

Global Economic Outlook

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Introduction

By Dr. Ira Kalish

In the summer of 2015, the global business climate was shaken by events in Greece and China. First, Greece appeared to come perilously close to defaulting on its sovereign obligations, thus potentially setting the stage for an exit from the Eurozone. While the Greek economy is very small and not directly of systemic importance to the Eurozone economy, there was considerable concern that the default would have a major spillover effect on European financial markets. Fortunately, the issue was resolved when Greece acceded to the European Union's demands, at least putting off a Greek-fueled Eurozone crisis.

Yet, even while Greece was in the news, concern about the much larger and more consequential Chinese economy was lurking in the background. It was known that China's economy was slowing, a potential equity price bubble was brewing, and China's financial system was laden with imbalances. However, once the Greek situation was out of the way, the Chinese situation started to boil over. Equity prices tumbled, the central bank allowed the currency to fall, and then—related or not—global equity prices started to tumble as well. Despite evidence of economic strength in the United States and a continuing recovery in Europe, China's slowdown has raised many questions about the overall global economic outlook. China has a big footprint in the global economy, influencing commodity prices, capital flows, growth in emerging countries, and business sentiment everywhere.

In this edition of Deloitte's *Global Economic Outlook*, our far-flung economists examine these issues and provide their outlook. We begin, quite naturally, with China. In my article, I look at the key issues: the debate over exactly how much the Chinese economy has slowed; the policy response to the slowdown; the relevance of China's equity bubble and its bursting; the decision to devalue the currency and its implications; and the global impact of a slower-growing Chinese economy. I expect that China's slowdown is not likely to have a hugely deleterious impact on the United States and Europe.

Next, Patricia Buckley discusses the relatively benign state of the US economy. She notes that, just as things seem to be going reasonably well, there remains a potentially disruptive impact from political conflict involving the budget and the debt ceiling. She also discusses the decision making of the US Federal Reserve (Fed) in the context of inflation and employment. She notes that low inflation is currently being driven by transitory factors and that, given the evident strength of the economy, the Fed is likely to raise interest rates before the year ends. How things will play out, however, will depend in part on how the US Congress approaches budgetary issues.

Alexander Börsch then offers his point of view on the state of the Eurozone economy. He says that the recovery is now broad based and that Europe appears able to withstand the negative consequences of a Chinese

slowdown. He notes that every Eurozone economy except France grew in the second quarter. Strength has been derived from export growth resulting from a weaker euro. In addition, lower energy prices have boosted consumer spending. The main weakness in Europe continues to be investment, the direction of which will largely determine how fast Europe grows in 2016.

In my article on Japan, I discuss the continuing weakness of the economy despite the massive program of quantitative easing. I expect that monetary policy, while important, is not sufficient to fix what ails Japan. Rather, further structural reforms—as promised as part of “Abenomics”—will likely be needed. Completion of the Trans-Pacific Partnership will go a long way toward creating the conditions for such reform.

Next, Rumki Majumdar examines the Indian economy. She discusses the relatively strong growth of late, and also looks at the controversy over the best way to measure India’s economic performance. Rumki notes that, as in some other parts of the world, growth has been fueled by consumer spending, while investment has lagged. However, she points to several factors that bode well for an upturn in investment. These include lower energy prices, which have boosted corporate profits, a looser monetary policy, rising consumer demand, and increased government-funded capital spending.

In his article on Brazil, Akrur Barua discusses the poor state of the Brazilian economy, the factors that led to a recent bond rating downgrade, and the potential consequences of that action, which include higher borrowing costs, more capital outflows, downward pressure on the currency, and greater difficulties in addressing Brazil’s serious fiscal imbalances. Akrur also looks at the poor state of consumer finances, weakness of business investment, and the poor international competitiveness of industry. His view is that only some form of political conciliation can start to address Brazil’s woes.

The British economy is the subject of Ian Stewart’s analysis. He notes that although problems in the global economy are having some negative impact on the United Kingdom, the domestic side of the economy is doing well. Lower energy prices combined with a tight labor market are boosting consumer purchasing power, thus fueling a consumer-led recovery. Ian also discusses how global events will likely conspire to delay monetary policy tightening.

In our next article, Danny Bachman analyzes the Canadian economy. Despite two consecutive quarters of declining GDP in the first half of this year, Danny does not believe that Canada has fallen into recession. Rather, the Canadian economy has slowed owing to troubles in the oil industry and their considerable negative impact on business investment. Moreover,

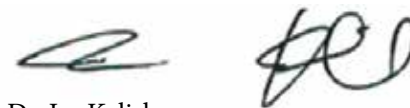
the Canadian economy has become heavily dependent on energy to the exclusion of industry. Indeed, Danny suggests that Canada suffers from the “Dutch disease,” in which energy-exporting countries see their non-energy industries lose competitiveness. Danny says that it is not clear whether the decline in the Canadian dollar will help to significantly alleviate this problem.

The South African economy is the subject of Lester Gunnion’s article. The economy is heavily dependent on commodities, and thus the slowdown in China and the rise of the US dollar have had a negative impact on South Africa. The weakness of the South African rand led to higher inflation, which, in turn, compelled the central bank to maintain a relatively tight monetary policy. In addition, Lester discusses the country’s internal obstacles to economic success, including electricity shortages, labor unrest, and a relative paucity of investment compared with other major emerging countries.

In the first of our two special-topic articles, Rumki Majumdar writes about the degree to which emerging markets are well prepared to deal with economic shocks. She looks at five of the world’s leading emerging markets—Brazil, India, Indonesia, South Africa, and Turkey—studying their

economic and financial performance in the two years since the so-called “taper tantrum” that occurred following the Fed’s announcement that it would soon end its program of asset purchases. Rumki states that, of the five countries, India appears to be best prepared to absorb problems in the global economy, especially given that it is not a commodity exporter.

In our last article, Akrur Barua, David Gruner, and Sunandan Bandyopadhyay examine global value chains (GVCs), a key component in today’s international trade ecosystem. As production processes get integrated into GVCs that cut across geographies, these value chains are set to benefit both developed and emerging economies as they help businesses become nimble and enable firms and economies to participate more in global trade.



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The slowdown and its global impact

By Dr. Ira Kalish

CHINA has been at the center of commentary about the global economy recently. The severe drop in Chinese equity prices, the continuing news about China's slowing economy, the country's decision to allow the currency to depreciate, and the widespread impression that China's economic woes are behind the recent sharp drop in global equity prices have all been front and center in the pages of the world's financial press. Let us consider how accurate the commentary is.

Measuring the slowdown

First, the economy is indeed slowing. In both the first and second quarters, real GDP was up 7.0 percent from a year earlier—the slowest rate of growth since 2009. In addition, for the past few months, industrial production has been rising at a low rate not seen since 2009. Moreover, many observers are convinced that the economy is actually

growing more slowly than the official numbers suggest. They observe that freight rail traffic is down from a year earlier and that electricity generation is growing very slowly. These and other data suggest a deeper deceleration of economic activity than the government is reporting. On the other hand, although manufacturing and construction have decelerated, the services sector in China continues to exhibit strength. Thus while the slowdown might not be as severe as some people fear, there is no doubt that the economy has slowed.

What is the source of the trouble? There are two key problems. First, there is excess capacity in heavy industry and property, both of which have seen debt-fueled investment booms in recent years. It should be no surprise, then, that investment spending has substantially decelerated, especially for property construction. Investment funded by foreigners has actually declined. Second, exports have declined. This is due, in part, to weak global demand.





In addition, as the Chinese renminbi has remained fairly steady in value against the US dollar, the dollar's rise has sent the renminbi soaring against the euro and the Japanese yen. The result has been a loss of competitiveness of Chinese exports to Europe and Japan. Thus it is no wonder that exports have declined, contributing to the weakness of the industrial sector.

The policy response

The principal policy response to economic weakness has been to ease monetary policy. This has entailed cuts to benchmark interest rates as well as a reduction in banks' required reserve ratios, with the latter boosting the supply of funds available for lending. The goal of such a policy is to boost credit market activity and, as a consequence, investment. The result has been that bank lending was up 14.4 percent in July versus a year earlier, the fastest rate of growth since late 2013. Yet investment in fixed assets continues to decelerate. Rather, the increased credit has allowed highly indebted businesses (especially property developers) to roll over existing debts. In addition, the increase in credit contributed to the equity price

bubble that reached its peak in June. Millions of households took on margin debt in order to purchase equities, only to see equity prices plummet over the course of the summer. The government intervened in the equity market in a variety of ways, the effect of which has been to stem the downward tide. As of this writing, equity prices are down around 40 percent from their peak but remain about 50 percent higher than in early 2014.

The global impact

In August, global equity prices, including Chinese prices, suddenly plummeted following news that China's manufacturing sector was weaker than many analysts had expected. Some analysts blamed the global rout on the collapse of China's equity market. Others suggested that concerns about China's slowdown, and its potential impact on the rest of the world, were the proximate cause. Some even worried that China might be headed for a recession. Are any of these the real reasons for the plummet?

First, it is increasingly apparent that the Chinese equity market is uncoupled from the state of the larger economy. The market soared when it was clear that China was slowing, and it plummeted following similar

It is **increasingly apparent** that the Chinese equity **market is uncoupled** from the state of the larger economy.

information. China's equity market is not well integrated into the global economy, nor does it play a major role in financing Chinese investment or as a source of wealth for Chinese households. Thus it is unlikely that the drop in Chinese equity prices can be blamed for events in the rest of the world.

Second, China's slowdown does have an impact on the rest of the world, but that impact is unevenly distributed. The slowdown in fixed asset investment has caused a drop in commodity prices, thus hurting exporters such as Australia and Brazil. The drop in manufacturing activity and trade has hurt East Asian countries that are integrated into China's manufacturing supply chain, including South Korea, Taiwan, and several countries in Southeast Asia. The impact of China's slowdown on the United States and Europe, however, is likely to be more muted. Although China is the third-largest export market for both the United States and Europe, even a sizable drop in exports to China would be expected to cut US or European GDP growth by only a few tenths of a percentage point.

Third, although China's economy has slowed, it appears unlikely to head toward a recession. There remain considerable pockets of strength in the economy, including the consumer sector, which is expanding at a healthy pace. Of course, a prolonged slowdown is possible, the duration of which will depend on the mix of policy that the government implements. Policies aimed at boosting consumer demand rather than investment are more likely to create conditions for sustainable acceleration in growth.

Finally, the sudden drop in global equity prices in August was probably fueled by news about China. But the reality is that there had already been considerable commentary about overvaluation and how markets were overdue for normal corrections. Companies with significant exposure to the Chinese market will face consequences from the Chinese slowdown. However, the overall European and US equity markets are likely to be mostly influenced by expectations about local market earnings and interest rates.



Of currencies and capital flows

There has been much talk about capital flowing out of China; one might wonder what exactly this entails. Here is a brief primer on currencies, capital flows, and what has been happening in China.

Consider how China obtains dollars. A simple example might involve a Chinese factory that uses local cotton and local labor to make T-shirts that are then sold to a big American retailer in exchange for US dollars. The company deposits those dollars in a Chinese bank. Then the bank might sell them to a local retailer who uses the dollars to purchase DVDs from a Hollywood studio to sell them to Chinese consumers. Essentially, the dollars have traveled back and forth, and T-shirts have effectively been traded for DVDs. Alternatively, the bank might sell the dollars to a wealthy Chinese individual who uses them to purchase a condo in Manhattan. This is a capital outflow: Again, the dollars have traveled back and forth, but now Americans have obtained T-shirts in exchange for someone in China owning a nice apartment in New York.

As for the wealthy Chinese individual, he or she has exchanged assets held in China for an asset held in the United States—thus his or her capital has flowed out of China. If China runs a trade surplus (exports exceed imports), which it has done for decades, it makes sense for the excess

dollars that China accumulates to be used by Chinese to accumulate US assets. Yet, until a few years ago, China not only ran trade surpluses, it also had almost no capital outflows. Instead, it had net inflows of capital. As such, there was an excess supply of dollars, or excess demand for renminbi. Normally, this would lead to an increase in the value of the renminbi, or a currency appreciation. Yet the Chinese government did not want that to happen, at least not too rapidly. So it massively purchased dollars in order to supply the market with the highly sought-after renminbi. That is why China's central bank accumulated such a huge amount of dollars: nearly \$4 trillion.

Lately, however, things have changed—dramatically. Chinese have started seeking overseas assets in a big way. This partly reflects the government's financial liberalization, but it also reflects the pessimism and worry of some wealthy Chinese who are eager to park their funds overseas. So lately the demand for dollars needed to buy foreign assets has actually exceeded the supply generated by selling those T-shirts. Normally this would lead to an increase in the value of the dollar or a decrease in the value of the renminbi, yet China's authorities have been reluctant to let the renminbi fall too quickly. Consequently, they have been selling dollars in order to meet the demand for dollars. In the last two years, capital outflows from China have amounted to hundreds of billions of dollars.

As **China sells dollars**, the question has arisen of how China's large-scale selling of US Treasury securities will affect **bond yields in the United States**.



The central bank has sold about \$350 billion in reserves. And although the central bank did recently allow a small currency depreciation, it quickly resumed intervention to prevent the currency from falling too much.

What happens next? If the central bank continues to sell dollars in order to maintain the exchange rate, Chinese investors will logically anticipate an eventual depreciation of the currency. This will lead them to demand more dollars in order to buy more condos in New York. Eventually, the central bank will run out of dollars and will let the currency fall. Chinese with condos in New York will then see a sizable capital gain. It would mean lower prices of exported Chinese goods, which means China would essentially be exporting deflation to the rest of the world. China's capital markets would become integrated into the global system. Foreign investors would seek bargains in China, and capital would eventually start to flow back into China, thereby putting upward pressure on the value of the renminbi. The problem is that the transition from today's situation to that eventuality could be a wrenching process.

Meanwhile, as China sells dollars, the question has arisen of how China's large-scale selling of US Treasury securities will affect bond yields in the United States. Could China disrupt US financial markets in the process? The answer is probably not. When the US Federal Reserve stopped massive purchases of Treasury securities last year, bond yields didn't move much. China already selling plenty of such securities in the past year does not appear to have influenced pricing. Moreover, if China started selling Treasuries in larger amounts, it would likely cause investors elsewhere to engage in a flight to the safety of US Treasuries. This is, of course, what usually happens when there is new uncertainty or volatility in the world. Finally, the reality is that the secondary market for US Treasuries is so large and liquid that it would take a massive sale in order to move that market. This seems highly unlikely and would probably only happen if China were in the midst of economic collapse—in which case, there would be the same flight to safety. As such, there appears to be no need to lose sleep over US Treasury yields.

Back to fiscal uncertainty

By Dr. Patricia Buckley

AFTER a very welcome but all too short period of fiscal calm, budget and debt battles have once again heated up—not the environment needed to foster business and consumer confidence.

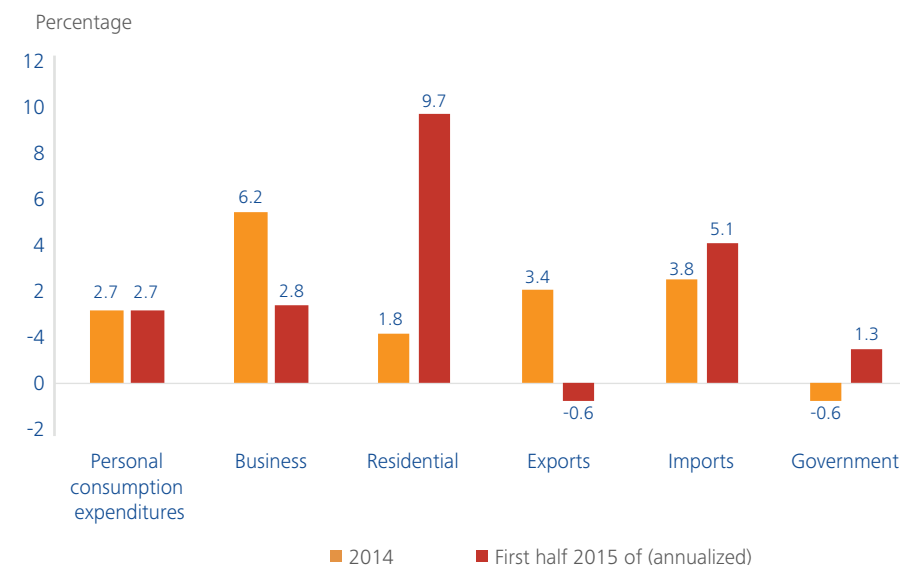
Politically unable to pass a full-year budget, US Congress has once again set the stage for a combined budget/debt ceiling battle, raising the possibility of government shutdown and default on US debt. The temporary budget measure keeps the government funded until December 11; however, in early November, the US Treasury will be unable to make timely payments owed to holders of debt and other government creditors—and this includes Social Security recipients. All this comes as the US Federal Reserve's (Fed's) policy-making body, the Federal Open Market Committee (FOMC), has been expressing growing confidence in the strength of the US economy, as it moves to raise interest rates by the end of the year for the first time since 2006. We will need to see how the fiscal drama plays out before we know what is next for the US economy.

Things were actually going fairly well ...

After a slow start in the first quarter, the US economy picked up in the second quarter, giving the first half of the year a solid, but certainly not stellar, annualized growth rate of 2.3 percent—only slightly below the 2.4 percent experienced in 2014 for the year as a whole. As figure 1 shows, while



Figure 1. Growth rates of real GDP components

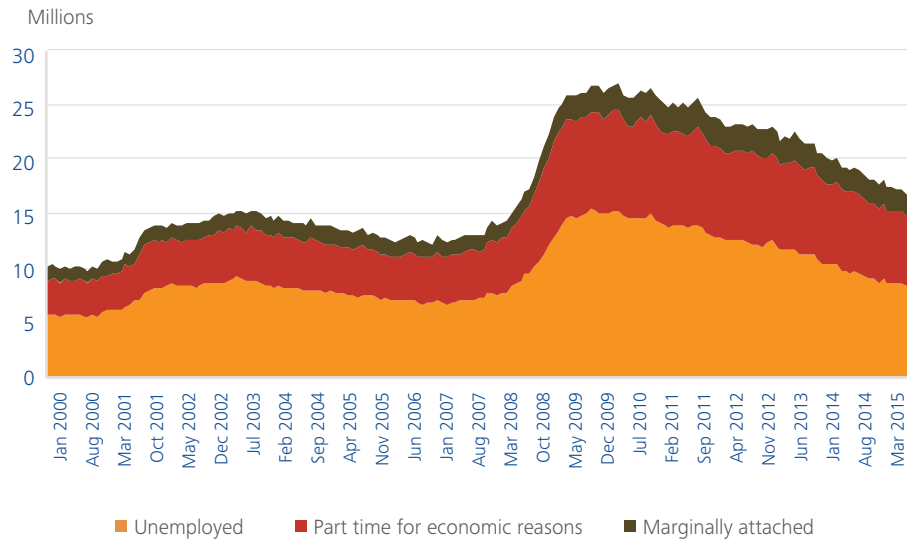


Source: US Bureau of Economic Analysis; Deloitte Services LP economic analysis.

Graphic: Deloitte University Press | DUPress.com

The labor market also continued to show improvement, with just under **200,000 jobs being created each month**, on average.

Figure 2. Slack in employment



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

Graphic: Deloitte University Press | DUPress.com

growth in real personal consumption in the first half of 2015 was on par with performance in 2014, performance in the other categories differed more substantially.

- Business investment slowed considerably in the first half compared with 2014, but the reduction is not as worrisome a barometer of overall business sentiment as it first appears. The softness was concentrated in the mining sector, where the decline in activity caused an actual drop in overall investment in structures and slowed investment in equipment. The third category, investment in intellectual products such as R&D and software, experienced strong growth during the first half.
- Residential investment is on pace to have the strongest year since the post-recession pop in 2012.
- The impact of the strong dollar can be seen in the decline in real exports and the increase in real imports. The decline in exports was due to a slowing of goods exports; services exports continued to grow during the first half of the year.
- The pickup in government spending is due to increases at the state and local level. Real federal spending grew only 0.6 percent.

The labor market also continued to show improvement, with just under 200,000 jobs being created each month, on average. While this is below last year's blistering pace of 260,000, it is still sufficient to continue to reduce the unemployment rate, which, as of September, stood at 5.1 percent—a rate only slightly above the FOMC members' estimates of the long-run level.¹

However, even with a low unemployment rate, there is considerable slack in the labor market. In addition to the 7.9 million people who are unemployed, 6.0 million people are working part time when they would like to be working full time. Further, there are just under 2 million people who,

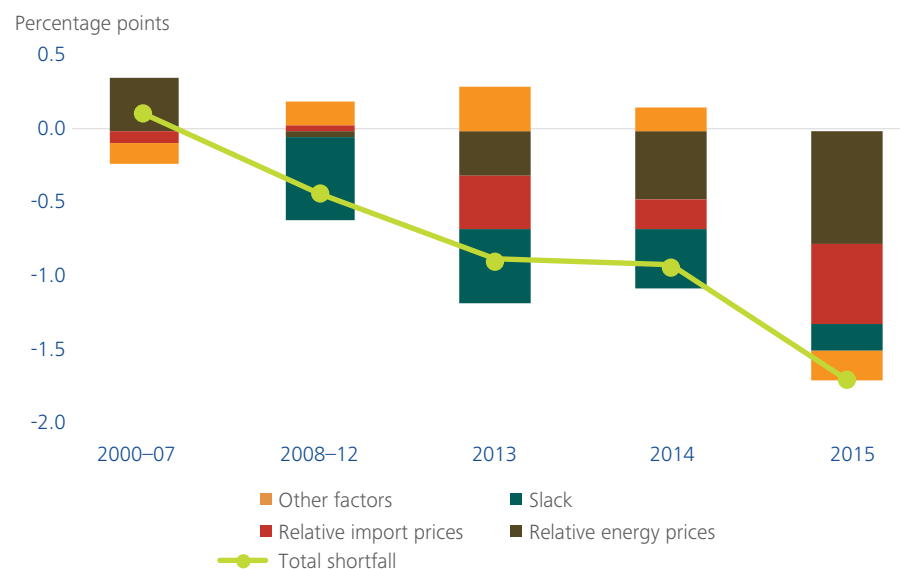
although they are not working and have not looked for a job in the last four weeks (necessary to be counted as unemployed), have looked for a job in the prior 12 months. As figure 2 shows, the number of people in all three of these categories remains elevated but is trending in the right direction.

With employment improving, what about price stability?

With one aspect of the Fed’s dual mandate, maximum employment, heading in the right direction, the other part of the mandate, stable prices, is proving more difficult to achieve. In 2012, for the first time, the FOMC adopted an explicit target of 2 percent for inflation as measured by the personal consumption expenditure (PCE) price index: If inflation is consistently below 2 percent, then the Fed is limited in its ability to use monetary policy to fight a recession, and high rates of inflation can result in the loss of buying power when income does not keep up with prices.²

Over recent years, PCE inflation has stayed well below the 2 percent target. However, the FOMC has expressed confidence that the forces keeping prices so low are transitory in nature and that prices will rise back to the target level within the next year or so; figure 3 shows the Fed’s disaggregation

Figure 3. Forces affecting PC inflation



Source: Federal Reserve Board staff calculations; Deloitte Services LP economic analysis.

Graphic: Deloitte University Press | DUPress.com

With one aspect of the Fed’s dual mandate, **maximum employment**, heading in the right direction, the other part of the mandate, **stable prices**, is proving more difficult to achieve.



of the forces keeping PCE inflation so low. Between 2000 and 2007, energy prices were rising faster than 2 percent, but that was being offset by slower growth in import prices and food. During the recession and its immediate aftermath (2007–12), growing slack in the economy—manifested by unemployment that reached 10 percent in 2010—helped pull inflation below the target by about 0.4 percentage points. In 2013, 2014, and 2015, the impact from slack in the economy was dissipating, and falling energy prices and declining relative import prices from the rising dollar forced PCE inflation even lower; it is currently over 1.5 percentage points below the target. Barring something unforeseen, the FOMC expects that “the 12-month change in total PCE prices is likely to rebound to 1–1/2 percent or higher in 2016, barring a further substantial drop in crude oil prices and provided that the dollar does not appreciate noticeably further.”³

Next steps depend on Congress and administration

Although the FOMC chose not to raise the federal funds rate in September, Chair Janet Yellen has given very strong indications that rates will rise before the end of 2015. For example, she noted that, at the September

meeting, 13 of the 17 FOMC members said that rates should rise before the end of the year; only three thought they should wait until 2016. (The remaining vote was for 2017.) The move to lessen the Fed’s “overly accommodative stance”—Yellen’s preferred terminology in lieu of “monetary tightening”—should be viewed as a vote of confidence in the US economy.⁴

It is to be hoped that Congress and the administration will be able to act as needed to bolster not only the Fed’s confidence, but also that of businesses and consumers. Either a December shutdown or a refusal to raise the debt ceiling before the Treasury defaults would cause harm to the economy. That Congress will be debating the two issues in the same time period—during a presidential campaign, no less—magnifies the potential for harm. The impact of a shutdown will depend on its duration: The last federal government shutdown was in October 2013 and lasted 17 days, with an estimated cost to the economy of around 0.5 percentage points.⁵

The suspension of the debt ceiling that had been in place since February 2014 ended on March 15, 2015. At that point, since spending was still outpacing revenues, the Treasury began implementing a series of “extraordinary measures” to continue paying all bills on time without incurring more debt. These measures

involve a change in operating procedures in which the Treasury stops redeeming existing and suspends new investments in various funds under its control, such as the Civil Service Retirement and Disability Fund and the Postal Service Retirees Health Benefit Fund.⁶ The Treasury is currently limited to cash on hand to pay the obligations incurred by the federal government. In his most recent letter to Congress on October 1, Treasury Secretary Jacob Lew stated that they “now estimate that Treasury is likely to exhaust its extraordinary measures on or about Thursday, November 5.”⁷ Should Congress fail to raise the debt ceiling and the cash is insufficient to pay the bills due on any given day, a queue begins to build, and the

payments fall further and further behind. This queue would include Social Security and Medicare recipients, holders of Treasury bonds and bills, military personnel, contractors, and those expecting tax refunds.⁸ While these direct impacts and the ensuing hardships they would cause are a certainty without an increase in the debt, the great unknown is the amount of turbulence in world financial markets that such an event would cause.

The degree of difficulty in successfully negotiating a budget and a debt ceiling deal was evidenced by the sudden, unexpected decision of House Majority Leader John Boehner to resign effective October 30. Hopefully, the seeds of a deal can be negotiated before he leaves office.

Endnotes

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Growing despite headwinds

By Dr. Alexander Börsch

THIS summer's events had the potential to completely derail the tepid recovery the Eurozone has experienced since the end of last year. The Greek debt crisis escalated dramatically, with intense tension between Greece and its creditors. After a new bail-out package was agreed upon, equity markets in China plunged. This gave rise to fears about the Chinese economy, a crucial market for Eurozone exports.

Despite this very volatile, challenging environment, the Eurozone has continued its recovery. In fact, this may be seen as evidence that the recovery can now weather external shocks. In this way, the Eurozone has left the “stall-speed-phase” of the recovery behind, in which it was highly vulnerable to external turbulences. The speed of the recovery is still not overwhelming, but the recovery has become more stable.

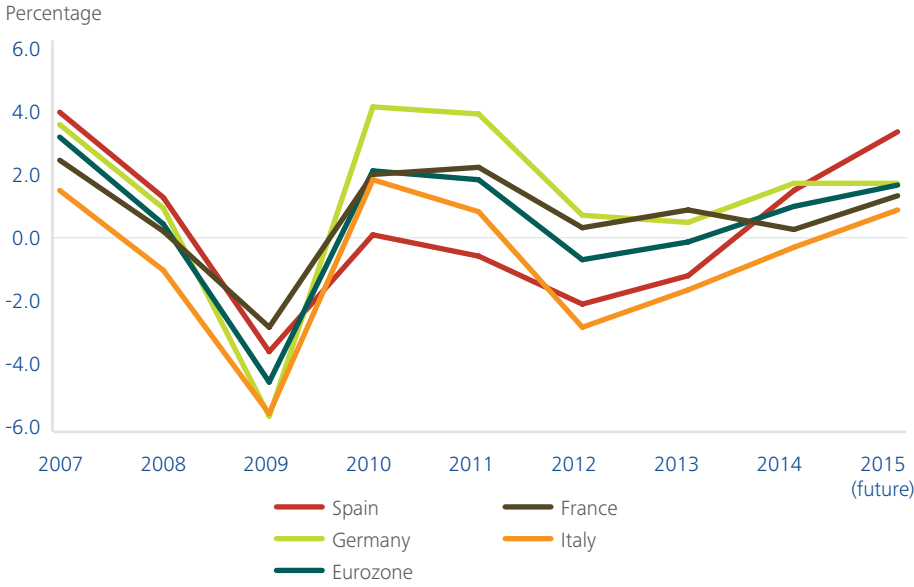
Positive recovery trends

The Eurozone grew 0.4 percent in the second quarter, after 0.5 percent in the first quarter. Against the backdrop of weak economic performance over the last years, there is a clear, positive longer-term trend based on some encouraging factors (figure 1). First, the recovery now rests on a strong basis. All Eurozone economies, except stagnating France, grew in the second quarter. Second, there is a





Figure 1. GDP growth

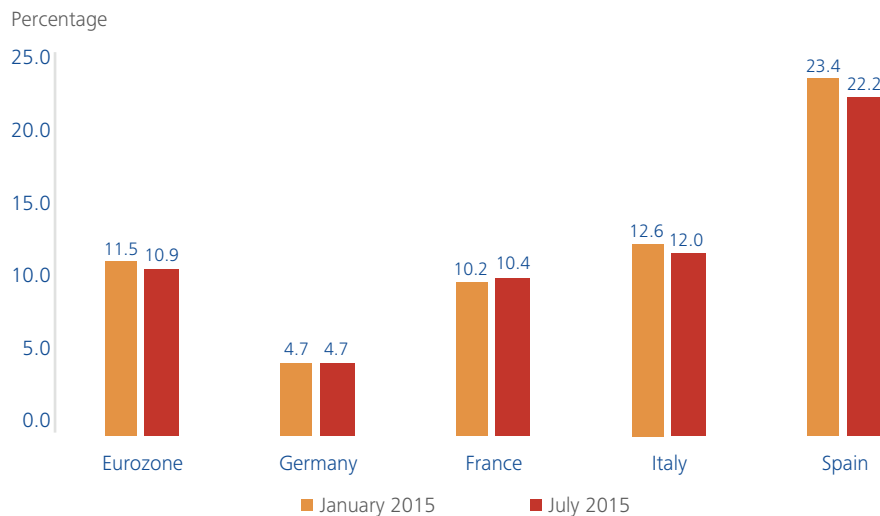


Source: Oxford Economics; Deloitte & Touche GmbH economic analysis.
 Graphic: Deloitte University Press | DUPress.com

The Eurozone has left the “stall-speed-phase” of the recovery behind, in which it was **highly vulnerable to external turbulences.**

Despite the generally positive trend, **there are still significant differences** between the four biggest Eurozone economies in the speed and depth of the recovery.

Figure 2. Unemployment rates



Source: Eurostat; Deloitte & Touche GmbH economic analysis.

Graphic: Deloitte University Press | DUPress.com

renewed growth dynamic in some countries. Spain experienced its highest quarterly growth since 2007, while the Italian economy grew in two consecutive quarters for the first time since 2011.

The growth drivers remained largely the same. Exports developed more than expected, driven by the devaluation of the euro. Also, private consumption further gained momentum, driven by somewhat lower rates of unemployment (figure 2) and low energy prices. Investment activity, however, remains weak and is still a drag on the recovery.

Early indicators also point in a positive direction. The Eurozone purchasing managers' index in September stands at 53.9, solidly in positive territory (values over 50 signal expansion), pointing to further solid expansion in the coming quarters.¹

Despite the generally positive trend, there are still significant differences between the four biggest Eurozone economies in the speed and depth of the recovery.

Germany

While in the last quarters, Germany's growth was mainly driven by domestic consumption—analysts already wondered whether Germany could become a consumer economy—this has changed, at least temporarily. While investment activity has still not recovered, currently it is again exports that drive growth, especially those to the United States.

In fact, the United States superseded France, which had the position of Germany's most important export market for over half a century. In the first half of 2015, exports to the United States grew almost 24 percent.² The reindustrialization of the United States, thanks to low energy costs, has been driving demand for German exports, particularly machine tools and equipment. The strong demand from the United States as well as the weak euro helped German exporters cope with weak world trade dynamics.

Nevertheless, it is unlikely that exports will continue to drive growth substantially in the coming quarters. The recovery will again become more consumer based. Consumer spending is likely to regain its dynamism,

driven by continuing employment growth and rising wages. This will push up imports so that, on balance, exports are unlikely to contribute substantially to growth, as was the case earlier this year and last year. Overall, growth in 2015 is expected to be around 1.6 percent.³

France

France has been the exception to the general positive growth trend in the Eurozone. While starting strongly in 2015, it lost momentum in the second quarter and was the only country in the Eurozone that stagnated. This was mainly due to a decline in consumption growth, which previously drove the recovery. While in other countries such as Italy and Spain, the unemployment rate went down somewhat and therefore supported consumption, the unemployment rate in France slightly increased over the first seven months of 2015 to 10.4 percent. Also, early indicators such as the purchasing managers' index show that business sentiment in France lags behind the Eurozone average.⁴

France has been the exception to the general positive growth trend in the Eurozone. While starting strongly in 2015, it lost momentum in the second quarter and **was the only country in the Eurozone that stagnated.**

While France's growth, at a forecasted 1.2 percent, is very likely to lag behind the Eurozone average in 2015, there are some encouraging signs. French exports should profit from the weak euro as well as from the general recovery in the Eurozone. Growth dynamics will therefore depend strongly on a return of consumer spending and a positive trend in the labor market, while investment recovery is likely only in the later phases of the recovery.

Italy

Italy has left the recession behind, and its recovery has been gaining strength. In the second quarter, the Italian economy grew 0.3 percent, after growing 0.4 percent in the first quarter. The recovery is mainly based on private consumption and an improving labor market. In fact, private consumption saw its strongest growth in the last five years. Unemployment went down to 12 percent, which is the lowest rate in the last three years. Similar to the overall trend in the Eurozone, corporate investments in Italy remain subdued; investment actually fell in the second quarter.

A moderate recovery is the baseline scenario for Italy. Consumer sentiment is positive, so private consumption is likely to further drive growth, while the weak euro will help Italian exports. Moreover, the recovery of the Eurozone as a whole is set to support Italian exports. The growth rate for 2015 is likely to be around 0.7 percent.

Spain

The Spanish economy shows the most remarkable and impressive performance among the big Eurozone countries. In the second quarter, the economy had the strongest growth since 2007. The recovery is

mainly based on strong domestic demand and exports, though investments in machinery and equipment have also been growing substantially. Consumption is supported by employment growth. In the last five quarters, employment grew by more than 900,000 jobs. While unemployment is still very high (22 percent), and many new jobs are temporary, Spain managed to achieve a strong reversal of the labor market.

The outlook for the Spanish economy remains positive, even if for the rest of the year the speed of the recovery is likely to somewhat decelerate. The recovery will be driven mainly by domestic demand in the short term. But even if the current dynamic decelerates, Spain is forecast to have, at 3.2 percent, by far the highest growth among the big Eurozone economies.

Outlook

The greater momentum of the recovery and its resilience against political and external turbulences are very good news for the Eurozone. Consumers remain the main driver of growth in the Eurozone, while exporters may compensate for the emerging-market weakness with greater exports to the Eurozone itself and to the United States. The big unknown going forward is the development of investments, which have been underwhelming since the recovery started. Corporates still seem unconvinced about the recovery or are hesitant in the face of various uncertainties within and outside the Eurozone. If their outlook changes, 2016 could give a decisive boost to the recovery. If not, the recovery is projected to remain at its current speed.



Endnotes

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Struggling to recover

By Dr. Ira Kalish

The state of the economy

Japan's economy failed to grow in the second quarter of 2015. Moreover, real GDP has fallen in three of the last five quarters—hardly an indication of a rebound in economic performance. Part of the problem is the weakness of the household sector. Household spending has increased only in 3 of the last 20 months—and it continued to fall in July. This reflects a combination of declining wages and virtually no inflation. In 6 of the last 12 months, consumer prices have fallen.¹ Meanwhile, consumer spending has not yet recovered from the shock of last year's increase in

the national sales tax. On the other hand, there are indications that the labor market is starting to tighten and, as a consequence, compensation is starting to improve. The unemployment rate is low, and the ratio of job openings to applicants reached a 23-year high in July. Moreover, a relatively large increase in the official minimum wage takes effect in October. Therefore, consumer spending could rebound somewhat in the second half of the year.

Another problem concerns business investment, which has remained stagnant, reflecting business pessimism as well as the negative effect of weak export demand. However, corporate earnings are rising rapidly,

Exports to China account for about 20 percent of Japanese exports. Thus, while the weaker yen has helped to boost exports to the United States and Europe, **Chinese weakness has hurt Japan's recovery.**

especially due to the impact of a weak Japanese yen on translated earnings from foreign operations. If a boost to wages causes a rebound in consumer demand, this should bode well for the willingness of businesses to invest.

Historically, Japan's growth has been fueled by exports of manufacturing goods. In 2014, real exports increased 8.4 percent, helping to offset weakness in nearly every other category of spending. However, in 2015, exports have weakened, largely because of the slowdown in China's economy. Exports to China account for about 20 percent of Japanese exports. Thus, while the weaker yen has helped to boost exports to the United States and Europe, Chinese weakness has hurt Japan's recovery. Still, the impending change in US monetary policy could lead to a further appreciation of



While QE has created some inflation, it remains well below the BOJ's target; in fact, **core inflation is close to zero.** Moreover, wages have mostly fallen, thus suppressing consumer spending power.

the US dollar. This, in turn, could significantly boost the competitiveness of Japanese exports to the United States. Also, trade in services has been a positive factor for the Japanese economy. Tourist arrivals, largely from Greater China and South Korea, soared in both 2014 and 2015. In August of this year, total tourist arrivals were up 64 percent from a year earlier.² Tourists are attracted, in part, to the low value of the yen.

Overall, the outlook for Japan's economy indicates continued slow economic growth. Inflation is likely to remain low, especially given the impact of declining energy prices and a weaker Chinese renminbi.

The policy environment

The principal policy tool that has been used to address the economic situation is the quantitative easing (QE) now underway by the Bank of Japan (BOJ). This involves massive purchases of government bonds, with the intention of boosting inflation (or at least averting deflation), suppressing the value of the yen and borrowing costs, and boosting wealth. All of these things have been accomplished, but it is increasingly clear that QE is not enough. While the drop in the yen has helped exporters, it has hurt domestically oriented businesses by boosting import prices. While QE has created

some inflation, it remains well below the BOJ's target; in fact, core inflation is close to zero. Moreover, wages have mostly fallen, thus suppressing consumer spending power. And while borrowing costs are low, this has not convinced businesses to invest more, especially given both weak external and domestic demand.

The question then is what more can be done to repair Japan's fragile economy. Recall that the economic policy of Prime Minister Shinzo Abe, popularly dubbed "Abenomics," involved three "arrows": monetary stimulus, fiscal stimulus, and structural reform. The monetary stimulus is clearly underway with QE. However, in nearly two years, it has failed to bring inflation close to the desired level. Yet, despite speculation to the contrary, it is not expected that the BOJ will accelerate the pace of asset purchases. As for fiscal stimulus, the opposite has taken place, with a sizable increase in the national sales tax in April 2014 and another one planned for April 2017. Moreover, the government continues to run a large budget deficit (7.7 percent of GDP in 2014) and has one of the highest debt-to-GDP ratios of any advanced industrial country. At the least, this means that any effort to temporarily boost the deficit in order to stimulate the economy (as has been suggested by some) would face severe political resistance and thus is unlikely to happen.

The principal remaining tool is structural reform. More specifically, this would entail legislation meant to remove obstacles to the proper functioning of the market economy. Such obstacles come in the form of labor market regulations, anticompetitive rules in various industries, and trade protection. The idea is that if these rules and regulations are removed, the private sector could become more productive, there would be a greater incentive to invest in those industries that become deregulated, and, consequently, the economy would grow faster.

Yet the pace of reform has been slow. The government has expended its political capital on foreign policy-oriented legislation. In September, the parliament passed controversial legislation to allow the use of Japanese troops in overseas combat. Now that the Trans-Pacific Partnership (TPP) has been completed, it should compel Japan to open various markets to greater competition and implement the kinds of structural reforms that Abenomics promised.

Endnotes

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Don't believe what numbers say but what investors do

By Dr. Rumki Majumdar

INDIA seems to be riding the ebb and flow of economic activity. After recording a blockbuster figure of 7.5 percent year over year in Q4 of fiscal year (FY) 2014–15, growth (the official measure of economic growth measured by GDP at market price, henceforth referred to as GDP) unexpectedly dipped to 7.0 percent in Q1 FY 2015–16.¹ What is more puzzling is that growth measured by gross value added on the supply side (at basic prices, henceforth referred to as GVA) accelerated from 6.1 percent in Q4 FY 2014–15 to 7.1 percent in Q1 FY 2015–16.

Amid this confusion over growth numbers, investors are still waiting to see enough positive change in economic activity before they feel confident about investing their capital. So far, growth has primarily been driven by consumption expenditure, while capital investment has lagged behind. India needs investment to ensure noninflationary

growth in the long run. Global companies are looking for opportunities to invest their capital, and India is an attractive destination owing to its better economic performance relative to its peers and favorable global developments.² Are policymakers taking advantage of this window of opportunity?

Decoding growth

The disconnect between the two measures of growth (GDP versus GVA) has been baffling economists and investors, who remain doubtful about the underlying growth momentum (figure 1). Setting aside the issue of GDP estimation methodology, the confusion can be attributed to the component of indirect taxes after accounting for subsidies to the government in the last two quarters.³ In Q4

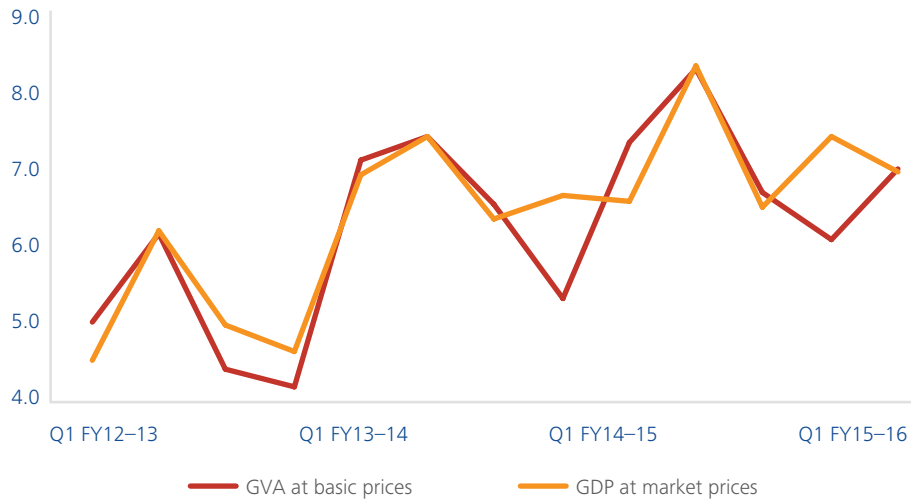




So far, growth has primarily been driven by consumption expenditure, **while capital investment has lagged behind**. India needs investment to ensure noninflationary growth in the long run.

Figure 1. The disconnect between the measure of GVA at basic prices and GDP at market prices

Percentage, year over year



Source: Reserve Bank of India, August, 2015; Deloitte Services LP economic analysis.

Graphic: Deloitte University Press | DUPress.com

FY 2014–15, strong net indirect tax collections buoyed the measure of GDP and added 1.4 percentage points to the GVA growth of 6.1 percent. However, in Q1 FY 2015–16, GDP growth turned out to be lower than GVA growth, despite higher GVA, robust indirect tax growth (after adjusting for changes in tax rates), and lower subsidies (owing to lower oil prices).⁴ In other words, higher GVA growth when added to stronger net indirect tax collections in Q1 led to slower GDP growth relative to the previous quarter.

The deflator for the net indirect tax collections was the “real” culprit. Since the nominal increase in the indirect tax collection was primarily due to an increase in tax rates by the government and not to any widening of the tax base, such a rise in tax collections was considered a “price effect.” While calculating the real GDP growth, this price effect was not included. Thus although net indirect taxes in nominal terms rose 39.9 percent, in real terms the increase was a mere 6.5 percent.⁵

Amid these conflicting data, it is imperative for investors to understand where India stands in terms of growth in economic activity. Since the GVA estimate removes the distortions due to taxes and subsidies, for now it may be considered a better measure. GVA movement over the last two quarters closely represents actual economic movement, as indicated by the high-frequency economic indicators.⁶ For instance, monthly numbers for the consumer durables index and the eight core industry indices indicated slower

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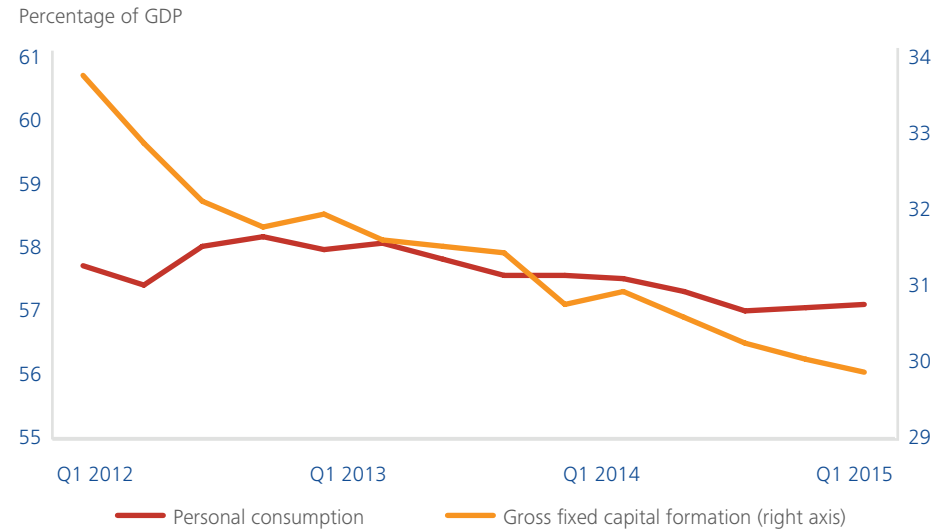
growth in Q4 FY 2014–15 and faster growth in Q1 FY 2015–16; this was somewhat mirrored in the GVA numbers. Economic activities classified under GVA that pointed to growth higher than 7 percent in Q1 FY 2015–16 were manufacturing; trade, hotels, transport, and communication and services related to broadcasting; and financial, insurance, real estate, and professional services.

On the expenditure side, GDP has primarily been driven by consumption expenditure (figure 2). What is noticeable is that the contribution of fixed capital investment to GDP fell steadily. Higher government consumption, with rising nonplanned expenditure, and poor exports might have discouraged investment in the economy, although the government's emphasis on capital investment lately is expected to crowd in private investments.

Stepping up investment is the formula for sustainable growth

The economic outlook remains positive as the International Monetary Fund predicts growth to be 7.5 percent in the next two fiscal years.⁷ The Reserve Bank of India (RBI) also expects 7.4 percent growth in FY 2015–16.⁸ However, if an economy that has primarily been driven by consumption so far wants to ensure sustainably strong and noninflationary growth in the long run, growth in fixed capital investment will be crucial. India has been suffering from supply bottlenecks since 2007 due to insufficient capacity creation. Investment has been much below its potential over the last few years. From a peak of 24 percent in the last quarter of FY 2009–10, the growth rate of gross fixed capital formation now languishes around zero.⁹ The stalling of projects, a term synonymous with large economic undertakings in infrastructure, manufacturing, mining, power, and so on, is widely accepted to be a leading reason for this decline.

Figure 2. Contribution to GDP



Source: Press Information Bureau of India, August 2015; Reserve Bank of India, August 2015; Deloitte Services LP economic analysis.

Graphic: Deloitte University Press | DUPress.com

The good news is that there has been a consistent rise in projects under implementation, as well as a steady decline in the number of stalled projects. Data released by the Centre for Monitoring Indian Economy showed an 8.4 percent rise in projects under implementation in Q1 FY 2015–16, marking the fastest increase in the last three years.¹⁰ Private sector projects being implemented rose 0.8 percent, the first expansion in the past two years. Stalled projects declined from a peak of 8.4 percent of GDP in Q4 2013–14 to 6.6 percent in the latest quarter, partly because of the government's emphasis on capital spending this fiscal year. These improvements will likely bear fruit and boost investment growth in the near future.¹¹

The falling number of stalled projects, declining global commodity and oil prices, increasing public investment in infrastructure, and signs of increasing consumer demand for goods could **persuade businesses to invest in capacity building** in the near term.

Falling oil and commodity prices have helped to contain input prices, which, in turn, may improve corporate profit margins. Higher margins will likely encourage companies to plough back a share of their increased profits into fixed capital investments.

The government has managed to bring down the fiscal deficit as a percentage of GDP to 4.1 percent in FY 2014–15 from 5.0 percent in FY 2012–13. In addition, to increase productivity, the government is channeling a higher proportion of spending toward capital expenditure. The first quarter of FY 2015–16 has seen a sharp increase in public investment in infrastructure and development projects. Such investment not only generates substantial direct employment but also fuels demand and growth in linked

sectors. Increased public sector investment will therefore likely crowd in private investment.

Lately there have been signs that consumer demand, which remained muted in the last few years, may be picking up. The IP index for consumer goods unexpectedly increased for two consecutive months (June and July 2015) for the first time since early 2013, on the back of strong consumer durable goods production. The IP index for consumer durables, which has been in negative territory since the end of 2012, turned positive in the last two months. It is possible that urban demand might have bottomed out and soon may see sustained growth. However, the IP index for consumer nondurables has turned negative in recent months, which implies rural demand is weak and is

likely to remain so due to a deficient monsoon. Overall, the turnaround in the IP index for consumer goods bodes well for capital investment in the economy. The IP index for capital goods has been showing strength lately.

In short, the falling number of stalled projects, declining global commodity and oil prices, increasing public investment in infrastructure, and signs of increasing consumer demand for goods could persuade businesses to invest in capacity building in the near term. A rise in fixed capital formation would likely remove supply constraints and boost growth without any inflationary impact on the economy.

Boost from an easy monetary policy?

Capital investment depends significantly on credit conditions in the economy, which are decided by the monetary authority and its policy stance. So far, credit conditions have remained somewhat tight, and there is some space for further easing. The RBI has also been vigilant about credit growth in the corporate sector. The RBI governor has resisted growing pressure from the finance ministry to ease monetary policy; the RBI has cut policy rates intermittently, albeit at a slow pace, citing higher inflation expectations, a poor monsoon, and global uncertainties, including the US Federal Reserve's (Fed's) policy rate hike.¹²

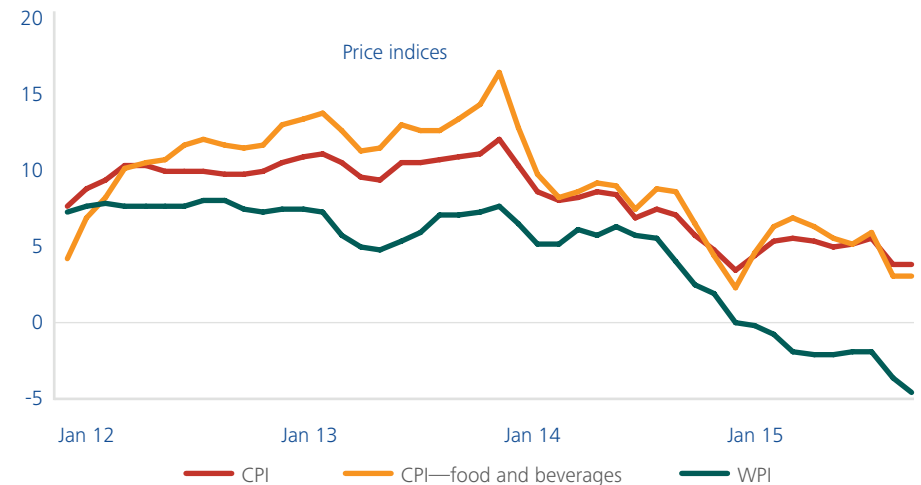
However, current data indicate that the fear of rising prices may be out of line with reality. Inflation has moderated since 2014 due to easing commodity and international oil prices, falling global food inflation, and tightening credit conditions in India. In addition, the government's proactive supply-side management, especially in respect to onion and pulses; offloading of surplus rice and wheat stocks; and restraining the hike in minimum support prices have helped put a lid on domestic food inflation. The latest data show a 3.7 percent increase in the consumer price index (CPI), while wholesale price inflation (WPI) has been in negative territory since November 2014. A fall in the CPI has been primarily due to a sharp fall in prices of food and beverages, which account for 46 percent of the CPI (figure 3).

The RBI announced a rate cut of 0.5 percent in its monetary policy meeting held on September 29. The rate cut was more than the market expected, but the Fed's status quo and sustained domestic disinflationary pressures allowed the RBI to ease its policy stance. The RBI indicated that it intends to be as accommodative as possible given its inflation targets.¹³

However, this might be the last rate cut for this year. This year's deficient monsoon might put upward pressure on food price inflation. It is feared that rising prices due to some failed crops may make food inflation go

Figure 3. Prices are falling

Percentage, year over year



Source: Ministry of Statistics and Programme Implementation, September 2015; Deloitte Services LP economic
Graphic: Deloitte University Press | DUPress.com

out of control. In addition, favorable base effects will start waning going forward. Latest data show an increase in both short- and long-term inflation expectations. The RBI would like to see a sustainable fall in prices before committing to further rate cuts. Households need to be convinced that inflation will likely remain low once commodity and oil prices start picking up.

Risks to global economic activities are skewed to the downside. The banking sector remains vulnerable to exogenous shocks. Banks in India are facing huge amounts of bad loans. With the current conditions of the stressed asset ratios (gross nonperforming plus restructured standard advances to gross advances) for the banking system rising to 10.9 percent as on March 2015, and credit growth at around 10 percent, the banks' ability to lend or cut lending rates gets restricted.¹⁴ In addition, corporate sector balance sheets are over-leveraged, which limits the sector's ability to borrow and invest, and, therefore, may deter businesses from incurring investments.

Moreover, easing monetary policy through rate cuts may not be enough to ensure strong investment growth. So far, banks have not cut lending rates, while deposit rate cuts have adversely affected household savings. The RBI stated that, with a cumulative rate cut of 125 basis points

since January 2015, it would now prefer to see front-loaded policy-rate reductions translate more fully to lower lending rates by banks before easing policy further. In addition, as an alternate source of funding, the RBI has allowed Indians to issue Indian rupee-denominated bonds with a minimum maturity of five years at overseas locations within the ceiling of foreign investment permitted in corporate debt (which is currently \$51 billion).¹⁵ These policies will likely benefit private sector credit growth and solidly boost investment sentiment, and thus the capital investment cycle.

Right policies should pave the way

Global companies are looking to invest their capital, and India is an attractive destination. According to a *Financial Times* report, "India is in pole position to pass both China and the US in the foreign direct investment league tables this year."¹⁶ All eyes are now on the pace at which the government brings about structural reforms in the economy. The implementation of critical reforms, such as amendments in goods and services tax and in land acquisition laws, is expected to significantly boost the investment cycle and help the economy realize its growth potential.

Latest data show an increase in both short- and long-term inflation expectations.

Endnotes

1. Growth is measured year over year in this article, unless otherwise specified.
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3. $\text{GDP at market prices} = \text{GVA at basic prices} + \text{indirect taxes on products (including import duties)} - \text{subsidies on products}$.
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A troubling dive into the known

By Akur Barua

ON September 9, Standard & Poor's (S&P) downgraded Brazil's long-term sovereign debt rating to junk.¹ Other rating majors, such as Moody's, still have Brazil at investment grade, although Moody's rating is just one notch above junk. Observers expected this rating downgrade due to faltering fiscal management during an economic recession, and political uncertainty has actually risen sharply in recent months, preventing critical budgetary reforms. It is perhaps ironic that Brazil's downgrade came at the hands of the same rating agency that promoted

the country to investment grade in April 2008.² At that time, it was a recognition of Brazil's rise in the global economic order. Now, for policymakers to regain that level will be a steep climb.

The moves that rocked the rating

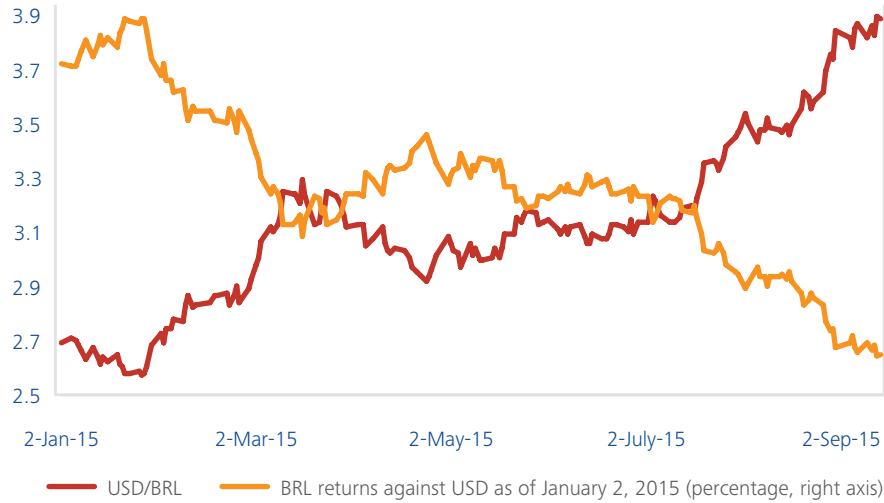
In July, S&P put Brazil on negative outlook, citing concerns about fiscal consolidation efforts and the economy; then came September's downgrade. A number of factors led

Deteriorating public finances in a recession were the last nail in the coffin, especially with political conflict sabotaging efforts to shore up fiscal health.





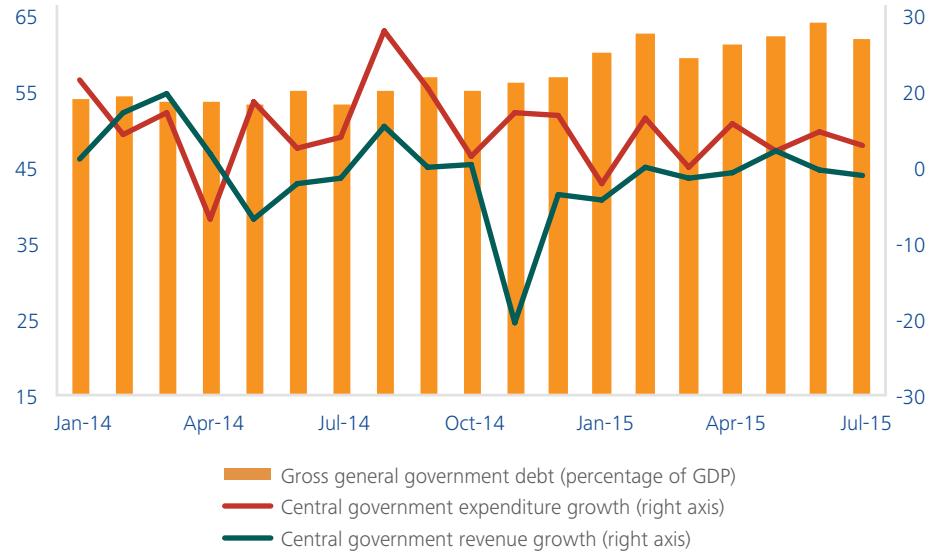
Figure 1. Real has lost about 34 percent against the US dollar this year



Source: Bloomberg, Deloitte Research; Deloitte Services LP economic analysis.

Graphic: Deloitte University Press | DUPress.com

Figure 2. Gross debt has risen; expenditure growth has outpaced revenues since May 2014



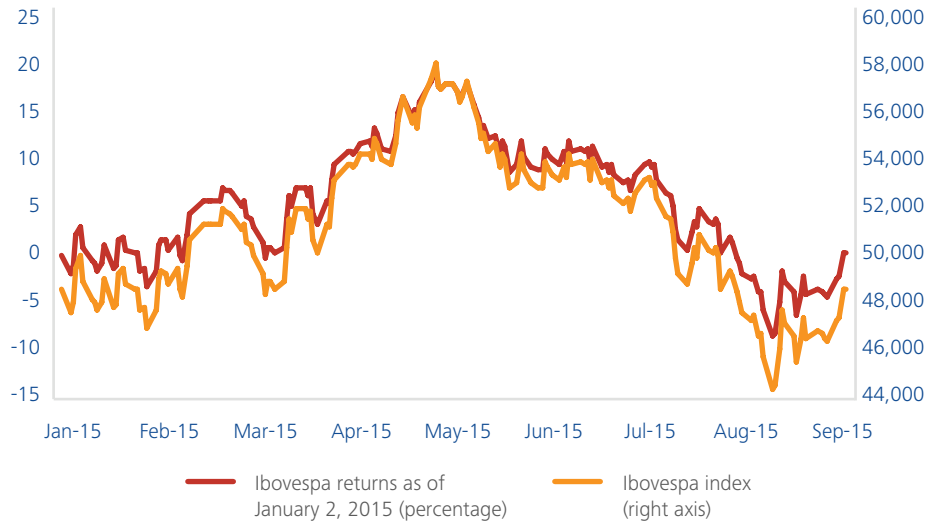
Source: Haver Analytics; Deloitte Services LP economic analysis.

Graphic: Deloitte University Press | DUPress.com

to this. First, economic activity has deteriorated since July’s cut in outlook (the economy slipped into recession in Q2) with key indicators pointing to a GDP contraction this year and the next. Second, with inflation running high, support from monetary policy is not expected. In fact, the Banco Central do Brasil (BCB) had left it too late to raise rates last year.³ Third, low commodity prices (Brazil’s main exports) and a weakening currency (figure 1) are putting more pressure on the economy. Finally, deteriorating public finances in a recession were the last nail in the coffin, especially with political conflict sabotaging efforts to shore up fiscal health.

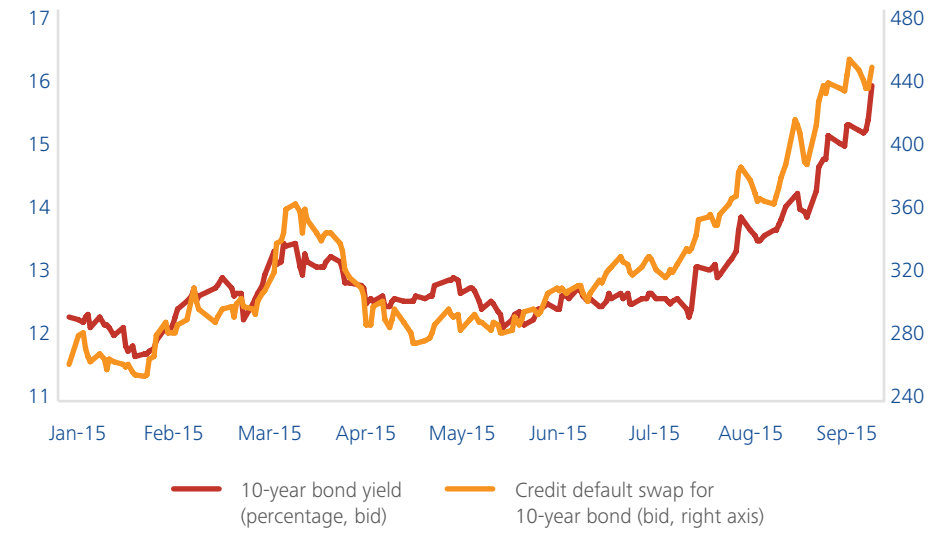
In fact, rising debt and the inability to curtail spending (figure 2) have been a concern since President Dilma Rousseff’s reelection. Even more perturbing is the unraveling of planned spending cuts and tax increases to spruce up public finances. Although many applauded Finance Minister Joaquim Levy’s initiative to reform public finances, the scandal at Petrobras proved to be a deal breaker, with investigations ensnaring top business and political leaders. With about 90 percent of government spending ring-fenced by a belligerent Congress, cutting down spending has proved to be a difficult task, as did the government’s failed attempts to

Figure 3. Equities under pressure due to global factors and deteriorating domestic conditions



Source: Bloomberg; Deloitte Services LP economic analysis.
Graphic: Deloitte University Press | DUPress.com

Figure 4. Bond yields and cost of insuring bonds have gone up



Source: Bloomberg; Deloitte Services LP economic analysis.
Graphic: Deloitte University Press | DUPress.com

introduce a financial transactions tax. Rousseff’s sliding popularity, now in single digits, has not helped matters.⁴

Interestingly, markets appear to have priced in a rating downgrade, especially after the Rousseff administration sent its 2016 budget to Congress on August 31. In the budget, the government set a primary deficit target (-0.5 percent of GDP) for 2016, the first time since 2000 that a budget failed to include a primary surplus. This was also the fifth time that the government had lowered its target. Markets reacted immediately: On September 1, the main Ibovespa index fell 2.5 percent, the real lost 2.1 percent against the dollar, and bond yields rose (figures 3 and 4). In

fact, domestic and global turmoil have been feeding into financial markets since the beginning of the year. And now, the downgrade has added to the gloom.

Most worrying is a rise in the cost of borrowing, which generally follows a downgrade to junk. Along with businesses and households, the government is likely to feel the pressure, especially when it is running a primary deficit. The government is expected to raise debt to meet prior obligations as well as for current expenditures—the latter at higher costs. With the economy expected to be in decline over 2015–16, the debt burden will likely rise during that time without sharp cuts to spending.

Interestingly, markets appear to **have priced in a rating downgrade**, especially after the Rousseff administration sent its 2016 budget to Congress on August 31.

Because of internal rules, institutional investors such as pension funds cannot hold securities rated junk, although often at least two rating agencies have to rate the debt as junk. For now, Moody's has Brazil at its lowest investment grade, with a stable outlook. But as the S&P downgrade shows, a downgrade by Moody's could come sooner than thought; S&P's came just six weeks after it had lowered Brazil's outlook to negative. If that happens, capital will flow out sharply, putting even greater pressure on the real and borrowing costs.

Economic activity on a downward slide

In Q2, GDP contracted 1.9 percent quarter over quarter, the sharpest decline since Q1 2009. The decline in Q1 (-0.7 percent) turned out to be higher than initially estimated (-0.2 percent). With two straight quarters of

economic contraction (figure 5), Brazil is now in a technical recession. For policymakers, weak domestic demand is the biggest headache: Private consumption fell 2.1 percent in Q2, down from a 1.5 percent decline in Q1. The contraction in Q2 was the sharpest since Q4 2001.

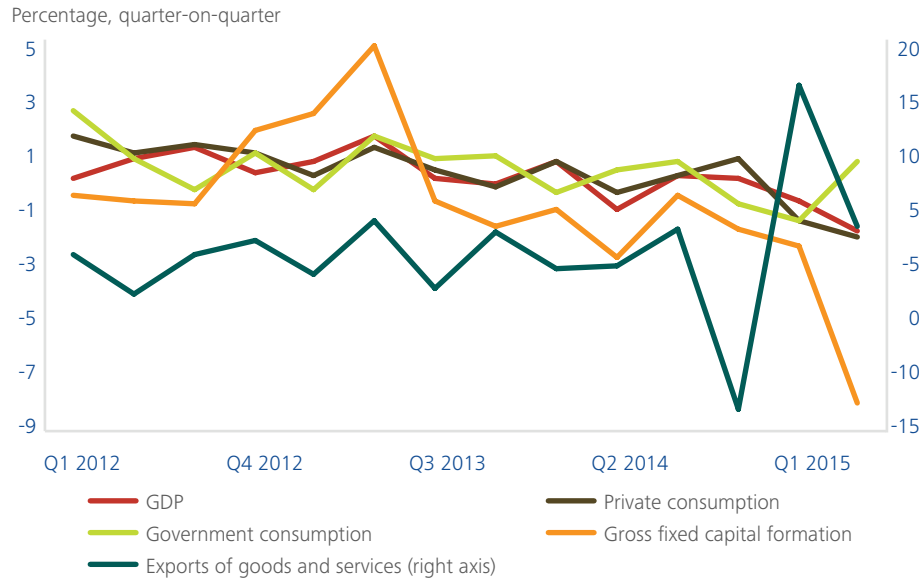
Investments are reeling from declining domestic demand, high borrowing costs, and weak business confidence. Gross fixed-capital formation fell 8.1 percent, worsening sharply from a 2.4 percent decline in Q1. The ongoing investigation into the Petrobras scandal is weighing heavily on private businesses' investment decisions and the awarding of contracts by the government; the latter's dip has also hit construction, which fell 8.4 percent in Q2.⁵ Exports were the only saving grace in Q2, rising 3.4 percent. However, the figure was much lower than the previous quarter's rise (16.2 percent).

Private consumption is in deep trouble

Households are facing both a deteriorating labor market and cuts to fuel and electricity subsidies. The subsidy cuts earlier this year have pushed up consumer inflation, which is now close to double digits (9.5 percent in August) and has dented real wages, at a time when wages are already under pressure due to rising unemployment (7.5 percent in July). For example, real average earnings for those in the private sector fell 3.0 percent year over year in Q2, following a 1.3 percent decline in Q1.

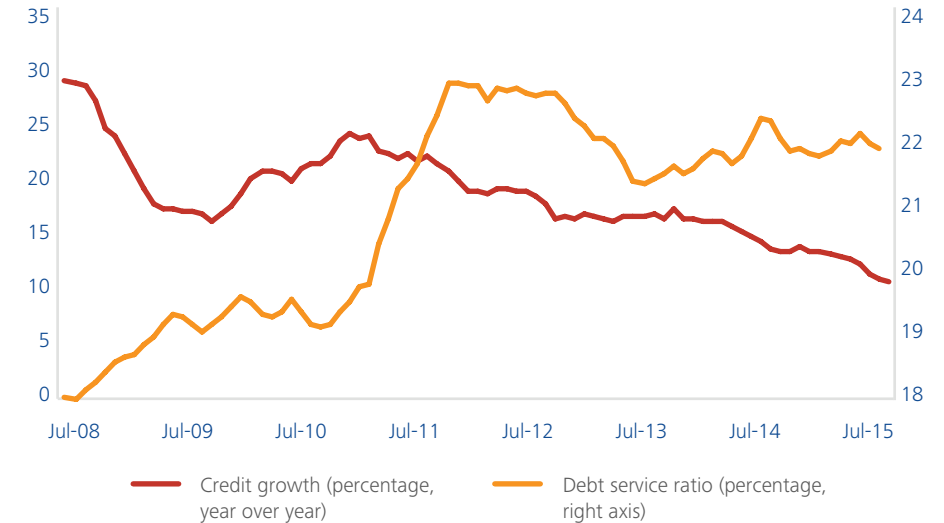
The BCB's efforts to tackle rising prices have not yet borne fruit, though, in all fairness, it takes time for monetary policy to have an impact. For the BCB, the task has become even more difficult due to a weak real (which has pushed up import prices) and a rise in administered prices (due to cuts in subsidies). With the

Figure 5. Falling investments and private consumption drag down the economy



Source: Haver Analytics; Deloitte Services LP economic analysis.
 Graphic: Deloitte University Press | DUPress.com

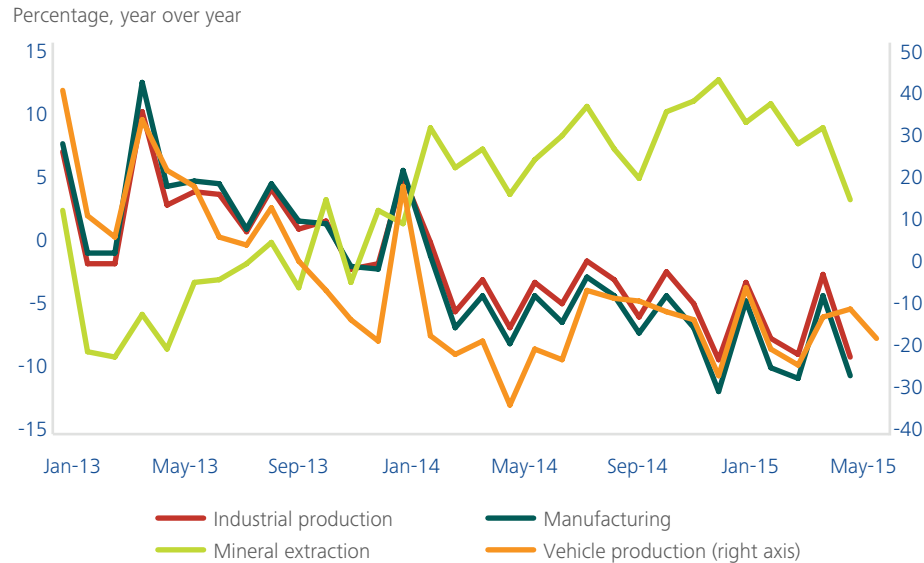
Figure 6. For households, credit growth has fallen while debt service costs remain high



Source: Haver Analytics; Deloitte Services LP economic analysis.
 Graphic: Deloitte University Press | DUPress.com

The **one bit of good news** is that a falling currency has made Brazilian exports more competitive. Indeed, the **real effective exchange rate fell 10.7 percent** between January and June.

Figure 7. Manufacturing continues to contract

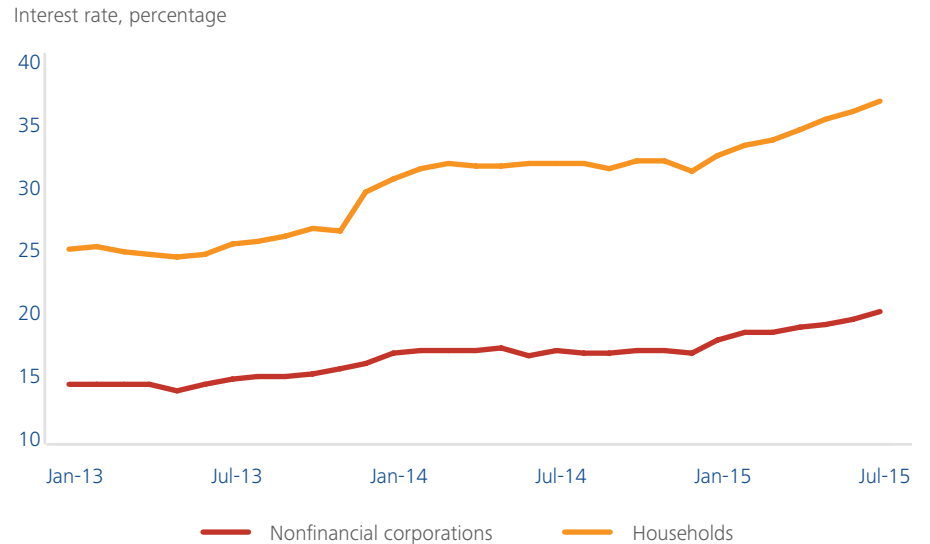


Source: Haver Analytics; Deloitte Services LP economic analysis.

Graphic: Deloitte University Press | DUPress.com

BCB raising rates and banks tightening credit, household credit growth has fallen sharply even as the debt service ratio remains high (figure 6). All these are putting pressure on private spending: Retail sales fell 3.5 percent year over year in July, the fourth straight month of contraction.

Figure 8. High cost of capital is a drag on investments and consumption



Source: Haver Analytics; Deloitte Services LP economic analysis.

Graphic: Deloitte University Press | DUPress.com

A difficult time for businesses

Business confidence has been in negative territory since April 2014, with the value in September at its lowest level since the series started.⁶ And the Getulio Vargas Foundation

manufacturing confidence index also fell to its lowest level since the series was started.⁷ Car sales growth has been in negative territory since March 2014, with the trend similar for overall manufacturing and industrial production (figure 7).

While a contracting economy and high cost of capital (figure 8) are weighing on confidence, businesses are equally troubled by rising uncertainty after the Petrobras scandal. The one bit of good news is that a falling currency has made Brazilian exports more competitive. Indeed, the real effective exchange rate fell 10.7 percent between January and June.⁸ However, for manufacturing companies, this may not be enough. The country does not rank high in global competitiveness, and policy-makers failed to pass necessary reforms in the boom years to address the problems.⁹

Time for political conciliation

Economists surveyed by the central bank forecast a 2.7 percent annual contraction in 2015, followed by a 0.8 percent decline in 2016.¹⁰ These numbers do not make for pleasant reading. One thing is certain: Without political conciliation, measures to improve government balances and tackle weak economic competitiveness will not see the light of day. It is possible that the downgrade may work in Rousseff's favor, forcing Congress to approve key measures and quelling dissent within the ruling coalition. But if it does not work out that way, Brazil's troubles may have just begun.

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Domestic strength, external worries

By Ian Stewart

THE global recovery has been punctuated by a series of shocks that, at times, slowed activity and sometimes threatened to derail it. From the US debt crisis to worries about the breakup of the euro area, Western policymakers have had to contend with a string of shocks. The latest is China's slowdown and a more generalized weakness in emerging markets. Financial markets took the US Federal Reserve's (Fed's) decision not to raise interest rates at its September meeting as confirmation that US growth—and growth in the rest of the industrialized world—is vulnerable to China's slowdown.

In the United Kingdom, there are signs that external weakness and a strong British pound are having some dampening effect: Manufacturing output has slowed, and surveys of manufacturers point to no improvement in the near term. Net trade unexpectedly contributed to a rebound in second-quarter UK activity, but this seems unlikely to last. Indeed, hopes of an export-led recovery look ambitious in the current environment.

Yet elsewhere the United Kingdom seems in decent shape. Lower commodity prices are a headache for producing nations such as Saudi Arabia,

Russia, and Brazil, but a boon for the commodity-consuming countries of the West. A collapse in food, fuel, and transport costs, along with a strong pound, pushed year-over-year UK inflation down to zero in August. At the same time, a tight labor market is, at last, putting upward pressure on nominal earnings. The interaction of flat inflation and accelerating wage growth means that real earnings are growing at the fastest rate in eight years (figure 1). Falling interest rates on mortgage and consumer credit have given the consumer sector an additional tailwind.

After a long period of consumer austerity, with spending battered by sluggish or declining earnings, things are looking up for UK consumers. In August, consumer confidence reached the highest level in 15 years.

The government has responded to emerging-market risks by pushing back the timing of interest rate rises. In August, Bank of England Governor Mark Carney repeated a well-worn formulation that the decision on UK rate rises would come “into sharper relief around the turn of the year.” This was widely interpreted to mean that rate rises were likely by late 2015 or early 2016. Yet by late September, following the Fed's decision

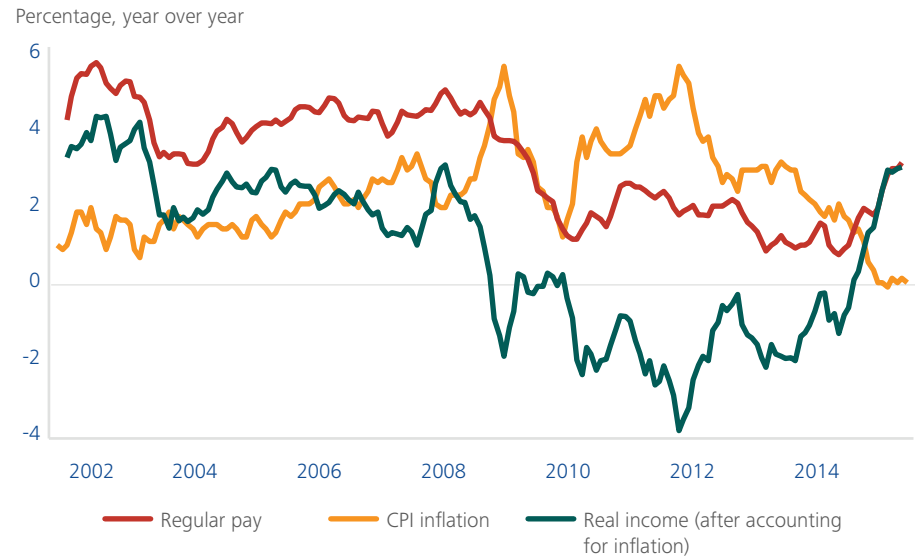
A collapse in food, fuel, and transport costs, along with a strong pound, pushed year-over-year UK inflation **down to zero** in August.



to keep rates near zero, the message abruptly changed: Bank of England Chief Economist Andy Haldane said that the next move in UK interest rates was as likely to be a reduction as a rise. Financial markets took notice and have priced in a less aggressive path for tightening—just as, when faced with previous external shocks, the central bank is leaning against the dampening effect on UK growth of emerging-market weakness by driving down interest rate expectations. With headline inflation flat on the year and core inflation at just 1.0 percent (figure 2), the central bank can afford to take its time in raising rates. The selloff in the UK equity market and slackening house price inflation further ease the need for immediate rate hikes.

The United Kingdom has been on the sidelines of the euro crisis and the more recent Middle Eastern migrant crisis. These events have seized the world’s attention, but they may well also influence UK public attitudes

Figure 1. Average earnings and consumer price annual growth rates

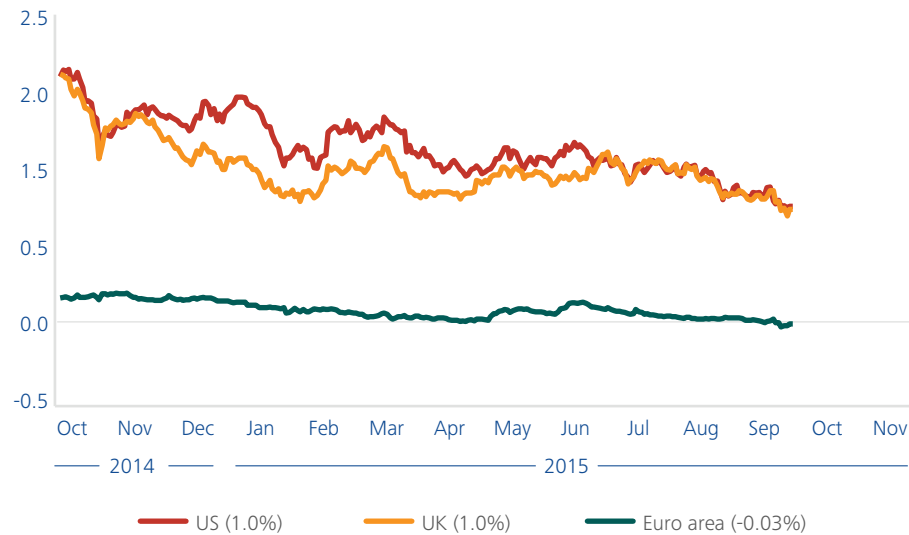


Source: Thomson Reuters Datastream; Deloitte Services LP economic analysis.

Graphic: Deloitte University Press | DUPress.com

Most opinion polls currently point in the direction of a **vote to remain in the European Union**, but that outcome is not guaranteed.

Figure 2. Expected three-month interest rates by December 2016



Source: Thomson Reuters Datastream; Deloitte Services LP economic analysis.

Graphic: Deloitte University Press | DUPress.com

toward the European Union. The UK government is committed to holding a referendum on EU membership before the end of 2017; at the moment, the most likely dates for the vote appear to be around June or autumn of next year. Most opinion polls currently point in the direction of a vote to remain in the European Union, but that outcome is not guaranteed. As the vote gets nearer, the issue may well exercise a growing effect on business sentiment, especially if the polls show a narrowing lead for the “yes” vote.

Despite political risks and external uncertainty, the momentum of domestic demand seems likely to sustain UK growth well into 2016. Our assumption is that the United Kingdom should post GDP growth around the 2.5 percent mark this year and next. This is a respectable if unspectacular performance, though it would be enough to put the country near the top of Europe’s not terribly impressive growth league.

When is it recession?

By Dr. Daniel Bachman

CANADIANS (or at least Canadian economists) have had the unpleasant experience of trying to figure out just what makes a recession. At the beginning of September, Statistics Canada delivered the expected news: The Canadian economy shrank for two quarters in a row.¹ Journalists immediately declared that a recession had occurred. But it's a bit more complicated than that, not least because Canada now has a semiofficial business cycle dating committee.

What makes a recession? This might be the economists' equivalent of medieval theological debates. The "two-quarter rule" is a good example of oversimplification of a complex subject. Economists don't actually use this rule. It was originally suggested by US statistician Julius Shiskin in 1974 as one of a number of possible rules of thumb.² While it was never really accepted within the economics profession, journalists latched onto it because it was simple—even if it is sometimes misleading.

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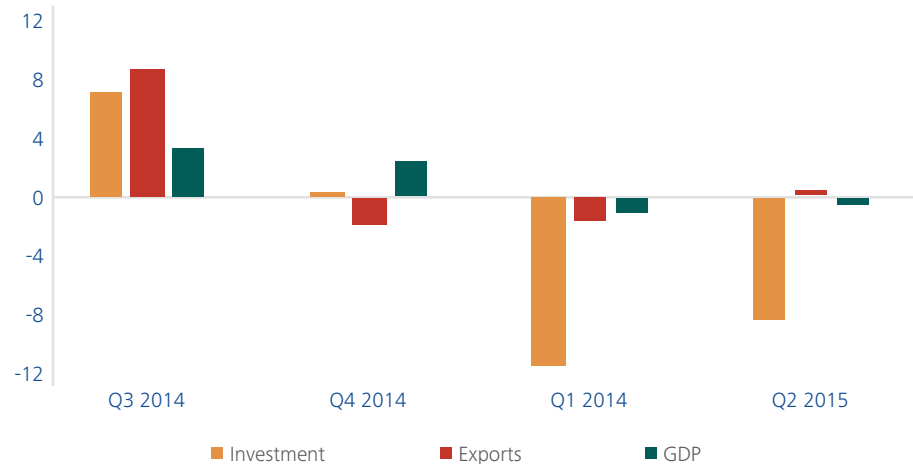


In Canada, the C. D. Howe Institute recently created a Business Cycle Council composed of leading Canadian economists to make recession determinations.³ This method allows flexibility in defining downturns, and (perhaps just as important) provides economists with a common understanding of cycles. That way, economists can argue about causes and features of the cycle rather than whether one occurred and what the exact timing was.

In July, the Business Cycle Council determined that data did not show that Canada—as a whole—had experienced a recession.⁴ Indeed, although GDP fell in two quarters in a row, it didn't fall by much. GDP in Q2 2015 was just 0.3 percent less than in Q4 2014. And employment between December 2014 and June 2015—while the economy was supposedly in recession—was up about 75,000 jobs. That's not exactly normal for a business cycle downturn. Meanwhile, Canadian households responded to the bad news by taking on yet more debt, and housing buyers in Toronto and Vancouver seemed determined to push those cities into the ranks of the world's most expensive. So it's not really surprising that the two-quarter rule just doesn't work in this case.

Figure 1. Drivers of Canadian GDP

Percentage change, annual rate



Source: Statistics Canada; Haver Analytics; Deloitte Services LP economic analysis.

Graphic: Deloitte University Press | DUPress.com

The role of oil

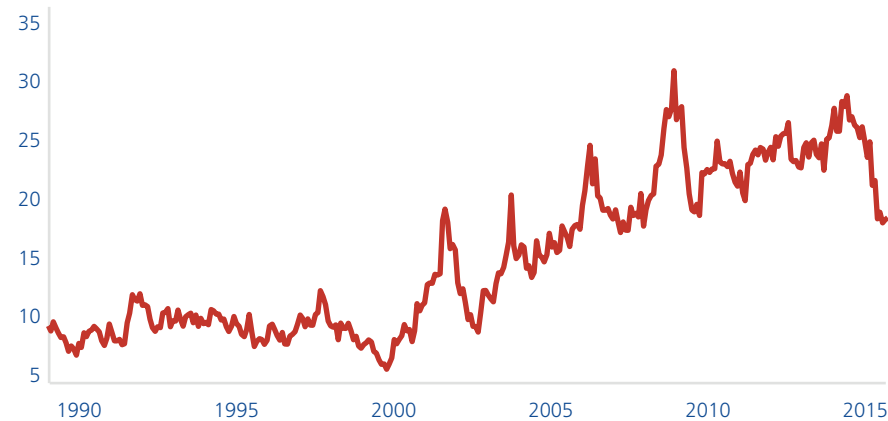
Whether or not it was a recession, the slowdown was blamed on—not surprisingly—slow growth in the United States and the drop in the price of oil in late 2014. The US economy can cause a lot of problems for Canada, but its contribution to Canada’s nonrecession was modest. Figure 1 shows that the slowdown was caused primarily by business investment rather than real exports.

The decline in business investment was led by industrial machinery and equipment (down 15 percent in the first two quarters of 2015) and engineering structures (down 10 percent). Investment in transportation equipment, in contrast, rose during these two quarters. But what gives the game away is the large decline in spending on mineral exploration (46 percent) during this period. The problem for Canada was not so much oil sales as it was a steep drop in investment in new crude production. In this, the Canadian experience was similar to the decline in US GDP in the first quarter. Falling investment in crude production (in the form of a fast decline in oil drilling rigs in use) was a big contributor to the slowdown in the United States. Low prices didn’t stop the oil flowing in North America, but they certainly put a dent in plans to find new oil to pump.

Volatile oil prices pose a significant problem for Canada. The Canadian economy has been reshaped over the past 20 years by a huge bet on oil. Exports of energy products jumped from about 10 percent of all exports in the late 1990s to almost 30 percent by 2014, as shown in figure 2. Four-fifths of Canadian energy exports are petroleum, crude, and refined. Canada bet on selling oil, mainly to the United States. As oil prices rose, the bet looked pretty good. Canada has long been an oil exporter, of course, but the new production comes from more expensive sources, particularly the “tar sands” in Alberta. The International Energy Agency estimates that 25 percent of Alberta’s tar sands production requires a Brent price above \$80 per barrel to be profitable (compared with just 4 percent

Figure 2. Exports of energy products

Share of total exports



Source: Statistics Canada; Haver Analytics; Deloitte Services LP economic analysis.

Graphic: Deloitte University Press | DUPress.com

of US “tight oil” production and 8 percent of deepwater production, which are other expensive sources).⁵ Canada’s bet, then, wasn’t just in producing oil but in producing oil that was some of the most expensive crude in the world.

As long as oil prices remained high, the bet appeared reasonable—at least to people in the energy industry. For Canada’s traditional industrial sector, the increased role of oil brought problems. Between 2001 and 2013, Canadian unit labor costs rose 18 percent more than US unit labor costs. For Canada’s industrial

heartland, these increased costs have meant trouble competing with foreign (that is, US) companies. Canadians have become quite worried about the “hollowing out” of Canada’s basic industries, particularly since the new energy industries aren’t located near population centers and employ relatively little labor in any event.

The problem is well known to economists under the name “Dutch disease.” In the 1960s, prospectors found significant natural gas reserves in the Netherlands. As production came on line and was exported to Germany, the

Canadian households responded to the bad news by **taking on yet more debt**, and housing buyers in Toronto and Vancouver seemed determined to push those cities into the ranks of the world’s most expensive.

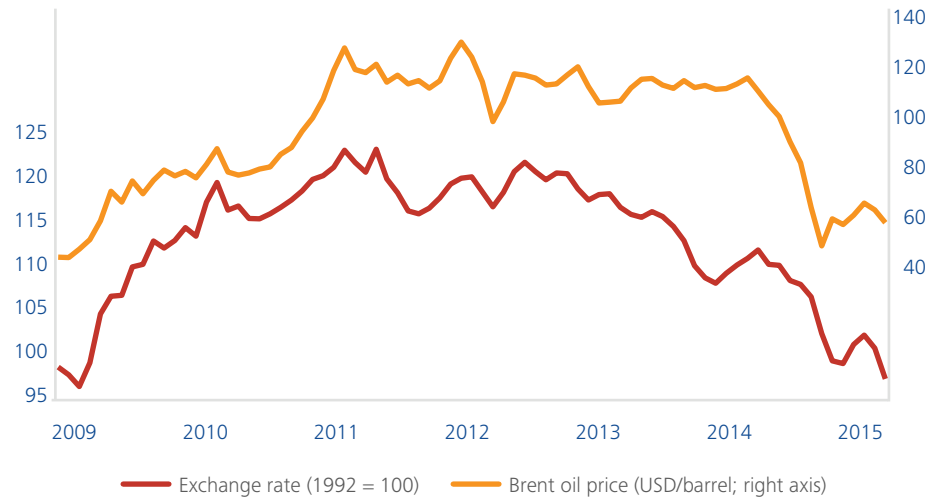
Netherlands experienced an inflow of capital that made traditional Dutch manufacturing uncompetitive. In the modern world, this takes the form of rising exchange rates. And the Canadian dollar has, indeed, followed the price of oil, rising between 2009 and 2010 and staying high along with the price of oil for several more years (figure 3).

The most disturbing thing about Dutch disease is that traditional industry, once lost, may be difficult to revive. The fall in oil prices is likely to put this question to the test in Canada. The falling Canadian dollar should provide a shot in the arm to Canadian industrial competitiveness, but whether Canadian producers will be able to respond remains an open question.

Enter the NDP

The winds from the prairies are bringing more than snow to Ottawa this fall. As of this writing, analysts are assigning a 50 percent probability to the October election resulting in a minority government led by Canada's New Democratic Party (NDP). When Canadians turn away from their hockey games this winter, they may be watching whether the NDP really means what it says about changing the country. After nine years of Stephen Harper's Progressive Conservative (PC) party, it could be quite a shock.

Figure 3. The Canadian exchange rate and oil price



Source: Bank of Canada; US Energy Information Administration; Haver Analytics; Deloitte Services LP economic analysis.

Graphic: Deloitte University Press | DUPress.com

Canada's bet, then, **wasn't just in producing oil** but in producing oil that was some of the **most expensive crude in the world**.

The rise of the NDP appears to be more related to a general inclination for change than a sincere desire among the electorate for the avowedly social democratic policies of the NDP. This was made clear by the surprise NDP victory in Alberta's provincial election in April. The NDP's strong support of climate change remediation policies and alternative energy plays strongly against Alberta's economic interest (in oil production, for example). But voters evidently wanted a change after 44 years of the PC running the province.

What would an NDP minority government try to do? The main economic initiatives look like they would be focused in two areas:

1. Climate change: This is a difficult problem for Canada, both because Canada's economy depends on exporting fossil fuels (as the nonrecession demonstrated) and because Canadians, like their neighbors to the south, enjoy their large automobiles and houses. The NDP would like to introduce a cap and trade system to price emissions, which is likely to be very controversial.

The **rise of the NDP** appears to be more related to a **general inclination for change** than a sincere desire among the electorate for the avowedly social democratic policies of the NDP.



2. Taxes: Everybody likes to lower taxes, and all three Canadian parties have plans to do what voters like. But the NDP plans include an offset: higher corporate taxes. This may prove to be very important to the NDP, as without some additional revenue the party is likely to find it impossible to meet other goals.

At this point, the NDP has committed itself to a balanced budget—an important consideration since it has a reputation as a party happy to borrow and spend. Canadian voters still

remember the budget problems of the 1990s. This had nothing to do with the NDP, which never had enough power to actually determine federal spending before. Many Canadians, however, are very proud of Canada's more recent fiscal probity, and the NDP prefers not to rock this particular boat. But while the NDP is promising to keep budgets balanced, the Liberals are advocating planned deficit spending to provide a Keynesian boost to the economy. A formal or informal NDP-Liberal alliance might lead to some relaxation of Canada's budget constraint.

The NDP is by no means assured of a victory, and whoever wins will probably face the unenviable task of running a minority government. This will give the PC and Liberal parties some say in what an NDP government can actually accomplish and is likely to put the brakes on some of the NDP's more ambitious proposals.⁶ Absent a surprising election in which one party wins a clear majority, the winter will almost certainly see intense negotiations in Ottawa between the three large parties.

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6. Polls as of mid-September give Canada's other parties—the Greens and the Bloc Québécois—few or no seats in parliament.

In a commodities trough

By Lester Gunnion

SOUTH Africa's economic recovery has been sluggish: GDP growth in 2014 was weak, and growth in 2015 is unlikely to be significantly better. A slowdown in China, a strong US dollar, and weak global commodity prices are likely to keep overall economic performance subdued; China's recent devaluation of the yuan and the impending hike in interest rates in the United States are also likely to exert pressure on South Africa's economy. A fall in the South African rand's value and the recent tightening of monetary policy to contain price pressures will likely add to the burden on indebted consumers, limiting economic growth. Further cause for concern stems from internal challenges such as electricity shortages and labor disputes as well as high unemployment, declining labor-force productivity, and a high degree of income inequality.

A shaky first half to 2015

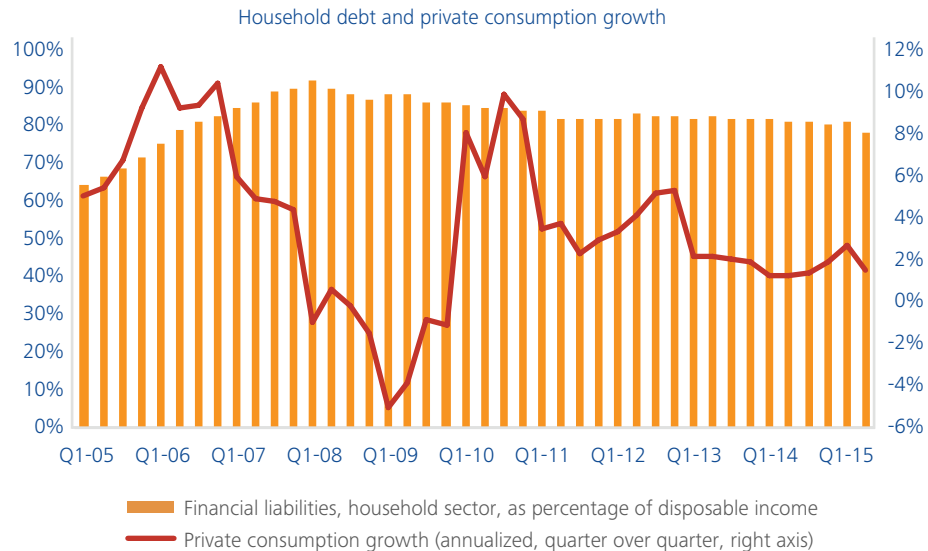
In the first half of 2015, the South African economy grew 1.6 percent relative to the same period a year ago. But a weak base year (2014) for calculating year-over-year growth clouds a realistic picture.

In Q1 2015, the economy grew 1.3 percent on a quarter-over-quarter seasonally adjusted annualized basis, but Q2 saw those gains reversed as the economy shrank 1.3 percent. The poor economic performance stems from contractions in key sectors such as manufacturing, mining and quarrying, and agriculture and related sectors.

On a quarter-over-quarter seasonally adjusted annualized basis, the manufacturing sector declined 2.4 percent in Q1 and 6.3 percent in Q2, while mining and quarrying surged 10.2 percent in Q1, only to decline 6.8 percent in Q2. Both sectors have been struck by a combination of internal and external headwinds, including internal obstacles such as electricity shortages and external challenges in the form of weak commodity prices. Agriculture and related sectors such as forestry and fishing plummeted 16.6 percent in Q1 and 17.4 percent in Q2 due to widespread drought conditions. The tertiary sector partially compensated for sluggish economic performance elsewhere: Finance, real estate, and business services grew 3.8 percent in Q1 and 2.7 percent in Q2, with increased activity in banking and financial intermediation driving growth.



Figure 1. Private consumption has been stifled by household debt, among other factors



Source: Oxford Economics; Haver Analytics; Deloitte Services LP economic analysis.

Graphic: Deloitte University Press | DUPress.com

From an expenditure component angle, private consumption slowed to an annualized growth rate of 1.2 percent in Q2 from 2.4 percent in Q1 (figure 1). Consumption has been stifled by factors such as rising prices (in Q2), household indebtedness, and stagnant consumer confidence. Public consumption grew a meager 0.4 percent in Q2 after shrinking 1.9 percent in Q1 as the South African government committed to fiscal consolidation in the face of growing debt. Gross domestic fixed investment—hampered by weak business confidence—slowed to a growth rate of 1.0 percent in Q2 from 1.8 percent in Q1.¹

Slowing China and strong US dollar likely to hurt the economy

China's slowing GDP growth, coupled with the strength of the US dollar, has weakened global commodity prices. On the one hand, slackening demand from China has depressed prices; on the other hand, a strong US dollar means that commodities, which are priced in dollars, now cost fewer dollars than before. This is significant to the South African economy, as commodities constitute a significant portion of the country's total export basket. Prices for some of South Africa's key exports such as

Prices for some of **South Africa's key exports** such as gold, platinum, coal, and iron ore **are currently at multiyear lows**. It is not surprising, then, that South Africa's exports in terms of US dollars have taken a tumble.

gold, platinum, coal, and iron ore are currently at multiyear lows. It is not surprising, then, that South Africa's exports in terms of US dollars have taken a tumble. Goods exports in dollar terms have declined year over year for the last three years (8.2 percent in 2012, 4.0 percent in 2013, and 4.9 percent in 2014), and the trend is likely to continue this year.² In fact, on a year-over-year basis, the US dollar value of goods exports declined for six of the first seven months in 2015. However, in terms of volume, South Africa's exports continued to experience growth: The volume index for exports (including gold) increased 5.6 percent in Q1 and 13.9 percent in Q2, albeit from a low base in 2014 (figure 2).³

Another factor likely to work against the South African economy is the devaluation of the Chinese yuan. A weaker yuan is likely to reduce the purchasing power of Chinese businesses, which translates into weaker demand for commodities. Further pressure will stem from a promised forthcoming hike in US interest rates, as repatriation of capital will further strengthen the US dollar. A weaker yuan and a stronger dollar could keep commodity prices depressed for an extended period, with commodity-exporting countries such as South Africa likely bearing the brunt. In fact, certain international mining companies, such as Lonmin and Anglo American, have already announced plans to close mines and reduce their workforce. Even though mining and quarrying activity in South Africa has picked up pace (relative to a year ago) after months of labor dispute in 2014, the initial momentum will likely be overshadowed by a bearish global commodity market. The mining sector is of significance to South Africa's economy. While directly accounting for only 5.0 percent of GDP in real terms (as of 2013), the sector accounts for a third of the country's total merchandise exports (30.5 percent as of 2013) and a fourth of South Africa's total exports (25.0 percent as of 2013). Furthermore, the mining sector engages more than half a million people in direct employment (510,000 as of 2013) and accounts for 8.0 percent of total private nonagricultural employment (2013).⁴

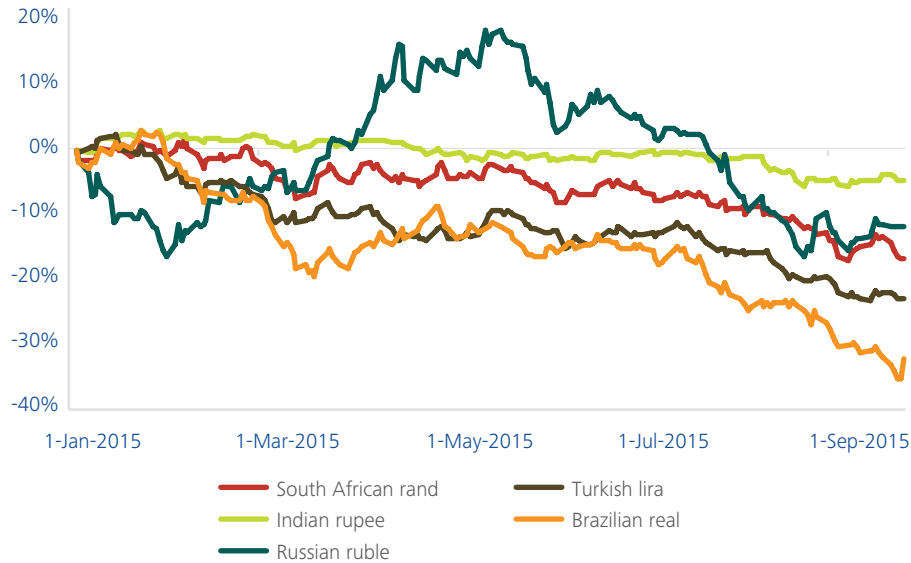
Figure 2. South Africa's exports continue to shrink in value, but export volumes have grown



Source: Haver Analytics; Deloitte Services LP economic analysis.

Graphic: Deloitte University Press | DUPress.com

Figure 3. Emerging-market currencies have declined against US dollar since start of 2015



Source: Bloomberg; Deloitte Services LP economic analysis.

Graphic: Deloitte University Press | DUPress.com

Figure 4. High unemployment and declining productivity are concerns



Source: Haver Analytics; Deloitte Services LP economic analysis.

Graphic: Deloitte University Press | DUPress.com

Rand declines, inflation creeps up, and monetary policy is tightened

A combination of an impending interest rate hike by the US Federal Reserve (Fed), a slowdown in China, weak commodity prices, and concerns over prolonged economic weakness in South Africa have resulted in a weaker

rand (figure 3). Since the beginning of 2015, the rand has depreciated 15.8 percent against the US dollar (as of September 22, 2015), which has in turn stoked inflation: After falling since May 2014, inflation edged up from 3.9 percent in February to 5.0 percent in July. Though this lies within the South African Reserve Bank’s target range of 3–6 percent, the upward trend in prices prompted the central bank to raise the

policy interest rate by 25 basis points to 6.0 percent in July. After this hike, inflation declined to 4.6 percent in August. However, if a weakening rand sustains price pressures, then a further increase in the policy rate remains a possibility, especially since South Africa’s meager foreign exchange reserves (\$41.2 billion as of August 2015) limit it from defending the currency in the open market. Moreover, higher interest

rates are also likely as emerging markets prepare for a Fed hike in interest rates, which will add to the burden on indebted households by driving up the cost of servicing debt. In Q1, household debt in South Africa stood at 78.4 percent of disposable income.⁵

One positive outcome of a weaker rand is that South Africa registered a trade surplus in Q2, its first surplus in three years. An improved trade balance contributed to a further narrowing of the current account deficit, which stands at 3.1 percent of GDP as of Q2, down from 6.2 percent of GDP a year ago.

South Africa's internal problems persist

In addition to headwinds from beyond its borders, South Africa has its fair share of internal problems; the most pressing have been electricity shortages and labor disputes.

Eskom, the country's public power utility, has struggled to meet demand for electricity over the last year, with households and businesses experiencing widespread "load shedding" since November 2014. The shortfall in electricity production is linked to delays in maintenance and several technical glitches in South Africa's aging power stations; furthermore, new capacity has been slow to come online. The shortfall in electricity production is a major blow for an economy in need of quicker growth. The manufacturing sector in particular has been hit hard, evidenced by the sector's poor showing in the first half of the year. While the supply of electricity is expected to improve slightly over the near term as the first six units of the newly constructed Medupi coal-fired power plant reach full capacity, electricity shortfalls are expected to continue over the medium term. Shortfalls are likely to result in higher power tariffs (projected to rise 12.7 percent in 2015), contributing to inflation that is likely to dampen consumption spending and rein in economic growth.⁶

Labor disputes have also held back economic growth: A recent study by the Department of Labor shows that the country experienced at least 88 labor strikes in 2014, resulting in a loss of 10.3 million workdays. The strikes, usually called after business owners refuse to meet trade unions' wage demands, cost the economy an estimated 6.1 billion rand (nearly \$500 million) in 2014, down from 6.7 billion rand in 2013.⁷ The mining sector in particular has been susceptible to strikes in recent years.

South Africa's internal problems don't end there. The country faces an unemployment rate of 25.0 percent (as of Q2 2015) and a contractionary trend in labor force productivity (figure 4). Output per

The country's **Gini index**, indicating inequality in income distribution, stood at 65.02 in 2011 (a higher reading indicates greater inequality), **far above other emerging economies** such as Brazil, Russia, and India.



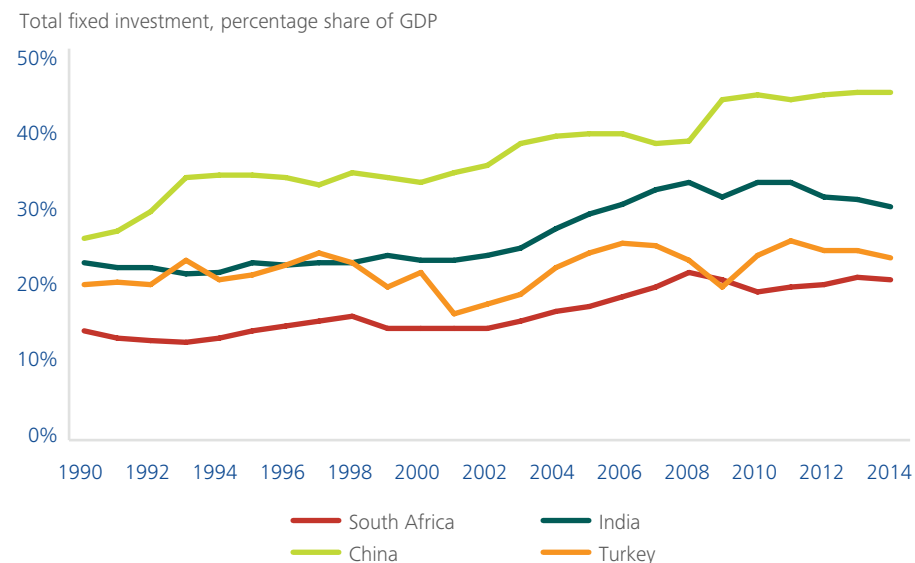
employed person has shrunk year over year for each of the last three years (by 0.3 percent in 2012, 0.8 percent in 2013, and 0.4 percent in 2014), and the trend is likely to continue in 2015. Furthermore, South Africa continues to struggle against inequality: The country's Gini index, indicating inequality in income distribution, stood at 65.02 in 2011 (a higher reading indicates greater inequality), far above other emerging economies such as Brazil, Russia, and India.

Investment and skill development are the way forward

South Africa's economy is in desperate need of a boost. Although uncertainty in the global economy and a bearish commodity market will likely keep the economy subdued in the near term, the government needs to plan ahead for the long term. While investment in infrastructure and skill development is critical to the economy's long-term success, South Africa's fixed investments as a percentage of GDP have languished in the range of 12.0–20.0 percent for the last quarter of a century. Total fixed investment was 20.7 percent of GDP in 2014, compared with 30.3 percent in India and 45.4 percent in China (figure 5).⁸

A well-defined roadmap for developing infrastructure would likely boost fixed investment and spark economic activity. However, to carry out such plans, the South African government will have to expand its revenue base, especially since the country's debt-to-GDP ratio has risen sharply over the last five years. Part of this can be achieved by reducing rampant unemployment. Targeted skill-development programs could pull more workers into the labor force, therefore boosting the tax base as well as the country's low national savings rate of 15.5 percent (compared with 50 percent in China, 34 percent in India, and 20 percent in Russia). Finally, diversification of the economy away from commodities would render it less vulnerable to global headwinds. It remains to be seen how South Africa's policy decisions chart its economic progress.

Figure 5. In the long term, South Africa could benefit from increased investment in infrastructure



Source: Oxford Economics; Deloitte Services LP economic analysis.

Graphic: Deloitte University Press | DUPress.com

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Are emerging markets prepared for the Fed rate hike storm?

By Dr. Rumki Majumdar

It has been two years since the US Federal Reserve (Fed) first signaled its intention to taper its massive quantitative easing program (QE3). The unexpected announcement in May 2013 panicked investors, and markets went into a frenzy of selling risky assets of emerging markets (EMs), with five in particular—Brazil, India, Indonesia, South Africa, and Turkey—among the worst affected. Poor economic fundamentals resulted in extreme volatility in their currency, bonds, and stock markets.¹

With the Fed setting the stage to announce a policy rate hike in its December Federal Open Market Committee (FOMC) meeting, the fear of more financial market turbulence is back. This time the scene is different, though: The Fed has been extremely cautious in communicating its intention to tighten US monetary policy and has given enough hints of raising rates in its last few FOMC meetings.²

However, risks to global economic activities are skewed to the downside. Oil prices are at levels last seen during the 2008 global financial crisis, with a high likelihood of being pushed down further, owing to

sluggish global demand and higher production in the near term. In addition, recent data indicate that China's economy is probably slowing faster than expected, with concerns sparking severe global financial market turbulence in late August: In a span of two weeks, about \$5 trillion of equity market capitalization was wiped out globally; China alone lost \$1 trillion in just one day. The Chinese government's inability to reduce its equity market volatility through interventions, including prompt action in August to devalue its currency, suggests that investors are worried about economic headwinds, and that there might be more asset price corrections coming.

Recently, some of the EMs' bankers expressed their confidence in their preparedness to face the outcomes of an impending Fed policy rate hike in the Jackson Hole meet.³ The question is: Are they really prepared?

To help answer this question, we analyzed the EMs' readiness by tracking their financial and economic performances since 2013, when the Fed first hinted at tapering QE3, as well as examining their near-term

economic outlook. Since it is impossible to cover every emerging economy for our analysis, we focused on five EMs—Brazil, India, Indonesia, South Africa, and Turkey—that were the most affected by the Fed’s 2013 “taper tantrum.” These five economies together accounted for over a third of total nominal GDP of all EMs (excluding China) in 2014.

We found that India has fared relatively better with respect to economic and financial sector performances since 2013, while conditions in Brazil and Indonesia appear worrisome. In addition, India’s near-term outlook is relatively favorable when compared with the other four economies.

In other words, India may be better prepared than the other four EMs in the event of a crisis. On the other hand, Brazil may limp toward a longer recovery. Indonesia, Turkey, and South Africa, too, may experience severe financial turmoil, with economic consequences lingering for years.

Did they learn their lessons from the Fed tantrums?

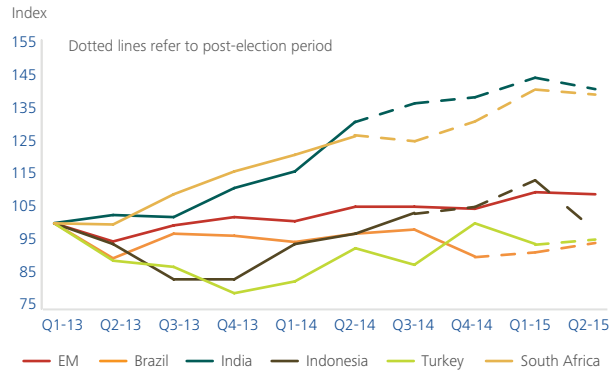
These five EMs held general elections fairly recently. Although there is less likelihood of political instability in the medium term, political risks

We found that **India has fared relatively better** with respect to economic and financial sector performances since 2013, while conditions in **Brazil and Indonesia appear worrisome.**



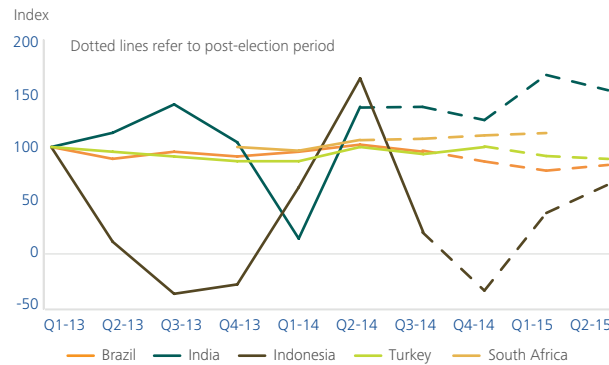
Figure 1. Comparing financial sector performances

Panel 1. MSCI index; Q1 2013 = 100



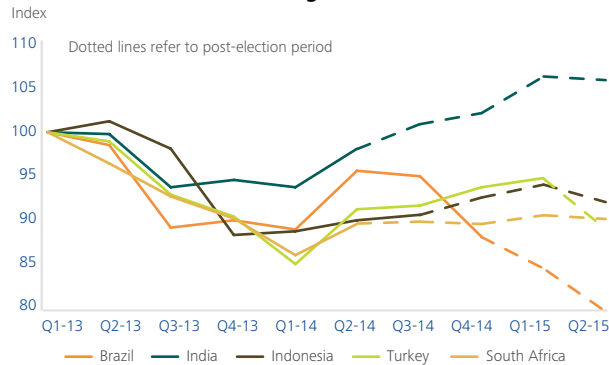
Source: Oxford Economics, September 2013; Haver Analytics, September 2013; Deloitte Services LP economic analysis.
Graphic: Deloitte University Press | DUPress.com

Panel 2. Portfolio investment; index Q1 2013 = 100*



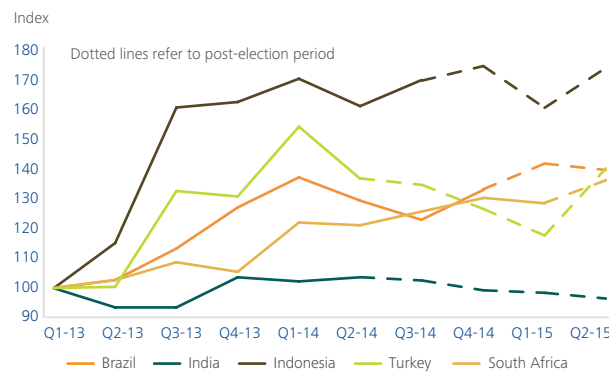
* No data are available for South Africa prior to Q4 2013, so this series is indexed to to this period.
Source: Oxford Economics, September 2013; Haver Analytics, September 2013; Deloitte Services LP economic analysis.
Graphic: Deloitte University Press | DUPress.com

Panel 3. Real effective exchange rate; index Q1 2013 = 100



Note: Fall in value represents depreciation, and vice versa.
Source: Oxford Economics, September 2013; Haver Analytics, September 2013; Deloitte Services LP economic analysis.
Graphic: Deloitte University Press | DUPress.com

Panel 4. 10-year interest rate spread vis-a-vis US*; index Q1 2013 = 100



*Spread is defined as the the 10-year interest rate of the government bond minus the 10-year Fed rate.
Source: Oxford Economics, September 2013; Haver Analytics, September 2013; Deloitte Services LP economic analysis.
Graphic: Deloitte University Press | DUPress.com

and policy uncertainty vary significantly across these five economies. Elections in India led to the formation of a government with an absolute majority in the parliament's lower house; the elected party won by promising economic reforms and is perceived to be investor-friendly. On the other hand, elections in Brazil and Turkey weakened their respective governments' position. Support for Brazil's president has collapsed, and a minority government in Turkey has increased political risks. One thing is common among these economies: Despite promises, the newly elected governments have thus far failed to implement structural reforms.

Financial sector performance

The four panels in figure 1 compare the experiences in the currency, bond, and stock markets of these five EMs, along with the inflow of portfolio investments. The variables are indexed to Q1 2013 in order to capture their movements prior to, during, and after the Fed's taper tantrum in summer 2013.

Panel 1: The stock price indices steadily improved in India and South Africa after the turmoil of 2013, with growth momentum remaining robust after their respective general elections as well. These two economies' indices outperformed the aggregate EM equity index by a significant margin throughout this period.

Equity indices in the other three nations took a longer time to bounce back. Turkey's and Brazil's indices still haven't recovered to their levels prior to summer 2013. The index in Indonesia regained some of its lost ground in 2014 but has fared poorly since the election.

Panel 2: Strong and steady growth in portfolio investment inflows in India and South Africa since 2014 aided their strong stock market performances. Portfolio investment inflows remained highly volatile in Indonesia throughout the period, though they improved marginally post the election. In contrast, elections in Brazil and Turkey failed to improve capital flows into their economy—a reflection of low investor confidence in the current governments.

Panel 3: We tracked these economies' real effective exchange rate instead of the valuation of their currencies relative to the US dollar. This helped in avoiding the effect of the appreciation of the dollar itself due to the Fed's QE3 tapering during this period and the strengthening of the US economy. Broad-based currencies in all, except in India, depreciated in real terms after 2013. Elections failed to contain the momentum of currency depreciation in Brazil, Turkey, and Indonesia—again evidence of low investor confidence in their governments. Brazil's domestic currency depreciated the most.

Panel 4: In order to counter plunging currencies and stop capital outflows during the economic turmoil of 2013, all the five

economies began drawing on their reserves and hiked their policy rates in Q3 2013. Elevated policy rates, in addition to investors' high risk perception, pushed up their long-term bond yields. At the same time, high demand for US Treasuries drove down long-term bond yields in the United States. While India managed to check its 10-year bond yield spread with respect to the Fed rate of similar maturity, the yield spread widened considerably for all the other four economies after summer 2013. Policy rate cuts in Turkey succeeded in narrowing the interest rate spread in the interim period, though increasing political risks and weakening economic prospects have reversed the trend lately.

Elections failed to contain the momentum of **currency depreciation** in Brazil, Turkey, and Indonesia—again evidence of **low investor confidence** in their governments.

Economic performance and outlook

Financial sector performance often reflects a country's economic performance and outlook. Since 2013, investors have, unsurprisingly, favored economies with improving economic fundamentals. The four panels of figure 2 compare the five EMs' economic performance and outlook.

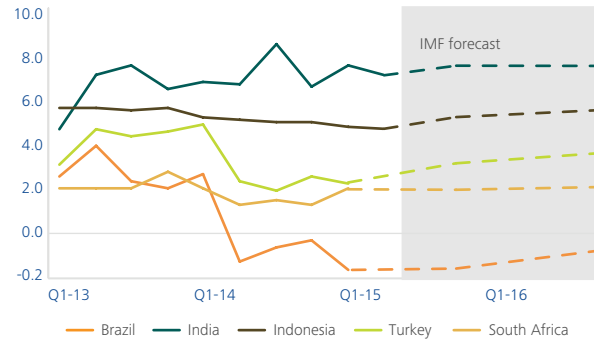
Panel 1: India's economic growth outperformed growth in the other economies; the economy is forecast to grow at a strong and steady pace in the next two years.⁴ Indonesia was the second-best performer in terms of economic activities. Brazil, in contrast, has been in a recession for some time, with economic activity expected to contract in the next two years.

Panel 2: India has had more success in taming inflation, managing to reduce its consumer price inflation from double digits to levels that are currently the lowest of the five economies. Brazil has failed to control inflation, although declining economic activity may ease pressure on prices in the next two years.

Panel 3: India stands out in its efforts to control its current account deficit, lowering it to 2 percent of GDP from 4 percent in the past two years. Turkey, too, has had some success,

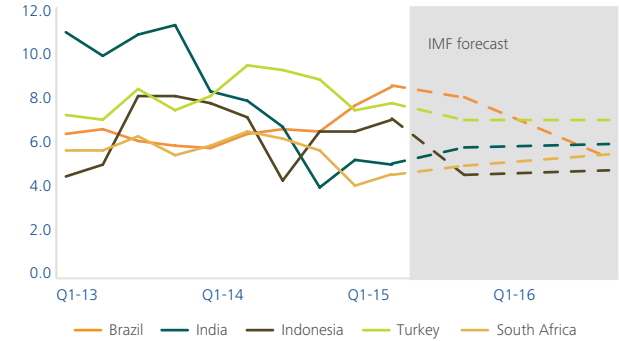
Figure 2. Comparing economic performances and their outlook

Panel 1. GDP growth



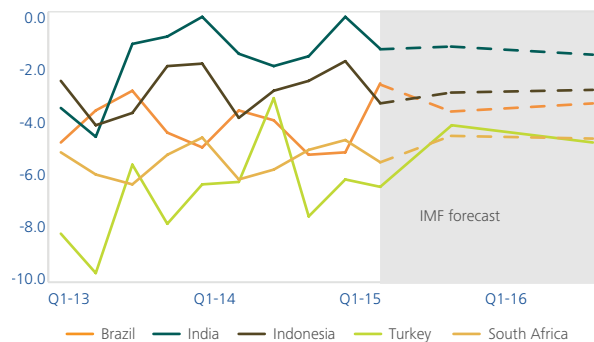
Source: Oxford Economics, September 2013; Haver Analytics, September 2013; Deloitte Services LP economic analysis.
Graphic: Deloitte University Press | DUPress.com

Panel 2. Consumer prices



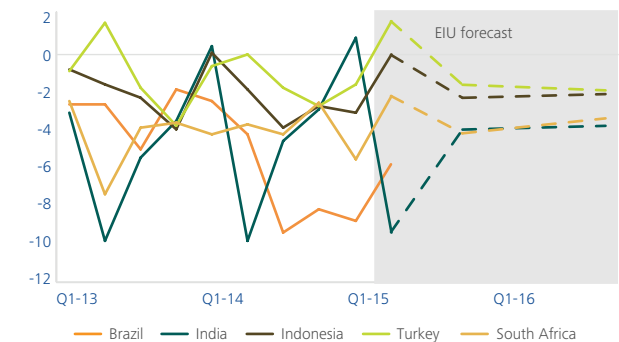
Source: Oxford Economics, September 2013; Haver Analytics, September 2013; Deloitte Services LP economic analysis.
Graphic: Deloitte University Press | DUPress.com

Panel 3. Current account balance



Source: Oxford Economics, September 2013; Haver Analytics, September 2013; Deloitte Services LP economic analysis.
Graphic: Deloitte University Press | DUPress.com

Panel 4. Fiscal deficit



Source: Oxford Economics, September 2013; Haver Analytics, September 2013; Deloitte Services LP economic analysis.
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containing its deficit from double to single digits. That said, volatility in current account imbalances remains a challenge for all the five EMs, as their trade balances have remained vulnerable to global risks.

Panel 4: Brazil has had serious trouble managing its fiscal deficit. In contrast, Turkey managed a sustainable fiscal account during this period. Volatility in the fiscal deficit concerned India, although it stayed within the government's target range post elections.

How have they fared overall?

Although two years is hardly enough for an economy to develop maturity to deal with severe crises, the direction of improvements in these economies since May 2013 suggests their vulnerability to global shocks.

By that measure, India unambiguously emerges as the winner: Its economic and financial sector performances distinctly outperformed those of the other four EMs since the Fed's first hint of tapering. Falling international oil prices, easing domestic credit conditions, and the government's efforts to improve India's infrastructure are expected to boost growth in the near term. In other words, India may have less to worry about any crisis arising due to a Fed rate hike, and it remains a preferred destination for investment among EMs.

Brazil, in contrast, was the worst performer, based on the measures we analyzed—and, due to both internal and external factors, appears to be in the most worrisome situation among the five EMs. The ongoing political

crisis, falling commodity prices, and China's economic slowdown are taking a toll on economic growth. In addition, the government's recent decision to cut back on austerity measures has frazzled investors; most credit agencies recently downgraded the country to junk status. The economy runs a significant risk of a forthcoming US rate hike causing severe financial turbulence, with a deeper recession possible if global risks go south. One saving grace is Brazil's reserve position, which may provide some cushion to financial volatility.

Since 2013, the performances of Indonesia, Turkey, and South Africa have closely followed that of Brazil. High dependence on commodity exports and the Chinese economy makes them vulnerable to falling commodity prices and economic weakness in China. In addition to the above risks, Turkey's domestic currency is highly exposed to the Fed interest rate hike because of its high external financing requirements. These economies' dwindling reserve positions make them highly vulnerable to global shocks.

Overall, investor sentiments toward these EMs have soured. The MSCI emerging market index has fallen close to 11 percent in the last three months, making it the worst quarter since 2011. Signs of distress in EMs have persuaded investors to remain vigilant of EM's asset market. Unsurprisingly, the Fed decided to postpone its decision to raise its policy rates in September, citing concerns about EMs. But for how long will the Fed postpone what is inevitable?

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4. There has been a change in the methodology to estimate GDP in India, and the GDP numbers have been revised up.

Global value chains: More a development strategy than a mere process

By Akrur Barua, David Gruner, and Sunandan Bandyopadhyay

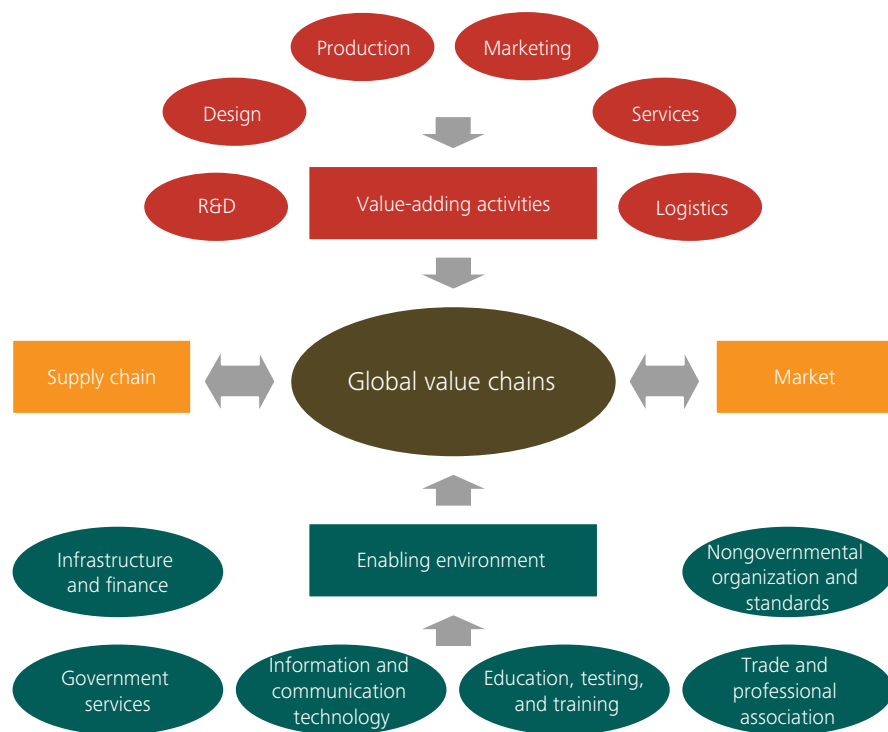
GONE are the days when you could pick up a product and immediately relate it to the country of its origin. “Made in the world” is perhaps a better way of describing the origins of most goods and services we consume today. Indeed, production processes nowadays involve bits of manufacturing, services, capital, and labor-intensive inputs that are funneled and get traded several times in well-defined yet complex stages spread across geographies. Welcome to the world of global value chains (GVCs), a key component in today’s international trade ecosystem (figure 1).

An interesting and unique aspect of GVCs is that they are relevant for both high-end products and services as well as relatively low-value-added ones. Ever thought about the origins of the cup of coffee that helped keep you awake for a meeting? Wondered where the beans came from, the logistics involved, the processing, the patent for the particular brand you sipped, and the accounting software that took care of the transaction? A

GVC does not end when a product or service is created. Instead, the chain spreads across activities, starting right from conception to its end use and beyond.¹

The rising prominence of GVCs is due in large part to the rapid advances in information and communication technology (ICT).² ICT has also facilitated a sharp rise in services trade, a key component of all GVCs (see the sidebar “Increasing prominence of services in GVCs”). In fact, competitive services provide the ideal field in which the full potential of GVCs can be unlocked. The rapid spread of GVCs and services within them are having a profound impact on how trade is measured and analyzed in contributing to economies’ growth and development strategies. They are also influencing policy implications vis-à-vis trade in how best to set new rules of the road for the global—and now GVC-intensive—marketplace.

Figure 1. Building blocks of global value chains



Source: Deloitte Development LLC.

Graphic: Deloitte University Press | DUPress.com

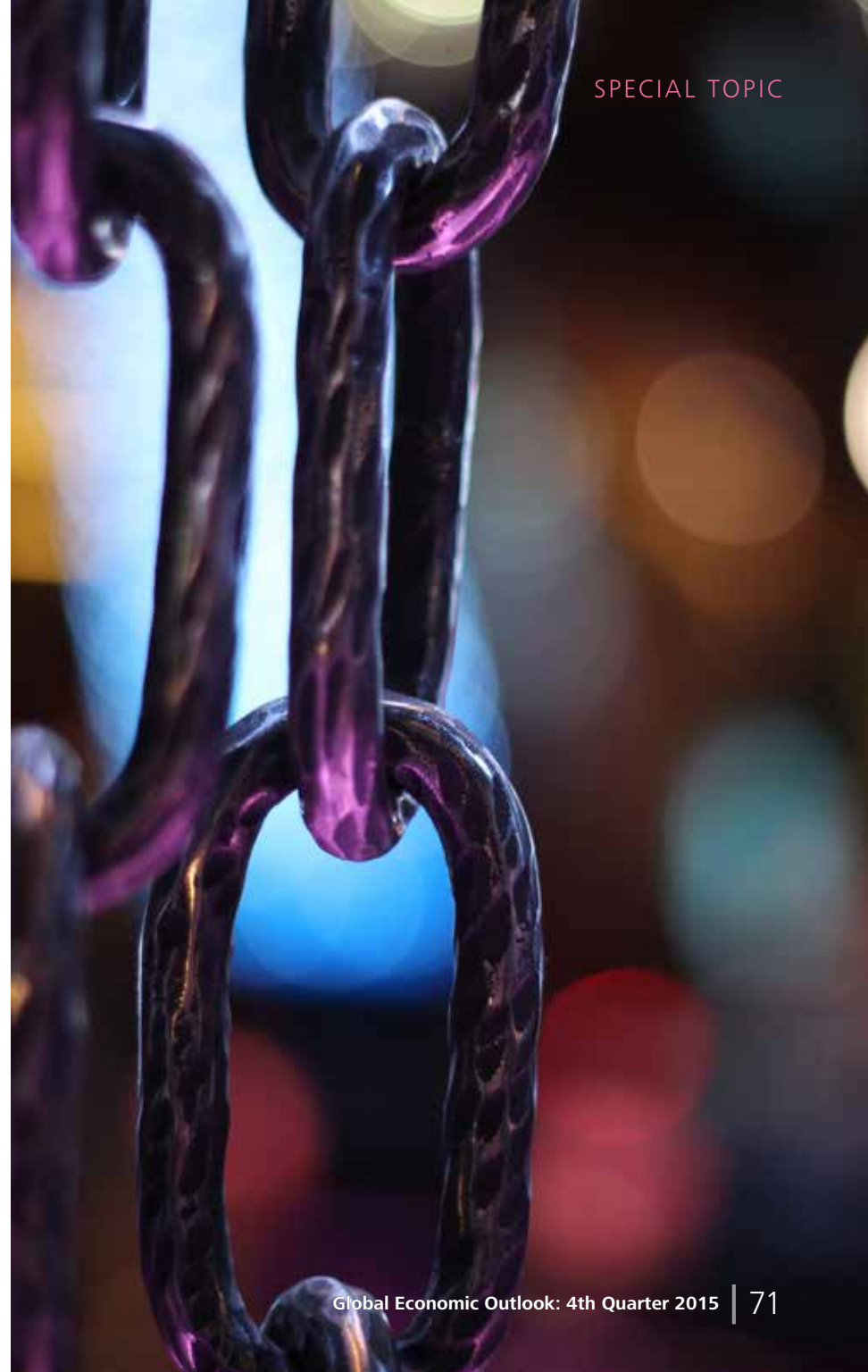
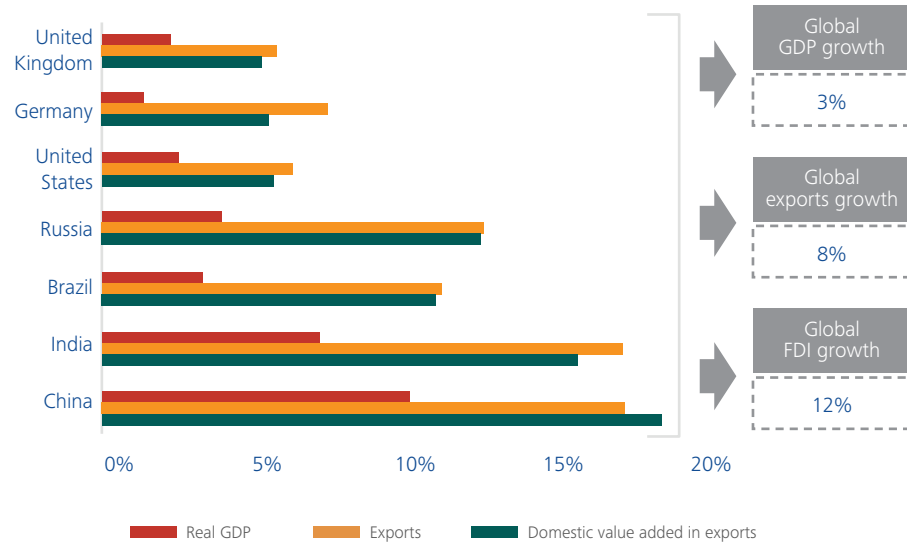


Figure 2. Strong role of GVCs in promoting trade and GDP growth (CAGR for key indicators over 1995–2011)



Source: OECD; Haver Analytics; UNCTAD; Deloitte Services LP economic analysis.

Graphic: Deloitte University Press | DUPress.com

GVCs have played a key role in global trade and growth

The spread of GVCs has aided the sharp growth in global trade and investments. Of course, trade agreements, including ones through the World Trade Organization (WTO) and its predecessor, General Agreement on Tariffs and Trade, have also helped. Nevertheless, greater exchange of goods and services would not have been possible without breaking down value chains across geographies. GVCs have enabled firms and economies to participate more in global trade and, hence, in greater value creation.

To support that point with solid data, however, is not easy given the difficulty in calculating value addition by firms and economies within GVCs. An economy’s contribution to a GVC, for example, is not reflected in total exports. Still, a few indicators come in handy. These include an economy’s participation index and the content of domestic value added in exports (see the sidebar “Measuring the value added by GVCs is an ongoing exercise”). For example, over 1995–2011, China’s domestic value added in exports recorded a compound annual growth rate (CAGR) of about 18 percent. As a result, China’s exports and GDP growth shot up during this period. A similar comparison across key economies highlights the contribution of GVCs to global trade, growth, and investments (figure 2).

INCREASING PROMINENCE OF SERVICES IN GVCs

Services are the “sleeping giant” of the global economy; their full potential is yet to be tapped. According to the World Bank, the share of value-added services in global GDP in 2013 was 70 percent, up from 61 percent in 1995.³ So it is not surprising that the role of services has also increased within GVCs, helping to expand existing GVCs and create new ones. In manufacturing GVCs, for example, there is a wide use of services such as:

- **Transport and warehousing, used to complement production**
- **Insurance and banking at multiple stages**
- **R&D, maintenance, and advertising at the beginning and end of GVCs**

Thanks to ICT, services can be increasingly unbundled, digitally transported, and traded across the world. An example of this is the outsourcing of back-end transaction processing. However, services are often overlooked in the wider context of GVCs. Ignorance about activities such as logistics, accounting, and after-sales services as components of GVCs is one reason. Also, the role of services in GVCs has been underreported owing to the lack of comprehensive statistical techniques. In an attempt to solve this problem, the Organization for Economic Cooperation and Development (OECD) and the WTO have been trying to measure the value added at different stages of a GVC (see the next sidebar “Measuring the value added by GVCs is an ongoing exercise”).

A country’s **participation index** is also another helpful indicator of GVC participation. It **measures an economy’s role** in a vertically fragmented production process.

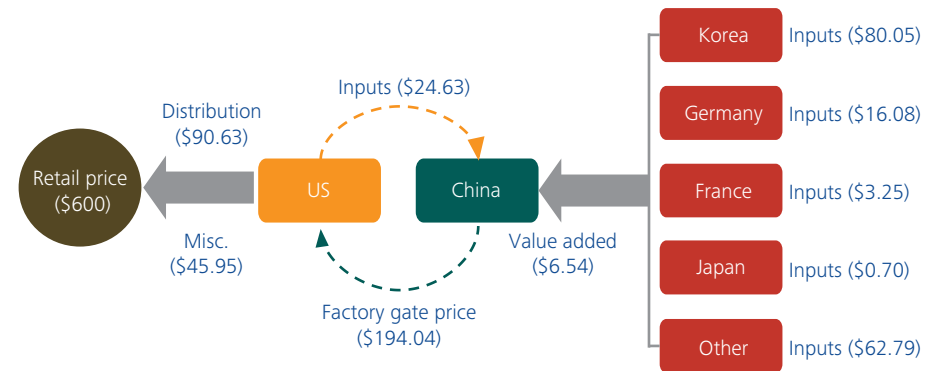
MEASURING THE VALUE ADDED BY GVCs IS AN ONGOING EXERCISE

To understand better the contributions of different players in a GVC, it is important to measure the value added at each stage. For example, China may export a smartphone valued at \$194.04, although it may have contributed only \$6.54 in value addition (figure 3). The rest are imports: design from a studio in the United States, software from India, a silicon chip from Singapore, and metals mined in Bolivia. Thus many countries benefit from the production of the smartphone, although traditional trade data often does not reveal this.

Thankfully, the OECD-WTO Trade in Value Added (TiVA) initiative allows better measurement of a country's value addition in exports.⁴ Work on this is still ongoing; data are currently updated until 2009–11. Measuring value addition also helps break a few myths. Traditional data show that China has high surpluses with the United States and the European Union, and a large deficit with Japan. When calculated in value-added terms, however, the surpluses and the deficit decrease due to high foreign content in China's exports.⁵

A country's participation index is also another helpful indicator of GVC participation. It measures an economy's role in a vertically fragmented production process. The index is expressed as a percentage of gross exports and indicates the share of foreign inputs (backward participation) in exports and domestically produced inputs (forward participation) used in third countries' exports.

Figure 3. Value creation and capture (in USD) for Apple® iPhone4*



* Apple is a trademark of Apple Inc., registered in the United States and other countries. "Global value chains: More development strategy than process" is an independent publication and has not been authorized, sponsored, or otherwise approved by Apple Inc.

Source: Organization for Economic Cooperation and Development, "Global value chains: Preliminary evidence and policy issues," March 2011, http://unstats.un.org/unsd/trade/globalforum/publications/gvc/n%20-%20OECD%20-%202011%20-%20GVCs%20-%20Preliminary%20Evidence%20-%20Policy%20Issues_March%2011.pdf; Deloitte Services LP economic analysis.

Graphic: Deloitte University Press | DUPress.com

GVCs as a development tool

Back in the early 1980s, when China slowly opened its economy, it was an unknown frontier. As it started using the GVC network, the country transformed fast. Today, China is the world's manufacturing hub and a key center of global growth. In this context, it is worth looking at a few numbers. In 1995, China's participation index was 25.7; by 2009, it had increased sharply to 46.1. And during that period, China emerged as one of the world's largest economies with a leading share in global trade (figure 4). China is not the only country worth quoting. Neighboring India has also fared well over the last two decades due to its participation in services GVCs. Policy liberalization in the early '90s and a well-qualified English-speaking workforce also helped. But even with this progression for both China and India, there remain opportunities for further pro-growth policy liberalization enhancements.

The emergence of GVCs as a route to economic progress ensures that countries need not wait for domestic champions to emerge to take on giant multinational companies. By linking to a GVC, businesses in a developing economy can tap opportunities, technology, and credit across the world. Contrary to the infant industry argument, GVCs enable a grand alliance of businesses—large and small—in the global marketplace. Moreover, in a world where technology and demand patterns change fast, GVCs help businesses to be nimble, thereby ensuring dynamism and sustainability. For example, as costs rise in India's information technology (IT) sector, the Philippines can attract more call centers, even as Indian firms try to move up the value chain.⁶

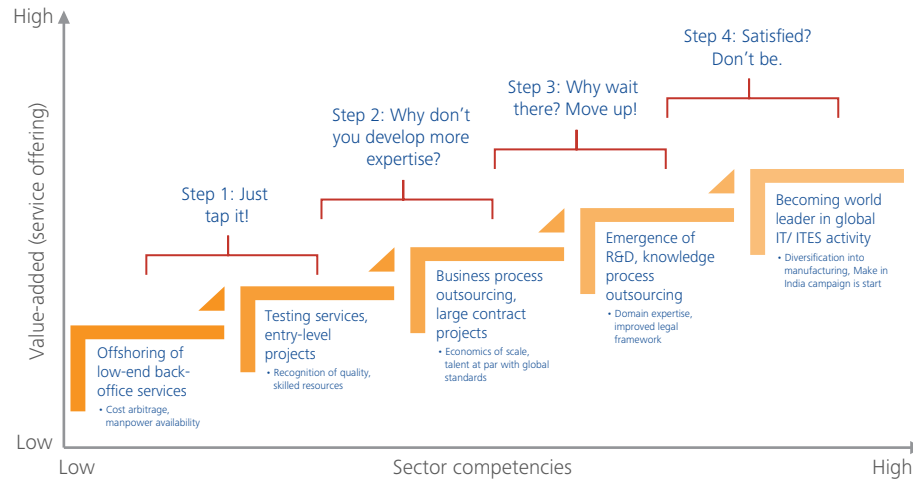
Figure 4. Rise in the participation index of China and India and their growing global stature

	1995		2009	
	China	India	China	India
Participation index score	25.7	23.9	46.1	43.2
Share in global exports (percentage)	2.9	0.7	10.5	2.3
Share in global GDP in terms of purchasing power parity (percentage)	5.9	3.8	13.1	5.8

Source: OECD; Haver Analytics; Deloitte Services LP economic analysis.

Contrary to the infant industry argument, **GVCs enable a grand alliance of businesses**—large and small—in the global marketplace.

Figure 5. India's tryst with GVCs in services and possible steps ahead



Source: Deloitte Development LLC.

Graphic: Deloitte University Press | DUPress.com

The four-step GVC participation roadmap

The participation of economies in a GVC is based on numerous factors, including competitive advantage, trade policy, and growth objectives. As an economy undertakes measures to open itself up to international markets, it can use the GVC route to promote trade and attract foreign investments. The following steps, not always chronological, illustrate a few ways to tap into GVCs (figure 5).

Step 1: Just tap it!

One step is to merely tap into relevant GVCs. Examples abound in Eastern Europe, Asia, and Latin America, where the first move of integrating with external markets has been to tap one small part of a GVC. For example, given its proximity to the United States and its membership in the North American Free Trade Agreement, Mexico first tapped into the auto supply chain. Today, Mexico exports more cars than any country except Germany, Japan, and South Korea.⁷

Instead of competing in all activities along a GVC, it may be prudent for economies to focus on one task (or a few). For example, certain service activities require less capital and infrastructure, thereby providing opportunities for developing economies. If these countries have a good low-cost knowledge base, they may turn out to be more competitive than developed economies. This is how Philippines initially came to global prominence in low-value-added IT-enabled services.⁸

Step 2: Why don't you develop more expertise?

Another step is to develop expertise in a particular field. One way to do that is through the creation of sustainable industrial clusters. This helps small and medium enterprises (SMEs) tap into (mainly) the lower end of a GVC and avail the technological and managerial expertise of lead players in the GVC. Clusters also enable policymakers and other stakeholders to adopt modernization of practices within SMEs such as better accounting standards, upgrading of skills, social security, and environmental standards. Germany's Mittelstand is a good example of how the country has leveraged the power of SMEs to develop expertise across key sectors.⁹ Others such as Bangladesh and Cambodia, with their large textile clusters, can draw important lessons from the German experience.

Step 3: Why wait there? Move up!

GVCs often provide firms the opportunity to move up the value chain, either in partnership with lead firms or on their own. For example, South Korean firms have moved up the value chain in high-tech industries. As firms move up a GVC, they seek global reach to diversify their market and tap technology and financing opportunities. This, in turn, helps them capture more value. Acquisitions and stake purchases by Chinese and Indian businesses in Europe and the United States are cases in point.

Specialization and moving up a value chain are important for businesses eyeing the domestic market as well. For example, the auto industry in India and China have hosted both foreign and domestic companies that have not only used inputs from local partners and suppliers but also catered to huge domestic demand. In 2010, China topped the United States as the world's largest car market.¹⁰

Step 4: Satisfied? Don't be.

While moving up GVCs in a sector is a good step for firms, it may not create sustainable gains for an economy. It could lead to concentration of economic power in a few successful firms (as in South Korea) or create vulnerability in a sector.¹¹ In China, the global downturn of 2008–09 dented the country's manufacturing-focused (export-dependent) growth model, thereby forcing it to turn to services and domestic demand for growth. Specializing in high-value-added activity across sectors also becomes important to address structural economic challenges, including demographics. For example, to ensure strong income growth for citizens and reduce the country's dependence on low-skilled labor, Singapore is focusing on enhancing the productivity of industries across a wide range of sectors.¹²

For example, the **auto industry in India and China** have hosted both foreign and domestic companies that have not only used inputs from local partners and suppliers but also catered to huge domestic demand. In 2010, **China topped the United States** as the world's largest car market.

Don't forget the enabling factors

To utilize GVCs better, economies need to focus more on key enabling factors. First, economies need a pro-growth trade and investment agenda. Further liberalization of trade policy is critical through support for open and international markets. Asia, for example, has been (and will continue to be) a big beneficiary in this regard. The ongoing impasse at the WTO and multilateralism are worrying trends, but they are the political reality, and, as such, alternative approaches to trade expansion should be pursued. Indeed they are being pursued, through the proliferation of regional and bilateral accords that are working to bring economies closer together (for example, TPP, TTIP, RCEP) and updating specific sets of rules (as in services). Collectively, such initiatives can help—and are helping—make an international trade agenda that is fit for GVCs and a global system that is better able to deal with the demands of today's global marketplace.

Second, countries also need a sound business environment to optimally utilize GVCs. A look at competitiveness and ease-of-doing-business rankings indicate that countries dominating the high-value-added part of GVCs also rank high in the above indicators (figure 6). Even for economies that do not make it to the top of the rankings, focusing on key components such as infrastructure have helped. For example, infrastructure is a big positive for China. Countries such as Indonesia and the Philippines are focusing ever more on infrastructure to attract investments in high-end manufacturing and services. Similarly, China would do well to create sound regulations and transparent institutions to promote services. Singapore's experience might help in this regard.

Figure 6. Economies at high-value-added stages of GVCs have strong enabling factors

	Global competitiveness index	Ease of doing business
Switzerland	1	20
Singapore	2	1
United States	3	7
Germany	5	14
Japan	6	29
United Kingdom	9	8
Taiwan	14	19
South Korea	26	5

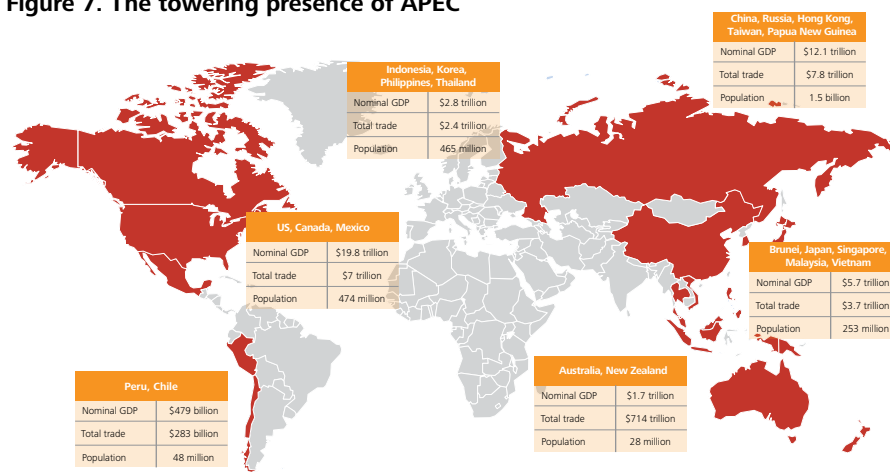
Source: World Bank; World Economic Forum; Deloitte Services LP economic analysis.

THE APEC GROUPING IS A STANDOUT IN DRAWING THE BENEFITS OF GVCS

The Asia-Pacific Economic Cooperation (APEC) is a forum of 21 Pacific Rim economies working together to promote economic integration and freer trade and investment throughout the region. It accounts for nearly half of global trade (figure 7).¹³ Currently, trade within APEC is focused on machine parts, high-tech electronics, and automobiles and related components. However, much of the opportunity for APEC lies in services and making service-related inputs embedded in products more competitive.

The extent to which APEC economies are involved in a vertically fragmented production process can be seen from their participation indices (figure 8). As of 2009, Singapore and Russia had the

Figure 7. The towering presence of APEC

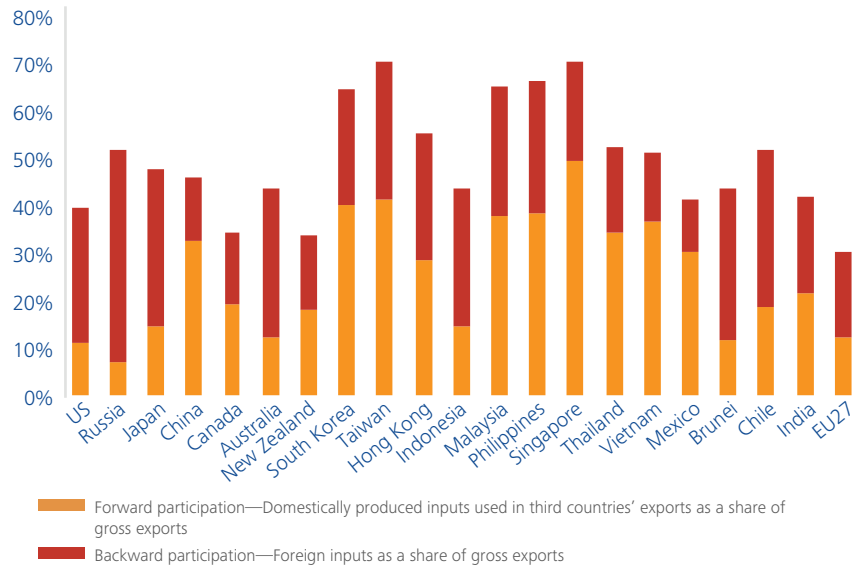


Note: Nominal GDP, population, and total trade data are from 2013.

Source: WTO; Deloitte Services LP economic analysis.

Graphic: Deloitte University Press | DUPress.com

Figure 8. Participation in GVCs: A look at APEC countries and European Union (2009)



Source: OECD; Deloitte Services LP economic analysis.

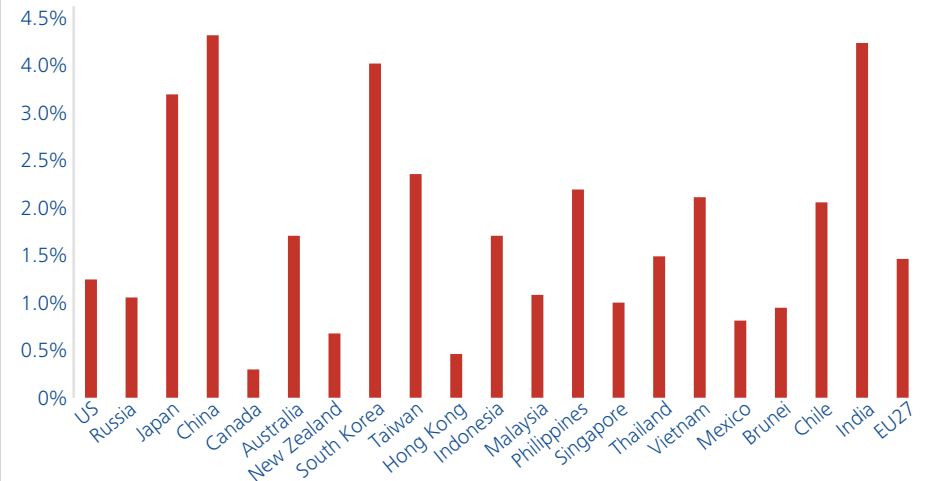
Graphic: Deloitte University Press | DUPress.com

highest backward and forward participation, respectively. Commodity exporters typically have high forward participation shares. The data also show that APEC countries have a much higher participation in GVCs compared with the European Union (figure 9). APEC countries have used the GVC engine to emerge as among the fastest-growing regions in the world, which include some of the erstwhile developing economies.

APEC countries have also taken the lead in developing a charter on GVC development and cooperation. The charter focuses on the need to strengthen regional economic integration by removing impediments to trade and investment, enhancing supply chain connectivity, and improving the business environment. Key objectives include:

- **Better information sharing through single-window mechanisms**

Figure 9. Growth in the participation route of GVCs (CAGR of participation index over 1995–2009)



Source: OECD; Deloitte Services LP economic analysis.

Graphic: Deloitte University Press | DUPress.com

- **Improved data collection**
- **Faster harmonization of procedures and regulatory requirements**
- **Proactive efforts to remove non-tariff barriers**

Indeed, enabling a more competitive GVC environment across APEC remains a top priority for leaders, if its objectives to create a more dynamic region are to be fully captured.¹⁴

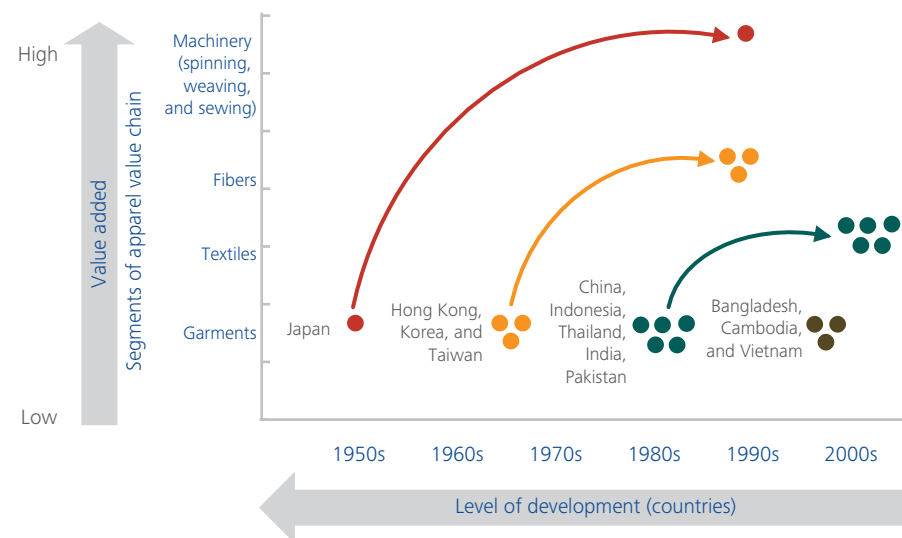
Beyond the winners and losers debate

In the wider rhetoric of benefits from global linkages, talk of winners and losers overshadows the conversation. In developing economies, the arguments mostly pertain to the protection of domestic industries, while in developed markets, issues such as offshoring are sensitive as they are often linked to the loss of low-skilled jobs. In truth, much of such conversation does not take into cognizance the dynamic nature of GVCs and the advent of new technology that compensates for losses at one end with gains at the other. Policymakers should consider a focus on training, support for SMEs, and infrastructure development.

In addition, gains tend to happen in higher-value-added activity. For example, while there have been low-end job losses in the United States, the country has immensely benefitted by moving up the GVC in services. The domination of Silicon Valley in technology is a great example of this. In fact, the dynamic nature of GVCs opens up new opportunities for numerous entrants, even as other countries move up (figure 10).

Data from TiVA reveal that GVCs have helped to lift all boats in the sea of international trade, and not some at the cost of others. For example, an analysis of the share in domestic value added in total exports for key economies shows us that the numbers have not changed drastically over time, especially in the last decade, even as total trade has shot up (figure 11).

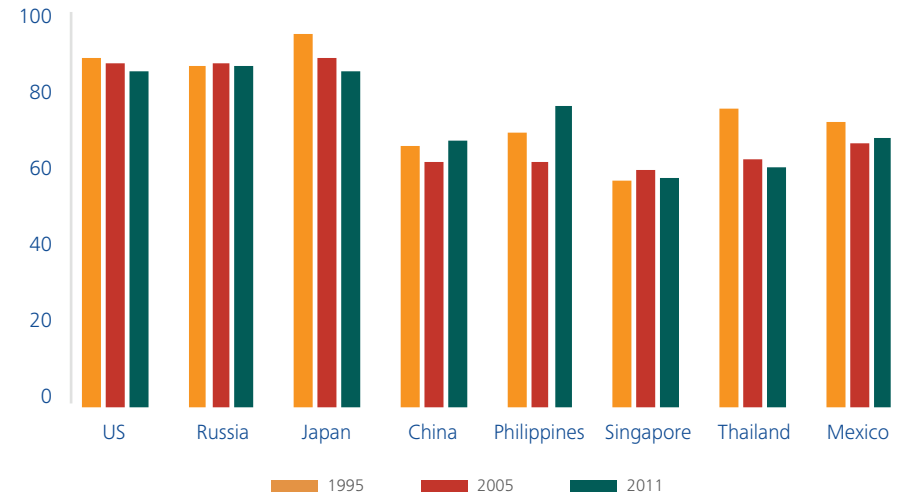
Figure 10. The apparel GVC and movements for key participating economies



Source: Deloitte Development LLC.

Graphic: Deloitte University Press | DUPress.com

Figure 11. Share of domestic value added in gross exports for key exporting nations in APEC



Source: OECD; Deloitte Services LP economic analysis.

Graphic: Deloitte University Press | DUPress.com

On a note of caution, tapping into GVCs without ensuring smooth interaction between different stakeholders may create problems. Here policymakers, nonprofit organizations, firms, and other key interlocutors at the high-value end of GVCs can play a major role. Ongoing dialogue to bridge differences not only enhances trust but also sets the stage for the exchange of information and technology that makes GVCs more efficient. It also serves as a platform to address and overcome local issues that may be hindering the GVC pipeline.

INTERVIEW WITH ANABEL GONZALÉZ OF THE WORLD BANK GROUP

The authors are grateful to Anabel González, senior director of the Trade and Competitiveness global practice at the World Bank, who provided a few of her own insights on the GVC landscape. Previously, González served as Costa Rica's minister of foreign trade.



Anabel González

Senior director, Trade and Competitiveness global practice

The World Bank Group

Q. What is the new GVC paradigm all about, and why is it such an important area to note vis-à-vis countries' economic growth agendas? What are the key takeaways for developed and developing economies?

González: While internationally fragmented production is not new, 21st-century GVCs represent the international flows of goods, services, people, ideas, technology, and capital, which together can boost employment and productivity across sectors in an economy. Instead of establishing the entire value chain domestically for an industry to become competitive internationally, developing-country firms can connect to GVCs by specializing in tasks where they have a comparative advantage. Subsequently, as they benefit from access to world-class technology, knowledge, and skills, developing economies can industrialize further by moving up the value chain. In developed economies, globally competitive lead firms use GVCs to carry out different tasks in the most cost-effective location. Firms, and countries, that don't will likely struggle to compete.

Q. Trade policy is increasingly interlinked with GVC dynamics. Can you share some insights on how a pro-growth and active global trade agenda can

better connect with GVCs, and what are some of the pitfalls to avoid? How can today's proliferation of international trade and investment agreement negotiations consider GVCs as they work to set new rules of the road for the global marketplace? How does this fit with the advancement of the services agenda?

González: Tariff liberalization is, but naturally, important to bring down costs in a GVC world where imports are as important as exports. The same holds true for non-tariff measures, which are increasingly becoming the major impediment to participating in the world economy. We also must not overlook the fact that trade and investment openness are complementary in a GVC context, where the latter goes beyond eliminating FDI restrictions to fostering a sound business environment. This, in turn overlaps considerably with trade facilitation—another important item on the global trade agenda that influences celerity and, therefore, the ability of firms to connect to GVCs. Securing commitments across a number of trade-related (non-tariff) measures in international agreements can expand GVCs through their effect on policy certainty and the internalization of cross-border policy spillovers. Services measures are no different, given that transportation and banking services, for example, are important for the competitiveness of other exports.

Q. Considering your responses to questions 1 and 2, how does this mesh with the ambitions of the work program and current priorities for APEC?

González: International cooperation in the realm of trade and trade-related policies will need further consolidation. And with a slow-moving multilateral trade system, regional agreements and forums are often in the spotlight. As APEC further studies the possibilities associated with a future FTAAP [Free Trade Area of the Asia Pacific], it is worth noting that “deep” trade agreements that cover a range of non-tariff measures can underpin the continued expansion of GVCs. As a word of caution, however, there is the risk of divergent regulatory regimes segmenting markets and raising trade costs as well as limiting the diffusion of GVCs beyond nonmembers. Coherence between regional trade agreements and the multilateral trading system is therefore the need of the hour.

Q. The World Bank is obviously a key contributor to the GVCs discussion. Can you share some specific examples of how the bank is working with actors around the world to optimize participation in GVCs and what are some stories of success?

González: The World Bank provides analytical services to client governments—at times in collaboration with other development partners—including on linking GVC participation to growth diagnostics, conducting impact evaluations, and exploring the role of SMEs. It also targets capacity building through (1) technical assistance in the realm of trade and investment policy to governments, and (2) firm-level advisories, including on best practices in vocational training and management skills. Last, but not least, it provides financing when necessary through development policy lending, investment operations, equity financing of private sector firms, and innovative guarantee schemes for supply chain operators. Take, for instance, Bangladesh, where a combination of analytics/advisory services to firms and government, IFC credit lines and investments in firms, and World Bank lending is being used to improve the competitiveness of its garment sector.

Q. In your opinion, is today's GVCs discussion just the tip of the iceberg as the world becomes ever more globalized and digitalized? If so, what comes next as it relates to movement of goods, services, capital, and people?

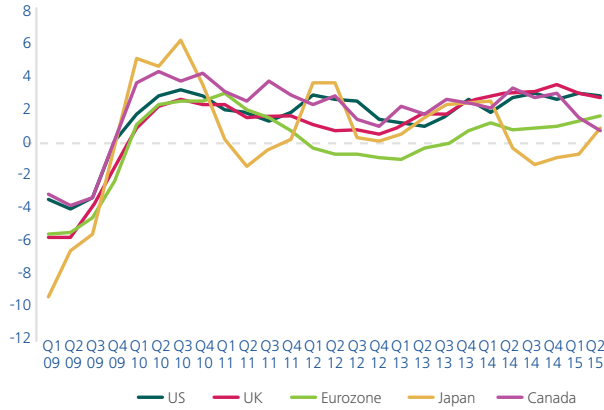
González: New technologies can bring down the costs of coordinating globally fragmented production further and push forward the development of GVCs as we know them today. Think of video and virtual reality conferencing, radio frequency identification technology, and cloud computing. At the same time, increased automation may eliminate low-skilled tasks that are easy to digitize and make the remaining tasks more skill- and capital-intensive. To the extent that this substitution occurs, technologies such as robotics and 3D printing will challenge the traditional GVC-based international division of labor. The reshoring of labor-intensive tasks may also be propelled by rising wages in China, high costs of doing business in low-income countries, and stagnant wages in developed economies. What about economic shocks? Energy price volatility and natural disasters, for example, can disrupt increasingly complex supply chain operations in an increasingly globalized world. The resulting losses to firms could, in principle, prompt a move toward near-shoring.

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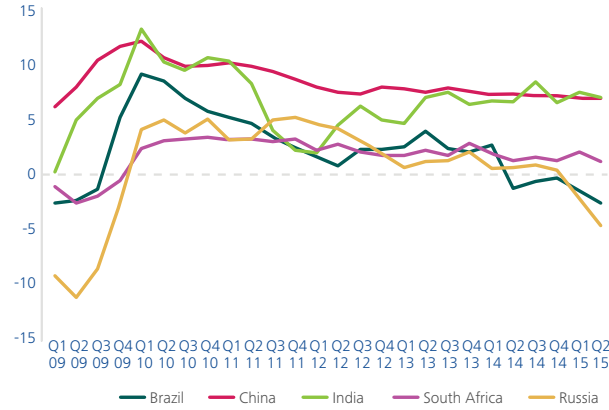
Economic indices

GDP growth rates (percentage, year over year)



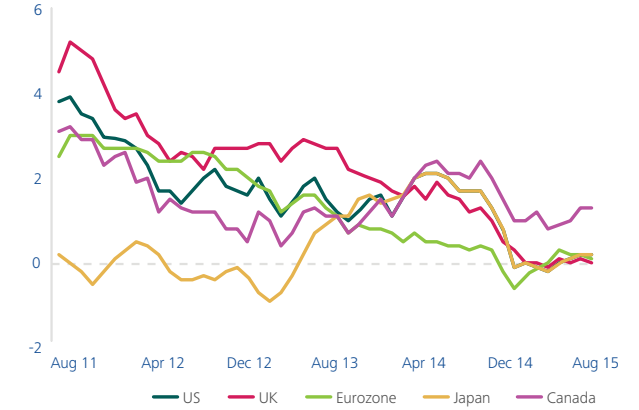
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GDP growth rates (percentage, year over year)



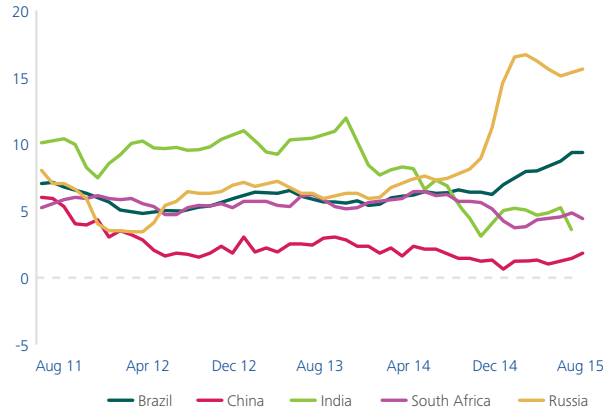
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Inflation rates (percentage, year over year)



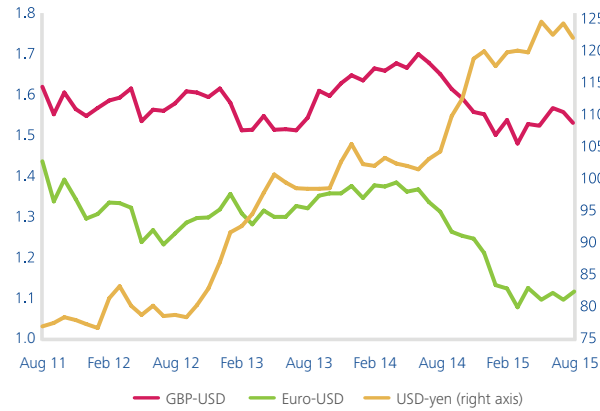
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Inflation rates (percentage, year over year)



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

Major currencies vs. the US dollar



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

Yield curves (as of September 25, 2015)*

	US Treasury bonds & notes	UK gilts	Eurozone govt. benchmark	Japan sovereign	Canada sovereign	Brazil govt. benchmark	China sovereign	India govt. actives	South Africa sovereign	Russia‡
3 months	0.00	0.55	-0.21	-0.02	0.43	14.77	2.39	7.40	6.30	10.12
1 year	0.32	0.52	-0.19	0.02	0.48	16.29	2.56	7.46	-	10.87
5 years	1.45	1.19	0.01	0.06	0.81	17.04	3.20	7.86	8.06	11.41
10 years	2.13	1.76	0.60	0.31	1.47	16.84	3.41	7.72	8.43	11.14

Composite median GDP forecasts (as of September 25, 2015)*

	US	UK	Eurozone	Japan	Canada	Brazil	China	India	S. Africa	Russia
2015	2.5	2.6	1.4	0.7	1.1	-2.4	6.9	7.5	1.5	-3.7
2016	2.7	2.4	1.7	1.2	2	-0.5	6.5	8	1.9	0.5
2017	2.5	2.3	1.5	0.7	2.2	1.5	6.5	-	2.4	1.2

Composite median currency forecasts (as of September 25, 2015)*

	Q4 15	Q1 16	Q2 16	Q3 16	2015	2016	2017
GBP-USD	1.54	1.54	1.54	1.54	1.54	1.53	1.56
Euro-USD	1.08	1.06	1.06	1.06	1.08	1.05	1.1
USD-yen	124	125	126	127	124	126.5	124
USD-Canadian dollar	1.34	1.35	1.33	1.34	1.34	1.32	1.25
USD-Brazilian real	3.75	3.79	3.78	3.95	3.75	3.85	3.53
USD-Chinese yuan	6.5	6.58	6.52	6.6	6.5	6.6	6.5
USD-Indian rupee	66.5	66.69	67	67.5	66.5	67.75	63
USD-SA rand	13.5	13.5	13.6	13.84	13.5	13.7	12.75
USD-Russian ruble	68.7	68	68	68.74	68.7	65	55.5

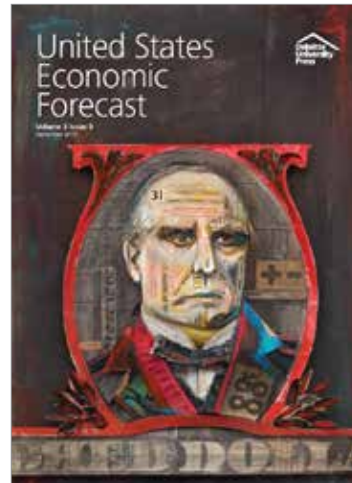
OECD composite leading indicators (amplitude adjusted)†

	US	UK	Eurozone	Japan	Canada	Brazil	China	India	South Africa	Russia Federation
Jan 13	100.0	99.9	98.8	99.7	99.5	100.7	100.6	99.4	100.7	99.6
Feb 13	100.1	99.9	98.9	99.9	99.5	100.5	100.6	99.3	100.7	99.5
Mar 13	100.1	99.9	99.0	100.1	99.5	100.3	100.7	99.2	100.6	99.4
Apr 13	100.2	100.0	99.1	100.3	99.5	100.0	100.7	99.1	100.6	99.4
May 13	100.3	100.0	99.2	100.5	99.5	99.8	100.7	99.0	100.6	99.4
Jun 13	100.4	100.2	99.4	100.7	99.6	99.6	100.8	98.9	100.6	99.4
Jul 13	100.4	100.4	99.6	100.9	99.7	99.4	100.8	98.8	100.6	99.5
Aug 13	100.4	100.6	99.8	101.0	99.8	99.3	100.8	98.7	100.6	99.7
Sep 13	100.4	100.8	100.0	101.1	99.9	99.3	100.8	98.6	100.5	99.9
Oct 13	100.4	101.0	100.2	101.3	100.0	99.4	100.7	98.6	100.5	100.0
Nov 13	100.4	101.1	100.3	101.3	100.0	99.4	100.6	98.5	100.4	100.2
Dec 13	100.4	101.1	100.4	101.4	100.0	99.4	100.5	98.5	100.3	100.4
Jan 14	100.4	101.2	100.5	101.3	100.0	99.4	100.4	98.5	100.2	100.5
Feb 14	100.4	101.2	100.6	101.1	100.0	99.3	100.3	98.5	100.1	100.7
Mar 14	100.4	101.2	100.6	100.9	100.1	99.3	100.2	98.6	99.9	100.9
Apr 14	100.5	101.2	100.5	100.7	100.1	99.3	100.1	98.6	99.8	101.1
May 14	100.5	101.2	100.5	100.4	100.2	99.4	100.0	98.7	99.8	101.3
Jun 14	100.5	101.2	100.4	100.2	100.2	99.5	99.8	98.8	99.8	101.4
Jul 14	100.5	101.0	100.4	100.0	100.3	99.7	99.7	98.9	99.9	101.4
Aug 14	100.5	100.9	100.3	99.9	100.3	99.8	99.6	98.9	100.0	101.3
Sep 14	100.5	100.8	100.3	99.9	100.3	100.0	99.4	99.0	100.1	101.0
Oct 14	100.4	100.7	100.3	99.8	100.2	100.0	99.2	99.1	100.1	100.6
Nov 14	100.3	100.6	100.3	99.9	100.1	100.0	99.0	99.2	100.1	100.2
Dec 14	100.2	100.5	100.4	99.9	100.0	100.0	98.8	99.2	100.0	99.7
Jan 15	100.1	100.4	100.5	99.9	99.9	99.9	98.6	99.3	99.9	99.4
Feb 15	100.0	100.3	100.6	99.9	99.8	99.7	98.5	99.4	99.8	99.2
Mar 15	99.9	100.2	100.6	100.0	99.7	99.5	98.3	99.4	99.8	99.2
Apr 15	99.8	100.1	100.7	100.0	99.6	99.2	98.2	99.5	99.8	99.1
May 15	99.7	100.0	100.7	100.0	99.6	99.0	98.1	99.6	99.9	99.1
Jun 15	99.6	99.8	100.7	100.0	99.5	98.9	97.9	99.7	99.9	98.9
Jul 15	99.5	99.7	100.7	100.0	99.4	98.7	97.6	99.8	99.9	98.7

*Source: Bloomberg ‡MICEX rates †Source: OECD

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

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