World Economic Forum's global competitiveness rankings, Russia's institutions (ranked 97 out of 144 countries) do not bring much cheer.¹⁴

Without addressing these structural flaws, it is unlikely that the Russian economy will improve in competitiveness and hence move to a higher sustainable growth trajectory.

The current crisis should serve as an opportunity for policymakers to implement some tough reforms. Without them, the economy will just mirror the ebb and flow of global hydrocarbon markets.

Endnotes

1. Anna Andrianova, "Russian first-quarter economic slump downwardly revised to 2.2%," *Bloomberg Business*, June 15, 2015, <http://www.bloomberg.com/news/articles/2015-06-15/russian-first-quarter-economic-slump-downwardly-revised-to-2-2->.
2. Andrey Ostroukh, "Bank of Russia plans to bring reserves to \$500 billion in 5-7 years," *Dow Jones Business News*, June 15, 2015, <http://www.nasdaq.com/article/bank-of-russia-plans-to-bring-reserves-to-500-billion-in-5-7-years-20150615-00764>.
3. Bank of Russia, "Data on the Bank of Russia currency interventions (monthly)," May 2015, http://www.cbr.ru/eng/hd_base/default.aspx?prtid=valint.
4. "Russian banks face profit-free future after \$400 million loss in April," *Moscow Times*, May 14, 2015, <http://www.themoscowtimes.com/article/520751.html>.
5. "Russians' trust in banks plummets in economic turmoil," *Moscow Times*, May 19, 2015, <http://www.themoscowtimes.com/business/article/russians-trust-in-banks-plummets-in-economic-turmoil/521784.html>.
6. Jack Farchy and Peter Spiegel, "Russia considers creation of 'bad bank' to aid financial sector," *Financial Times*, January 28, 2015, <http://www.ft.com/intl/cms/s/0/11e60ab6-a6d8-11e4-9c4d-00144fe-ab7de.html#axzz3dUrkVv1y>.
7. Lidia Kelly, "Russian banks have enough capital to weather severe shocks – cenbank," Reuters, May 21, 2015, <http://in.reuters.com/article/2015/05/20/russia-economy-banks-stresstest-idINL5N0YB54M20150520>.
8. Andrew Critchlow, "Russia faces \$100bn corporate debt mountain," *Telegraph*, June 18, 2015, <http://www.telegraph.co.uk/finance/globalbusiness/11683564/Russia-faces-100bn-corporate-debt-mountain.html>.
9. Transparency International, "2014 Corruption Perceptions Index," 2014, <http://www.transparency.org/cpi2014>.
10. Andrey Ostroukh, "Bank of Russia cuts key interest rate to 11.5%," *Wall Street Journal*, June 15, 2015, <http://www.wsj.com/articles/bank-of-russia-cuts-key-interest-rate-to-11-5-1434366079>.
11. Ibid.
12. Oxford Economics, "Country economic forecasts," June 2015.
13. Martin Russell, *The Russian economy: Will Russia ever catch up?* European Parliamentary Research Service, March 11, 2015, [http://www.europarl.europa.eu/RegData/etudes/IDAN/2015/551320/EPRS_IDA\(2015\)551320_EN.pdf](http://www.europarl.europa.eu/RegData/etudes/IDAN/2015/551320/EPRS_IDA(2015)551320_EN.pdf).
14. World Economic Forum, *The global competitiveness report 2014–2015*, September 2, 2014, <http://www.weforum.org/reports/global-competitiveness-report-2014-2015>.

Good growth ahead

By Ian Stewart

AFTER a barnstorming performance in 2014, UK growth unexpectedly eased in the first half of 2015. GDP rose a lackluster 0.3 percent between the fourth quarter of 2014 and the first quarter of 2015, a weaker performance than that of the euro area economy. A slowdown in service sector output was a principal culprit, but the United Kingdom's trade performance remains strikingly weak. The United Kingdom's poor productivity performance, in part the flip side of its success in increasing employment, seems to have weighed on export performance, as has the

strengthening of the British pound against the euro. Yet the fundamental drivers of UK growth are generally supportive, and domestic demand remains perky.

Monetary and financial conditions are easy, with strong growth in consumer credit and signs of a revival in corporate credit demand. The risk appetite in financial markets has been fairly buoyant this year, with risk assets such as equities outperforming bonds. The labor market has tightened significantly in the last year. Employment has hit an all-time high, despite the public sector having shed 1

The risk appetite in financial markets has been fairly buoyant this year, with **risk assets such as equities outperforming bonds.**



A photograph of a rustic stone wall with a wooden door, heavily covered in green ivy. The wall is made of reddish-brown bricks and grey stone. The door is made of dark, weathered wood. The ivy is lush and green, covering most of the wall and the top of the door. The scene is outdoors, with green grass visible at the bottom.

million jobs in the last six years, and the unemployment rate has dropped to an eight-year low of 5.5 percent.¹ Indeed, the United Kingdom has a higher proportion of its working-age population employed than the United States, an economy that Britain has long looked to as a model of labor market flexibility.

A tightening labor market is starting to generate upward pressure on wages after several years of little, if any, growth. Growth in average earnings has accelerated markedly in the last year. And with inflation around zero, and likely to stay thereabouts for the rest of the year, the stage seems set for a long-awaited recovery in consumer spending power.

EU membership

One major uncertainty for the UK economy was resolved in the second quarter of the year. The May 8 general election avoided the widely expected outcome of political gridlock and, instead, delivered a majority Conservative government. This has avoided any precipitous change in or chronic uncertainty around economic policy. But it has, simultaneously, created a significant new uncertainty, with the possibility that UK voters could vote to leave the European Union in a referendum on membership due to take place within the next two years. This seems an outside chance rather than the

most likely outcome: The referendum campaign is likely to see all political parties, with the exception of the UK Independence Party, campaign for continued membership (albeit with a significant minority of Conservative Party MPs campaigning for withdrawal). Moreover, most business lobby groups seem set to support continued membership.

Public opinion has already shifted in a more pro-EU direction. A Pew Research Center survey carried out in the second quarter of 2015 showed support for remaining in the European Union at 55 percent, with 36 percent of voters favoring leaving the European Union.² Predicting the outcome of polls two years ahead is a highly speculative business, but from where we are at the moment, the most likely outcome seems to be that the United Kingdom will stay in the European Union.

Will productivity improve?

We conclude by returning to the question of UK productivity, widely regarded as the Achilles' heel of the British economy. Many economies have faced a slowdown in productivity growth since the financial crisis, but among the industrialized economies, the United Kingdom's performance has been conspicuously poor.

One comforting theory is that output has been underestimated in recent years, and, as a result, productivity growth has been underestimated. Certainly GDP numbers are choppy and prone to revision, often years after the event. If GDP gets revised up—and it often does—the United Kingdom's productivity performance will look better. Another angle on this theme is that technology is raising welfare in ways that are not being recognized in conventional measures of economic activity—for instance, people getting free music and videos via video-streaming sites or using free online map services.

But, for us, a leading suspect in this story is that the financial crisis made credit hard to come by, companies became averse to risk, and investment and innovation collapsed. The resulting deterioration in the United Kingdom's stock of tangible and intangible assets—from machinery and buildings to highly trained workers, and research and development—has made employees less productive.

If this is the case, then a revival in capital spending will, in time, reboot productivity. Collectively, UK companies have ample reserves of cash. The largest businesses, which are the main drivers of capital spending, have good access to credit. The corporate sector probably has the means to invest, and, with

existing capital assets wearing out, they have a growing need to do so.

The next few years are likely to see stronger capital spending, which will give a fillip to productivity. At the same time, rising demand will mean more work for existing employees—who during the downturn might have been involved in internal projects, marketing, and bidding—and this will reinforce the recovery in productivity.

More time and investment should help revive UK productivity growth. If not, the United Kingdom is moving into an era of slower growth as well as slower growth in living standards.

Endnotes

1. Thomson Reuters Datastream, accessed June 2015.
2. Bruce Stokes, *Faith in European project reviving: But most say rise of Eurosceptic parties is a good thing*, Pew Research Center, June 2, 2015, <http://www.pewglobal.org/2015/06/02/faith-in-european-project-reviving/>.

Different stories from the same book

By Akrur Barua

THE news out of India in the past few months has been intriguing. According to the first estimate of national accounts data for Q1 2015, economic activity picked up during the quarter. In fact, at 7.5 percent year over year, GDP growth was higher than that of China (7.0 percent). To the casual observer, such a healthy growth figure would appear out of place with growing calls for more growth-oriented monetary policy. Indeed, on June 2, the Reserve Bank of India (RBI) cut its key policy rate by 25 basis points (bps), the third such move this year. Apparently that was not enough for the equity markets; India's wider NIFTY index ended 2.3 percent lower on June 2.

Concerns about growth and the need for stimulus are not surprising given that, apart from GDP numbers, other economic indicators have been rather subdued. These include data for credit growth, manufacturing activity, and corporate profits. Of course, this has led to much debate on the new GDP series introduced earlier this year.¹ No wonder then that the RBI has been circumspect, preferring to strike a balance between the new GDP numbers and the weakness in key economic indicators while framing

monetary policy. And, with inflation going down, the central bank decided on another dose of policy loosening to stimulate growth.

Growth moves up, albeit with weaknesses

The Indian economy picked up pace in Q1 2015, which is also the last quarter of India's financial year 2014–15 (or Q4 FY 2015). GDP growth went up to 7.5 percent year over year from 6.6 percent in the previous quarter (figure 1). This took overall growth for FY 2015 to 7.3 percent, up from 6.9 percent in FY 2014. While annual growth was a tad lower than the Central Statistics Office's 7.4 percent forecast in February, it was nevertheless the fastest pace in the last four years.²

In Q4 FY 2015, the economy benefitted from strong private consumption growth, which almost doubled from the previous quarter to 7.9 percent. The recovery in private consumption augurs well for the economy given the sector's large share (about 60 percent) in GDP. Government consumption fell 8.0 percent as the government tried to get the fiscal deficit



down to the targeted 4.1 percent of GDP by the end of the fiscal year. Encouragingly, the government was successful: Latest data show that the deficit fell a little below 4.0 percent of GDP.

Exports continue to be a big worry, contracting 8.2 percent in Q4 FY 2015; this was the sharpest decline since Q1 FY 2013 from when the new GDP series became available. Like exports, investments have been feeling the heat due to delayed projects, debt-laden corporations, deteriorating asset quality in banks, and high interest rates. Gross fixed capital formation grew 4.1 percent in Q4 FY 2015, up from 2.4 percent in the previous quarter. However, the figure is lower than at the start of the financial year and much below levels required to push GDP growth to the coveted double-digit mark.³

Worrying trend of falling exports

Declining exports (figure 2) do not fit well with the government's ambitious targets, including the Make in India campaign. In March, goods exports fell 21.3 percent year over year, the sharpest decline since July 2009, when the world was in the grip of the global financial crisis. The story hasn't changed much in April and May. A number of factors are weighing on India's exports. First, weak growth in Europe and the United States has dented the demand for exports.

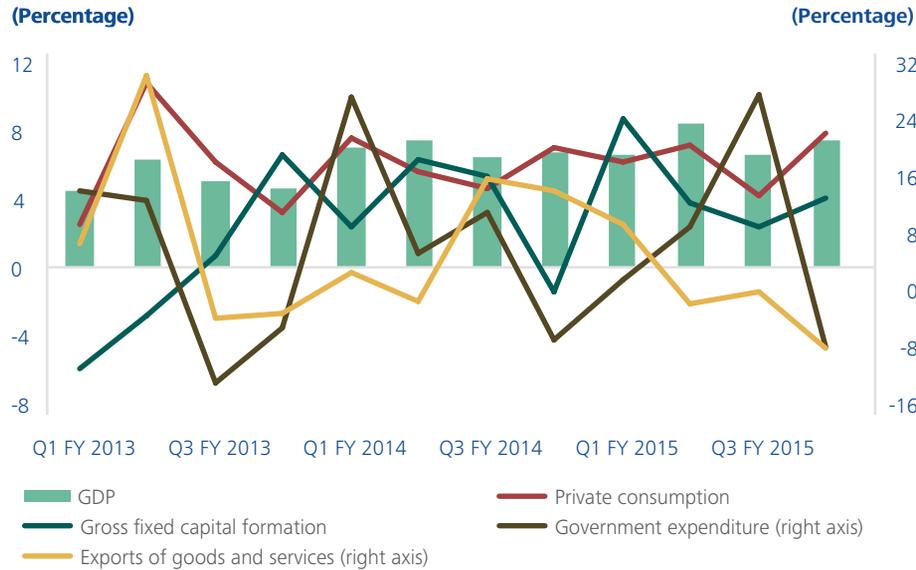
Second, exporters have lost out due to the Indian rupee's gain against major currencies (figure 3). Concerns about the US Federal Reserve potentially raising interest rates in the next six months has sent emerging market currencies down; among these, the rupee has fared relatively well. Also, central banks in Europe (the European Central Bank, the Swiss National Bank) and Asia (the Bank of Japan) have carried out aggressive monetary easing, thereby sending their currencies lower. These central banks' actions have also increased currency volatility, a bigger headache for exporters. Another reason volatility has gone up is emerging risks such as the crisis in Greece and a probable equity bubble in China. The flux in currency markets will continue in the near term, keeping the pressure on India's exporters even though the rupee will likely depreciate against the US dollar going forward.

RBI cuts rates again to stimulate growth

On June 2, the RBI cut its key policy rate by 25 bps to 7.25 percent. A rate cut was definitely on the cards. Data available before the decision showed retail inflation going down to 4.9 percent in April, a four-month low (in May, it went up marginally). However, inflation is not the only reason that the RBI chose to ease monetary policy; the central bank is worried about continued weakness in key economic indicators, especially

The **flux in currency markets** will continue in the near term, keeping the pressure on India's exporters even though **the rupee will likely to depreciate** against the US dollar going forward.

Figure 1. Growth appears to be back on track



Source: Haver Analytics, June 2015; Deloitte Services LP economic analysis.

Graphic: Deloitte University Press | DUPress.com

credit growth (figure 4) and fixed investments. No wonder then that the RBI has eased rates thrice this year by a total of 75 bps.

The RBI's choice of a 25 bps cut, and not a larger one, on June 2 was due to a number of factors. First, although inflation is currently low (figure 5), the RBI expects price pressures to rise due to the weak monsoon's impact on food prices. The Indian Meteorological Department

has predicted that total rainfall this monsoon season will be only 88 percent of the long-period average.⁴ Also, inflation could rise if there is any sharp upward movement in global oil prices and the government holds firm on its new policy of market-determined domestic fuel prices.

Second, the central bank appears cautious about the impact of rate cuts. The percolation

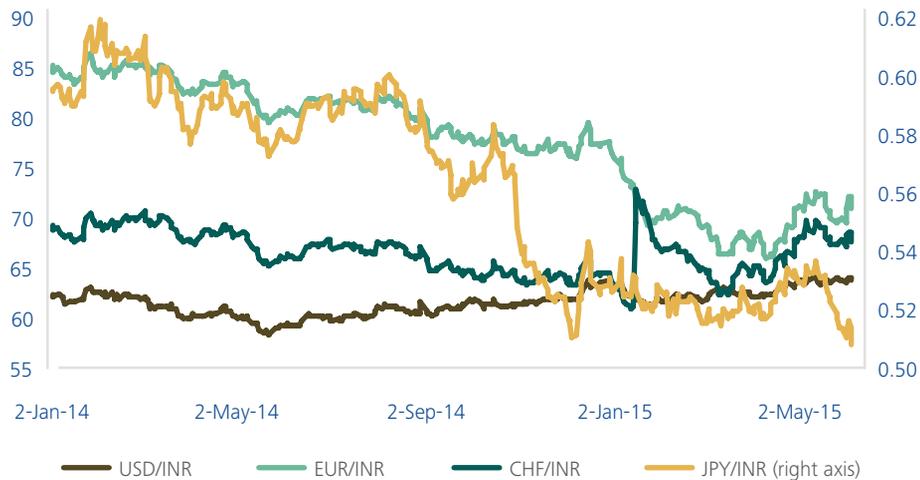
Figure 2. Merchandise exports (USD) have been trending downward over past few months



Source: Haver Analytics, June 2015; Deloitte Research economic analysis.

Graphic: Deloitte University Press | DUPress.com

of rate changes throughout the banking system is important for the success of monetary policy. The two previous rate cuts this year have not been mirrored by the banking system (or at least by a large part of it), much to the chagrin of the RBI.⁵ Observing recent behavior, it is likely that the RBI has chosen to “wait and watch” before loosening policy further.

Figure 3. Rupee has made gains against euro and yen since Q4 2014

Source: Haver Analytics, June 2015; Deloitte Services LP economic analysis.

Graphic: Deloitte University Press | DUPress.com

The clear demarcation of powers between the RBI and a debt management agency will **prevent a conflict of interest** that is apparent in the present system.

Finally, the RBI appears committed to restoring its inflation-fighting credibility, which had taken a hit during 2010–12. The central bank is also intent on forcing the government to take care of supply-side changes, a key factor behind inflationary pressures in India. The RBI is likely to match any fiscal consolidation efforts by the government. After rewarding a decline in the fiscal deficit with a surprise rate cut in March, the RBI will wait for more progress on fiscal correction before any loosening.⁶

It's not just about cutting rates but also strengthening banks

So far this year, bank lending hasn't gone up due to the RBI's rate cuts. There are multiple reasons behind this. First, Indian banks are under stress given rising nonperforming assets (NPAs) in their portfolios (figure 6). Moreover, the current NPA figure (4.4 percent of gross assets) understates the problem. According to ICRA, a lagged recognition of bad assets will push up NPAs this financial year to 5.9 percent; the figure goes up to 9.5–10.5 percent if restructured loans are included.⁷

NPAs for public sector banks (PSBs), which account for about 70 percent of total bank assets in India, are a big worry. For example, in 2013, PSBs had NPAs worth 4.4 percent of total assets; in contrast, the figure for new private sector banks was 1.8 percent. So any revival in credit growth is unlikely without an improvement in the balance sheets of PSBs. This requires capital infusion; the current budgeted amount of 69.9 billion rupees is inadequate.⁸ Also, while the current policy of targeting more efficient PSBs for capital infusion seems prudent, the problems of less efficient banks also must be tackled. The government appears to be in favor of merging weaker PSBs with larger, better-placed ones.⁹ Until now, however, not much of a roadmap has been available, and it could be a while before any consolidation takes place.

The government would benefit from taking this opportunity to improve bankruptcy laws and corporate governance rules, which will go a long way in solving the problem of asset quality in banks. Encouragingly, in the budget for FY 2016, the government has stated that it intends to introduce a comprehensive bankruptcy code this financial year. While the government has taken a few steps to better manage PSBs to improve their efficiency and allow them to compete better with their private sector counterparts, these steps are not enough.¹⁰ A good way forward for the government would be to gradually reduce its stake in PSBs to less than 50 percent and cede management control. Also, to increase competition and avenues of credit, the government should relook at policies regarding operations of foreign banks and the current slow pace of granting new bank licenses.

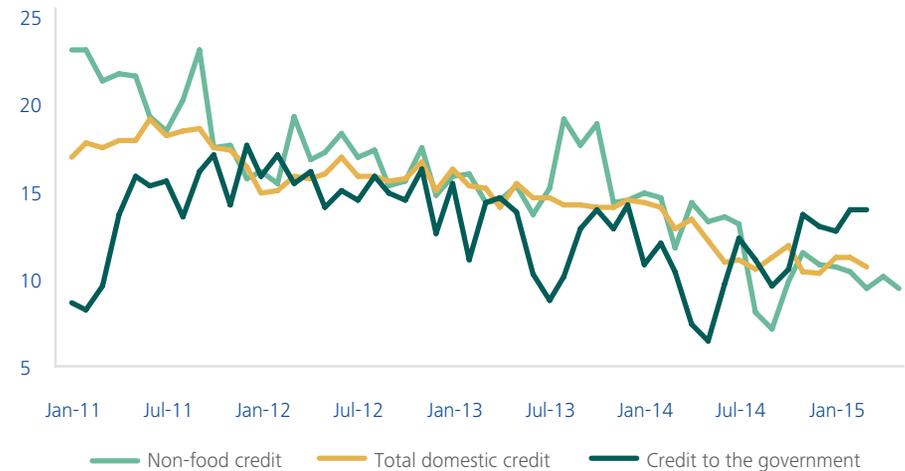
Need to up the ante on reforms

Declining capital quality in banks is not the only problem hindering credit and investments. Low financing opportunities raise the need for other avenues of credit such as well-functioning bond markets. While the budget for FY 2016 proposed setting up a public debt management agency and granting greater power to the Securities and Exchange Board of India to set the base for a strong bond market, the government has now gone back on its position, probably heeding RBI protests.¹¹

The clear demarcation of powers between the RBI and a debt management agency will prevent a conflict of interest that is apparent in the present system. Currently, the RBI sets monetary policy to target inflation and also manages the government's debt. The first task, which is to set rates, seems to be at odds with the second, which is to be the government's investment banker. Without separating these two responsibilities, it will not be possible to set up a vibrant bond market with a sound yield curve.

Figure 4. Commercial bank credit to private sector has been slowing down

(Percentage, year over year)

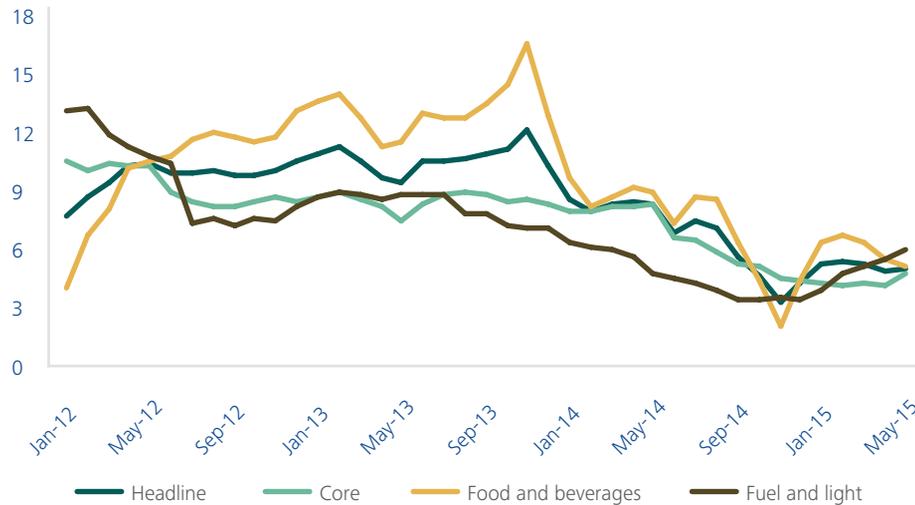


Source: Haver Analytics, June 2015; Deloitte Services LP economic analysis.

Graphic: Deloitte University Press | DUPress.com

Figure 5. Poor monsoon could force up food prices and hence inflation

(Percentage, year over year)



Source: Haver Analytics, June 2015; Deloitte Services LP economic analysis.

There appears to be not much headway in setting up a monetary policy committee within the RBI. Such a committee is critical for conduct of monetary policy, especially given the RBI's mandate to target inflation under the new monetary policy framework agreement.¹² Other reforms also seem to be stuck. In the previous session of parliament, bills for introducing a goods and services tax and for acquiring land were postponed. All eyes will now be on the next parliament session for progress on these bills.

Figure 6. As NPAs have gone up in India's banking sector, return on equity has fallen



Source: Haver Analytics, June 2015; Deloitte Services LP economic analysis.

Graphic: Deloitte University Press | DUPress.com

Getting some of those reforms passed will be a test for the government. But without these reforms, the positive economic momentum created by the current government's election in 2014 will wane. This could take some of the shine off the government's efforts to attract global investors and help India become an economic powerhouse in the medium to long term. It will also test the government's credibility, especially given its poll promises to accelerate economic growth.

Endnotes

1. Rumki Majumdar, "India: Big-bang changes to growth and a forward-looking budget," *Global Economic Outlook*, Q2 2015, Deloitte University Press, April 21, 2015, <http://dupress.com/articles/global-economic-outlook-q2-2015-india/>.
2. Central Statistics Office, "Press note on advance estimates of national income 2014-15 and quarterly estimates of gross domestic product for the third quarter (Q3) 2014-15," Government of India, February 9, 2015, http://mospi.nic.in/Mospi_New/upload/Press_note_for_Q3_AE_2014-15.pdf.
3. Puja Mehra, "Time ripe to shift gears for double-digit growth: Jaitley," *Hindu*, May 23, 2015, <http://www.thehindu.com/news/national/time-ripe-to-shift-gears-for-doubledigit-growth-jaitley/article7236594.ece>.
4. Reuters, "IMD forecast: 66 percent chance of deficient rain," *Indian Express*, June 3, 2015, <http://indianexpress.com/article/india/india-othersindia-downgrades-monsoon-forecast-from-93-to-88-percent-stokes-drought-fears/>.
5. "Raghuram Rajan indicates banks have no excuse not to pass on rate cuts," *Economic Times*, April 7, 2015, http://articles.economictimes.indiatimes.com/2015-04-07/news/60902902_1_lending-rates-raghuram-rajan-policy-rate; NDTV Profit, "RBI wants banks to cut lending rates to bring down EMIs," June 2, 2015, <http://profit.ndtv.com/news/economy/article-rbi-wants-banks-to-cut-lending-rates-to-bring-down-emis-767960>.
6. Rafael Nam and Neha Dasgupta, "RBI surprises again with post-budget rate cut," Reuters, March 4, 2015, <http://in.reuters.com/article/2015/03/04/rbi-monetary-policy-rat-cut-idINKBN0M007Y20150304>.
7. "Indian banks' NPA to remain high at 9-10 percent, says ICRA," *Economic Times*, June 9, 2015, <http://economictimes.indiatimes.com/industry/banking/finance/banking/indian-banks-mpa-to-remain-high-at-9-10-per-cent-says-icra/articleshow/47595414.cms>; "Nearly 40 percent of recast loans could slip into NPAs: ICRA," *Financial Express*, June 8, 2015, <http://www.financialexpress.com/article/industry/banking-finance/nearly-40-of-recast-loans-could-slip-into-npas-icra/81895/>.
8. "FinMin, banks to mull on higher capital infusion for PSBs," *Business Standard*, June 12, 2015, http://www.business-standard.com/article/economy-policy/finmin-banks-to-mull-on-higher-capital-infusion-for-psbs-115061100956_1.html; Ritu Singh, "RBI urges FinMin to double capital infusion in PSU banks," *CNBC-TV18*, June 12, 2015, http://www.moneycontrol.com/news/cnbc-tv18-comments/rbi-urges-finmin-to-double-capital-infusionpsu-banks_1405197.html.
9. Remya Nair and Anup Roy, "Government to push bank reforms, may encourage mergers," *Live Mint*, March 2, 2015, <http://www.livemint.com/Industry/gzFxdJUfPYZZCs9AJeKy0L/Govt-to-push-bank-reforms-may-encourage-mergers.html>.
10. T. T. Ram Mohan, "Get real with public sector banks," *Hindu*, May 16, 2015, <http://www.thehindu.com/opinion/op-ed/dealing-with-management-and-operational-issues-of-public-sector-banks/article7211093.ece>; Suvashree Choudhury and Rajesh Kumar Singh, "India to tighten screws on banks' window dressing of accounts," Reuters, June 9, 2015, <http://in.reuters.com/article/2015/06/08/india-banks-accounts-idINKBN0OK1K020150608>.
11. NDTV Profit, "Arun Jaitley postpones move to clip RBI's wings on public debt," May 1, 2015, <http://profit.ndtv.com/news/economy/article-arun-jaitley-postpones-move-to-clip-rbis-wings-on-public-debt-759699>.
12. Ministry of Finance, *Agreement on monetary policy framework*, Government of India, February 20, 2015, <http://finmin.nic.in/reports/MPFAGreement28022015.pdf>; Reserve Bank of India, *Report of the expert committee to revise and strengthen the monetary policy framework*, January 2014, https://rbidocs.rbi.org.in/rdocs/PublicationReport/Pdfs/ECOMRF210114_F.pdf.

No escape from a contraction

By Akrur Barua

THIS year was never going to be easy for Brazil. It started with a fiscal austerity overdrive, and rightly so, given the profligacy of the last four years. In addition to aiming to raise revenue, the government cut spending, including subsidies on fuel and electricity. Consequently, administered prices have shot up, forcing inflation higher. But it was not as if price pressures were low to start with. Inflation has been above the midpoint of the Banco Central do Brasil's (BCB's) target range of 2.5–6.5 percent since September 2010. A bout of rate cuts in 2011–12 was ill

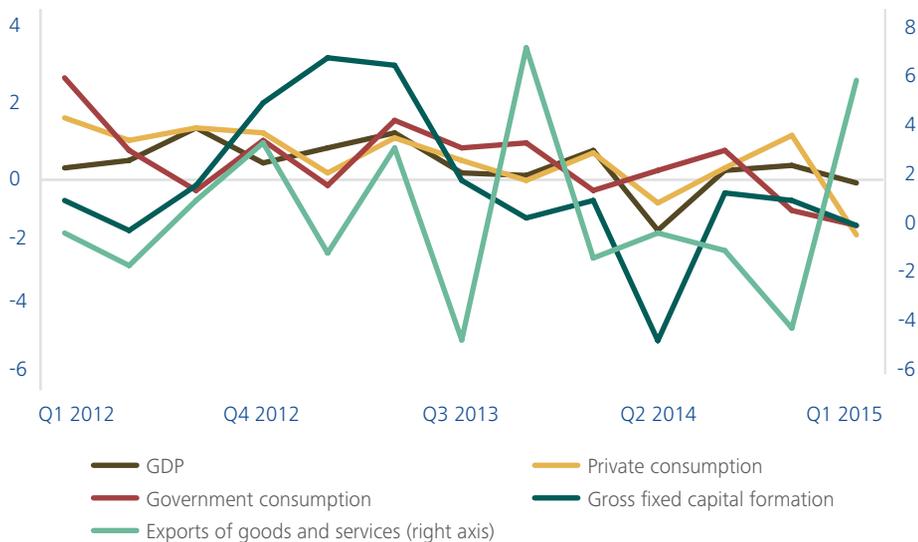
timed and dented the BCB's credibility. Thankfully, the BCB appears intent on regaining lost ground and getting inflation under control. It has raised the key SELIC rate a total of 275 basis points (bps) since October 2014, setting a hawkish tone for its policy outlook. As expected, the mix of tough fiscal austerity and monetary tightening is taking a heavy toll on domestic demand. With the labor market deteriorating, and pessimism rife among consumers and businesses, the stage is set for a recession this year.

As expected, the mix of **tough fiscal austerity and monetary tightening** is taking a heavy toll on domestic demand.



Figure 1. Falling investments and private consumption dragged down GDP growth in Q1 2015

(Percentage, quarter over quarter)



Source: Haver Analytics, June 2015; Deloitte Services LP economic analysis.

Graphic: Deloitte University Press | DUPress.com

Falling domestic demand drags down economy in Q1

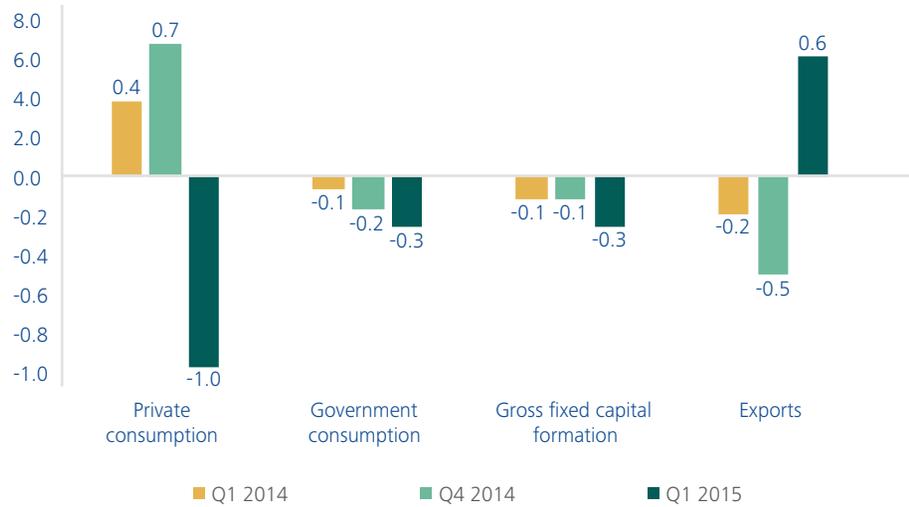
Brazil's GDP contracted 0.2 percent quarter over quarter in Q1 2015, reversing from a 0.3 percent rise in Q4 2014. Domestic demand was hit hard in Q1, falling 1.4 percent due to contractions in three key components: private consumption, investment, and government expenditure (figure 1). Private consumption, which has been the mainstay of GDP growth in recent years, fell 1.5 percent in Q1 2015. This was a sharp deterioration from a 1.1 percent rise in Q4 2014 (figure 2). Households, which were already reeling from high debt, are now having to cope with rising unemployment, high inflation, subsidy cuts, and rising interest rates.

Weakening private consumption is one in a series of bad news for investment activity in Brazil; business confidence is already low, and the cost of capital is rising. It is not surprising then that gross fixed capital formation fell 1.3 percent in Q1 2015, down from a 0.6 percent decline in Q4 2014. A scandal at oil giant Petrobras has not helped either; the company has already shelved its investment targets for this year. The scandal is also likely to affect government projects, especially those in infrastructure and where subcontracting is involved.¹ Fiscal support for the economy will only get worse as the government tightens finances and tries to prevent a sovereign rating downgrade. For example, in Q1, government consumption fell 1.3 percent compared with the 0.9 percent contraction in Q4 2014.

Economic growth in Q1 would have been worse had it not been for a jump in net exports. Exports rebounded in Q1, rising 5.7 percent. And although imports grew 1.2 percent during the quarter, net exports still contributed strongly to GDP growth. Exports are likely to have benefited from primary sector shipments and an increase in coffee prices in Q1. Part of this is reflected in a 4.7 percent expansion in agriculture in Q1; mining and petroleum also fared well (3.3 percent). In contrast, both industry (-0.3 percent) and services (-0.7 percent) declined, reflecting the strong contraction in domestic demand during the quarter.

Figure 2. Sharp fall in contribution of private consumption to GDP growth in Q1 2015*

(Percentage, quarter over quarter)



*Calculations are based on quarterly seasonal adjustment by Haver Analytics.

Source: Haver Analytics, June 2015; Deloitte Services LP economic analysis.

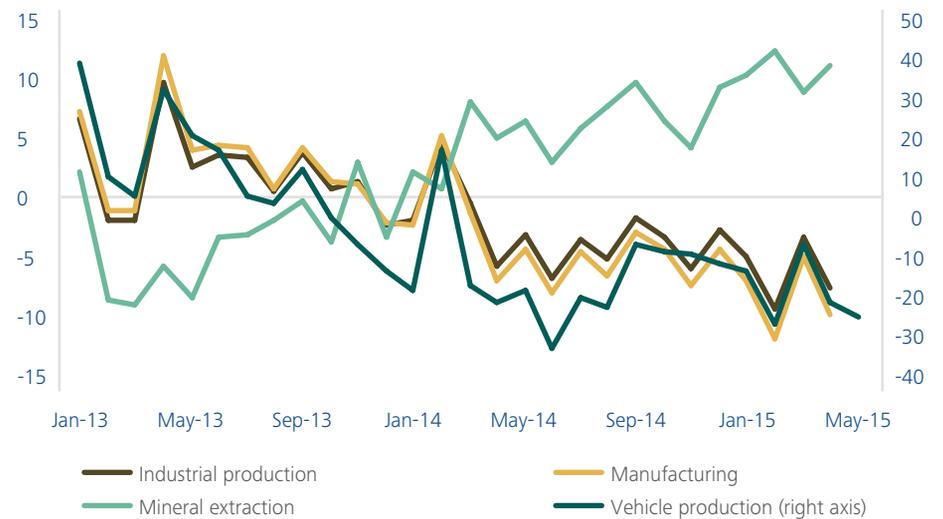
Graphic: Deloitte University Press | DUPress.com

It's not getting any better in Q2

Brazil's woes will not go away any time soon. Latest data indicate a likely contraction in GDP in Q2 as well, thereby ushering in a recession. In April, industrial production fell 7.6 percent year over year, the 14th straight month of contraction. Similarly, data for the purchasing managers' index (PMI) show that manufacturing activity in May fell to its lowest level since September 2011 (figure 3).² Within manufacturing, the auto industry

Figure 3. Manufacturing has not done well since 2013; mineral extraction is rare bright spot

(Percentage, year over year)



Source: Haver Analytics, June 2015; Deloitte Services LP economic analysis.

Graphic: Deloitte University Press | DUPress.com

has been hit hard. An end to fiscal sops for car purchases and rising interest rates are weighing on car sales. Seasonally adjusted domestic automotive sales fell a little less than 7.0 percent month over month in May, while production dropped 7.6 percent.³ The National Association of Automobile Manufacturers (ANFAVEA) expects sales to drop a staggering 20.6 percent this year, and production by 17.8 percent.⁴

The industry slowdown is denting the labor market. Data for the manufacturing PMI reveal that in May firms cut jobs at the fastest pace since July 2009.⁵ In the auto industry, ANFAVEA says that payrolls have shrunk 9 percent in the past year; about one in six workers appear to be in furlough.⁶ The story is similar in construction, where about 293,000 workers have lost jobs between October 2014 and April 2015.⁷ All these factors have impacted unemployment (figure 4). In April, the unemployment rate went up to 6.4 percent from 6.2 percent in March. April's unemployment figure is the highest since May 2011.

BCB continues hawkish stance

On June 3, the BCB raised its benchmark SELIC rate by 50 bps to 13.75 percent, the highest rate since January 2009. This hawkish stance, no doubt, aims to both restore credibility and dent price pressures. The BCB aims to bring inflation down to 4.5 percent by December 2016.⁸ Despite the rate hikes, price pressures remain elevated (figure 5) due to a hike in administered prices (fuel and electricity). In May, inflation went up to 8.5 percent from 8.2 percent in April. May's inflation figure was the highest since December 2003. As a result, and also due to financial markets' continued wariness about the BCB's credibility, inflation expectations for 2016–19 remain high.

Nevertheless, the BCB has gained some ground in its efforts to force inflation expectations down. For example, inflation expectations for 2016 have fallen to 5.5 percent.⁹ They could decline further if the BCB sticks to its tight monetary policy; to force down expectations,

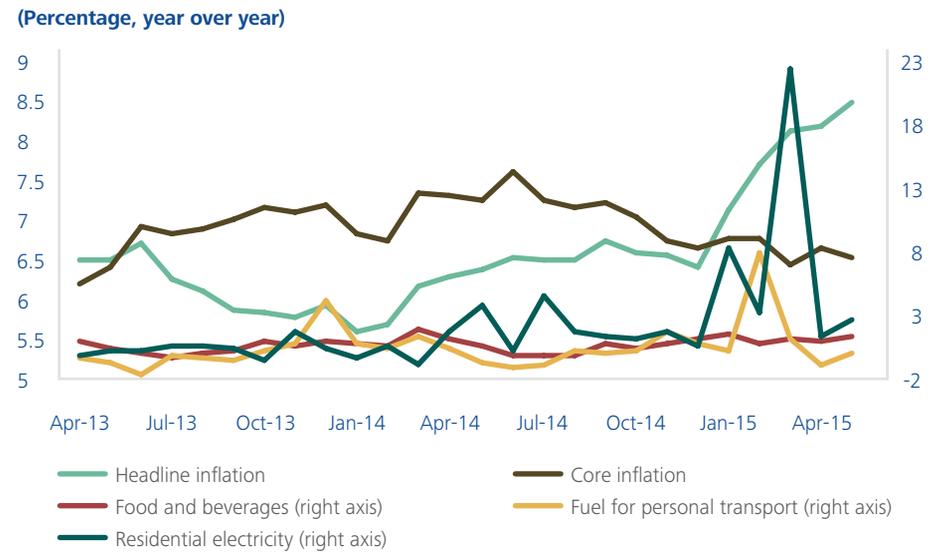
Figure 4. Unemployment has gone up this year; retail sales are feeling the heat



Source: Haver Analytics, June 2015; Deloitte Services LP economic analysis.

Graphic: Deloitte University Press | DUPress.com

Figure 5. Price pressures remain elevated



Source: Haver Analytics, June 2015; Deloitte Services LP economic analysis.

Graphic: Deloitte University Press | DUPress.com

Weakening private consumption is one in a **series of bad news for investment activity in Brazil**; business confidence is already low, and the cost of capital is rising.

Figure 6. Real has lost ground against US dollar and euro



Source: Haver Analytics, June 2015; Deloitte Services LP economic analysis.

Graphic: Deloitte University Press | DUPress.com

the BCB could hike the SELIC rate another 25–50 bps this year. Like many of its global peers, the BCB could do better in communicating its policy stance. For example, contrary to the BCB’s hawkish message, markets currently expect the SELIC rate to come down in early 2016. This is not helpful in getting inflation expectations down, and the BCB needs to find ways to make its policy decision more transparent, and hence credible.¹⁰

Overall, inflation is likely to slow down in 2016 as the base effect of the hike in administered prices sets in; slowing aggregate demand will also weigh on inflation next year. This year, though, there will be little respite from surging prices. Economists surveyed by the BCB expect inflation to end this year at 8.5 percent; it will be the first year since 2004 when inflation will likely end above the BCB’s ceiling (6.5 percent). In 2016, inflation is expected to fall to 5.5 percent.¹¹

The currency could, however, play spoilsport for the BCB if the US Federal Reserve (Fed) hikes rates ahead of market expectations. This year, for example, the Brazilian real has gone down 14 percent against the US

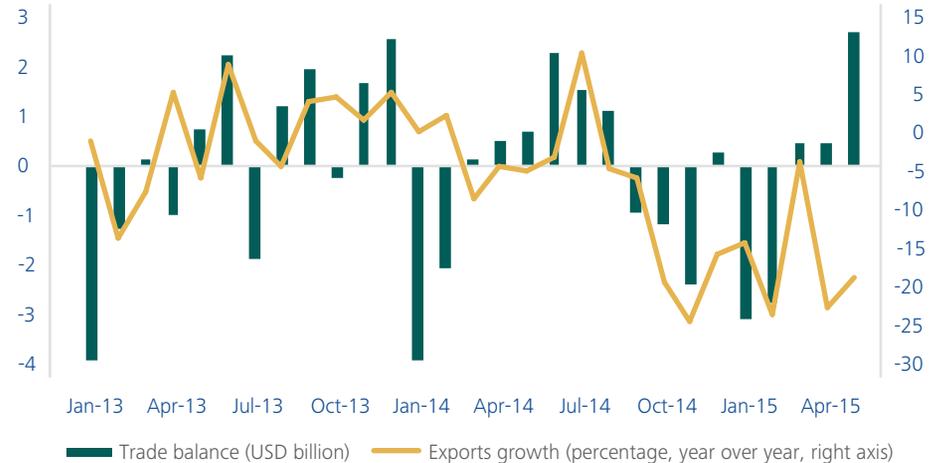
dollar (figures 6 and 7). However, fears of a Fed rate hike are not the only factor contributing to the real's weakness; the currency is also suffering from negative external balances. For example, in Q4 2014, the current account deficit (not seasonally adjusted) deteriorated to 5.3 percent of GDP, a level not witnessed since Q4 2001; the deficit has not got any better this year.

Despite the real's strong decline, it is likely that the currency has almost run its downward course for the near term. As the economy slowly starts to recover next year, and fiscal health improves, the real is likely to find some support.

Contraction in 2015

A tight monetary policy, subsidy cuts, and a worsening labor market will keep the pressure on consumers in 2015. In May, consumer confidence, as measured by the Getulio Vargas Foundation, fell to 85.1 from

Figure 7. On year-over-year basis, goods exports (in USD) have been weak since mid-2014



Source: Haver Analytics, June 2015; Deloitte Services LP economic analysis.

Graphic: Deloitte University Press | DUPress.com

Overall, **inflation is likely to slow down in 2016** as the base effect of the hike in administered prices sets in; **slowing aggregate demand** will also weigh on inflation next year.

85.6 in April; the index inched back to a record low set in March.¹² Consumer pessimism is weighing on private spending in Q2 and will continue to for the rest of the year. As a result, private consumption growth for the whole of 2015 is likely to slip into negative territory from 0.9 percent in 2014.

The economy will also have to bear with weak investments and falling government spending. Private investment is already low, and declining business confidence—which, in May, fell to its lowest level in nearly five years—will not help. External demand is not likely to come to the

economy's rescue given slowing growth in China, a key export market for Brazil's commodities. And although a weak real will make Brazilian exports competitive, the country's declining fortunes in manufacturing have left it too weak to take much market share from others.

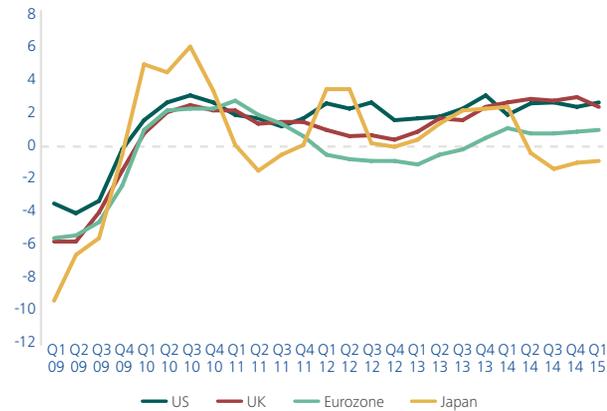
In this scenario, GDP is set to shrink in 2015. Results from the latest BCB survey of economists show that GDP is likely to contract 1.3 percent this year before returning to moderate growth of 1 percent in 2016.¹³ If this happens, 2015 will witness Brazil's worst economic performance in the last quarter century.

Endnotes

1. Akrur Barua, "Brazil: Into the storm," *Global Economic Outlook*, Q2 2015, Deloitte University Press, April 21, 2015, <http://dupress.com/articles/global-economic-outlook-q2-2015-brazil/>.
2. Markit Economics, "Markit Brazil manufacturing PMI," June 1, 2015, <http://www.markiteconomics.com/Survey/PressRelease.mvc/773a3b32453a43ae9d38c8d716ac9b06>.
3. Haver Analytics, June 2015.
4. Aluisio Alves, "Update 1: Brazil auto industry sees steepest downturn in 17 years," Reuters, June 8, 2015, <http://www.reuters.com/article/2015/06/08/brazil-autos-idUSL1N0YU0ZW20150608>.
5. Markit Economics, "Markit Brazil manufacturing PMI."
6. Alves, "Update 1."
7. Jeffrey T. Lewis and Will Connors, "Brazil GDP shrinks in first quarter," *Wall Street Journal*, May 29, 2015, <http://www.wsj.com/articles/brazil-economy-contracts-less-than-expected-in-first-quarter-1432903544>.
8. Silvio Cascione, "Brazil set for another steep rate hike despite recession signs: Reuters poll," Reuters, May 29, 2015, <http://www.reuters.com/article/2015/05/29/us-brazil-economy-interest-rate-idUSKBN0OE2BJ20150529>; Paulo Trevisani, "Brazil raises key interest rate to 13.75 percent amid stagflation," *Wall Street Journal*, June 3, 2015, <http://www.wsj.com/articles/brazil-raises-key-interest-rate-to-13-75-1433374362>.
9. Reuters, "Brazil raises interest rates again, signals more hikes," *CNBC*, June 3, 2015, <http://www.cnn.com/id/102731413>.
10. Silvio Cascione and Walter Brandimarte, "Brazil's central bank faces growing concern on rate hikes," Reuters, May 28, 2015, <http://www.reuters.com/article/2015/05/28/brazil-cenbank-idUSL1N0YH2FJ20150528>.
11. Reuters, "Table: Brazil 2015 inflation estimates rise - central bank survey," June 8, 2015, <http://www.reuters.com/article/2015/06/08/brazil-cenbank-survey-idUSEMNF630RX20150608>.
12. Julia Leite, "Brazilian stocks post world's worst drop as pessimism takes hold," *Bloomberg*, May 26, 2015, <http://www.bloomberg.com/news/articles/2015-05-26/worsened-consumer-confidence-in-brazil-sinks-ibovespa-futures>.
13. Reuters, "Table: Brazil 2015 inflation estimates rise - central bank survey."

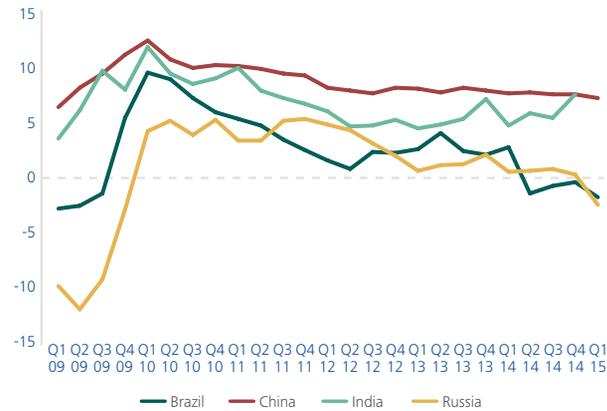
Economic indices

GDP growth rates (percentage, year over year)



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

GDP growth rates (percentage, year over year)



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

Inflation rates (percentage, year over year)



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

Inflation rates (percentage, year over year)



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

Major currencies vs. the US dollar



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

Yield curves (as of June 19, 2015)*

	US Treasury bonds & notes	UK gilts	Eurozone govt. benchmark	Japan sovereign	Brazil govt. benchmark	China sovereign	India govt. actives	Russia‡
3 months	0.00	0.52	-0.19	0.00	14.04	1.70	7.67	9.99
1 year	0.22	0.49	-0.15	0.01	14.25	1.84	7.68	10.31
5 years	1.63	1.50	0.14	0.10	12.78	3.34	7.87	11.27
10 years	2.33	2.04	0.81	0.45	12.55	3.61	7.70	10.85

Composite median GDP forecasts (as of June 19, 2015)*

	US	UK	Eurozone	Japan	Brazil	China	Russia
2015	2.2	2.5	1.5	0.9	-1.2	7	-3.6
2016	2.8	2.4	1.7	1.5	1	6.7	0.5
2017	2.7	2.4	1.5	0.7	2	6.5	1.5

Composite median currency forecasts (as of June 19, 2015)*

	Q3 15	Q4 15	Q1 16	Q2 16	2015	2016	2017
GBP-USD	1.51	1.5	1.49	1.5	1.5	1.52	1.57
Euro-USD	1.07	1.05	1.05	1.05	1.05	1.1	1.14
USD-Yen	125	125	126	126	125	127	127
USD-Brazilian real	3.25	3.3	3.32	3.35	3.3	3.38	3.58
USD-Chinese yuan	6.21	6.2	6.2	6.19	6.2	6.15	6.1
USD-Indian rupee	64.33	64.6	64.75	65.6	64.6	65	62
USD-Russian ruble	56.1	56	57	55	56	56.5	55.97

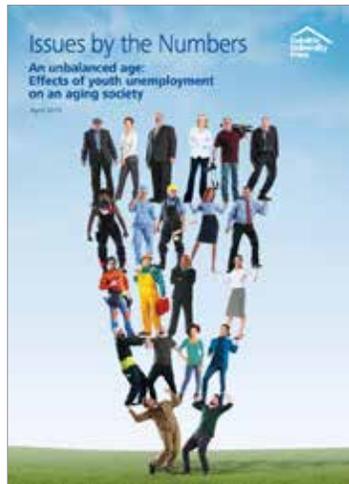
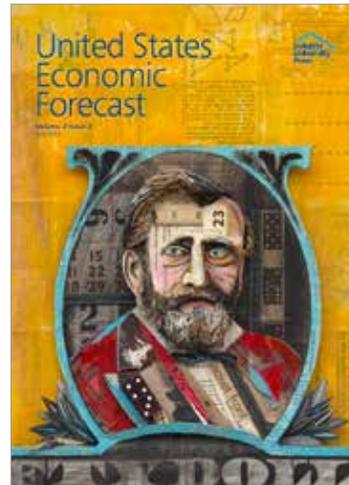
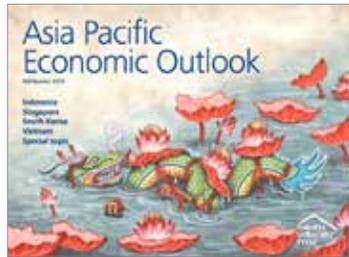
OECD composite leading indicators (amplitude adjusted)†

	US	UK	Eurozone	Japan	Brazil	China	India	Russia Federation
Apr 13	100.2	99.9	99.2	100.3	99.9	100.1	99.0	99.1
May 13	100.3	100.0	99.3	100.5	99.6	100.1	98.9	99.1
Jun 13	100.3	100.1	99.5	100.7	99.4	100.1	98.8	99.1
Jul 13	100.4	100.3	99.7	100.8	99.2	100.1	98.7	99.2
Aug 13	100.4	100.5	99.9	100.9	99.1	100.0	98.6	99.3
Sep 13	100.4	100.7	100.1	101.1	99.1	100.0	98.6	99.5
Oct 13	100.4	100.9	100.3	101.2	99.1	99.9	98.5	99.6
Nov 13	100.4	101.0	100.4	101.3	99.1	99.7	98.5	99.7
Dec 13	100.3	101.0	100.5	101.3	99.1	99.5	98.5	99.8
Jan 14	100.3	101.0	100.6	101.2	99.0	99.3	98.5	100.0
Feb 14	100.3	101.0	100.7	101.1	99.0	99.1	98.5	100.1
Mar 14	100.3	101.0	100.7	100.8	98.9	98.9	98.6	100.3
Apr 14	100.3	101.0	100.7	100.6	98.9	98.7	98.6	100.5
May 14	100.4	101.0	100.6	100.3	98.9	98.6	98.7	100.7
Jun 14	100.4	101.0	100.6	100.1	99.0	98.6	98.8	100.8
Jul 14	100.4	100.8	100.5	99.9	99.1	98.6	98.8	100.9
Aug 14	100.4	100.7	100.5	99.8	99.2	98.6	98.9	100.8
Sep 14	100.4	100.6	100.4	99.8	99.3	98.7	99.0	100.5
Oct 14	100.3	100.4	100.5	99.8	99.3	98.8	99.1	100.2
Nov 14	100.3	100.3	100.5	99.8	99.3	98.9	99.2	99.9
Dec 14	100.2	100.3	100.6	99.8	99.3	99.0	99.3	99.5
Jan 15	100.2	100.2	100.7	99.8	99.4	99.1	99.5	99.3
Feb 15	99.8	100.2	100.6	99.9	99.3	98.0	99.0	99.2
Mar 15	99.7	100.1	100.7	99.9	99.1	97.7	99.0	99.3
Apr 15	99.5	100.0	100.7	100.0	99.0	97.5	99.0	99.6

*Source: Bloomberg ‡MICEX rates †Source: OECD

Note: A rising composite leading indicator (CLI) reading points to an economic expansion if the index is above 100 and a recovery if it is below 100. A CLI that is declining points to an economic downturn if it is above 100 and a slowdown if it is below 100.

Additional resources



Deloitte Research thought leadership

Asia Pacific Economic Outlook, Q3 2015: Indonesia, Singapore, South Korea, Vietnam, household debt in Asia

United States Economic Forecast, Volume 3 Issue 2

Issue by the Numbers, April 2015: An unbalanced age: Effects of youth unemployment on an aging society

Please visit www.deloitte.com/research for the latest Deloitte Research thought leadership or contact Deloitte Services LP at: research@deloitte.com.

For more information about Deloitte Research, please contact John Shumadine, Director, Deloitte Research, part of Deloitte Services LP, at +1.703.251.1800 or via e-mail at jshumadine@deloitte.com.

About the authors



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



Dr. Patricia Buckley is director of Economic Policy and Analysis at Deloitte Research, Deloitte Services LP.



Ian Stewart is chief economist, Deloitte UK.



Dr. Alexander Börsch is director of research, Deloitte Germany, Deloitte & Touche GmbH.



Lester Gunnion is an economist and a senior analyst at Deloitte Research, Deloitte Services LP.



Akrur Barua is an economist and a manager at Deloitte Research, Deloitte Services LP.

Contact information

Global Economics Team

Aditi Rao

Deloitte Research
Deloitte Services LP
India
Tel: +1.615.209.3941
E-mail: aditirao@deloitte.com

Dr. Ira Kalish

Deloitte Touche Tohmatsu Limited
USA
Tel: +1.213.688.4765
E-mail: ikalish@deloitte.com

Dr. Patricia Buckley

Deloitte Research
Deloitte Services LP
USA
Tel: +1.517.814.6508
E-mail: pabuckley@deloitte.com

Dr. Alexander Börsch

Deloitte Research
Germany
Tel: +49.(0)89.29036.8689
E-mail: aboersch@deloitte.de

Ian Stewart

Deloitte Research
Deloitte & Touche LLP
UK
Tel: +44.20.7007.9386
E-mail: istewart@deloitte.co.uk

Dr. Rumki Majumdar

Deloitte Research
Deloitte Services LP
India
Tel: +1.615.209.4090
E-mail: rmajumdar@deloitte.com

Akrur Barua

Deloitte Research
Deloitte Services LP
India
Tel: +1.678.299.9766
E-mail: abarua@deloitte.com

Lester Gunnion

Deloitte Research
Deloitte Services LP
India
Tel: +1.615.718.8559
E-mail: lgunnion@deloitte.com

Global Industry Leaders Consumer Business

Antoine de Riedmatten

Deloitte Touche Tohmatsu Limited
France
Tel: +33.1.55.61.21.97
E-mail: aderiedmatten@deloitte.fr

Energy & Resources

Carl Hughes

Deloitte Touche Tohmatsu Limited
UK
Tel: +44.20.7007.0858
E-mail: cdhughes@deloitte.co.uk

Financial Services

Chris Harvey

Deloitte LLP
UK
Tel: +44.20.7007.1829
E-mail: caharvey@deloitte.co.uk

Life Sciences & Health Care

Pete Mooney

Deloitte Touche Tohmatsu Limited
USA
Tel: +1.617.437.2933
E-mail: pmooney@deloitte.com

Manufacturing

Tim Hanley

Deloitte Touche Tohmatsu Limited
USA
Tel: +1.414.977.2520
E-mail: thanley@deloitte.com

Public Sector

Paul Macmillan

Deloitte Touch Tohmatsu Limited
Canada
Tel: +1.416.874.4203
E-mail: pmacmillan@deloitte.ca

Telecommunications, Media & Technology

Jolyon Barker

Deloitte & Touche LLP
UK
Tel: +44.20.7007.1818
E-mail: jrbarker@deloitte.co.uk

US Industry Leaders

Banking & Securities and Financial Services

Robert Contri

Deloitte LLP
Tel: +1.212.436.2043
E-mail: rcontri@deloitte.com

Consumer & Industrial Products

Craig Giffi

Deloitte LLP
Tel: +1.216.830.6604
E-mail: cgiffi@deloitte.com

Life Sciences & Health Care

Bill Copeland

Deloitte Consulting LLP
Tel: +1.215.446.3440
E-mail: bcopeland@deloitte.com

Power & Utilities and Energy & Resources

John McCue

Deloitte LLP
Tel: +1.216.830.6606
E-mail: jmccue@deloitte.com

Public Sector (Federal)

Robin Lineberger

Deloitte Consulting LLP
Tel: +1.517.882.7100
E-mail: rlineberger@deloitte.com

Public Sector (State)

Jessica Blume

Deloitte LLP
Tel: +1.813.273.8320
E-mail: jblume@deloitte.com

Telecommunications, Media & Technology

Eric Openshaw

Deloitte LLP
Tel: +1.714.913.1370
E-mail: eopenshaw@deloitte.com



Sign up for Deloitte University Press updates at DUPress.com.

About Deloitte University Press

Deloitte University Press publishes original articles, reports and periodicals that provide insights for businesses, the public sector and NGOs. Our goal is to draw upon research and experience from throughout our professional services organization, and that of coauthors in academia and business, to advance the conversation on a broad spectrum of topics of interest to executives and government leaders.

Deloitte University Press is an imprint of Deloitte Development LLC.

About this publication

This publication contains general information only, and none of Deloitte Touche Tohmatsu Limited, its member firms, or its and their affiliates are, by means of this publication, rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. This publication is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your finances or your business. Before making any decision or taking any action that may affect your finances or your business, you should consult a qualified professional adviser.

None of Deloitte Touche Tohmatsu Limited, its member firms, or its and their respective affiliates shall be responsible for any loss whatsoever sustained by any person who relies on this publication.

About Deloitte

Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee, and its network of member firms, each of which is a legally separate and independent entity. Please see www.deloitte.com/about for a detailed description of the legal structure of Deloitte Touche Tohmatsu Limited and its member firms. Please see www.deloitte.com/us/about for a detailed description of the legal structure of Deloitte LLP and its subsidiaries. Certain services may not be available to attest clients under the rules and regulations of public accounting.

Copyright © 2015 Deloitte Development LLC. All rights reserved.
Member of Deloitte Touche Tohmatsu Limited

