Global Economic Outlook

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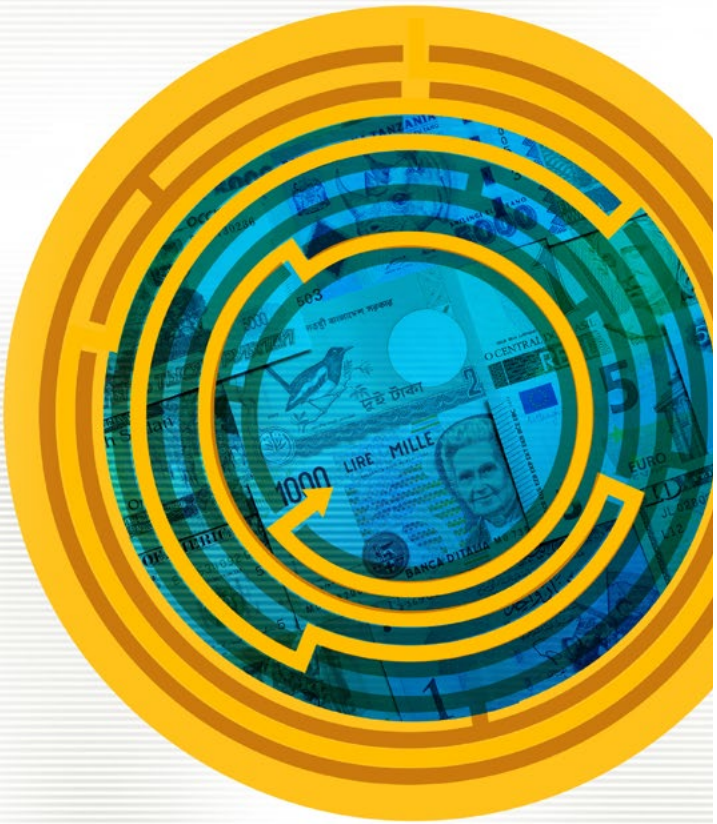

Illustrations by Stephanie Dalton Cowan

Introduction

By Ira Kalish

THE global economy has lately been characterized by relatively slow growth, weak business investment, persistent deflationary pressures, and slow growth of cross-border trade in goods and services. These issues have led to concerns that the current policy mix in major economies is not up to the task of fueling faster growth. Indeed, in the major developed economies, monetary policy seems to be the only game in town, with few countries focused on fiscal or structural actions. In this issue of Deloitte's quarterly *Global Economic Outlook*, our far-flung economists offer views on each of the major economies in the world. A common theme appears to be either inadequacy of policy actions or uncertainty about what policy makers will do.

We begin with our article on the US economy, in which Patricia Buckley says that growth is likely to be better in the second half than in the first. She notes that the sharp decline in inventories sets the stage for a revival of growth. In addition, she points to the continued strength of the labor market as fueling consumer spending. Plus, an unusually large increase in real household income not only bodes well for spending but also helps to reverse the rise in income inequality. Patricia concludes that the US economy remains strong and that the major risks to the economy come from external events as well as the upcoming presidential election.

Alexander Börsch offers our next article on the Eurozone. He focuses mainly on the potential impact of the UK Brexit referendum on the other European economies. He notes that the initial fears about financial market disruption have been allayed by a quick response from the European Central Bank. He also discusses the mainly incompatible negotiating positions of the United Kingdom and the European Union, rendering likely a period of uncertainty. He concludes that the negotiations will probably dominate the agenda of EU leaders in the next few years. A close economic relationship between the two is seen as optimal, but differences over immigration policy could undermine such relations.

In my article on China, I discuss the continuing debate over the dangers of debt in the Chinese economy. I point to a study from the Bank for International Settlements that suggests that China's debt relative to GDP is unusually and dangerously high. Despite this, I point to data showing that credit creation in China is accelerating, particularly in the household sector. While this has been intentional on the part of policy makers who are keen to avoid a deeper economic slowdown, it exacerbates longer-term problems. Meanwhile, I point to recent data suggesting that the Chinese economy may be stabilizing after a period of deceleration.

In his article on Japan's economy, Akrur Barua says that an unusually aggressive monetary policy, involving massive asset purchases and negative policy interest rates, has failed to achieve its goals. Although the Bank of Japan has recently signaled an intention to ease policy even further, Akrur suggests that monetary policy may have gone as far as it can. Rather, he suggests that the government might benefit from implementing the third arrow of Aben-

omics: structural reform. However, the government has, instead, focused on a modest boost to the second arrow, fiscal stimulus, and Akrur does not expect this to be especially effective.

India is the focus of our next article, written by Rumki Majumdar. She says that although the Indian economy faces some headwinds, new legislation involving tax and bankruptcy reforms could set the stage for an acceleration of growth. Moreover, these reforms are likely to embolden the government in attempting to enact labor market reforms. Such action would ease the cost of doing business, promote more employment, and stimulate more inbound foreign investment. As for the latter, the government is also attempting to ease restrictions on such investment.

In our next article, Lester Gunnion examines the Russian economy. He says that there are signs that the period of declining activity may be coming to an end, and that the Russian economy might have hit bottom. He points to a stable currency, slowing inflation, an easing of monetary policy, and a revival in oil production. Yet he also raises concerns that a number of headwinds will prevent a robust recovery. These include continued Western sanctions, which are having a chilling effect on inbound investment in the energy sector. Moreover, weak foreign investment will inhibit the diversification of Russia's economy that is so badly needed. In addition, Lester notes continuing weakness of income growth and consumer spending.

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Editor-in-chief

Dr. Ira Kalish

Managing editor

Aditi Rao

Contributors

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

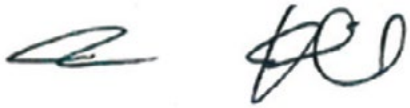
Editorial address

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

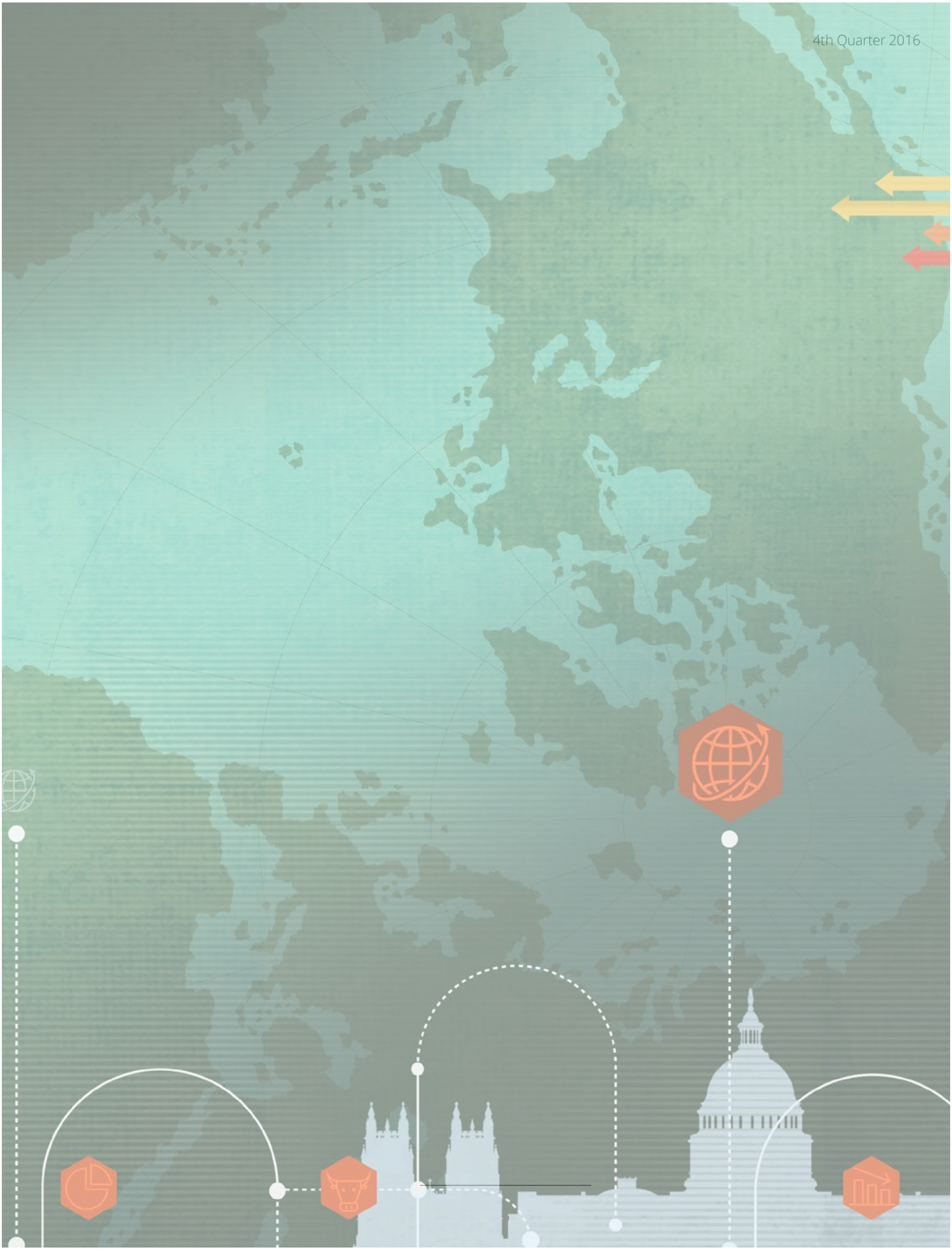
Brazil is the focus of Akrur Barua's next article. The country that hosted the recent Olympic Games continues to suffer from one of its worst downturns in modern times. With inflation remaining high and fiscal mismanagement over the past year, the central bank has been compelled to keep monetary policy tight, thereby inhibiting an economic recovery. Yet, with the currency having risen, there is reason to expect a deceleration of inflation. Indeed, inflation has been slowing this year, prompting the central bank to cut its policy rate for the first time in four years in October. A tighter fiscal policy could give the central bank the wiggle room to ease policy further. Thus the basis for a rebound appears to be developing.

In his article on Canada, Daniel Bachman bemoans the continued weakness of the economy. He says that despite a weak currency, non-oil exports have failed to revive sufficiently to drive growth. Moreover, the central bank is not yet comfortable with easing monetary policy, given continued relatively high inflation. On the other hand, the potential fiscal stimulus planned by the government could help to boost growth going forward. Beyond the short-term economic outlook, Danny also devotes considerable attention to the planned free-trade agreement between Canada and the European Union. He discusses what is holding up the agreement despite its recent completion, the impact of Brexit on EU thinking, as well as the potential impact of the Canadian deal on a similar planned EU deal with the United States.

For our last article, Akrur Barua looks at the oddly named issue of "helicopter money." This is the idea that a central bank can circumvent the banking system and simply drop money from the sky—or to be more precise, it can fund government spending by just boosting the money supply. The idea is that, when the financial system is not functioning properly, this might be a useful alternative to traditional policy. Helicopter money was first suggested by Milton Friedman and later discussed by former Fed chairman Ben Bernanke, who came to be known as "helicopter Ben." In his article, Akrur discusses what helicopter money entails, how it is different from quantitative easing, and why it may or may not be effective in dealing with today's challenges. Akrur concludes that the major country most likely to try this policy is Japan.



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



Growth remains muted, but finally good news on family income

By Patricia Buckley

ALTHOUGH GDP growth of the last three quarters posted very similar rates of around 1.0 percent (at seasonally adjusted annual rates), in several ways Q2 2016 was stronger than either Q4 2015 or Q1 2016.[1] As shown in figure 1, the decrease in private inventory investment subtracted a substantial 1.3 percentage points from growth in Q2 2016. Since the contribution from inventory investment generally nets out to zero over time, this subtraction of negative contributions, the largest in an unusually long string of five quarters, is due to reverse soon. Furthermore, in Q2, consumer spending grew sufficiently to contribute 2.9 percentage points to GDP growth, a significantly larger contribution than in prior quarters. Additionally, during the most recent quarter, the contraction in business investment was considerably less than in recent history, and exports grew slightly after contractions in the three prior periods.

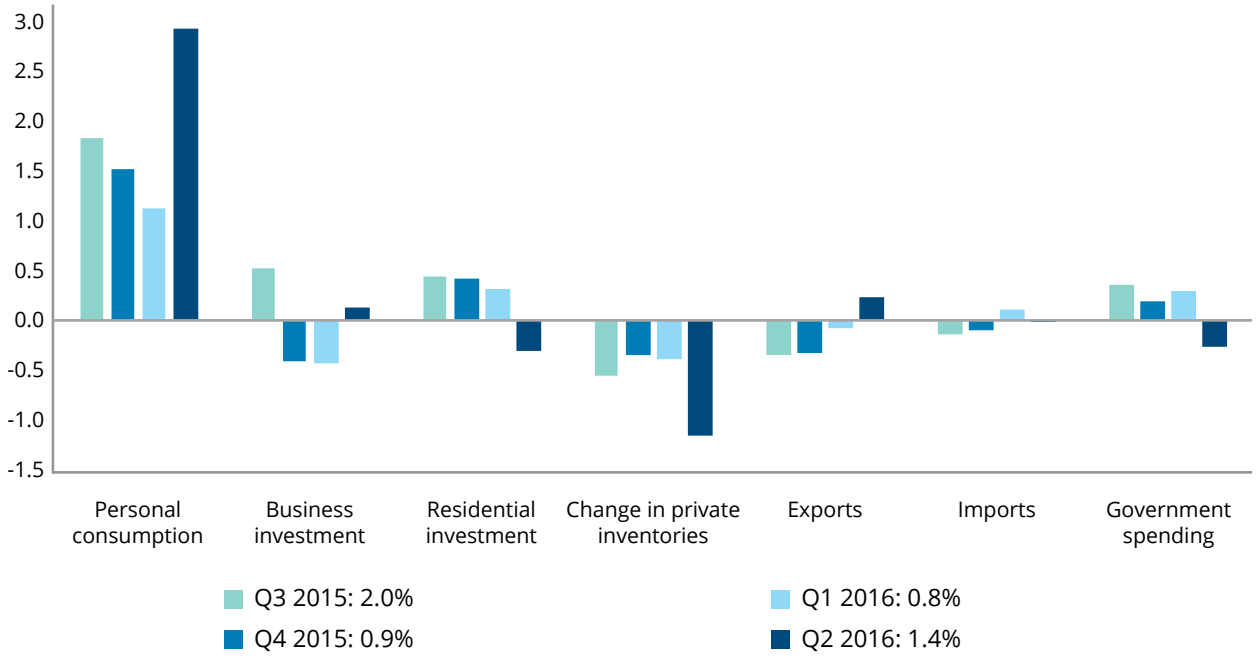
The US consumer's ability to continue to support growth reflects the continued strengthening of the labor market and, for the first time since 2007, a rise in family income.

An improving labor market—but not quite healed

Although the pace of job creation has slowed somewhat in 2016, the improvement in the labor market is evident across many dimensions, even though many measures have not returned to pre-recession readings. Consider:

- The unemployment rate has been at 5.0 percent or lower for 12 months, essentially on par with the average unemployment rate during the last expansion.

Figure 1. Contributions to percentage change in GDP



Source: Bureau of Economic Analysis.

Graphic: Deloitte University Press | dupress.deloitte.com

- The labor force participation rate has stopped falling and has remained stable since the beginning of the year. However, labor force participation is about three percentage points lower than prior to the recession.
- The number of long-term unemployed (those unemployed for 27 weeks or longer) continues to trend down, as does the proportion of the long-term unemployed. However, both of these measures are still above their pre-recession levels.
- The median number of weeks of unemployment is down to around 11 weeks, although still higher than the 8-week median just before the onset of the recession, a significant reduction from the 25-week record at the peak of the recession.[2]

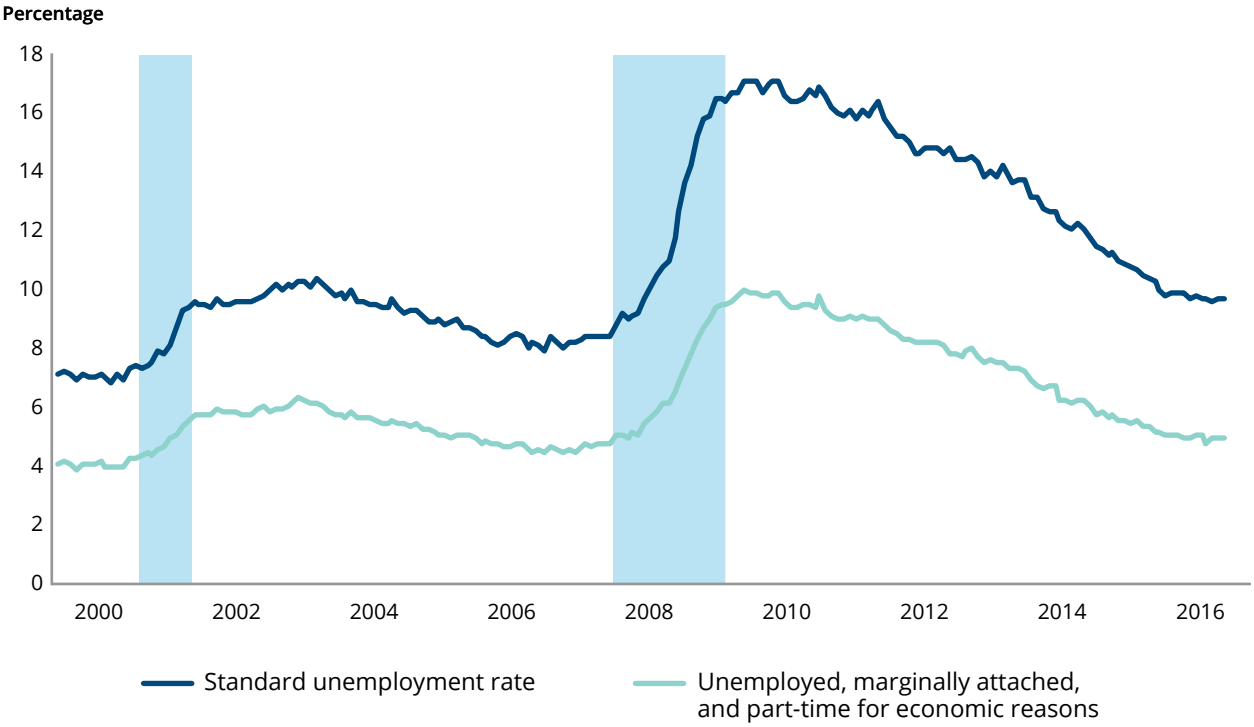
Another area of improvement has been in the more expansive measure of unemployment. The standard definition of the unemployment rate considers only those individuals who are available for work and have looked for work in the four weeks preceding the survey. The Bureau of Labor Statistics also publishes more expansive measures that better capture underutilization, for example, those who want a job but have not looked for a job in the past 12 months, and those who are working part time but would prefer a full-time job. Figures 2a and 2b show a comparison of this more expansive measure with the standard measure of employment. Figure 2a shows that these two measures follow a similar pattern. However, as figure 2b makes clear, there was a divergence in the magnitude of the percentage-point difference between these two measures during the recession—and that difference has been slow to dissipate.

Improvements to well-being

Thus, even with continued job growth and low unemployment by the standard measure, there remains slack in the US labor market. In late 2014, the gradual improvements began to translate into real increases in the average hourly wage after five years of decline or stagnation. However, averages do not give any information about how these gains are distributed—the average can rise even if the improvement is concentrated among the high earners. Interestingly, the US Census Bureau recently published its 2015 estimates for real median household income and poverty rates, and the news was positive on both fronts.[3]

Thus, even with continued job growth and low unemployment by the standard measure, there remains slack in the US labor market.

Figure 2a. Two measures of unemployment



Note: The shaded areas represent recessions.

Source: Bureau of Labor Statistics.

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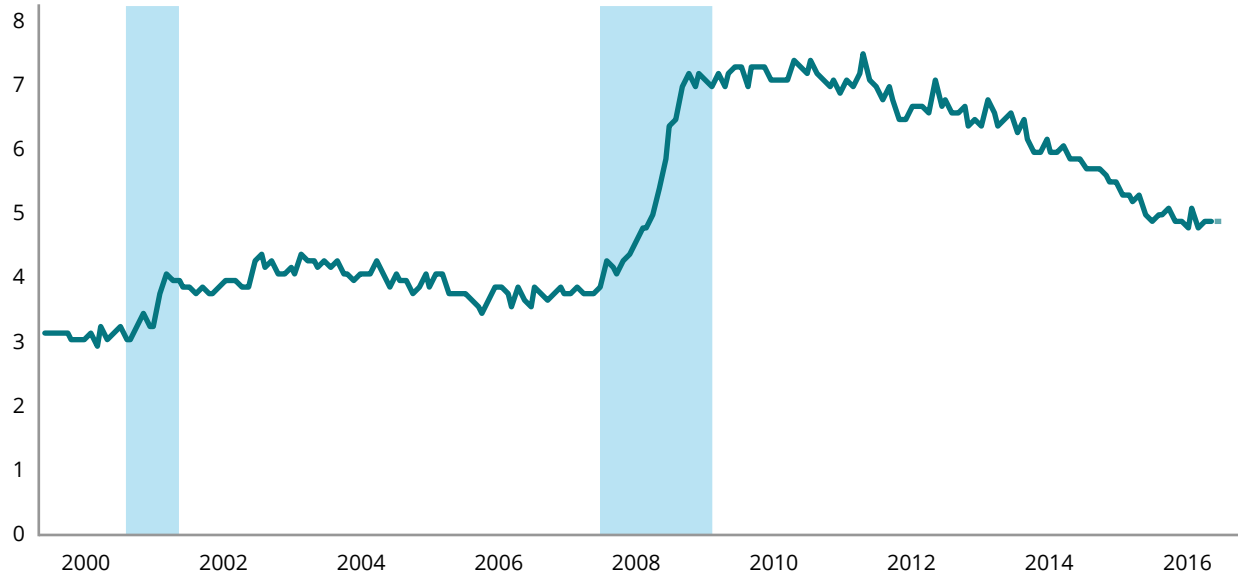
Figure 2b. Difference between the two measures of unemployment



Note: The shaded areas represent recessions.

Source: Bureau of Labor Statistics.

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As shown in figure 3, in 2015 real median household income rose for the first time since 2007, although the real dollar value of that income remains below the levels of both 2007 and the peak of 1999. The rise in the median points to gains among lower earners. However, in looking at actual measures of inequality, the difference between 2014 and 2015 was not statistically significant, but even if income inequality did not lessen, at least it did not get worse.[4]

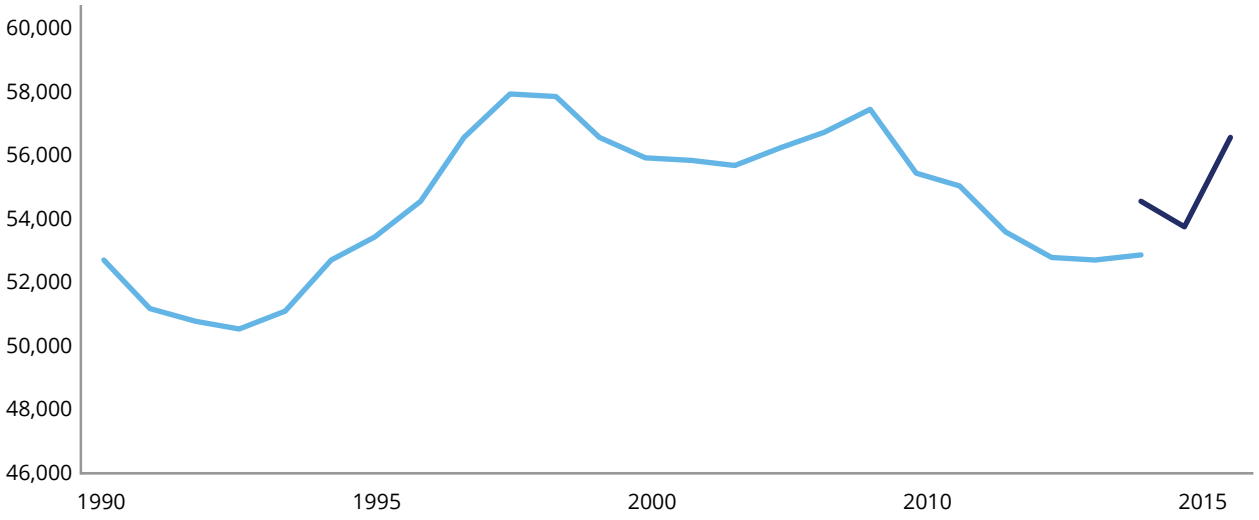
The Census Bureau's estimate of poverty rates also showed improvement. Between 2014 and 2015, the composite, or "official," poverty rate dropped 1.2 percentage points from 14.8 percent to 13.5 percent. The number of people in poverty also dropped by 3.5 million to 43.1 million. The improvements were broad based across demographic groups. However, even with these improvements, the poverty rate is still 1.0 percentage point higher than in 2007.[5]

Where to go from here?

With these facts in hand, the Federal Open Market Committee (FOMC) of the Federal Reserve Board decided at its September meeting to leave the target for the federal funds rate at 0.25–0.50 percent. The FOMC decided that with inflation still continuing below its 2.0 percent target, it could continue to support the maximum employment goal of its twin statutory mandate since the other goal of price stability remained well in hand.[6] Telegraphing the committee's future intent, the economic projections released along with the statement included an assumption of 0.6 percent for the 2016 aggregate federal funds rate. This implies that the FOMC is aiming for an interest rate increase in this calendar year, most likely in December.[7] However, FOMC's decisions are driven by data, and as of the June meeting, they were still targeting two increases this year.

Figure 3. Real median household income

2015 US dollars



Note: The data for 2013 and beyond reflect the implementation of the redesigned income questions, hence the discontinuity.

Source: US Census Bureau.

Graphic: Deloitte University Press | dupress.deloitte.com

For now, the fundamentals of the US economy remain strong, with the risks to the downside focused largely on external events—and the US presidential election coming up on November 8.

As noted at the beginning of this chapter, initial data covering July and August indicate a stronger Q3 is underway. Personal consumption, while not looking as strong as in Q2, continues to exhibit healthy growth, and early indicators for business investment and housing are looking much stronger. If these trends hold, a December rate increase becomes even more certain.

For now, the fundamentals of the US economy remain strong, with the risks to the downside focused largely on external events—and the US presidential election coming up on November 8. Since political prognostication is outside the scope of this author's expertise, I can only comment on the economic policies of the next US president when I know who it will be. For now, it is probably enough to keep in mind that the actual powers of the Executive Branch of the US government are fairly limited; Congressional consent is required for most changes, as any current or former president would attest.

Endnotes

1. All statistics in this article have been sourced from the Bureau of Labor Statistics or Bureau of Economic Analysis unless otherwise stated.
2. Bureau of Labor Statistics, Current Population Survey, downloaded September 28, 2016.
3. Bernadette D. Proctor, Jessica L. Semega, and Melissa A. Kollar, *Income and poverty in the United States: 2015*, US Census Bureau, September 2016, http://www.census.gov/content/dam/Census/library/publications/2016/demo/p60-256.pdf.
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Dealing with Brexit

By Alexander Börsch

FOUR months after the decision of the United Kingdom's electorate to leave the European Union, the fog around what Brexit exactly means for the Eurozone and the European Union has not disappeared. The direct economic effects have been limited so far, as financial markets, helped by central banks' decisions, remained relatively calm. Politics has been more affected than economics, as European leaders try to figure out how they can react and what sort of strategy they should adopt in the upcoming negotiations with the United Kingdom.

While these political decisions will have substantial repercussions on the European economy, especially regarding the future form of the European Union and the future relationship with the United Kingdom, it is much too early to argue that Brexit will have limited effects in the long run as well. While the shock to the financial markets has not happened, the effects on the real economy are likely to materialize in a less spectacular, yet very palpable way.

The immediate reactions to Brexit

It was widely feared that the biggest immediate effect of Brexit would play out on the financial markets, sending shock waves through the global financial system. Given the problems in the Eurozone's banking system, this would have affected the Eurozone in a very big way. However, the shock to the financial markets failed to materialize. After a brief period of volatile financial markets, European stock prices rebounded, and the Euro Stoxx 50 reached its pre-referendum value in late July.

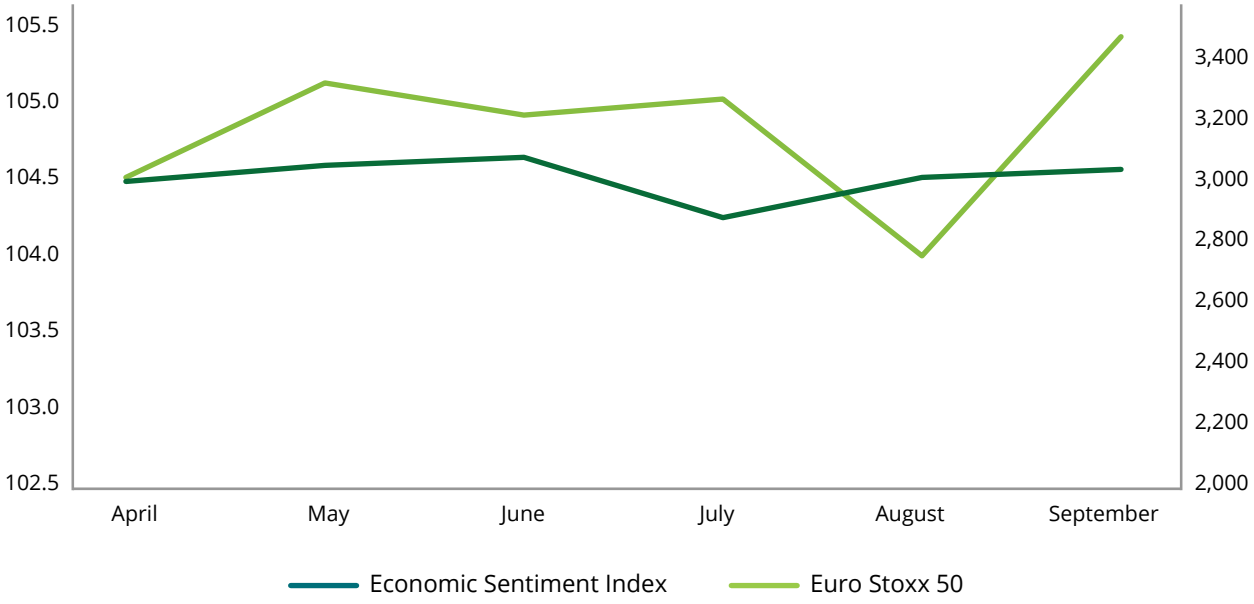
Politics has been more affected than economics, as European leaders try to figure out how they can react and what sort of strategy they should adopt in the upcoming negotiations with the United Kingdom.

The relative calm is partly due to central bank reactions and liquidity, which reassured investors. Second, the effects of Brexit are hard to assess for financial market participants, as they will be completely dependent on the future model of EU-UK economic, trade, and investment relations. Until the negotiations begin and the probabilities of which future model is likely to emerge are known, it is hard to price Brexit into valuations. This will change once relevant information flows and probabilities can be attached to the possible outcomes.

The Eurozone's GDP grew 0.3 percent in the second quarter, after 0.5 percent in the first, suggesting that the recovery had continued until the Brexit referendum. After the referendum, economic sentiment went down, but not in a big way (figure 1). Sentiment surveys proved resilient immediately after the referendum; they fell slightly in August, but improved in September, mainly driven by a rebound in the manufacturing sector.[1] Thus growth in the Eurozone can be expected in the coming quarter.

The updated macroeconomic predictions for growth in the Eurozone in 2017 were lowered because of Brexit uncertainty; increased uncertainty about its impact on future consumer and industry confidence will have, according to the International Monetary Fund and the Organization for Economic Cooperation and Development, a slightly negative impact on economic growth in 2017.[2] However, one decidedly negative effect can be expected regarding investments. Investments in Eurozone were recovering before Brexit, a development that fueled hope for a self-sustaining recovery. Given the uncertainties surrounding Brexit, it is unlikely that the positive investment trend will continue, so the recovery might continue to be based mainly on private consumption.

Figure 1. EU economic sentiment decreased slightly



Source: European Commission, Economic Sentiment Index, September 2016, http://ec.europa.eu/economy_finance/db_indicators/surveys/index_en.htm.

Graphic: Deloitte University Press | dupress.deloitte.com

Getting ready for the negotiations

That an immediate crisis after the referendum could be avoided does not imply that there are no serious long-term consequences of Brexit. In the real economy, the risks stemming from a potential disruption of trade relations have not disappeared. The long-term consequences will depend on the outcome of the EU-UK negotiations that are likely to start at some point in 2017.

Meanwhile, European institutions have started to get ready for the negotiations. The European Commission and the European Parliament have appointed their lead negotiators. The European Parliament is involved because it has a vote on the final withdrawal agreement. It can agree with or reject the final outcome, but cannot change it. The commission will be heavily involved in the negotiations, but will depend on mandates from the member states' governments. Generally, the withdrawal agreement has to be decided by the qualified majority of member states, that is, by 72 percent of the member states representing at least 65 percent of the population.

> Currently, the positions of the United Kingdom and the European Union seem incompatible.

Widely diverging political positions

Among the governments of the EU-27, no coherent strategy has emerged on how to approach the Brexit negotiations. Broadly, there are at least three different positions:[3]

- **The deeper integration camp:** European institutions as well as some of the southern member states tend to see Brexit as an opportunity to deepen European integration. This implies a speedy Brexit and negotiation goals that stress the deterrent effect on other member states.
- **The security camp:** Other member states, especially those in Eastern Europe, stress the security aspect of Brexit; they fear a weakening of Atlantic security ties and favor strong ties with the United Kingdom.
- **The market camp:** Central European states tend to worry about a disruption of trade ties and support a liberal trading regime with the United Kingdom, but want to avoid "cherry-picking" and a watering down of the four freedoms of the Single Market (free movement of people, capital, goods, and services).

The negotiation position of the European Union will have to consider these competing interests, which increases the likelihood of complex negotiations linking several political issues areas.

Free movement of people a key issue

Nevertheless, one crucial issue in the negotiations is predictable, namely immigration and the free movement of people. Currently, the positions of the United Kingdom and the European Union seem incompatible. For the European Union, free movement of people is a nonnegotiable part of the Single Market, while controlling immigration was the key objective of the Brexit camp. In this sense, the United Kingdom's access to the Single Market and the future economic relationship will largely depend on a compromise on immigration.

An important factor in this context will be public opinion on the free movement of people in the European Union, especially considering the elections in France and Germany in 2017. Currently, attitudes toward a compromise with the United Kingdom

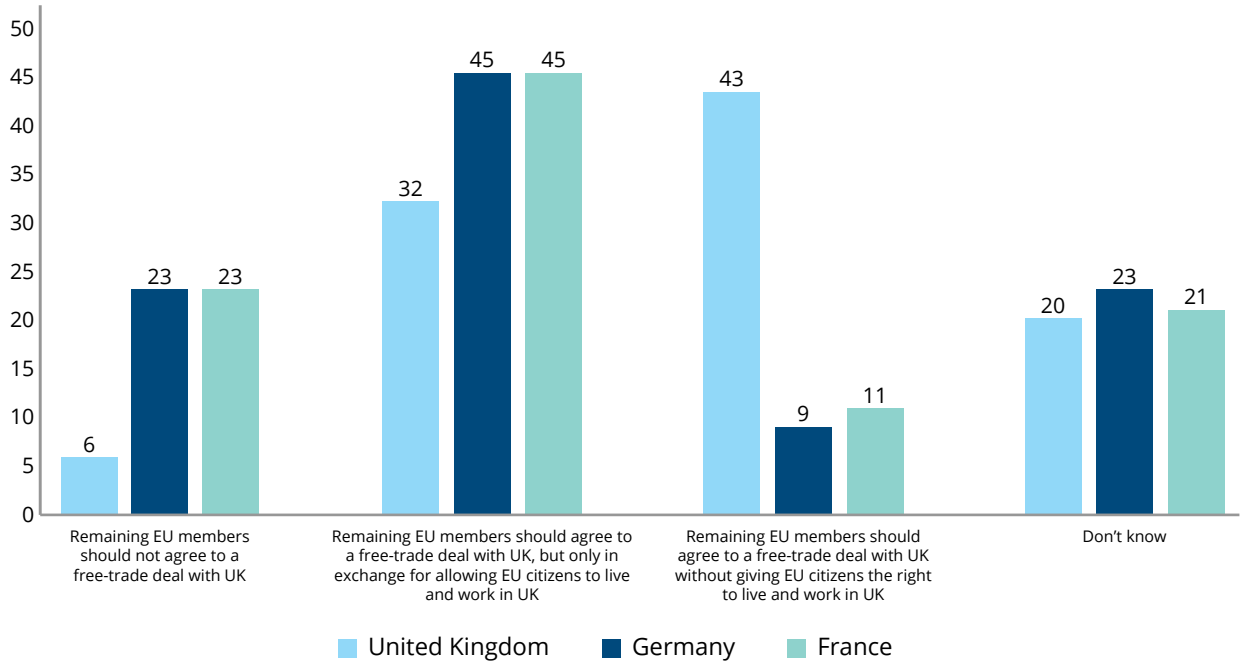
on the free movement of people are quite negative. According to survey research by YouGov, almost a quarter of respondents in France and Germany reject a free-trade deal with the United Kingdom in general, and almost half of them think that there should only be a trade deal if EU citizens can live and work in the United Kingdom (figure 2). Only around 10.0 percent would favor a trade deal without free movement of people.[4]

Think tank proposals seek to reconcile the positions of the United Kingdom and the European Union. They suggest that the United Kingdom could continue to participate in the mobility of goods, services, and capital, while labor mobility would be confined to temporary labor mobility and not to the free movement of people in general. This arrangement would be linked in terms of political governance with a close and structured intergovernmental relationship between the European Union and the United Kingdom.[5] Whether proposals along these lines will have a chance to create room for a compromise remains to be seen. Without progress on the immigration issue, an economically favorable outcome of the negotiations seems unlikely.

In any case, the Brexit negotiations will shape the European Union's agenda in the years to come and will bind considerable administrative capacity and resources. From an economic point of view, not to disrupt the deep economic relationships between the United Kingdom and the European Union that has developed over the last four decades should be a key goal.

Figure 2. Public attitudes in the United Kingdom, Germany, and France regarding a free-trade deal

It has been suggested that the next British government may seek a free-trade deal with the European Union, but without any right for EU citizens to live and work in the United Kingdom. Which of the following reflects your view?



Source: YouGov, "YouGov/Eurotrack survey results," conducted June 30–July 5, 2016, https://d25d2506sfb94s.cloudfront.net/cumulus_uploads/document/rm136y08iq/Eurotrack_June_Results_WebsiteV1.pdf.

Graphic: Deloitte University Press | dupress.deloitte.com

Endnotes

1. European Commission, Economic Sentiment Index, September 2016, http://ec.europa.eu/economy_finance/db_indicators/surveys/index_en.htm.

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Debating debt and investment

By Ira Kalish

More debt controversy

The topic of Chinese debt continues to generate interest and controversy. A new study from the Bank for International Settlements (BIS), which is a clearing house for the world's central banks, says that China's debt level is excessive and dangerous. It looks at the "credit gap," which is the percentage difference between total debt as a share of GDP and its long-term trend. Right now, according to the BIS, China's credit gap is over 30 percent, three times higher than the level the BIS deems to be dangerous, and far higher than any other major emerging market. China's gap has been steadily rising since 2011. The BIS says that the credit gap "has been found to be a useful early warning indicator of financial crises." It also notes that China's total debt, including both private and public sector debt, is now about 255 percent of GDP.[1] This compares with 279 percent for developed economies on average and 394 percent for Japan—suggesting that China's debt level is not excessive.[2] Yet China is an emerging country, and emerging countries historically carry far less debt as a share of GDP than developed economies. In addition, China's debt is disproportionately issued by the corporate sector rather than by the government, which is problematic because, unlike governments, corporations cannot raise taxes or print money. Thus their debt is riskier. Meanwhile, the BIS says that China's high credit gap indicates that banks ought to have more capital.

Meanwhile, Chinese bank lending continues to grow. It accelerated in August, doubling from the low level recorded in July. The volume of outstanding loans was up 13.0 percent from a year earlier. However, most of the increase was due to strong mortgage lending, indicating that businesses are not substantially tapping into formal credit markets. Rather, household borrowing accounted for 71.0 percent of new bank

> Lower interest rates and smaller down payment requirements for homes have evidently fueled property investment.

loans, most of that undertaken for property purchases. In addition, total social financing (TSF), a broader measure of credit creation that includes off-balance-sheet lending by banks as well as bond issuance, tripled in August from the previous month. Historically, property developers and state-owned enterprises have tapped into the TSF market.

The acceleration of credit creation partly reflects an easing of monetary policy by the central bank, including efforts to stimulate the property market. Lower interest rates and smaller down-payment requirements for homes have evidently fueled property investment. However, policy makers are likely concerned that businesses are hoarding cash rather than investing. This reflects the fact that China is plagued by excess industrial capacity, declining wholesale prices, and weakening profits. As such, it might not make sense for policy makers to ease monetary policy any further if it only serves to boost property investment but does nothing for business investment. Moreover, excessive property investment could ultimately lead to a sharp drop in property prices, thereby leading to difficulties in servicing debts. Thus policy makers find themselves caught between a desire to avoid a contraction of credit and a desire to avoid excessive credit creation.

The latest data suggest stabilization

Recently, there was a spate of new data from the Chinese government indicating that the Chinese economy is stabilizing, fueled in part by government stimulus and an easing of monetary policy. Here are some of the details:

- Industrial production increased 6.3 percent in August versus a year earlier, the fastest rate of growth since March 2016. The manufacturing component of industrial production was up a healthy 6.8 percent. By ownership, output was up only 3.6 percent for government-owned enterprises, up 6.4 percent for shareholder enterprises, and up 6.7 percent for foreign-funded enterprises, including those funded from Hong Kong and Taiwan. This comes despite considerable weakness of exports.
- Investment in fixed assets was up 8.1 percent in the first eight months of 2016 versus a year earlier. This included a 21.4 percent increase in investment spending by state-owned enterprises, which account for 61.4 percent of total investment. There were big increases in investment by state-owned enterprises, heavy industry, high-technology companies, and for the purpose of building infrastructure. Evidently, government efforts to stimulate the economy played a role in much of this. The big investment increase by state-owned enterprises is worrisome because such businesses are laden with excess capacity and declining profitability. This comes despite efforts to shutter superfluous factories.
- Investment in real estate in China increased 5.4 percent in the first eight months of the year versus a year earlier. This included a 4.8 percent increase in residential property investment. However, the high volume of residential starts suggests that property investment will accelerate in the months ahead. Floor space of residential starts was up 11.7 percent. Plus, there was considerable turnover in the property market. Floor space of residential buildings sold was up 25.6 percent, and the value of residential buildings sold was up 40.1 percent. This is worrisome given the large excess capacity in this market. It reflects government efforts to stem the slowdown in such investment.
- China's retail sales increased 10.6 percent in August versus a year earlier, the fastest rate of growth since December of last year. This included a 13.1 percent increase in automotive sales. Real, or inflation-adjusted, retail sales were up 10.2 percent. The relative strength of retail spending is welcome given the need to transition economic growth away from dependence on investment and toward dependence on consumer spending.[3]

One of the factors that allegedly contributed to China's strong economic growth in the past few decades was a massive amount of investment in infrastructure.

The efficiency of investment

One of the factors that allegedly contributed to China's strong economic growth in the past few decades was a massive amount of investment in infrastructure. Indeed, the data reveal that this continues apace. Yet a new study by Oxford University researchers says that more than half of such investments have "destroyed, not generated" economic value. The researchers report that the cost of the investment in these cases exceeded the economic benefit, often resulting in unserviceable debts. The report states:

> Far from being an engine of economic growth, the typical infrastructure investment fails to deliver a positive risk-adjusted return. Poorly managed infrastructure investments are a main explanation of surfacing economic and financial problems in China. We predict that, unless China shifts to a lower level of higher-quality infrastructure investments, the country is headed for an infrastructure-led national financial and economic crisis.

The report also poured cold water on the notion that infrastructure played a vital role in China's rapid growth. It said, "It is a myth that China grew thanks largely to heavy infrastructure investment. It grew due to bold economic liberalization and institutional reforms, and this growth is now threatened by over-investment in low-grade infrastructure." It warned against other emerging markets focusing too much on the quantity of infrastructure investment rather than market-opening reforms.[4]

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Two arrows too many

By Akrur Barua

REMEMBER that time from childhood when you ran out of tricks to sneak another muffin from the kitchen? Well, it appears that the Bank of Japan (BOJ) is sharing a similar fate. As it announced its new policy stance on September 21, one could not help but wonder if the central bank had indeed emptied its ammunition. Be it quantitative easing or negative interest rates, the BOJ for a long time now has been at the forefront of using unorthodox monetary policy to counter deflation and prop up the economy. So, as it declares that its next target is the long end of the yield curve, it is worth thinking whether the BOJ has been trying too hard for too long.

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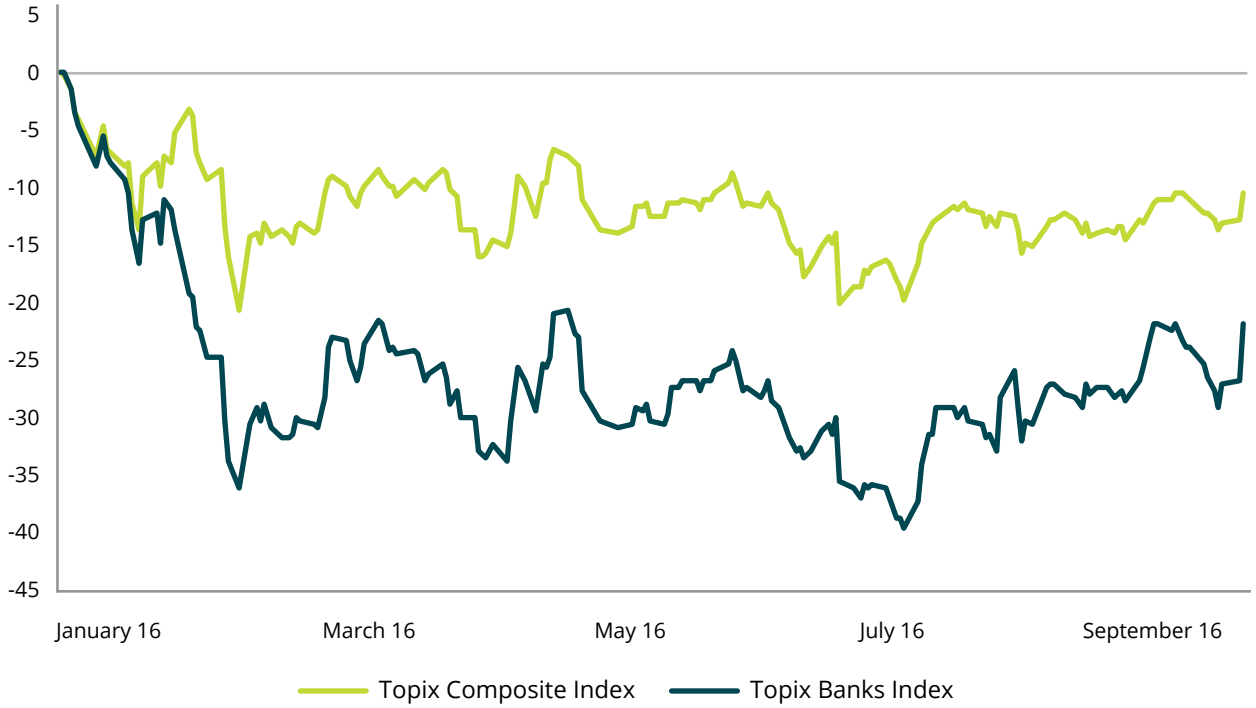
Flipping as they flop?

In addition to its annual asset purchase program—commonly referred to as quantitative easing (QE)—and negative interest rates, the BOJ has now decided to target the long end of the yield curve. In short, the BOJ wants to keep 10-year bond yields close to zero.[1] The move is not surprising given fears of a prolonged period of below-zero long-term interest rates, which have dented banks' margins—interest earnings on bank loans (or assets) are dependent on long-term interest rates—and the earnings of pensioners who depend on long-term fixed-income assets.

Not surprisingly, the latest BOJ move has lifted bank stocks, which have been under pressure since the advent of negative interest rates. After the BOJ's decision, the Topix Banks Index went up 7.0 percent by end of day on September 21, the highest single-day gain for the index since February. Prior to September 21, the index had lost 27.1 percent this year, much worse than the 12.7 percent decline in the overall Topix Index (figure 1).[2]

Figure 1. Bank stocks have been hit this year due to negative interest rates

Returns with respect to January 4



Source: Bloomberg.

Graphic: Deloitte University Press | dupress.deloitte.com

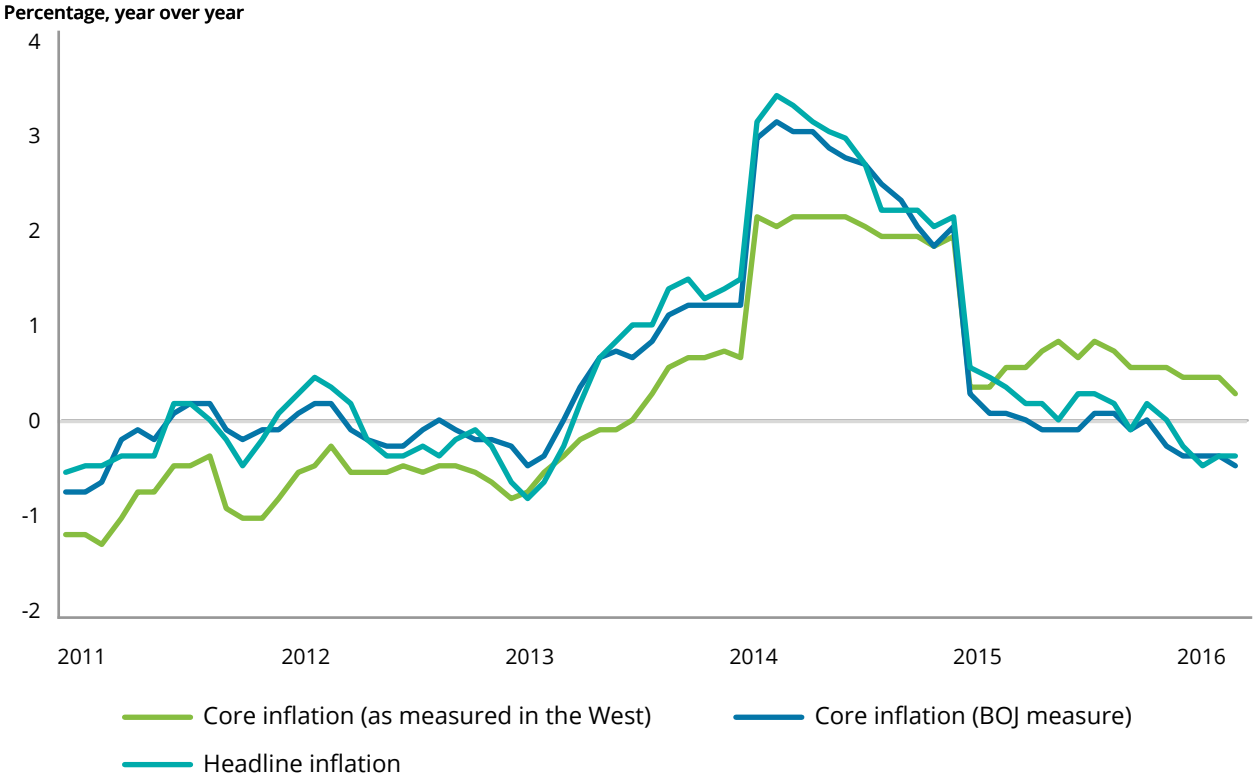
The BOJ, in its monetary policy meeting, also tried to reassert its commitment to fight deflation. The central bank stated that, if required, it would let inflation overshoot its 2.0 percent target. It's not clear, however, what new measures it will use in future. But, if one is to go by Governor Haruhiko Kuroda's actions—aggressive QE and then negative interest rates—then something similar to using perpetual bonds to fund government spending cannot yet be ruled out.[3]

Not much succor from negative interest rates so far

The BOJ's latest gambit comes amid concerns about a number of advanced nations' overdependence on monetary policy.[4] The central bank, in particular, may be trying too hard, when economic theory suggests that monetary policy alone cannot bring in medium- to long-term growth.[5] The data also raise questions regarding the efficacy of continued unorthodox policy. The BOJ's policy of negative interest rates, for example, has not had much impact of late compared with the initial phase of aggressive QE since Kuroda took over in 2013.[6] For starters, the country continues to grapple with deflationary pressures. Core inflation—all items except fresh food as defined by the BOJ—has been flitting in and around negative territory since July 2015 and for much of 2016. In fact, core inflation in July (-0.5 percent) was the lowest in more than three years. The aggravation of deflationary pressures hints at the lack of impact of unorthodox monetary policy, especially negative interest rates, this year (figure 2).

If the BOJ had thought that a barrage of cheap money will force demand up sharply through credit offtake, then so far it has been proved wrong. Growth in loans outstanding from domestic banks, for ex-

Figure 2. Deflationary pressures are once again asserting themselves



Source: Haver Analytics.

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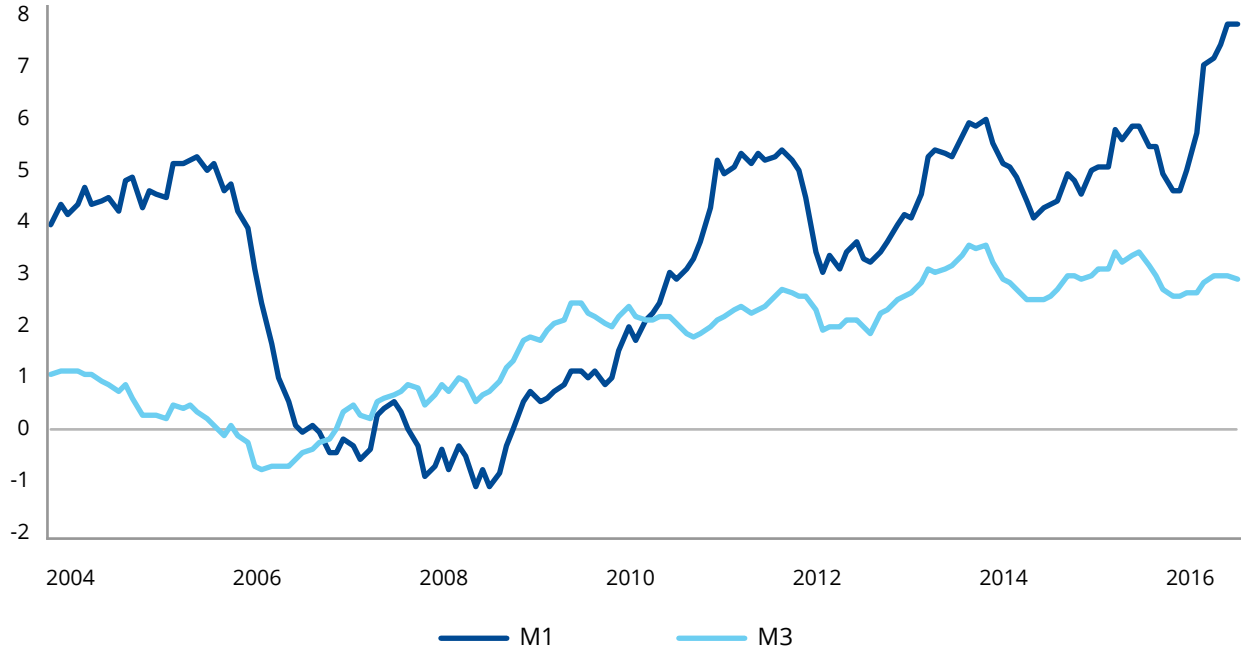
Figure 3. Narrow money (M1) growth has far outpaced broad money (M3) growth

Percentage, year over year



Source: Haver Analytics.

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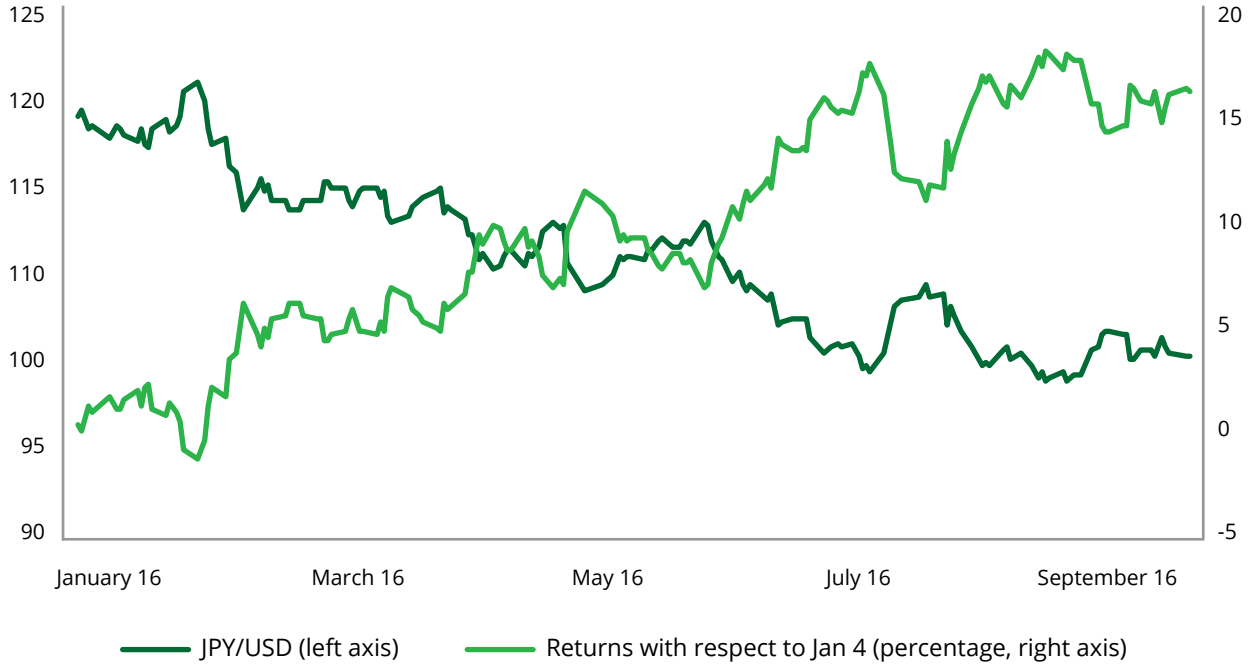
ample, was 2.4 percent year over year in Q2, down from 2.8 percent in Q1 and 3.4 percent a year before. A deeper analysis of the distribution of loans by sector—manufacturing, nonmanufacturing, and individual—also highlights a similar story.[7] That the steady binge of unorthodox monetary policies, including negative interest rates, has not done much is also evident from diverging trends in the growth of broad (M3) and narrow money (M1) this year (figure 3).

Slow credit growth despite easy credit conditions is primarily the result of households and businesses remaining circumspect about borrowing and spending more. In an aging society, consumers are still grappling with slow earnings growth, a deflationary environment, and uncertain economic prospects. Monthly real and nominal household expenditure growth (year over year), for example, has been negative for much of the year.[8] And in Q2, real household consumption growth slowed to 0.6 percent (seasonally adjusted annual rate, or SAAR) from 2.8 percent in Q1.

In the midst of volatile and weak consumer spending, it would be wrong to assume that businesses will invest more. Corporates are opting to hold on to cash rather than spend. Real private nonresidential investment, for example, contracted in both Q1 and Q2 (SAAR) despite healthy corporate profits.[9] Japanese businesses are also grappling with declining exports; real exports fell 5.8 percent in Q2. A strengthening Japanese yen has not helped. While the initial bout of QE helped weaken the currency and boost exports as the BOJ had hoped, the bout of yen weakening has run its course. In 2013 and 2014, the yen fell 16.4 percent and 12.9 percent, respectively, against the US dollar. But last year, it remained almost unchanged. And despite aggressive QE and negative interest rates this year, the currency is up 16.9 percent against the greenback (figure 4).

The yen's strength has also dented the BOJ's fight against deflation. Due to the yen's gains, import prices in yen have dropped by anywhere from 17.9 to 23.3 percent year over year in the first eight months

Figure 4. The yen has strengthened 16.9 percent against the US dollar this year



Source: Haver Analytics.

Graphic: Deloitte University Press | dupress.deloitte.com

of this year. This, in turn, has put downward pressure on consumer prices.

Negative interest rates have also impacted money market liquidity. In February—a month after the introduction of negative interest rates—the average amount outstanding in money markets (uncollateralized) during the month fell 39.5 percent, with market participants caught unawares. Unfortunately, the scenario has only worsened since then (figure 5).

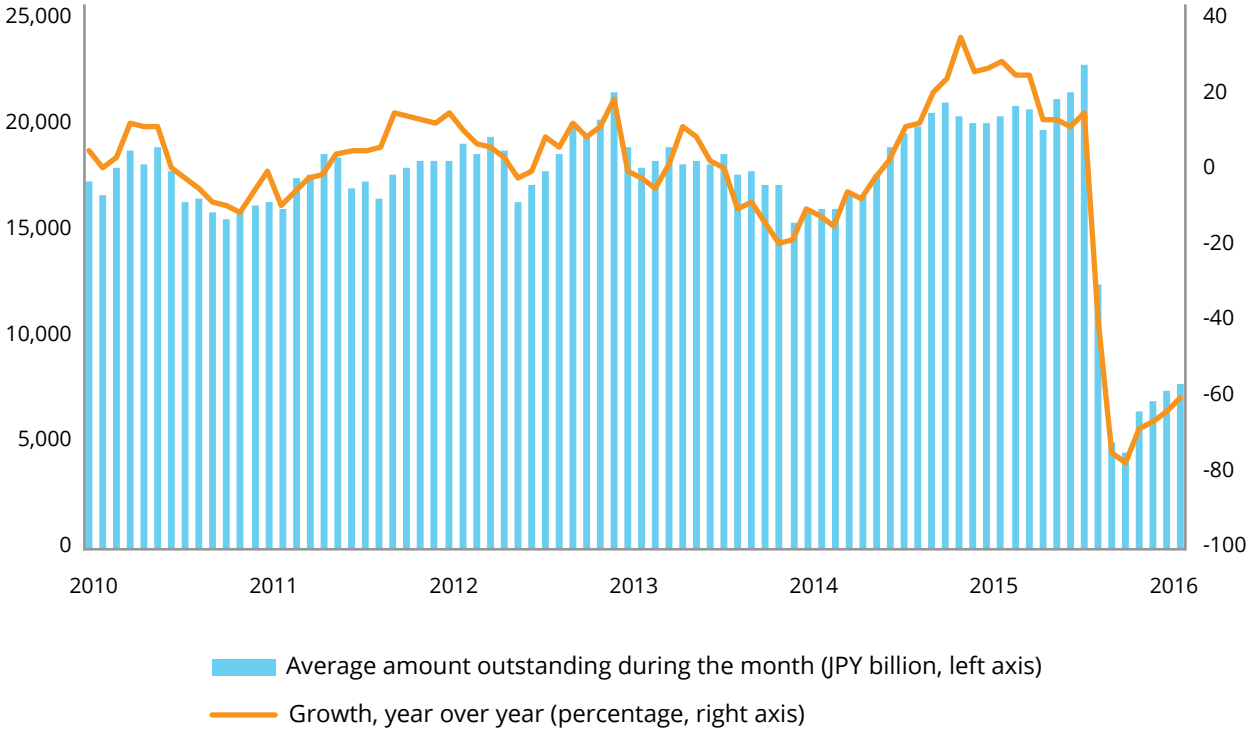
The continued purchase of Japanese government bonds by the BOJ also raises concerns about the stability of government debt (more than 250 percent of GDP) and the BOJ's balance sheet. The latter now owns about 38.0 percent of the total Japanese government bonds, and this will go up given the ongoing QE.[10] With the government postponing its fiscal targets, questions about the sustainability of debt naturally arise. That can change, however, if a sizable portion of the debt that the BOJ owns is changed to a zero-coupon perpetual bond.[11] Of course, such a move will not be without controversy, as it will amount to some form of monetization of government debt.

No third arrow even now

To restore growth in the face of the fading impact of monetary policy, Prime Minister Shinzo Abe announced a fiscal stimulus measure of 28 trillion yen in July. So will the fiscal magic work where the monetary one has not? Not likely, if medium- to long-term growth is the issue. While the stimulus has come at the right time—when economic growth is faltering—the new fiscal package falls short on a number of issues:

- Like previous measures, the immediate spending component is smaller than the announced package.[12] Only 13.5 trillion yen is dedicated to new measures, with new spending of 7.5 trillion

Figure 5. Money market liquidity has been hit due to negative interest rates



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To restore growth in the face of the fading impact of monetary policy, Prime Minister Shinzo Abe announced a fiscal stimulus measure of 28 trillion yen in July.

yen likely this year and the next. The remaining 6.0 trillion yen will be in the form of loans.[13]

- A large chunk of the announced stimulus will be used for infrastructure (such as ports and Maglev trains), while some of it will be directed toward disaster relief. Spending on these projects would have happened in some form or the other even without the stimulus.
- The fiscal package misses out on productivity-enhancing investments. Productivity has been stagnant in Japan, a major worry given the country's aging population and labor force.

What has been absent throughout has been Abe's third arrow: structural reforms. For example, there has been no major move so far to deregulate the labor market and make key services sectors more competitive. There is also no big measure to reform corporate governance, essential for enhancing economic competitiveness. And, although Abe announced a 3.0 percent hike in minimum wages, there is no frontal push yet to force businesses to raise wages—key to higher consumer spending. Most importantly, subtle efforts to raise female participation in the labor force—critical for potential GDP growth—have not made much headway. With so much still to do, it's not surprising that repeated fiscal stimulus and monetary easing are not making much of an impact. If the yen's movement is anything to go by, the BOJ's move on September 21 definitely falls short. After declining initially, as the BOJ would have hoped, the currency climbed up again later to end the day just 0.1 percent lower against the US dollar. It's imperative then that Abe release his third arrow to regain momentum. Mere promises won't suffice.

Acknowledgments

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Finding new feet through reforms

By Rumki Majumdar

INDIA is hailed as a bright spot amid a slowing global economy.[1] That said, sluggish investment, mining and construction activities, and farm output in the first quarter of the current fiscal year (FY)[2] raise concerns about the economy's ability to generate jobs, increase income, and reduce poverty at a sustainable pace.[3] India maintains a medium-term (five-year) growth expectation of 8.0 percent, which requires strong growth in investment and rural income. However, both areas have failed to grow at an impressive rate in the past few quarters.

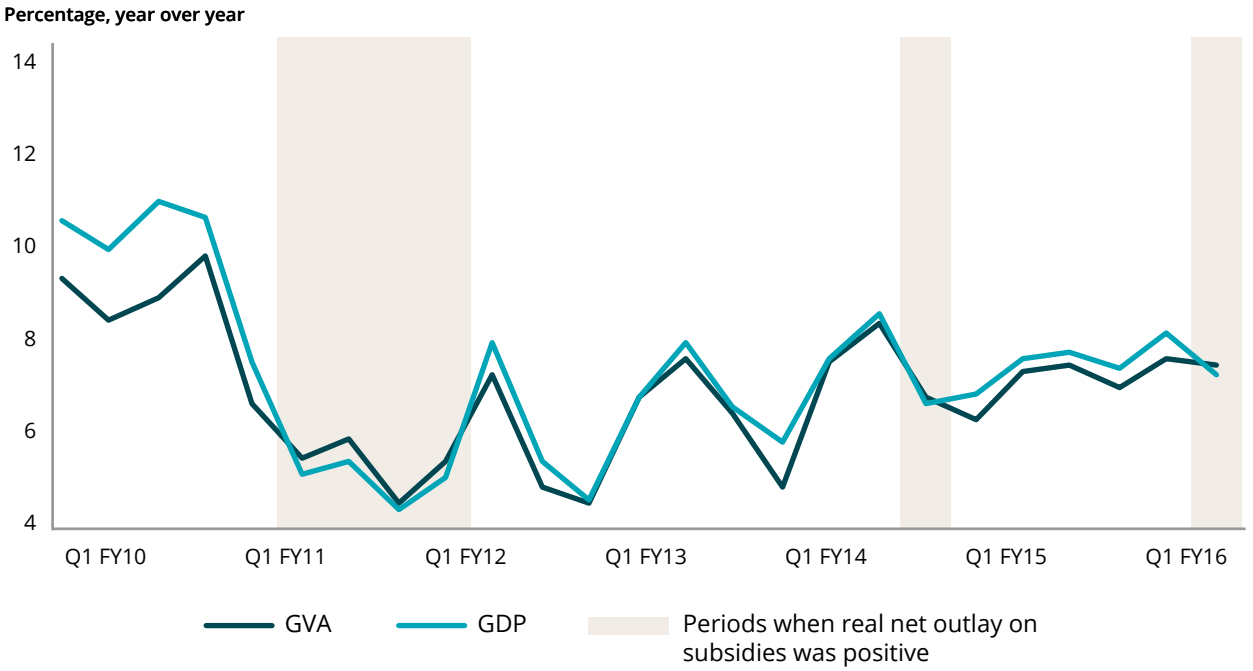
While a close-to-normal monsoon has improved the prospect of rising rural income in the coming quarters, private investment needs to see a sustainable uptick. Recent reforms, such as the passage of the bankruptcy code and the goods and services tax (GST), are expected to pave the way for improved business sentiments and greater ease of doing business. Not to mention, the recent institutionalization of the monetary policy and the setting up of a panel to review the Fiscal Responsibility and Budget Management (FRBM) Act are likely to go a long way toward improving macroeconomic stability and boosting investment. The impact is already evident as India moves up 16 places and now ranks 39 in the Global Competitiveness Index, 2016–17.[4] The gain has been broad based, with reform efforts on improving public institutions, opening the economy to foreign investors and international trade, and increasing transparency in the financial system aiding in improving India's ranking, which has gained the most in the list.

Growth softens as weak investment raises concerns

India witnessed a slight moderation in growth in Q1 FY 2016–17; gross value added (GVA) grew 7.3 percent year over year in Q1 FY 2016–17 compared with 7.4 percent in Q4 FY 2015–16, while GDP grew 7.1 percent compared with 7.9 percent in those respective quarters.[5] GDP is arrived at by subtracting subsidies net of taxes from GVA. Since the adoption of the new methodology to estimate GDP, the net subsidy component (subsidies net of taxes) has resulted in significant variations between the two measures of growth, not to mention the methodological concerns about the way this component is deflated.[6] For the first time in the past six quarters, GDP growth fell below GVA growth, primarily due to a rise in subsidies and a fall in union excise duties and services tax (figure 1).

Government spending on infrastructure (roads and railways) and a revival of private investment in response to rising domestic demand will likely be the key determinants of investment growth.

Figure 1. The two measures of growth



Source: Central Statistical Organization, Government of India, August 2016.

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The services sector, led by the public administration, defense, and other services sector, helped retain the growth momentum, while the construction as well as the mining and quarrying sectors performed poorly. On the expenditure side, the strongest thrust to growth came from government consumption expenditure, which grew a substantial 18.7 percent (figure 2). Exports for goods and services turned positive for the first time after five consecutive quarters and were the second-biggest contributor to growth. On the other hand, private final consumption expenditure growth, which had underpinned growth thus far, fell relative to previous quarters. But what concerns investors and analysts the most is the contraction in gross fixed capital investment for the second consecutive quarter.

In July, the industrial production index fell, negating almost all the gains of the previous two months. The contraction in the capital goods sector, which has been in negative territory since November 2015, was the biggest drag. While the government is trying to push public investment expenditure up, private sector investment remains weak. That said, the GDP estimate suggests a high subsidy outflow in Q1; the fiscal deficit during the period April–July 2016 was already at 73.7 percent of the budget estimate. In other words, there will likely be very little room for the government to spend on capital expenditure for the rest of the year.

Easing monetary policy may not be enough

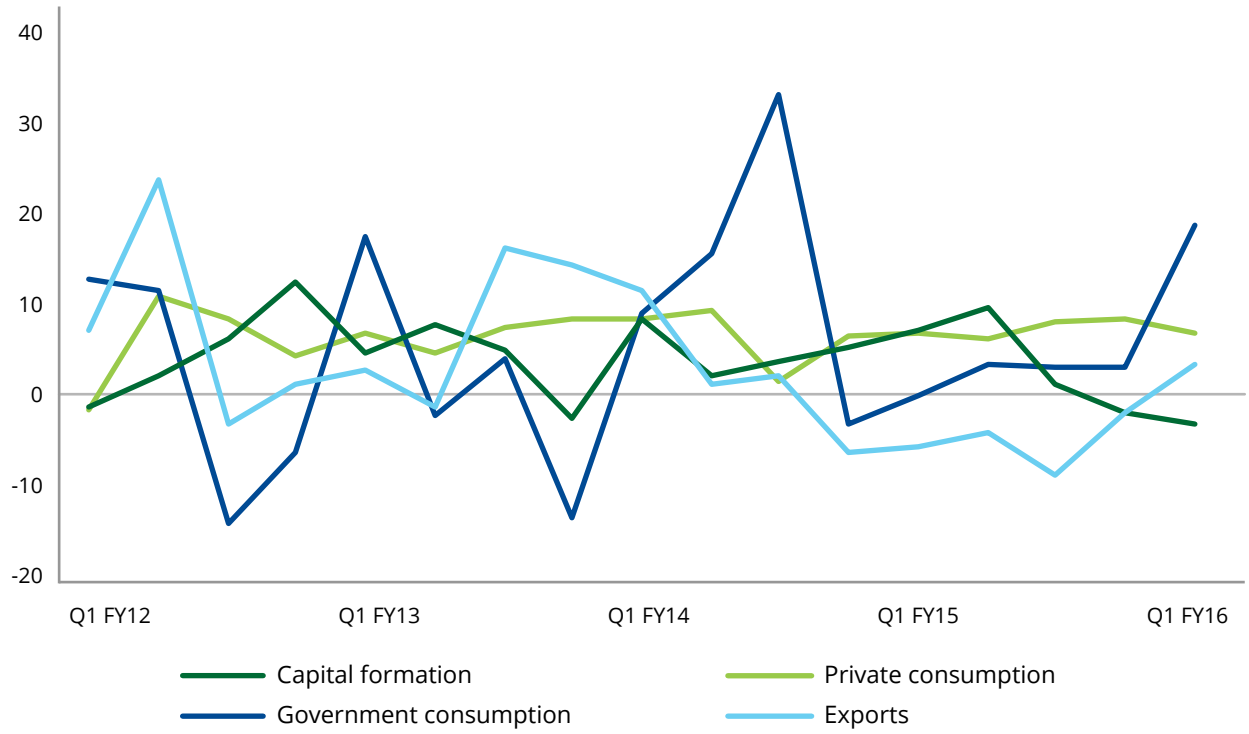
The economy has heavily depended on private consumption spending for growth. However, to ensure sustainably strong and noninflationary growth in the long run, stepping up fixed capital investment will be crucial. Can the Reserve Bank of India (RBI) use monetary policy instruments to provide the desired thrust to capital expenditure and, thereby, economic growth?

Inflation continues to remain low and may decrease further owing to a good monsoon, in turn leading to falling food prices. The external sector's health has improved considerably in the past few quarters. At 0.1 percent of GDP, India achieved the lowest current account deficit in Q1 FY 2016-17 since 2004. Foreign direct investment remains strong, and foreign exchange reserves are at record-high levels. Institutional investment inflows turned positive in Q1 after registering a net outflow in FY 2015–16. Low inflation and comfortable levels of the current account balance and currency provide a window for the new RBI governor to cut policy rates in order to accommodate growth concerns. Accordingly, the RBI announced a policy rate cut of 0.25 percent in its latest monetary policy statement, suggesting that it is willing to boost credit growth and demand in the economy.

However, a policy rate cut may not be very effective given that banks are not yet willing to pass on the benefits of rate cuts to consumers. Short-term liquidity concerns and high bad loans are keeping banks cautious of undertaking lending activities. Recent reforms such as narrowing the liquidity adjustment facility corridor (the excess of repo rate over and above the reverse repo rate) and introducing the marginal cost of fund-based lending rate (this is a modification to the existing base rate that factors in the repo rate while deciding the lending rate by commercial banks) will likely ensure better transmission of benefits. That said, borrowing rates are only one of the factors that feed into investment decisions. For businesses to feel confident and then spend, there is a need to improve the financial inclusion of small-scale investors and access to funds.

Figure 2. Expenditure as a component of GDP

Percentage, year over year



Source: Central Statistical Organization, Government of India, August 2016.

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The recent spate of reforms

The other issue is the poor ease of doing business in India, caused by bottlenecks in infrastructure and manufacturing investment, tax issues, and the lack of investment in priority sectors. In several of my previous analyses, I emphasized the need to address structural and institutional weaknesses, and argued that addressing them effectively would go a long way in boosting investors' confidence and creating a business-friendly environment.[7]

Over the past two years, the government has undertaken several measures on the economic policy front, a few of which are mentioned in table 1. Although the progress on reforms has been gradual, the recent passage of the bankruptcy law and the GST bill, among others, is among the landmark reforms that are expected to change the way India does business and support its growth outlook.

Instead of introducing the reforms at the center, the government has encouraged states to implement these reforms. The possible logic may be that once states start implementing reforms and see the benefits, there will be little resistance to accepting reforms at the center.

The bankruptcy code: Currently, India ranks low in resolving insolvency (136 out of 189 countries); according to a World Bank report, resolving bankruptcy in the country could take more than four years.[8] The passage of the bankruptcy code is expected to help lenders and creditors recover their money within a year, aid banks and lenders in recovering their loans from big businesses and willful defaulters, and discourage big corporates from defaulting. The code will likely ensure a quick release of productive assets that are locked in sick business units, allow failed businesses to wind up faster, and help entrepreneurs to make a quick exit. All these will likely aid in improving India's corporate bond market.

In addition, to address the growing issue of nonperforming assets in the banking sector, the government has taken steps to deal with willful defaulters and those in trouble during economic hardship. Amendments are being made to the existing law to ensure that the recovery process is more efficient and expedient. Various measures are being undertaken to revive stressed sectors, such as steel, textiles, power, and roads, and capitalize banks to allow them to correct their balance sheets.

The goods and services tax: This law replaces a plethora of taxes—central, state, interstate, and local—as well as multiple rates, thresholds, and exemptions, with a single and uniform tax for goods and services across the country. The law is expected to create a common market with seamless transfer of goods and services across the country, increase resource allocation efficiency, and plug leakages.

The GST law will likely give a boost to foreign investments and the Make in India campaign because of the potential of the unified common national market. As tax rates stabilize and cost efficiency improves, prices for consumer goods will likely come down in the medium to long term. It will likely increase consumer spending, growth, and employment opportunities in an economic virtuous circle. In addition, revenue collection for the government

Table 1. Recent reforms

Reforms	Progress status
Agriculture	
Remove government-mandated minimum prices for agricultural goods	Proposed/incomplete
Deregulate fertilizer pricing	Proposed/incomplete
Banking	
Ease flexibility to help banks achieve priority sectors' lending targets	Partially completed
Ease of doing business	
Create a unified national tax for goods and services	Partially completed
End retrospective taxation of cross-border investments	Partially completed
Revise bankruptcy code to make it quicker and easier for companies to file for bankruptcy	Completed
Revise land acquisition bill to make it easier for states to use eminent domain to purchase land	Partially completed
Offer new businesses one-stop shopping for clearances	Proposed/incomplete
Ensure that business owners can receive permit in 10 days or less	Proposed/incomplete
Communication	
Conduct transparent auctions of telecom spectrum	Completed
Foreign investment	
Infrastructure	
Allow more than 50% foreign investment in defense	Partially completed
Allow more than 50% foreign investment in railways	Completed
Allow foreign investment in construction projects	Completed
Allow more than 50% foreign investment in insurance	Partially completed
Raise the ceiling on foreign institutional investment in Indian companies	Proposed/incomplete
Retail	
Reduce restrictions on foreign investment in multibrand retail	Partially completed
Reduce restrictions on foreign investment in single-brand retail	Partially completed
Allow more than 50% foreign investment in direct retail e-commerce	Partially completed
Other	
Allow cities to issue municipal bonds to raise funds	Proposed/incomplete
Allow foreign lawyers to practice in India	Proposed/incomplete
Energy and mining	
Deregulate diesel pricing	Completed
Deregulate natural gas pricing	Partially completed
Deregulate kerosene pricing	Proposed/incomplete
Open coal mining sector to private/foreign investment	Completed
Industry	
Relax government controls over corporate downsizing	Proposed/incomplete
Extend the expiration date of industrial licenses	Completed
Fiscal	
Use direct benefit transfer to deliver cash subsidies	Partially completed
Use direct benefit transfer to deliver goods subsidies	Partially completed

Source: Center for Strategic and International Studies, "The Modi government's reform program: A scorecard," http://indiareforms.csis.org/, accessed September 27, 2016.

Graphic: Deloitte University Press | dupress.deloitte.com

These reforms, ranging from infrastructure development to ease of doing business to labor, are imperative, but the real key to the success of these wide-ranging reforms will be in the details.

will likely improve over time through better tax compliance and higher profits as businesses save on tax administration costs.

Labor market reforms: The government is now gearing up for bold reforms in the labor market by considering the labor ministry's proposal to introduce two legislations covering industrial relations and wages. These are aimed at enhancing the ease of doing business and generating employment. It is expected that freeing up the labor market from dated laws will also lure foreign investment and encourage small firms to expand.

These reforms, ranging from infrastructure development to ease of doing business to labor, are imperative, but the real key to the success of these wide-ranging reforms will be in the details. For instance, the real test of the GST reform lies in the way it is implemented. The very first challenge would be to decide the GST rate: Too high a rate could send inflation out of control, while too low a rate could result in revenue losses. Also, the mechanism to resolve disputes needs to be clear. Flawed implementation of the GST could result in little or no benefits in terms of higher economic growth.

Institutionalization of the fiscal and monetary policy frameworks

Fiscal consolidation: While remaining committed to fiscal prudence and consolidation, the finance minister announced during the FY 2016–17 Union budget that the government would initiate a review of the FRBM Act.[9] The reviewing panel will be responsible for examining the need and feasibility of aligning fiscal expansion or contraction with credit contraction and expansion, as well as changing the fiscal deficit target from a fixed number to a range.

Institutionalization of the monetary policy: During the budget, the finance minister also initiated the amendment process of the 1934 RBI Act along with setting up a monetary policy committee (MPC). The preamble in the RBI Act, as amended by the 2016 Finance Act, now states that the primary objective of the monetary policy is to maintain price stability, while keeping in mind the objectives of growth and meeting the challenges of an increasingly complex economy.[10] This will help anchor inflation expectations, improve monetary transmis-

sion, and reconcile any conflict between the RBI and the government, which usually wants lower interest rates to lift economic growth. The center brought into force the provisions of the amended RBI Act regarding the constitution of the MPC on June 27, 2016, so that the statutory basis of the MPC is made effective. Urjit Patel, who succeeded Raghuram Rajan as the RBI governor in September and is also one of the key architects of the new monetary policy framework, kept the ball rolling on the monetary policy by finalizing the six-member MPC.

The government's reform initiatives, commitment to fiscal consolidation, and the monetary policy institutionalization are bolstering macroeconomic fundamentals, which, in turn, are augmenting the economy's ability to deal with external shocks. For instance, India has been able to brush aside the impact of Brexit: The effect on India's stocks, bonds, and currencies has been minimal; equity market indices have been on the rise; and sovereign bond yields have continued their downward trajectory. The depreciation in the Indian rupee has been contained as well.

The reforms' impact is expected to be reflected in investments. The devil lies in the details, and once businesses are confident about their effective implementations, capital spending is likely to pick up at a sustainable pace.

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Too early for optimism

By Lester Gunnion

RUSSIA might well be nearing the bottom of its painful recession. After contracting for five straight quarters, a sixth quarter of milder contraction, despite being rooted in a weak base quarter from a year ago, brings hope that the worst has passed. The Russian ruble has stabilized, inflation is slowing, monetary policy has eased, and oil production is booming. Additionally, Russia's return to the international bond market, though troublesome at first, indicates a large investor appetite for Russian debt, despite sanctions. Ruble-denominated bonds and equities have gained as well. However, despite the pockets of good news, there is no dearth of concern regarding the Russian economy. Foreign investment flow has been reduced to a trickle, and Russia's ambitions in the energy sector continue to be stymied by international sanctions. A pivot toward Asia has failed to produce any traction beyond commodity- and energy-related ties. Moreover, Russia's strategy of import substitution continues to be marred by a lack of integration into global value chains (GVCs) and underinvestment on the domestic front. A fiscal shortfall is unlikely to help the situation. Finally, Russian citizens continue to withstand the worst of the downturn. Given such a cloudy picture, it is far too early for optimism.

Russia returns to international debt markets

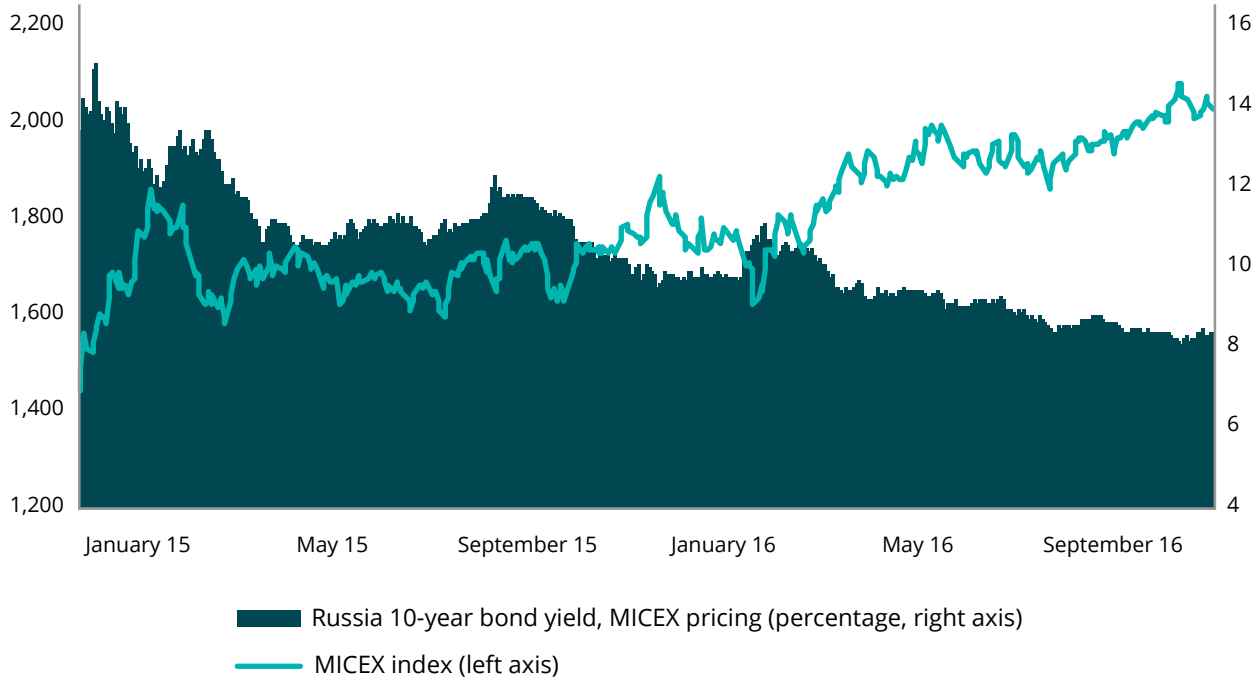
Russia returned to the international debt market for the first time in three years by issuing 10-year dollar-denominated sovereign bonds in May. International sanctions that shut out western capital markets to Russian firms proved to be far reaching

Foreign investment flow has been reduced to a trickle, and Russia's ambitions in the energy sector continue to be stymied by international sanctions.

as international banks, particularly in Europe, navigated away from handling Russia's sovereign bond offering. Chinese banks, invited to step in, were not forthcoming either, primarily because of a lack of reach in the capital markets of the United States and Europe. Moreover, international clearing houses in Belgium and Luxembourg, critical components of the global financial mechanism for servicing international debt issuance, remained skeptical lest the money raised by sovereign bonds be funneled back to Russian firms under sanctions, thereby raising the possibility of penalties being imposed by the United States and the European Union. These uncertainties resulted in only $1.75 billion of the $3.0 billion bond sale being placed in the initial offering.[1] However, as soon as international clearing houses agreed to service Russian debt, the remaining $1.25 billion of sovereign bonds were snapped up by international investors, with investors from the United States, United Kingdom, and Europe accounting for 96 percent of the purchase, and Asian investors accounting for just 4 percent.[2] In all, Russia's sovereign bond offering of $3 billion registered total demand of $7 billion.[3] Encouraged by the issue of sovereign debt, Russian companies not covered by sanctions have also returned to international debt markets, primarily to refinance existing debt that is due to mature in the short term.

Ruble-denominated debt has also attracted foreign investors. Russia's 10-year bond yields declined from 15.0 percent in January 2015 to 8.0 percent in

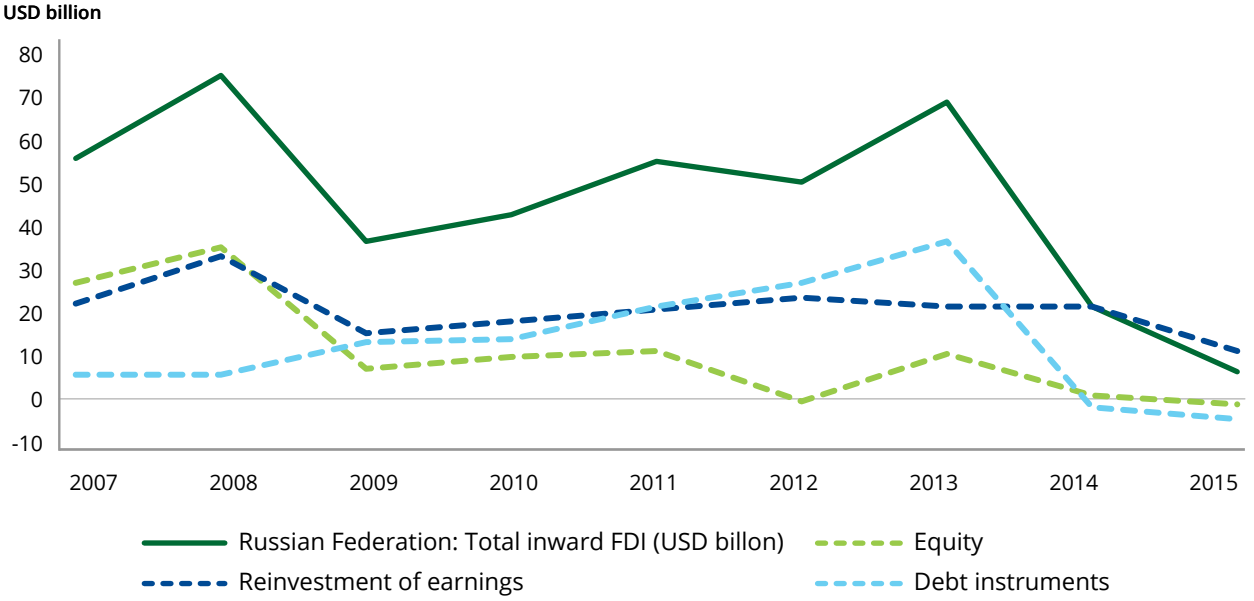
Figure 1. Russian bonds and equities have gained



Source: Bloomberg.

Graphic: Deloitte University Press | dupress.deloitte.com

Figure 2. FDI flows into Russia have slowed markedly



Source: Bank of Russia, "External sector statistics: Foreign direct investment in the Russian Federation," http://www.cbr.ru/eng/statistics/?PrtId=svs.

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August 2016.[4] Russian equities are also in demand. The dollar-denominated RTS index has risen 33.0 percent relative to the beginning of the year, while the ruble-denominated MICEX has risen 16.0 percent during the same period (figure 1).[5] All of this flies in the face of an ongoing recession and international sanctions. Debt and equity investment in Russia have been buoyed by the rebound in oil prices compared with the beginning of the year, relative stability of the ruble, a scarcity of Russian debt in international markets, and, most importantly, attractive yields on assets in comparison to western markets. As a result, net capital outflow from the private sector slowed to just $2.4 billion in Q2 2016 (from $152 billion for the whole of 2014), even turning positive in August.[6]

Declining FDI may weigh on future growth

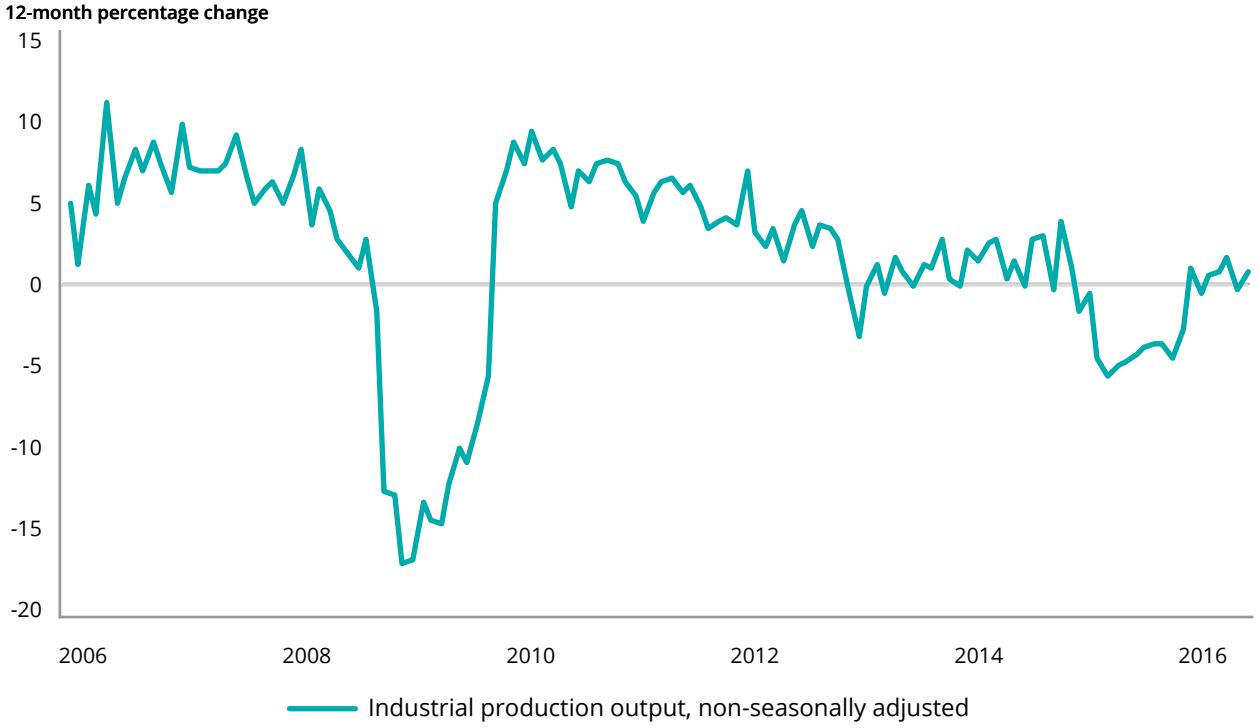
Apart from some positive news in debt and equity markets, Russia's foreign direct investment (FDI) landscape has not attracted much interest. FDI flows into Russia have slowed markedly since the United States and the European Union imposed political and economic sanctions on the country. In addition to international sanctions, business risks associated with macroeconomic uncertainty have kept foreign investors away. Annual FDI flow into the Russian economy fell from $69.2 billion in 2013 to $6.5 billion in 2015, a drop of 91.0 percent (not revised for "round tripping"[7]). In fact, FDI flows in 2015 were down 82.0 percent relative to 2009 ($36.6 billion), when foreign investment slumped at the peak of the global financial crisis (figure 2). Russia's pivot toward China looked promising when FDI from China surged in 2014. However, in 2015, FDI from China fell to almost half of the 2014 level as oil prices collapsed, China's growth rate slowed, and Russia's economy started contracting.

The drying up of foreign investment in Russia is likely to add to the challenge of diversifying the economy by revitalizing industrial production. For instance, without the transfer of technical expertise, industrial production is likely to remain sluggish. The average 12-month percentage change in industrial output for the first eight months of 2016 was just 0.1 percent; this is despite industrial output declining year over year in every month through 2015 (figure 3). The pause in technology transfer from western economies could also affect Russia's ambitions in its large hydrocarbons sector, particularly in the Arctic and the shale reserves of the Bazhenov formation. In 2014, a US-Russia joint venture to explore the Arctic for oil was taken off the table due to sanctions. Sanctions also prohibit the transfer of equipment or services for exploring shale reserves—which is pertinent, as Russia is home to the largest shale oil reserves on the planet. However, Russia's oil production has increased since 2014 despite sanctions. This is mainly due to an increase in drilling in western Siberia's Soviet-era brownfields. In essence, Russia has expanded and advanced the timeline of conventional production by reinvesting in existing fields.

Additionally, the Russian oil sector has started extracting unconventional tight oil from deposits in Tyumen and Achimov, classified as "hard-to-recover resources" from formations that are geologically different from shale and therefore not under the purview of sanctions. However, ramping up production also implies increased taxation, as Russia's energy sector is taxed on production and not on profits. This tax system has served as a disincentive to further investment in existing projects. Tax breaks for greenfield projects are meant to attract foreign investors, but with sanctions in place and global oil prices low, there is not much of an incentive for foreign money. More importantly, if Russia does not have access to western technology to ex-

The drying up of foreign investment in Russia is likely to add to the challenge of diversifying the economy by revitalizing industrial production.

Figure 3. Weak growth in industrial production output



Source: Federal State Statistics Service/Haver Analytics.

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plore the Arctic deepwater and shale reserves, production from conventional sources are likely to drop in the medium term. The length of US-EU sanctions as well as the trajectory of oil prices are likely to become progressively more important to Russia's energy industry and overall economic progress.

Ties with Asia continue to be resource driven

Russia's pivot to Asia has been characterized by commodity- and energy-related deals. In March, the Bank of China extended a $2.2 billion five-year loan to Russia's largest state-owned gas producer, which is likely to be used as refinance.[8] Additionally, in April, two Chinese state-owned banks agreed to extend $12 billion in funding for a Russian liquefied natural gas project in the Arctic.[9] This follows a $400 billion 30-year gas supply deal between Russia and China, signed in 2014. The China National Petroleum Corporation has also expressed an interest in acquiring a stake in Russia's Rosneft, which is looking to shed a 19.5 percent stake in order to finance Russia's fiscal shortfall.[10] Increased dependence on China as a source of finance, coupled with the relatively low price of oil and gas, will likely increase China's bargaining power in fixing the terms of current and future energy deals with Russia.

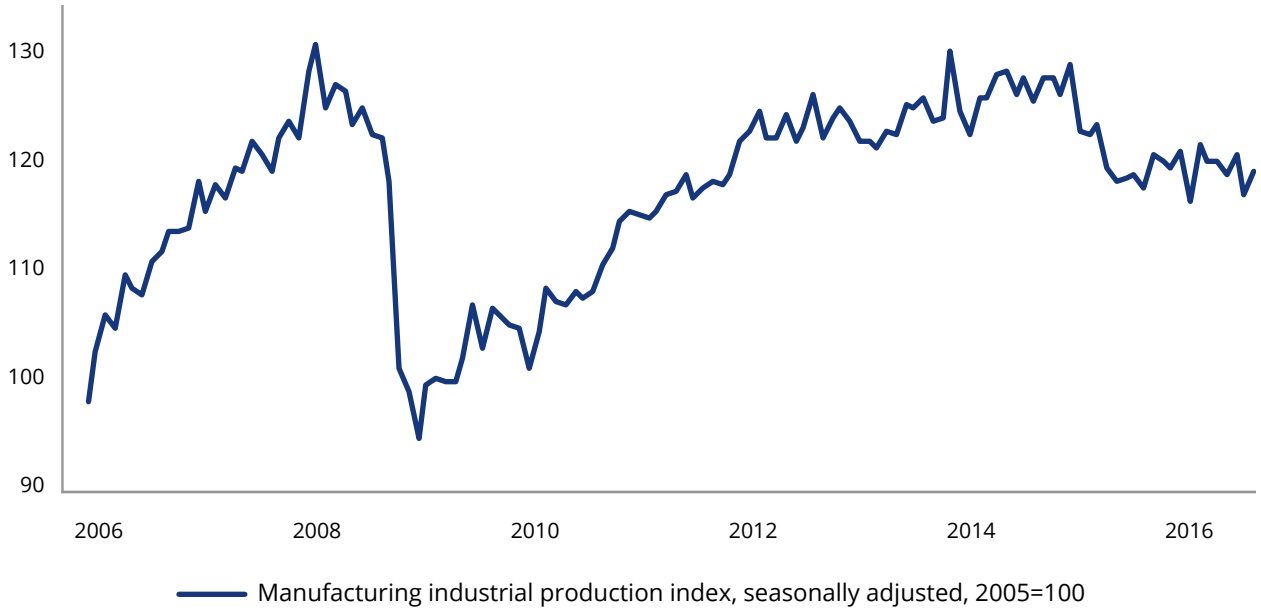
Greenfield investment projects in Russia's far east have been dominated by another large importer of commodities and energy: Japan. Japan accounted for 25.0 percent of the total capital expenditure in the region between January 2003 and July 2016.[11] Investment during this period has been predominantly in metals and hydrocarbons.

Import substitution stifled by isolation and underinvestment

While the hydrocarbon industry is strongly driven by global developments, Russia's strategy of import substitution is geared toward economic sovereignty. In order to achieve this goal, Russia needs to diversify its economy away from a dependence on hydrocarbons. Russia's vast manufacturing sector, for instance, presents a great opportunity for economic diversification. However, Russia's import substitution efforts in the manufacturing sector have failed to overcome a dependence on the import of machinery and equipment.[12] In fact, the manufacturing industrial production index indicates a sector in retreat (figure 4). Part of the reason behind this is that Russian industry as a whole is not well integrated into GVCs; participation in backward linkages is weak, while participation in forward linkages is primarily driven by the hydrocarbons sector.[13] The large manufacturing sector is therefore comparatively uncompetitive on the global stage and continues to depend on expensive imports. Furthermore, manufacturing output is consumed domestically. Activity in the manufacturing sector and in the economy as a whole is therefore strongly dependent on the earnings of the hydrocarbon sector. As a result, when hydrocarbon prices fall, economic activity across other sectors declines as well.

In order to break its dependence on the hydrocarbon sector, Russia needs to invest in infrastructure and skills, apart from making efforts to integrate into GVCs. However, domestic investment has not been forthcoming; gross fixed capital formation has declined year over year for eight straight quarters.[14] Similarly, the development of workforce skills has been sluggish: Labor productivity has declined year over year for seven straight quarters. Investment and development plans will probably be constrained by a fiscal deficit likely to exceed 3.0 percent of GDP in 2016. The focus is therefore likely to be on privatizing state-owned assets rather than on investing in infrastructure or skills.

Figure 4. Manufacturing industrial production in decline



Source: Federal State Statistics Service/Haver Analytics.

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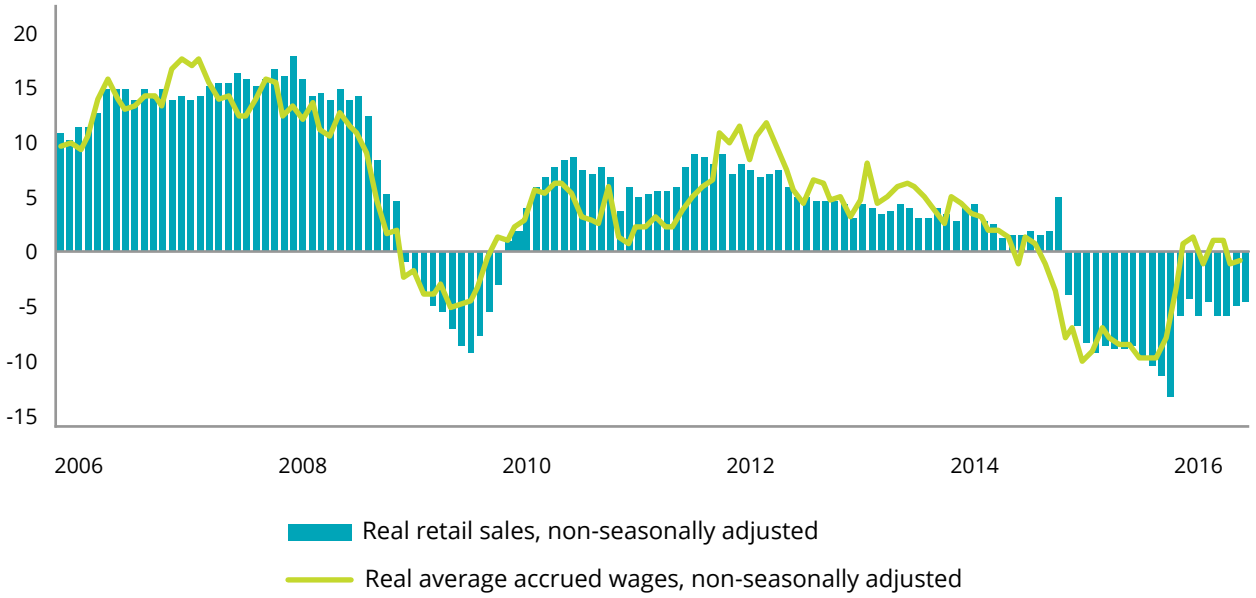
Russia's consumers, critical to the future of the economy, continue to weather the worst of the recession.

Russia's consumers bear the brunt

Russia's consumers, critical to the future of the economy, continue to weather the worst of the recession. Real incomes are still in decline (figure 5), and pensions for the elderly, having been deindexed from inflation, represent a loss in real income. As a result, real retail sales declined 5.1 percent year over year in August—the 20th month of decline. A voter turnout of less than 50 percent in the recent parliamentary elections is a likely indicator of dissatisfaction among consumers. Ironically, the near-term outlook for Russia seems brighter than a year ago, as the economy contracted 3.7 percent in 2015 but is likely to contract by less in 2016 (1.2 percent). Annual growth in 2017, if any, is likely to be weak, at 1.0 percent.[15] Even if the economy does indeed return to growth in the medium term, continued dependence on hydrocarbons (particularly in an environment of low prices), underinvestment in diversification of the Russian economy, and the persistence of sanctions will limit growth in the long term.

Figure 5. Real income and retail sales continue to decline

12-month percentage change



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Finally, that elusive rate cut

By Akrur Barua

IN October, Banco Central do Brasil (BCB) cut its key policy rate (Selic rate) by 25 basis points from a 10-year high of 14.25 percent.[1] The central bank had last cut the Selic rate in 2012. In recent weeks, economists and markets closely followed BCB moves, wondering when the central bank will bring down the cost of borrowing to provide some succor to the economy. After all, fiscal support in the short to medium term is unlikely given the high fiscal deficit and growing government debt. And the economy has gone through a tumultuous period of political uncertainty, with long-term confidence in the new government yet to be tested despite initial cheers from the markets.

It appears now that the BCB has finally obliged. However, it would be naïve to assume that the October rate cut indicates a path to continued monetary loosening in the near term. In fact, the quantum of the rate cut—25 and not 50 basis points—indicates that BCB is wary of inflation, which, at 8.5 percent, is still much above the central bank's target range of 3.0–6.0 percent.

> Once a poster boy for growth, consumer spending contracted yet again in Q2.

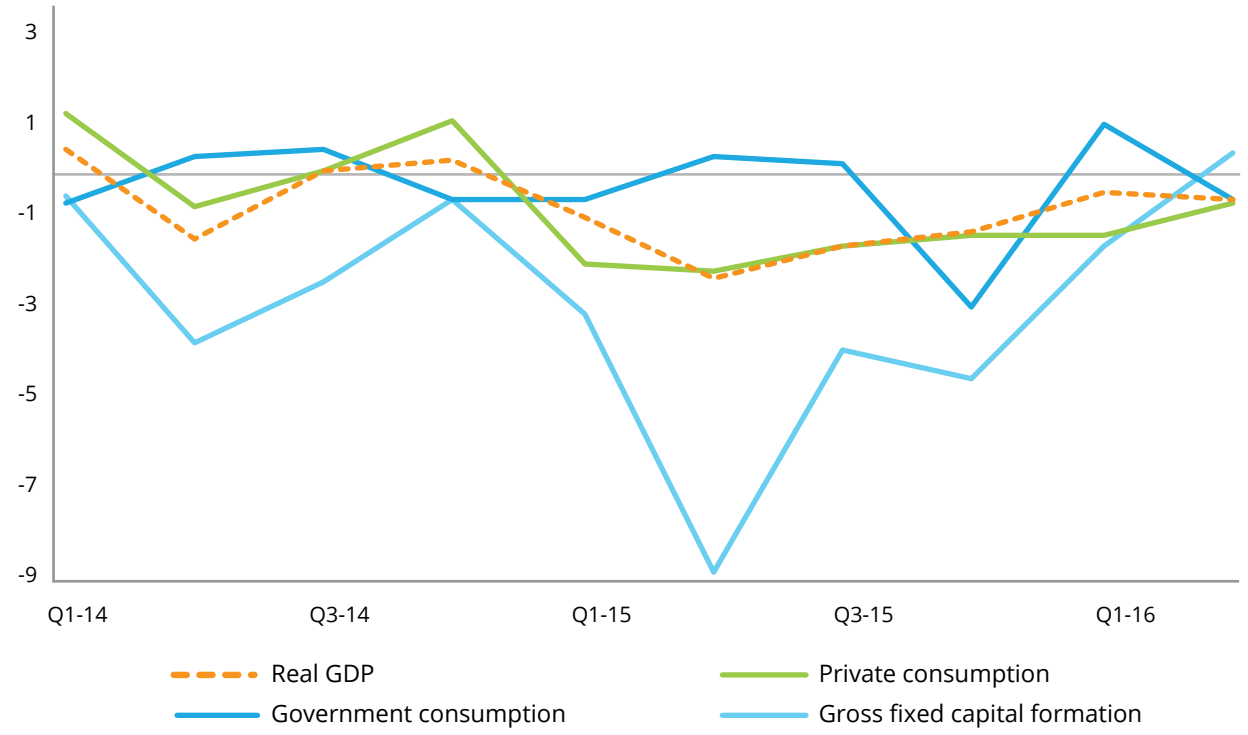
Consumers in need of some help

Brazil's economy contracted 0.6 percent quarter over quarter in Q2, the sixth straight quarterly decline (figure 1). While the pace of contraction has slowed, it will be some time before growth turns positive. In the central bank's October 7 survey, for example, the median growth forecast for 2016 was -3.2 percent, with growth likely to move up to 1.3 percent next year.[2] The International Monetary Fund (IMF), however, puts its growth forecast for 2017 much lower at 0.5 percent, although its July forecast is an improvement from its April number.[3]

A key worry for economic activity is consumer spending. Once a poster boy for growth, consumer spending contracted yet again in Q2. Spending by consumers is also likely to remain subdued if trends in monthly retail sales are anything to go by: Sales volumes fell 0.6 percent in July and August, reversing a 0.2 percent gain in June. Consumers have been battered by rising unemployment and high inflation. Real average monthly earnings, for example, have been in decline since early 2015, and

Figure 1. GDP continued to contract in Q1 and Q2, but at a slower pace than in 2015

Percentage, quarter over quarter



Source: Haver Analytics.

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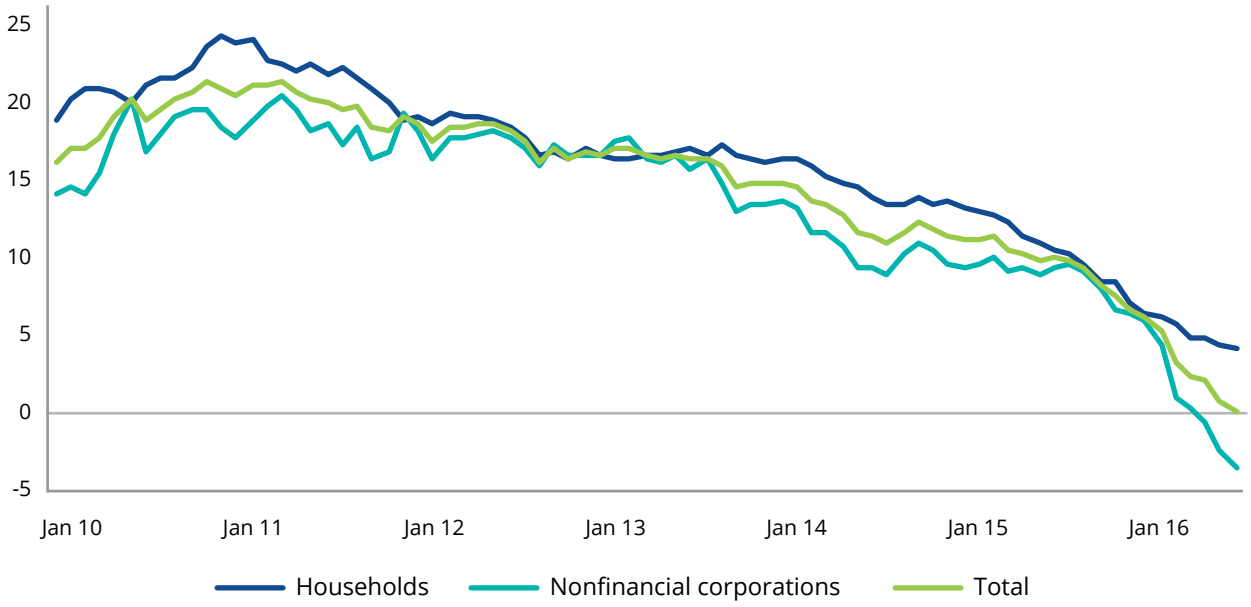
Figure 2. Credit growth has been going down steadily in the past few years

Percentage, quarter over quarter



Source: Haver Analytics.

Graphic: Deloitte University Press | dupress.deloitte.com

the unemployment rate went up to 11.8 percent in July and August (more than three percentage points higher than a year before).[4] Worse, the labor market is unlikely to improve soon as the economy is not poised for a strong recovery in 2016–17.[5]

With the fiscal side set to remain tight—subsidies have been cut, and proposed reforms will hit welfare spending—the onus will fall on monetary policy to stimulate consumer demand. Any rate cut will aid credit creation by lowering the cost of finance. Credit growth has been moribund due to high interest rates and slowing demand (figure 2). A cut in interest rates will also help consumers who are eager to deleverage. Households had gone on a spending binge a few years ago due to cheap credit from state development banks. Between 2005 and 2015, for example, household debt as a share of disposable personal income went up by about 25 percentage points, while the debt service ratio shot up by more than 5 percentage points.[6]

Businesses, too, need some help

The weak economy and political turmoil have hit domestic demand and, hence, corporate profits. Businesses have also been hurt by the high cost of capital, which in turn has dented credit for the private sector. Credit growth for nonfinancial corporations, for example, turned negative in May (figure 2). All these factors have hit investments severely. Gross fixed capital formation fell 25.6 percent in the last three years and has contracted every quarter since 2014 barring Q2 2016.

The drop in business activity can also be seen from growth trends in manufacturing and services. Manufacturing has contracted 18.1 percent in the three years up to Q2 2016, with services managing to grow just 5.1 percent during this period. Even in services, a weak economy is taking its toll, with growth falling to -0.8 percent in Q2 from -0.4 percent in Q1. Add to this the private sector's long-running grievances over ease of doing business—especially the taxation regime—and one can sense a classic case of a prolonged low-investment environment. This does not augur well for productivity and potential GDP growth.

The dark clouds for businesses, however, appear to be thinning a bit. The political environment, a cause for much of the uncertainty over the last year, has improved, with the new government expected to continue in office until 2018, when presidential elections will be held. Markets have reacted favorably to the new economic team in place, with long-term bond yields going down. Business confidence has also improved (figure 3). So any drop in the cost of capital, courtesy BCB, will add to the rising optimism.

For BCB, inflation numbers are a worry

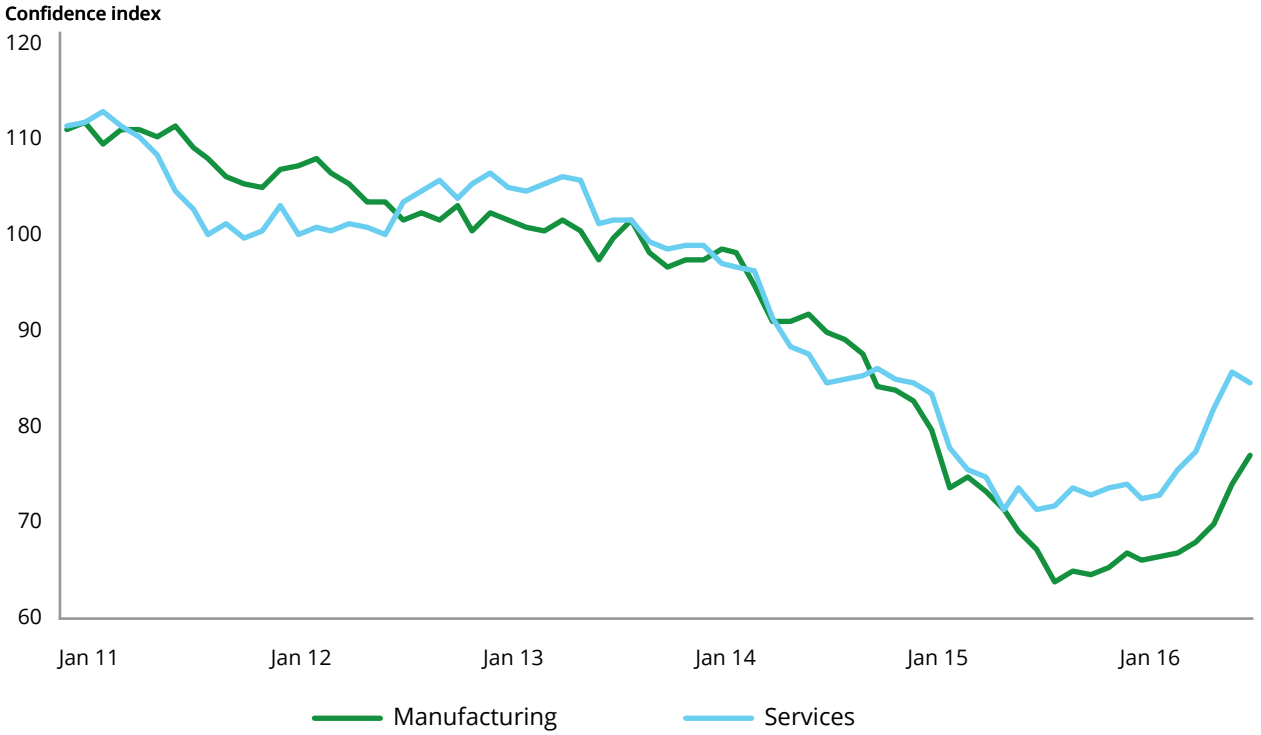
Inflation has been one of the sore points of BCB's monetary management. The last time inflation hit the midpoint (4.5 percent) of the central bank's target range was way back in August 2010. It is no wonder, then, that BCB's credibility has been hit. The central bank will thus be more cautious in its approach going forward. While both headline and core

The weak economy and political turmoil have hit domestic demand and, hence, corporate profits.

inflation figures have come down this year, the pace of decline slowed in July and August; the figures for August were slightly higher than the ones for July (figure 4). Thankfully, inflation declined slightly in September, and so did core inflation, probably influencing BCB's October rate cut decision.

A quick look at the components gives us a mixed picture. Food inflation, for example, continued to be high in September, but fell on a month-over-month

Figure 3. Confidence in both manufacturing and services has been going up of late



Source: Haver Analytics.

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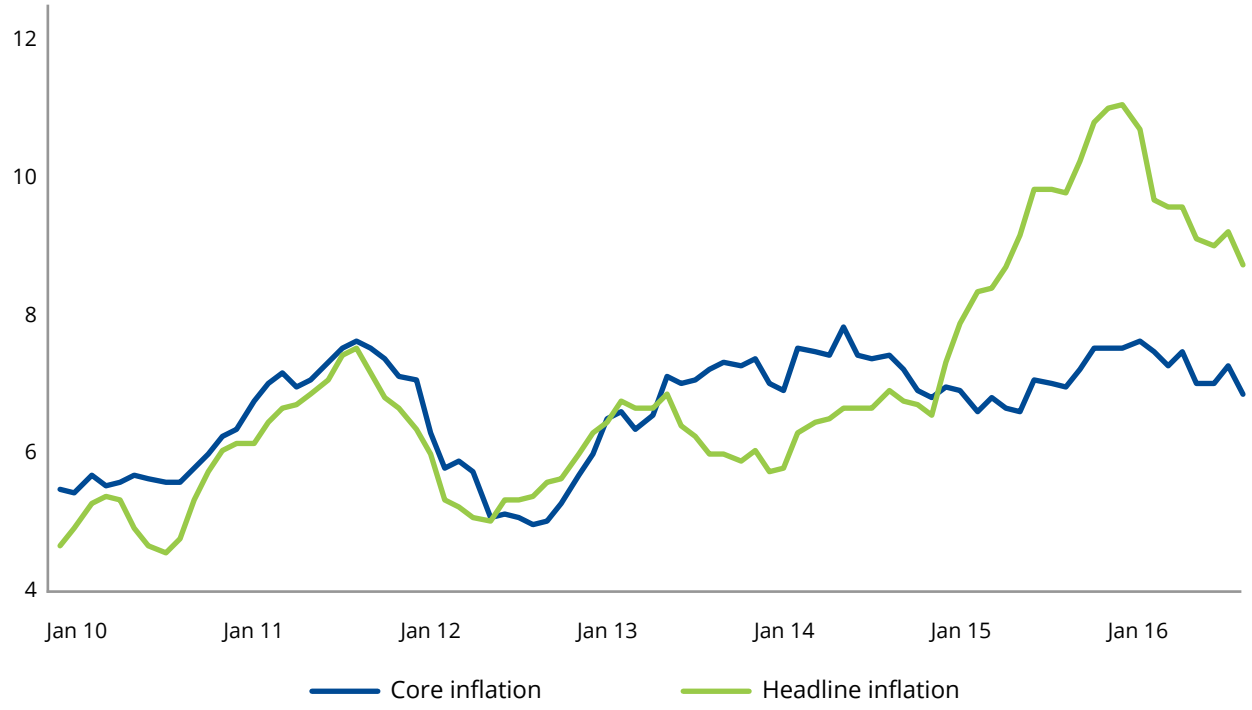
basis—a positive sign given the component's large share in the headline price index. Services inflation, which had gone up in August, probably due to price hikes during the Olympics, fell in September. Moreover, growth in regulated prices, which include utilities, public transportation, and fuel, has also gone down this year. Regulated prices had spiked in 2015, as the government cut subsidies. So, toward the end of this year, a high base effect is likely to come into play here.

Contrary to 2015, the currency's strength will be helpful in pushing down inflationary pressures. Since the beginning of the year, the Brazilian real has gained more than 22.0 percent against the US dollar to emerge as one of the best-performing emerging-market currencies. Although worrisome for exports—that sector has been the lone light this year—a strong real is likely to push inflation lower.

Figure 4. Although headline and core inflation have fallen this year, they went up slightly in August

Percentage, year over year



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Time for the fiscal side to deliver

In August, Dilma Rousseff was officially impeached, paying the way for President Michel Temer, her former deputy, to continue in office for the next two-and-a-half years. Temer's economic team has so far found a vote of confidence from the markets: Equities are up, and bond yields have gone down. Markets are particularly enthused by his reform proposals, both fiscal and structural. The proof of the pudding, however, is in the eating. Some of these reforms will be difficult to pass and may be unpalatable for a population reeling from severe economic contraction.[7] The proposal to cap real government spending, for example, may require cuts in other social welfare programs. Reforms in pensions, where costs are expected to soar over the next decade, will be even more difficult.

For now, some reforms are likely to get legislative approval because of the numbers in favor of Temer. The dire state of public finances may also strengthen the government's hand. Markets will be watching with interest. Any dithering by the government is likely to reverse gains made in equities and bonds so far, which, in turn, could impact inflation expectations and force BCB to be more cautious. For example, even though inflation expectations for the next 12 months have gone down to 5.1 percent in October from 7.1 percent in January, the figure is still above BCB's midpoint target. As BCB President Ilan Goldfajn recently pointed out, inflation expectations will decline toward the target only if there are better fiscal management and economic reforms.[8] That will, however, take some time. Until then, BCB is likely to tread a cautious, data-dependent path.

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Waiting for the European Union

By Daniel Bachman

Where are the exports?

The decline in oil prices in late 2014 hit Canada hard. As a producer of the most expensive oil in the world, Canada was vulnerable.[1] But Canadians might have expected the country's diversified economy to provide some cushion. A large chunk of the Canadian economy is invested in manufacturing, not energy. When oil prices were hovering at 100 US dollars (USD) per barrel, Canadian manufacturers complained—not unreasonably—that oil was crowding out more employment-rich activities in Canada's industrial heartland by raising the value of the Canadian dollar and making industrial exports uncompetitive.

> But real measures of Canadian exports showed growth as well.

When oil prices fell, the exchange rate behaved as expected (and as manufacturing-intensive Ontario and Quebec hoped). The Canadian dollar (CAD), plunged from CAD 1.07 per USD in mid-2014 to CAD 1.42 by January 2016 (although it has since come back to around CAD 1.30). That's a hefty 32 percent increase in Canadian competitiveness right there. Initially, exports responded. Figure 1 shows that nonenergy export growth picked up to the 10 percent range, and exports of major industrial products grew at more than 20 percent for some time.[2] Some of this growth is likely because much of this trade is invoiced in US dollars, so the same exports are worth more Canadian dollars. But real measures of Canadian exports showed strong growth as well. The growth of jobs and activity in Ontario and Quebec easily offset the loss of jobs in resource-heavy provinces, especially oil-rich Alberta.

Sometime early this year, however, things changed. As figure 1 shows, Canadian nonenergy export growth stopped in early 2016. Industrial exports were below their year-ago level in July. That's not a good sign for the Canadian economy, and not what should be happening as long as oil prices remain soft. Without the continued shift to manufacturing exports, Canada faces a significant challenge in reaching and maintaining full employment.

Growth worries

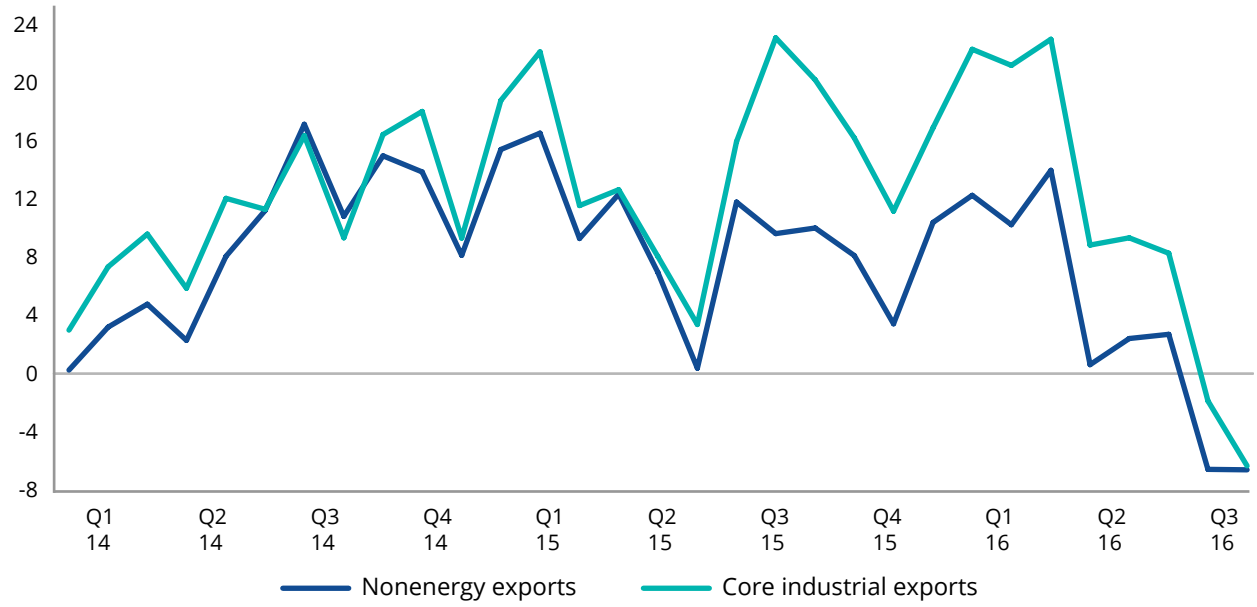
Canada registered a 1.6 percent decline in GDP in Q2 2016.[3] Statistics Canada pointed out that, excluding the impact of the Alberta wildfires, GDP growth would have been positive—but just barely.[4] Q3 growth will likely show a significant rebound in Q3, but the underlying trend is a bit worrisome. Business investment has been soft recently, and exports have stopped contributing to growth as well. To some extent, that's the result of recent US weakness. But the sudden slowdown in exports is more than might be explained by US growth dropping to the 1 percent range.

The labor market still appears a bit weak. While year-over-year job growth is slowing in the United States, it was 1.7 percent in September. Canada's job growth, on the hand, grew to only 1.2 percent in June (when the latest payroll data were available; see figure 2). Canada's 7.0 percent unemployment rate compares unfavorably with the United States' 4.9 percent. The Canadian economy's inability to create jobs is a matter of concern.

Not surprisingly, the Bank of Canada has kept interest rates on hold. The September statement suggested that there are reasons for optimism,[5] but the direction of policy is clear: The Bank of Canada is waiting—and a big number for Q3 GDP won't change that.

Figure 1. Export growth

Percentage change, year over year

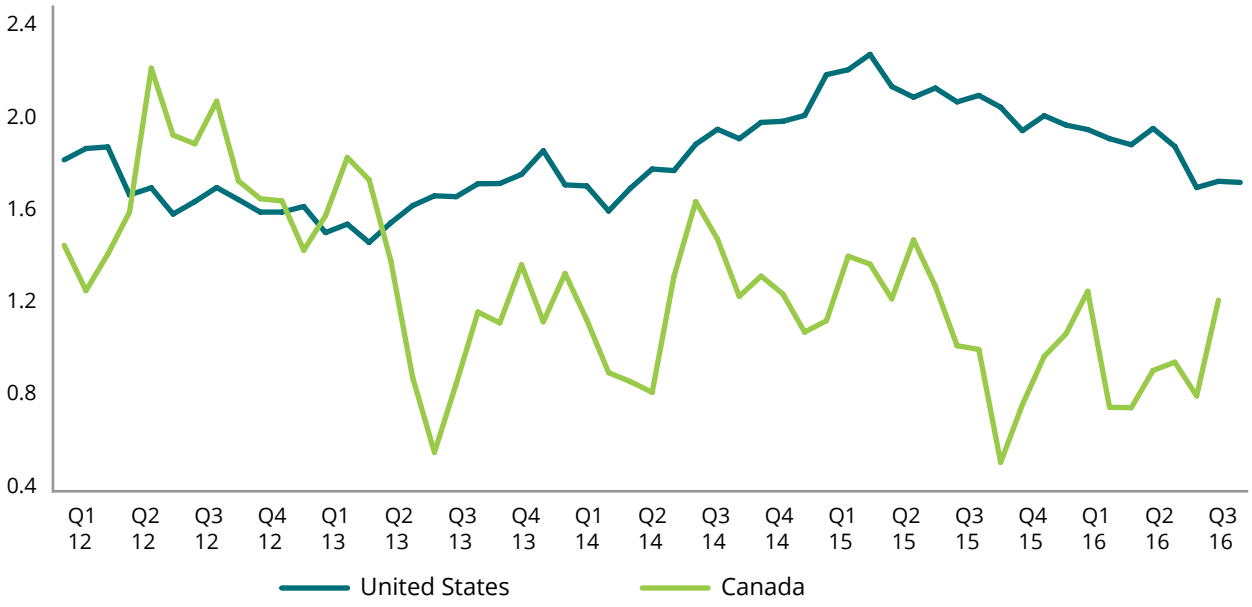


Source: Statistics Canada/Haver Analytics.

Graphic: Deloitte University Press | dupress.deloitte.com

Figure 2. Lagging Canadian job growth

Percentage change, year over year



Source: Statistics Canada and US Bureau of Labor Statistics/Haver Analytics.

Graphic: Deloitte University Press | dupress.deloitte.com

But, as the statement noted, Canadians have a significant reason to be optimistic. The bank expects the government's infrastructure spending program to show up in economic data by the fourth quarter. That should help add some needed jobs and domestic demand. This autumn, the Canadian economy hopes for rescue—not by the Royal Canadian Mounted Police, but by Prime Minister Justin Trudeau's embrace of Keynesian economics.[6]

Canada's trade treaty with Europe: Further Brexit fallout?

In August 2014, Canada and the European Union signed an ambitious trade agreement, the Comprehensive Economic Trade Agreement (CETA). Two years later, the treaty has yet to come into effect. While the economic gains are likely to be modest, Canada's experience with its most ambitious trade treaty since the North American Free Trade Agreement demonstrates how much the atmosphere surrounding such agreements has been poisoned by growing opposition to globalization and the rise of nationalistic political leaders in the European Union as well as in the United States (but, so far, not so much in Canada).

It also demonstrates that negotiating anything with the European Union is a difficult task. Negotiations started—and, in theory, ended—under the previous Canadian Conservative government. The Liberals—victors in the recent election—also supported the agreement, and the new government has adopted completing the treaty as a policy objective. As long as the treaty has the support of the government, final ratification by Canada is certain. Why, after more than two years, has the treaty not taken effect? That's a story about the European Union, not Canada.

On the conclusion of the negotiations, the European Union required time for legal review and to translate the treaty into the European Union's 23 official languages. As that happened, treaty opponents found their voices. Meanwhile, the overall mood in the developed world has turned against such agreements: The success of Brexit, the opposition of both US presidential candidates to the Transatlantic Trade and Investment Partnership (TTIP), and the success of Eurosceptic parties in many EU countries underline how little political support exists for increased globalization.

As is common these days, the key problems are not around tariffs on manufactured products, or even trade in agricultural products. Instead, the most controversial provisions involve intellectual property and the resolution of investment disputes. The exact nature of these issues is too complex to completely cover in this short essay.[7] Broadly, the issues include protection for pharmaceutical patents, agreement on common rules for labeling agricultural products, and common standards for copyright protection. A further problem is the agreement for settling investment disputes. The European Union essentially reopened negotiations in January over this particular issue. Canadians have been tolerant about the delay so far, but the European Union's inability to complete the agreement is likely getting a bit frustrating.

This autumn, the Canadian economy hopes for rescue—not by the Royal Canadian Mounted Police, but by Prime Minister Justin Trudeau's embrace of Keynesian economics.

Why has the European Union been so finicky while negotiating with Canada? CETA may set parameters for the much more controversial TTIP agreement between the European Union and the United States. It's a huge treaty between two of the largest economic entities in the world, and it's not surprising that EU negotiators would be careful about letting CETA set precedents for TTIP.

Then came Brexit. Originally, the European Commission believed (and stated strongly) that the commission and the European Parliament could ratify the treaty for Europe. Many Europeans, especially those opposed to one or more of CETA's provisions, have argued that the treaty must be ratified instead by parliaments in all 28 EU countries instead.[8] These arguments were brushed off by the commission.

After Brexit, it became clear that the commission's position was politically untenable. In July, the commission backed off, deciding to accept the treaty "provisionally" while sending it to member parliaments to be ratified. At the time of this writing, Canada and the European Union are planning a summit for October, to include a treaty-signing ceremony. However, despite Canadian optimism—Trade Minister Chrystia Freeland has promised to "press ahead" with implementation of the treaty[9]—opposition in Europe is gathering steam.[10]

Implementation of the treaty is not likely to have a huge impact on Canada's economy. A joint study by the Canadian and EU authorities prior to the negotiations found that full liberalization of goods and services trade between the two countries would increase Canada's GDP by about 0.8 percent and the European Union's GDP by less than 0.1 percent.[11] But even if the immediate impact is not huge, diversification of trade would be useful for the Canadian economy. Currently, about three-fourths of Canada's exports go to the United States, and about two-thirds of the country's imports come from the United States. Since the United States has been the most reliable driver of global growth in the past few years, Canadians have little reason to complain in the near term. But longer-term experience implies that Canada would benefit from closer relations with another major economy, like the European Union. Unfortunately, despite the best efforts of Canada's government, Brexit and Europe's overall political problems may prevent this from happening in the near future.

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Helicopter money: Yet another unconventional monetary policy tool

By Akrur Barua

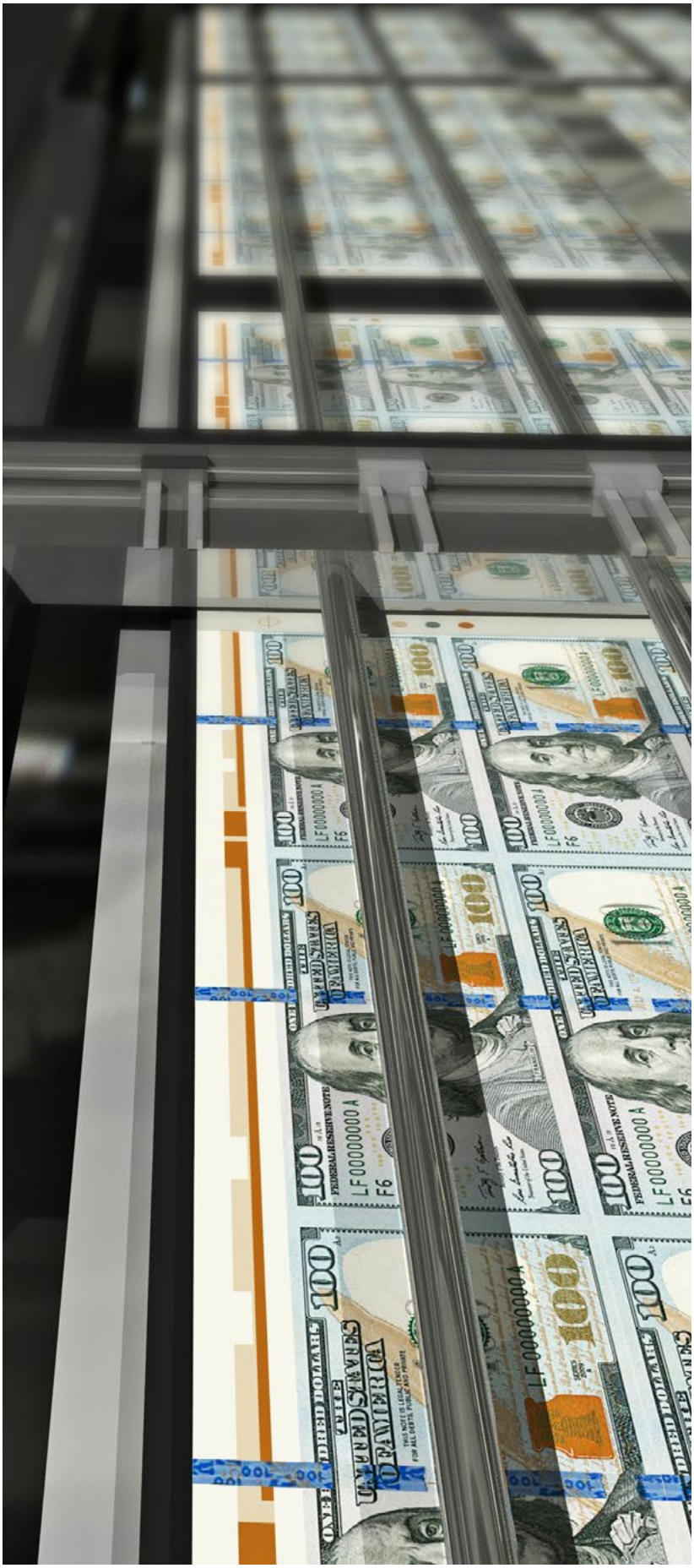
If you find the idea of helicopters dropping dollar bills fanciful, think again. Since the Great Recession, many an unorthodox idea has been floated to encourage economic growth and counter deflation. Recently, central banks were buying government debt and even taking interest rates into negative territory. And it's been happening across continents—North America, Europe, and Asia—as policy makers desperately try to revive their economies. It comes as no surprise, then, that yet another unconventional idea is being discussed: helicopter money.

Choppers full of money? Not really

Helicopter money literally means dropping money from helicopters for people to pick up and spend. The idea is that if people get unexpected one-time cash rewards, they will spend more, and the economy will revive. The concept was first discussed about five decades ago by Noble Prize winner Milton Friedman in *The Optimum Quantity of Money*.[1] Over the years, however, as monetary policy developed into an orthodox discipline, Friedman's idea was lost in the annals of policy-making debate, until recently when former US Federal Reserve (Fed) chairman Ben Bernanke talked about it.[2]

Although money dropped from the air seems exciting, especially if a big bag of greenbacks lands in your backyard, it is not the literal translation that economists are talking about—it's about printing money and giving it to economic agents to spend. One way that could happen is if central banks put money directly into people's bank accounts. The idea of central banks dealing directly with spending decisions, however, runs counter to modern-day practices where it is the fiscal authority that is responsible.[3] So for a helicopter money mechanism, there has to be a "monetary plus fiscal" approach.[4]

Central banks can, instead, lend to the Treasury through a zero-coupon perpetual bond. The government can then spend that money on, say, infrastructure, or transfer it to the people, or do a bit of both.[5] Such a framework keeps the essential components of a helicopter money mechanism intact: Consumers and the government can use the money for spending, and neither the borrower pays interest, nor is there a rise in the debt burden.[6] The government, however, has to bear the burden of deciding who gets what if they transfer money to consumers. If it is an equal transfer, for example, then it will be regressive in the same way equal taxes are, thereby proving controversial.[7] Apart from a mechanism to solve such problems—both ethical and operational—any helicopter money framework (figure 1) will also require strong oversight to maintain accountability.



Helicopter money literally means dropping money from helicopters for people to pick up and spend. The idea is that if people get unexpected one-time cash rewards, they will spend more, and the economy will revive.

Figure 1. Two sample helicopter money mechanisms—the "monetary-fiscal approach" is more feasible based on existing regulations

Graphic: Deloitte University Press | dupress.deloitte.com

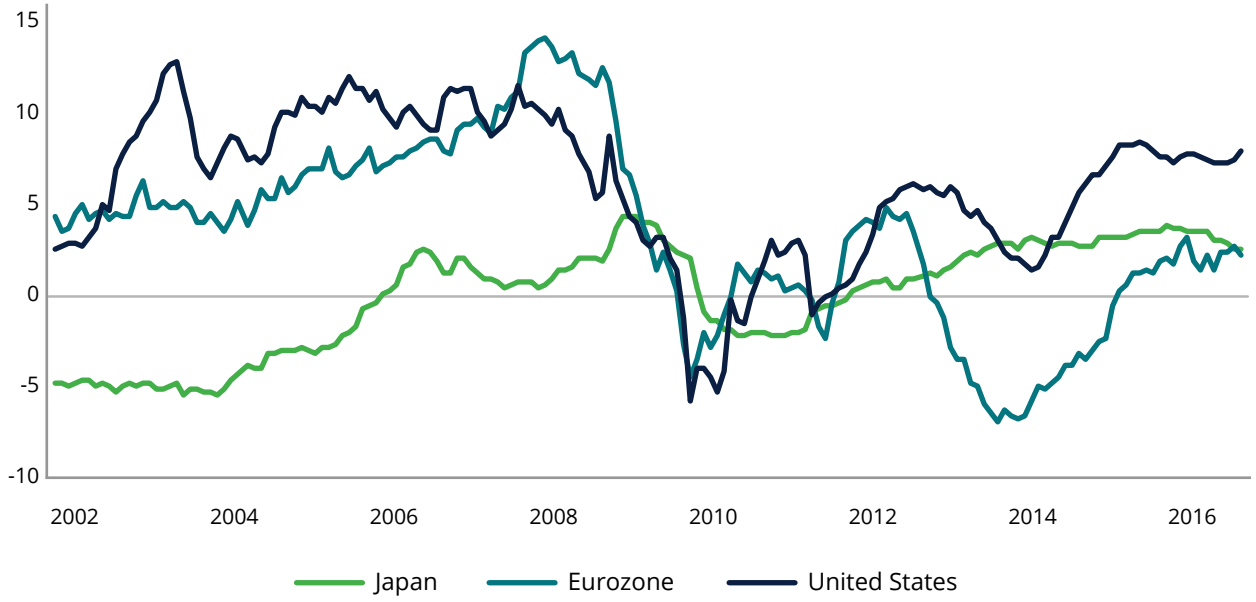
Helicopter money is different from quantitative easing

Unlike quantitative easing (QE), helicopter money is direct lending by the central bank to the government. In QE, the central bank buys government debt from the market. Unlike QE, helicopter money has no interest to be paid and principal to be repaid. QE's focus is to put money into banks by buying bonds and other assets from them. Banks can then lend part of that money to consumers and businesses, and hence, through a multiplier effect, push up economic growth. Unfortunately, banks have been reluctant to lend more, thereby denting credit creation. So, despite years of strong monetary easing, credit growth has been slow, especially in the Eurozone and Japan (figure 2).

Helicopter money provides a better alternative, in theory, as money goes directly into people's savings accounts or to the government to spend. As a result, the impact on economic growth and deflation is likely to be higher. Also, helicopter money does not increase the government's debt burden as the lending is in the form of a perpetual bond with zero coupon. Thus the argument that governments will spend now and tax later—as happens in a fiscal stimulus—is not valid. Moreover, unlike QE, where it is hoped that consumer spending will rise, due indirectly to asset values rising, helicopter money puts money directly into consumers' hands.

Figure 2. Credit growth has been weak despite aggressive monetary easing

Credit growth, percentage, year over year



Note: For Japan, we have considered total outstanding loans of domestically licensed banks. For the Eurozone, we have taken loans to Eurozone residents by all monetary financial institutes. For the United States, we have taken bank credit by all commercial banks.

Source: Haver Analytics.

Graphic: Deloitte University Press | dupress.deloitte.com

Why all the clamor for the helicopter?

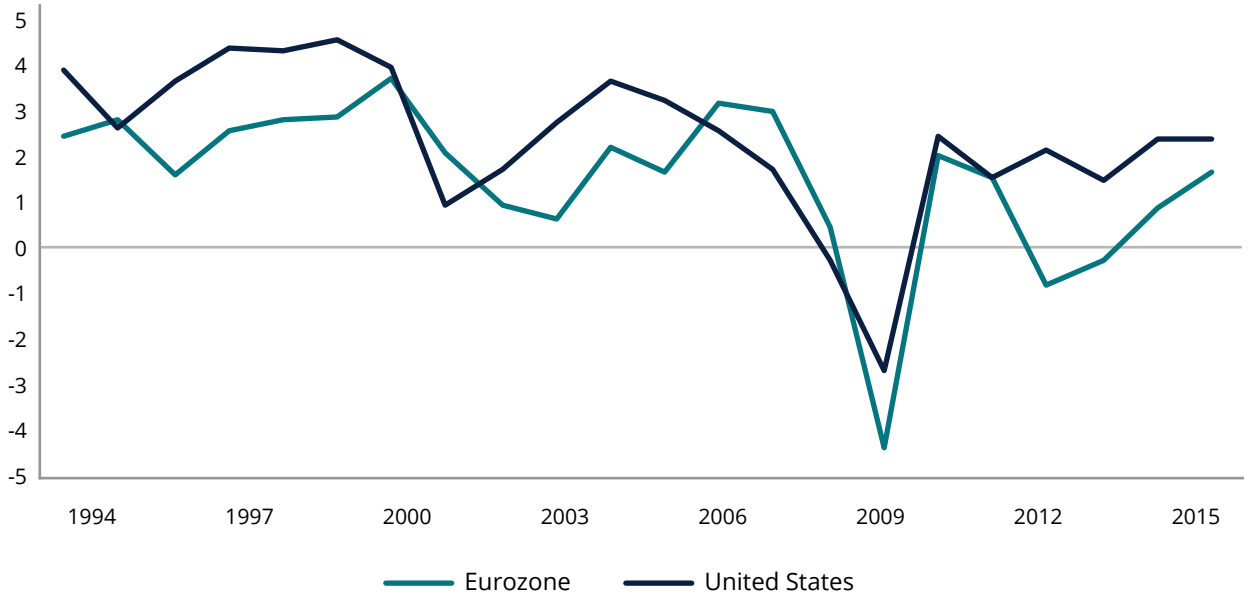
Recent discussion about helicopter money is not surprising given that policy makers across advanced economies are struggling to get their economies back on track. In the Eurozone, for example, GDP is just 1.4 percent higher than its Q1 2008 peak before the global financial crisis—some economies within the region have fared even worse.[8] While the United States has done better, GDP growth is still lower than pre-2007 highs (figure 3), with the Fed yet to get interest rates back to normal. And in Japan, deflationary pressures are back despite QE and negative interest rates.[9]

The surge of unorthodox policy, including recent debates about helicopter money, is also a continuation of a trend of overreliance on monetary policy.[10] Despite initial attempts at fiscal stimulus, utilizing government spending has faded in advanced economies, especially the United States and the Eurozone.[11] In the United States, as recent debt ceiling crises have shown, disagreements over debt levels have hurt any efforts at using the current environment of low interest rates to stimulate the economy through, say, higher spending on infrastructure.[12]

In Europe, fiscal efforts to spruce up growth have been severely hampered by the sovereign debt crisis. With public debt at record-high levels (figure 4), governments have leaned heavily on central banks. Strong disagreements among major economies in the Eurozone on fiscal measures—Germany is pro-austerity, while Italy is not—have also dented coordinated fiscal measures.[13] Most importantly, in many of these economies, structural reforms have been slow as they are deeply unpopular, especially amid continued fiscal austerity. Politicians, as a result, have passed on the baton to central bankers.

Figure 3. In the Eurozone and United States, growth has been lower than pre-crisis highs

Annual GDP growth, percentage



Source: International Monetary Fund/Haver Analytics.

Graphic: Deloitte University Press | dupress.deloitte.com

Helicopter money will not be easy to implement

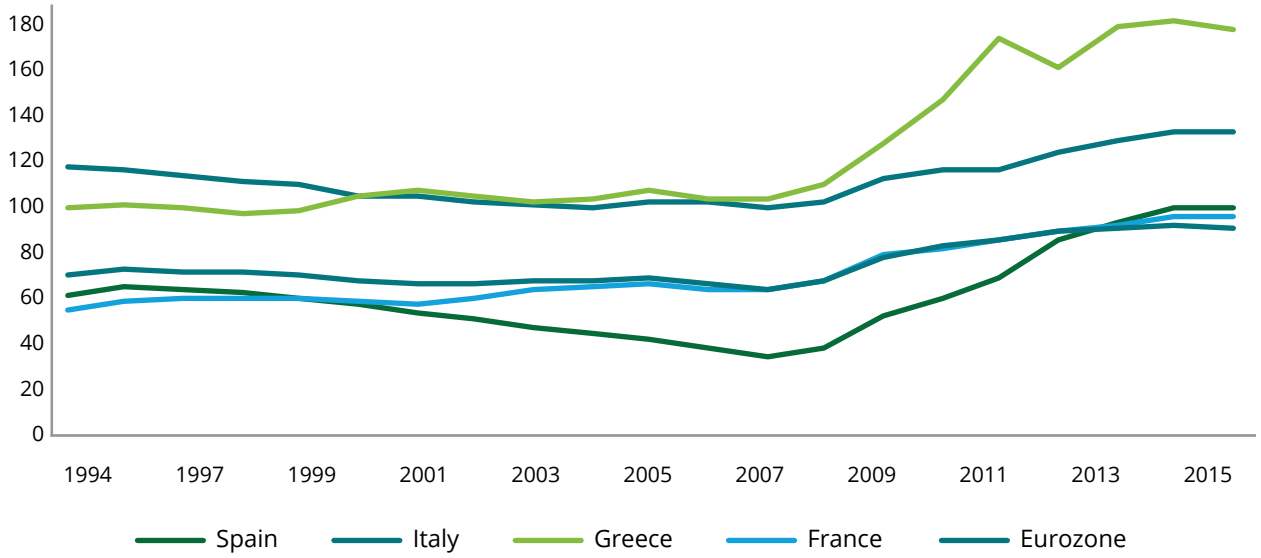
There are, however, a number of practical difficulties in implementing helicopter money. First, helicopter money translates to some form of monetization of government debt, which is a strict no-no in traditional central banking.[14] In many economies, memories of high inflation from monetization efforts are still fresh. Do you remember the value of 1 million Zimbabwe dollar some years ago? Back in early 2000, Argentina suffered a similar fate, as is Venezuela currently. In emerging economies such as India, strengthening the tenets of orthodox central banking has aided growth and improved confidence in the economy.[15] Helicopter money will be a step back from that.

Second, helicopter money envisages strong cooperation between the central bank and the fiscal authority, which will be a challenge.[16] In the Eurozone, economies such as Germany are likely to oppose any form of monetization of government debt; it was difficult to get them on board with QE in the first place.[17] Also, in an era where central bank independence is widely coveted, getting central banks and fiscal authorities to come closer raises fears about undue influence on monetary policy.[18]

Finally, even though rules can be created for a smooth process, those rules might also be changed later, especially related to spending (such as before elections). Most importantly, coordination between fiscal and monetary policy once does not ensure coordination every time.

Figure 4. Government debt in the Eurozone is high, especially for troubled economies

Government debt as a share of GDP, percentage



Source: International Monetary Fund/Haver Analytics.

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Apart from the practical implementation of helicopter money, there is also the question of whether we need such a monetary policy tool in the first place.

For some, it may be worth keeping a chopper handy

Apart from the practical implementation of helicopter money, there is also the question of whether we need such a monetary policy tool in the first place. Key indicators in the United States, for example, have been improving: The labor market is strong, consumer spending surged in Q2, and economic growth has been higher than in the Eurozone and Japan.[19] Thus helicopter money is likely to be discussed in the United States as a last-resort, counter-deflationary weapon rather than one for immediate use.[20] In the Eurozone, where QE is in force and interest rates are negative, it is probably better for central banks to defer any decision on helicopter money because it leaves them some ammunition for any future crisis. Yet another unorthodox policy is not likely to help the European Central Bank's credibility, given the weaker-than-expected impact of a swathe of tools already in place.[21]

If at all helicopter money sees the light of day in the near term, in all likelihood it will be in Japan. With government debt now amounting to more than 250 percent of GDP and the Bank of Japan's 38 percent share of that debt, it is likely that the bank may change its share or some part of it into zero-coupon perpetual bonds.[22] While this may not be helicopter money in its purest form, it is still a close approximation.


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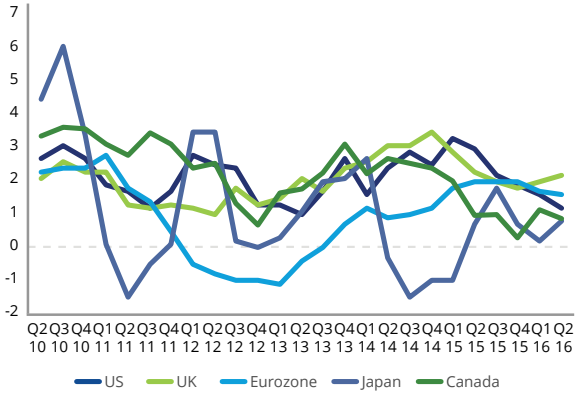
Economic indices

GDP growth rates (percentage, year over year)



Source: Bloomberg, Haver Analytics.

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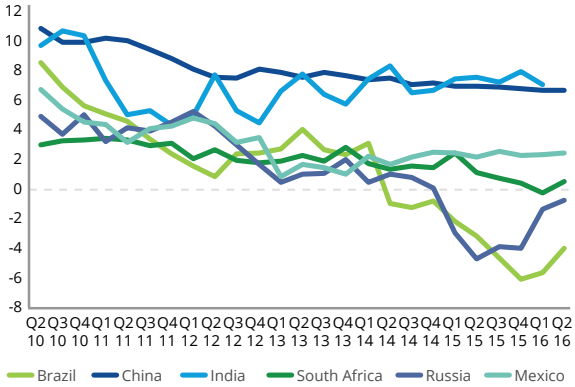
GDP growth rates (percentage, year over year)



Source: Bloomberg, Haver Analytics.

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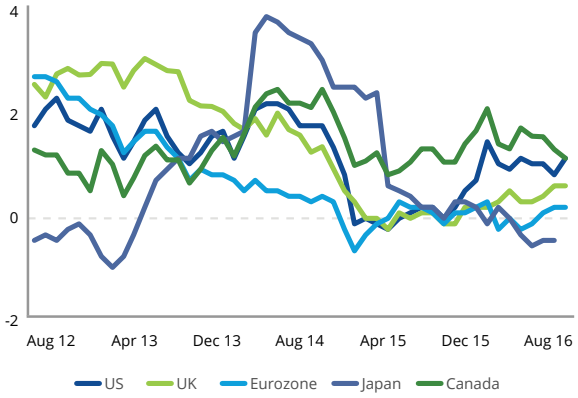
Inflation rates (percentage, year over year)



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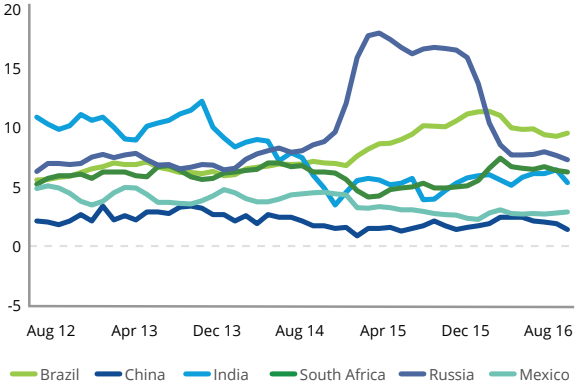
Inflation rates (percentage, year over year)



Source: Bloomberg, Haver Analytics.

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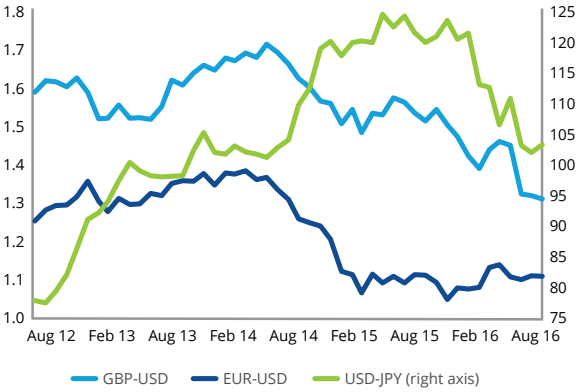
Major currencies versus the US dollar



Source: Bloomberg, Haver Analytics.

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Yield curves (as of September 27, 2016)*

	US Treasury Bonds & Notes	UK Gilts	Eurozone Govt. Benchmark	Japan Sovereign	Canada Sovereign	Brazil Govt. Benchmark
3 Months	0.18	0.33	-0.75	-0.34	0.53	14.17
1 Year	0.57	0.09	-0.58	-0.25	0.53	12.51
5 Years	1.12	0.18	-0.58	-0.20	0.59	11.80
10 Years	1.58	0.70	-0.12	-0.06	0.99	11.89

	China Sovereign	India Govt. Bonds	South Africa Sovereign	Russia*‡	Mexico
3 Months	2.14	6.50	7.65	9.76	4.66
1 Year	2.25	6.66	-	9.04	5.16
5 Years	2.70	6.81	8.02	8.40	5.89
10 Years	2.79	6.77	8.63	8.20	6.17

Composite median GDP forecasts (as of September 27, 2016)*

	US	UK	Eurozone	Japan	Canada	Brazil	China	India	South Africa	Russia	Mexico
2016	1.9	1.8	1.6	0.6	1.4	-3.5	6.5	7.5	0.5	-0.9	2.1
2017	2.3	2.1	1.6	0.8	2	0.9	6.2	7.6	1.3	1.2	2.5
2018	2.1	2.2	1.6	0.6	2.2	1.8	6.2	7.8	1.9	1.5	2.7

Composite median currency forecasts (as of September 27, 2016)*

	Q4 16	Q1 17	Q2 17	Q3 17	2016	2017	2018
GBP-USD	1.29	1.28	1.29	1.3	1.29	1.31	1.33
Euro-USD	1.1	1.09	1.09	1.1	1.1	1.1	1.15
USD-Yen	104	104.5	105	108	104	110	110
USD-Canadian Dollar	1.32	1.32	1.31	1.29	1.32	1.27	1.29
USD-Brazilian Real	3.35	3.4	3.45	3.46	3.35	3.48	3.53
USD-Chinese Yuan	6.75	6.76	6.8	6.8	6.75	6.8	6.85
USD-Indian Rupee	68	68	68	67.75	68	68	67
USD-SA Rand	14.68	14.75	14.79	15	14.68	15	14.25
USD-Russian Ruble	65.08	64.68	64	64.25	65.08	65.25	65
USD-Mexican Peso	18.78	18.66	18.5	18.3	18.78	18.35	18

*Source: Bloomberg ‡MICEX rates †Source: OECD

OECD composite leading indicators (Amplitude adjusted)†

	United States	United Kingdom	Euro area	Japan	Canada	Brazil	China	India	South Africa	Russian Federation	Mexico
Apr 13	100.3	100.0	99.0	100.4	99.5	100.0	100.8	99.0	100.7	99.3	100.1
May 13	100.4	100.2	99.2	100.6	99.5	99.7	100.8	98.9	100.6	99.3	99.5
Jun 13	100.5	100.3	99.3	100.8	99.6	99.5	100.9	98.8	100.6	99.4	99.0
Jul 13	100.6	100.6	99.5	101.0	99.7	99.3	100.9	98.7	100.7	99.5	98.8
Aug 13	100.6	100.9	99.7	101.1	99.8	99.1	101.0	98.6	100.7	99.7	98.7
Sep 13	100.6	101.1	99.9	101.2	99.9	98.9	101.0	98.5	100.6	99.9	98.7
Oct 13	100.6	101.3	100.1	101.4	100.0	98.8	101.0	98.5	100.6	100.1	98.8
Nov 13	100.6	101.4	100.3	101.4	100.1	98.6	100.9	98.4	100.5	100.2	98.8
Dec 13	100.6	101.5	100.4	101.5	100.1	98.5	100.9	98.4	100.5	100.4	98.8
Jan 14	100.6	101.5	100.4	101.4	100.1	98.3	100.8	98.4	100.4	100.6	98.8
Feb 14	100.7	101.5	100.5	101.3	100.1	98.3	100.7	98.4	100.3	100.8	98.7
Mar 14	100.7	101.6	100.5	101.1	100.2	98.3	100.6	98.4	100.2	101.0	98.7
Apr 14	100.8	101.6	100.4	100.8	100.2	98.3	100.6	98.5	100.1	101.2	98.7
May 14	100.8	101.6	100.4	100.6	100.3	98.4	100.5	98.5	100.1	101.4	98.7
Jun 14	100.9	101.5	100.3	100.4	100.3	98.5	100.5	98.6	100.2	101.5	98.8
Jul 14	100.9	101.4	100.2	100.3	100.4	98.6	100.4	98.7	100.3	101.6	99.0
Aug 14	100.9	101.3	100.1	100.1	100.4	98.6	100.3	98.7	100.4	101.5	99.2
Sep 14	100.9	101.2	100.1	100.1	100.4	98.6	100.2	98.8	100.5	101.2	99.6
Oct 14	100.9	101.1	100.1	100.1	100.3	98.4	100.0	98.8	100.6	100.9	99.9
Nov 14	100.8	101.0	100.1	100.1	100.3	98.2	99.9	98.9	100.6	100.4	100.1
Dec 14	100.8	101.0	100.2	100.1	100.2	97.9	99.8	98.9	100.5	100.1	100.3
Jan 15	100.7	101.0	100.3	100.2	100.1	97.7	99.7	99.0	100.4	99.8	100.6
Feb 15	100.6	100.9	100.4	100.2	100.0	97.6	99.6	99.0	100.4	99.7	100.7
Mar 15	100.5	100.9	100.4	100.3	99.9	97.5	99.6	99.0	100.4	99.7	100.7
Apr 15	100.4	100.8	100.5	100.3	99.9	97.4	99.5	99.1	100.4	99.7	100.4
May 15	100.3	100.7	100.5	100.4	99.8	97.4	99.4	99.1	100.4	99.7	100.1
Jun 15	100.2	100.6	100.5	100.4	99.8	97.4	99.3	99.2	100.3	99.6	99.7
Jul 15	100.1	100.4	100.5	100.3	99.7	97.3	99.2	99.3	100.2	99.5	99.3
Aug 15	99.9	100.2	100.5	100.2	99.6	97.3	99.0	99.3	100.0	99.2	99.0
Sep 15	99.7	100.0	100.5	100.1	99.5	97.3	98.9	99.4	99.9	98.9	99.0
Oct 15	99.5	99.9	100.5	100.0	99.5	97.3	98.8	99.5	99.9	98.7	99.0
Nov 15	99.4	99.7	100.6	99.9	99.4	97.3	98.7	99.6	99.8	98.4	99.0
Dec 15	99.3	99.6	100.6	99.8	99.3	97.4	98.6	99.7	99.8	98.2	99.2
Jan 16	99.2	99.5	100.5	99.7	99.3	97.5	98.6	99.8	99.7	98.1	99.5
Feb 16	99.2	99.4	100.5	99.7	99.3	97.8	98.6	99.9	99.6	98.2	99.7
Mar 16	99.2	99.3	100.4	99.7	99.4	98.2	98.6	100.1	99.4	98.5	99.9
Apr 16	99.2	99.3	100.4	99.6	99.5	98.7	98.7	100.2	99.3	98.8	100.1
May 16	99.1	99.3	100.3	99.6	99.6	99.3	98.9	100.4	99.2	99.2	100.4
Jun 16	99.1	99.3	100.3	99.6	99.7	99.8	99.0	100.6	99.1	99.5	100.6
Jul 16	99.0	99.3	100.2	99.6	99.8	100.3	99.2	100.8	99.0	99.9	100.8

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.

Source: OECD.

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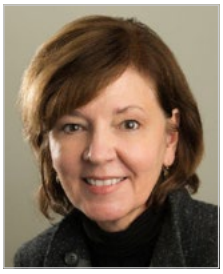
For more information about Deloitte Research, please contact
John Shumadine, Director, Deloitte Research, part of Deloitte Services LP,
at +1.703.251.1800 or via e-mail at jshumadine@deloitte.com.

About the authors

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

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



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

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

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

Dr. Daniel Bachman is a senior manager for US macroeconomics at Deloitte Services LP.

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

Contact information

Global Economics Team

Dr. Daniel Bachman
Deloitte Research
Deloitte Services LP
USA
Tel: +1.202.220.2053
E-mail: dbachman@deloitte.com

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

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

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

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

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

Dr. Rumki Majumdar
Deloitte Research
Deloitte Services LP
India
Tel: +1.470.434.4090
E-mail: rmajumdar@deloitte.com

Aditi Rao
Deloitte Research
Deloitte Services LP
India
Tel: +1.470.434.3941
E-mail: aditirao@deloitte.com

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

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

Kenny Smith
Deloitte Consulting LLP
Tel +1.415.783.6148
Email: kesmith@deloitte.com

Consumer & Industrial Products

Seema Pajula
Deloitte & Touche LLP
Tel: +1.312.486.1662
E-mail: spajula@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 England
Deloitte & Touche LLP
USA
Tel: +1.713.982.2556
E-mail: jengland@deloitte.com

Scott Smith
Deloitte & Touche LLP
USA
Tel: +1.619.237.6989
E-mail: ssmith@deloitte.com

Public Sector (Federal)

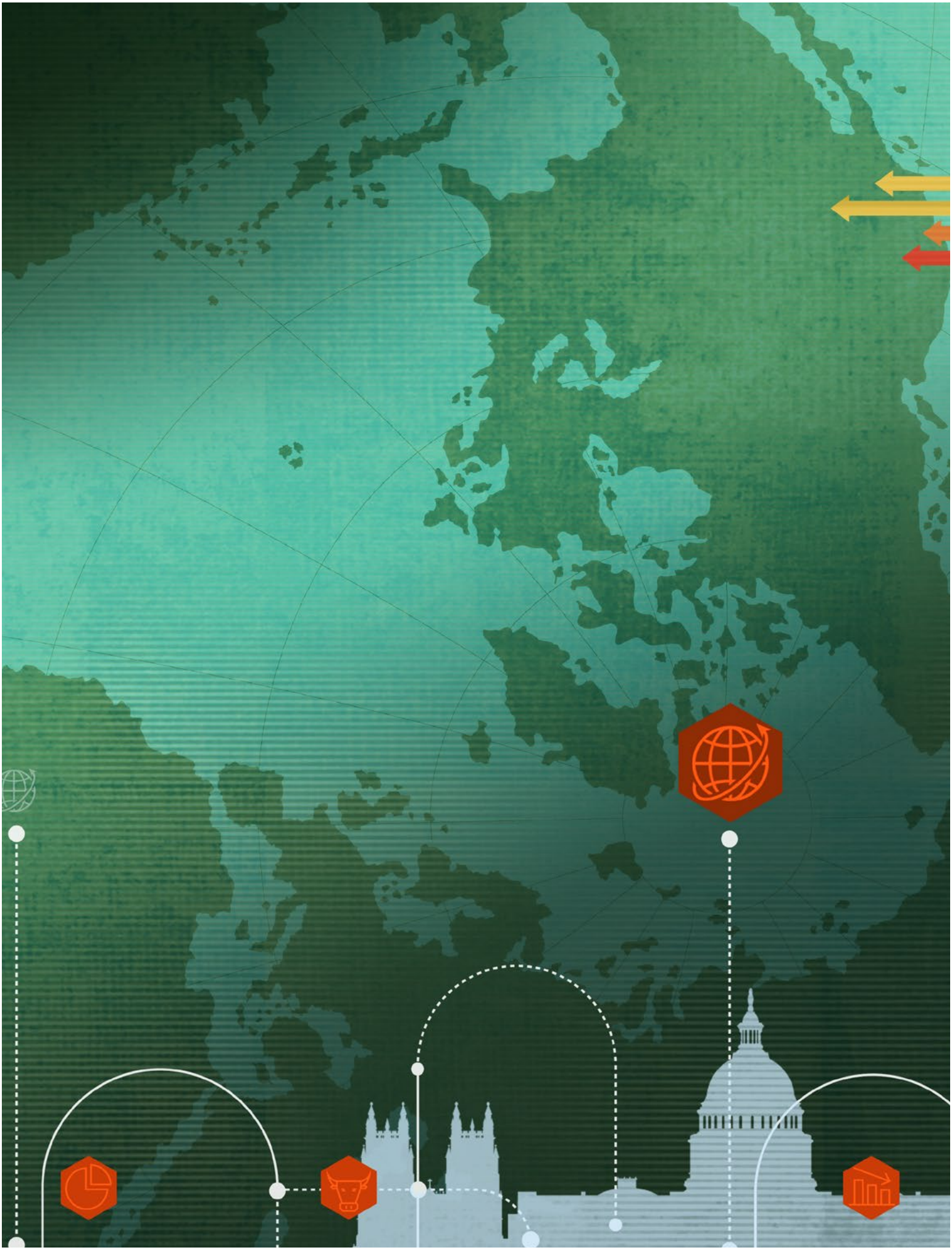
Daniel Helfrich
Deloitte Consulting LLP
Tel: +1.571.882.8308
E-mail: dhelfrich@deloitte.com

Public Sector (State)

Mark Price
Deloitte Consulting LLP
Tel: +1.617.585.5984
E-mail: maprice@deloitte.com

Telecommunications, Media & Technology

Sandra Shirai
Deloitte Consulting LLP
Tel: sshirai@deloitte.com
E-mail: +1.415.783.5515



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