Global Economic Outlook

2nd Quarter 2014

Deloitte University Press

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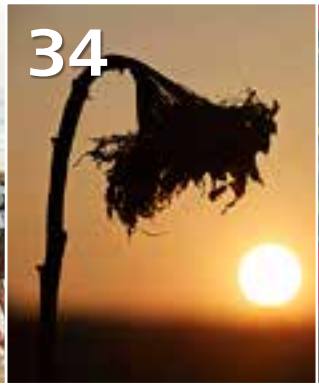

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Preface by Dr. Ira Kalish

FOR much of the past few years, the major global economic trend was weakness in developed countries and considerable strength in emerging markets. That appears to be reversing. Growth is picking up speed in the United States and Europe, while it has declined considerably in most of the major emerging markets. In addition, the inflationary environment in the two groups is very different. In the United States and Europe, inflation is so low that there are worries about deflation. Consequently, central banks have plenty of wiggle room to maintain aggressive monetary policies, thereby assisting the nascent recovery. In emerging markets, on the other hand, inflation is uncomfortably high. The result is that central banks are maintaining tight monetary policies, thereby exacerbating economic weakness and delaying recovery. Finally, much of the trouble in emerging markets stems from a reversal of capital flows. In recent years, due to very low interest rates in the United States, capital has flowed to emerging markets, putting upward pressure on local currencies. Now, with US monetary policy beginning to change, capital is flowing in the opposite direction, causing downward pressure on currencies. The latter is one reason for the tightening of monetary policy in emerging countries.

Still, despite the slowdown in emerging markets, growth remains higher on average than in developed economies. That is because these countries continue to catch up to the most affluent countries. They can more easily boost productivity simply by shifting workers from farms to factories. Developed countries, on the other hand, are at the frontier of technology and business best practices. Their productivity growth must come mainly from innovation and implementation of new technologies and business practices. So, although the emerging countries are in a temporary funk, their longer-term prospects remain quite good.

In this edition of our quarterly report, we look at the short- to medium-term situation around the world. We begin with Alexander Börsch's assessment of the Eurozone. He notes that, until recently, most growth in the region has come from exports. He predicts, however, that as the recovery unfolds at a moderate pace, more growth will come from consumer demand and investment.

Next, I offer my view on the outlook for China. I discuss the continuing slowdown in economic activity as well as the tough balancing act the government faces. On one hand, it wants to maintain adequate growth. On the other, it wants to restrain the growth of credit in the shadow banking system lest a financial crisis takes place. As such, I examine recent events in Chinese credit and currency markets and discuss how the government is attempting to resolve imbalances in these arenas.

Patricia Buckley then offers her views on the US economy. She takes a decidedly optimistic view on the coming year. Patricia walks the reader through the various major components of GDP and explains why there is cause for cheer. She notes positive influences on investment and trade, as well as a lack of negative influences on government spending.

Our next article focuses on Japan. In this article, I discuss some of the mixed signals coming from the Japanese economy. I also discuss the fears concerning the tax increase that took place on April 1 and the potentially damaging impact on economic growth. Finally, I examine a range of factors that will determine how Japan performs once the initial impact of the tax increase wanes.

In our article on India, Rumki Majumdar suggests that, following some rough patches, the worst is probably over. She also says that, although growth is likely to pick up for the remainder of this year, the longer-term performance of the Indian economy will hinge especially on the outcome of the upcoming election. Rumki notes that, in the past, economic growth was better when there was a stable government following elections.

Russia has been in the news lately. In his article on Russia, Akrur Barua notes that, even before the recent crisis, Russia's economic performance was modest at best. Aside from the impact of the current political crisis, Akrur examines such issues as high inflation, a declining currency, and constraints on monetary policy. In addition, he focuses on the various ways in which the crisis will have a further negative impact on economic performance.

In their article on Brazil's economy, Rumki Majumdar and Akrur Barua suggest that, absent reforms, the economic outlook for Brazil is poor. They note the various constraints on growth, including high consumer indebtedness, excessive regulation of the labor market and its negative impact on investment, tight monetary policy, and mixed signals from the government. They discuss the ways in which a failure to reform is stymying growth.

In his article on the UK economy, Ian Stewart expresses surprise at the strength of the recovery—surprise that is shared by many other economists. Still, Ian notes that productivity has lagged considerably. Without a sustained boost in productivity, the pace of recovery cannot be realized.

Finally, Akrur Barua and Sunandan Bandyopadhyay offer some interesting thoughts on the state of global trade. They discuss recent trends in trade and the impact on growth. They also examine recent movements toward and away from trade liberalization, with particular emphasis on two very important sets of negotiations.

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Eurozone

Recovering at different speeds

By Dr. Alexander Börsch

IN the first quarter of 2014, the recovery in the Eurozone that started last year continued and consolidated. That the recovery has withstood economic turbulences in the emerging markets and geopolitical crises in the immediate neighborhood of the European Union speaks for a fairly robust and intact growth trend.

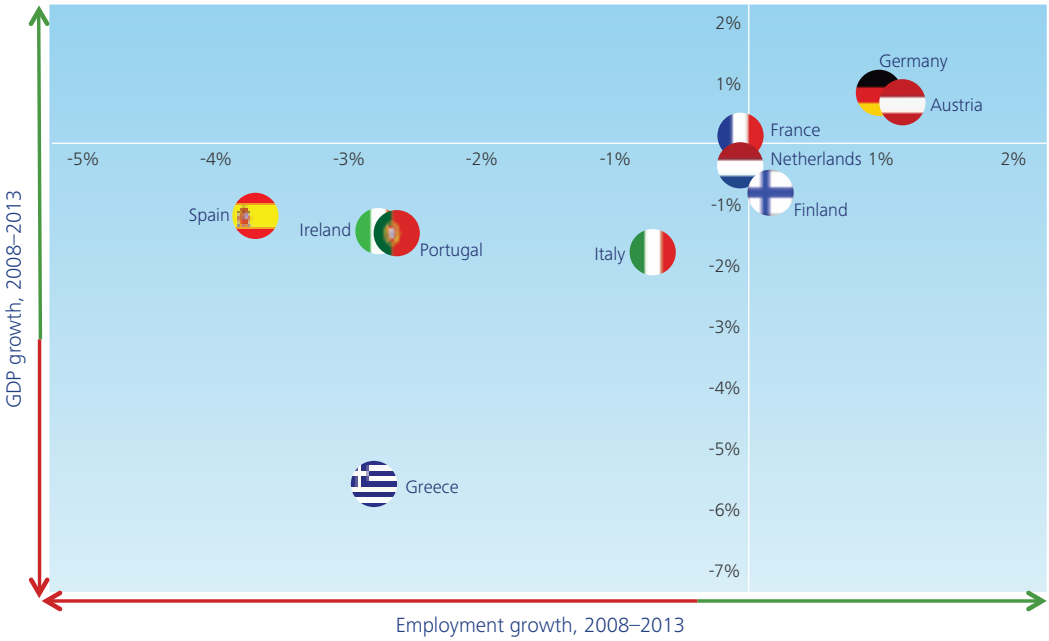
This recovery will be quite different from usual recoveries, however. How it will develop and how strong it will be is substantially shaped by the legacy of the financial and euro crises. The ongoing deleveraging processes, difficult financing conditions in parts of the Eurozone, low credit demand from firms, and low investment activity are the background against which the recovery has to unfold.

Varieties of recession

One of the enduring legacies of the financial crisis is the degree of divergence in economic development in the Eurozone. Originally designed to create a unified economic area with synchronized business cycles, the Eurozone actually developed in the other direction during the crisis. The recession had a remarkably different impact on the Eurozone members, to the point that Eurozone averages have become increasingly misleading. Figure 1 shows the average GDP and employment growth over 2008–2013.

The crisis countries—Greece, Spain, Portugal, and Ireland—show an extremely negative performance on both dimensions; their economies shrank substantially and lost employment in a dramatic way. Italy too has seen a shrinking economy and decreasing employment. France and the Netherlands have, by and large, stagnated in the last five years, while the central European countries, particularly Germany and Austria, could grow moderately and build up employment.

Figure 1. Average GDP and employment growth, 2008–2013



Source: Eurostat.

Graphic: Deloitte University Press | DUPress.com

The recovery in the Eurozone is ongoing and it is progressing at different speeds and degrees of strength across the region. For the Eurozone as a whole, this adds up to a moderate recovery.

The contours of the recovery

The recession in the Eurozone as a whole ended in Q3 2013. Disaggregating the growth performance of the Eurozone shows that the only GDP component that has continuously contributed to growth since 2009 has been exports. Investments and consumption turned negative in the first half of 2011 and remained so for more than two years. It was only in the last quarters of 2013 that investment and consumption crossed the threshold separating negative from positive contributions. Their revival in 2013, in some cases driven by rising exports, has been crucial for the end of the recession.

The good news for the Eurozone is that in 2014 the recovery will continue to broaden. Consumption and investments will increase, making the Eurozone recovery less dependent on international markets. Investment propensity is on the rise, crucially supported by a more stable environment within the Eurozone and historically low interest rates. At the same time, many companies, especially in Central Europe, have successful years behind them and increasingly see investment opportunities for their accumulated reserves. For example, German companies intend to use their accumulated reserves in 2014 mainly for domestic and foreign investments, according to the Deloitte CFO Survey.

The projected upswing for consumption in the Eurozone is more surprising, given that unemployment is still at record levels. Consumer sentiment has increased and is at a six-year high for the Eurozone as a whole (see figure 3). While German consumers are highly confident, Spanish consumer sentiment is now in positive territory, for the first time in seven years. The reasons might be due to consumers' perception that the main part of deleveraging is over or that a turning point for the labor markets is near. Not only is consumer sentiment on the increase, but consumers are also more optimistic about their financial situation over the next 12 months.

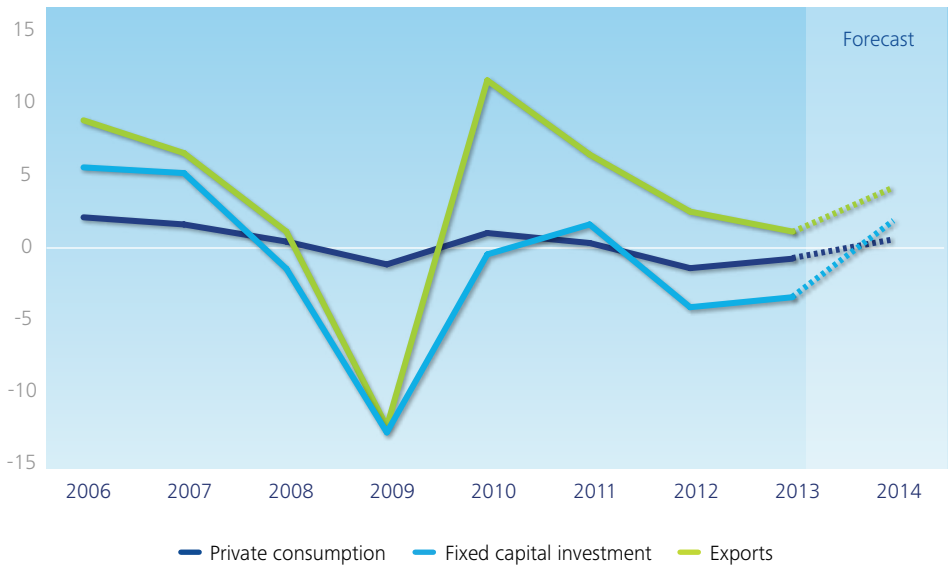
Varieties of recovery

The diversity of the Eurozone economies, which became apparent during the recession, will not disappear during the recovery. Behind the Eurozone averages are still substantial differences. The outlook for the four biggest Eurozone economies is therefore mixed.[1]

Germany is likely to experience a continuing shift in growth dynamics. While exports drove German growth in the years after the financial crisis, this has been changing. In 2013 it was consumption that drove the meagre growth rate of 0.3 percent, while the growth contribution of exports and investments was negative. In 2014, exports are likely to rise, but imports will rise even faster so that the external growth contribution will again be negative. Growth impulses will mainly come from the domestic economy. Consumption will continue to increase, driven by wage increases and a very robust labor market. The main growth contribution in 2014 will come from investments. The investment propensity of German firms is increasing and should be reflected in a substantial improvement in investments. In short, growth in Germany in 2014 should hover around 2 percent.

The situation in France is different. After a strong second quarter in 2013, falling exports and decreasing investments weighed on growth. Investments and exports are likely to recover slowly in 2014 too and will only very moderately contribute to GDP growth at most, while high unemployment and low wage increases depress domestic demand. Public investment and public consumption will stabilize the economy, but this is unlikely to be enough for a strong recovery.

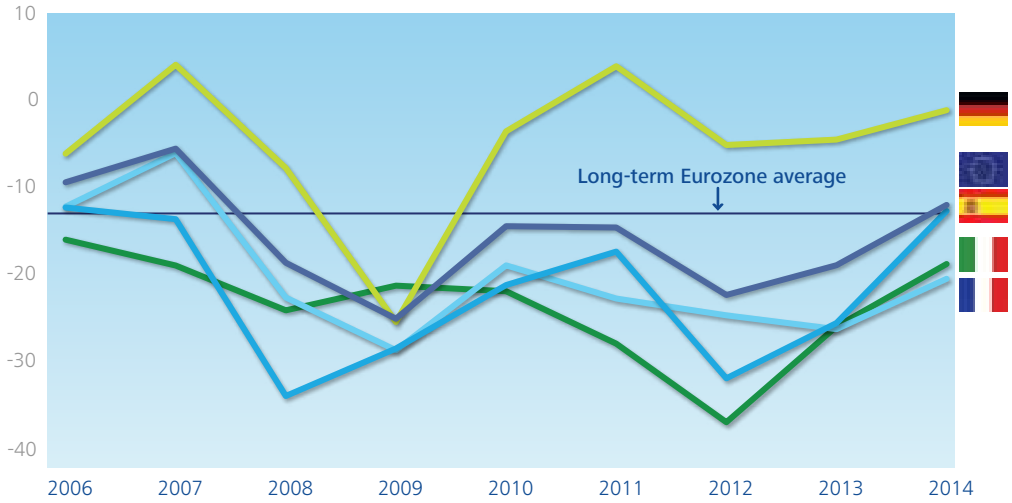
Figure 2. Eurozone private consumption, exports, and investment (change in %)



Source: Eurostat-WKO.

Graphic: Deloitte University Press | DUPress.com

Figure 3. Consumer sentiment indicator for selected Eurozone countries



Source: European Commission.
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Growth in 2014 should be mildly positive and, depending mainly on demand, be somewhere between 0.2 percent and 1 percent.

Italy faces similar difficulties as France. It has been in recession since 2011, shrinking by 1.9 percent in 2013. Difficult financing conditions and uncertainty about the future course of economic policy are holding back investments, while exports do not foster growth. Demand suffers from high unemployment and the government has very little room to stimulate the economy, given the extremely high level of public debt. As a consequence, projections assume either stagnation or meagre positive growth up to 0.6 percent.

Spain enjoys a relatively positive outlook, compared to previous years. Although the deleveraging process is far from over, and unemployment is still extraordinarily high, it seems that Spain has reached a crucial turning point. The economy stopped shrinking in the second half of 2013, and the effects of the reforms undertaken started showing results: They lowered unit labor costs, and Spain managed to increase its exports by almost 5 percent in 2013. These export successes increasingly spill over to the domestic economy, leading to small positive growth contributions of consumption and investment. Overall growth in Spain is likely to be in the region of 1 percent in 2014, meaning that Spain will grow again after several years of a shrinking economy.

The recovery in the Eurozone is ongoing and it is progressing at different speeds and degrees of strength across the region. For the Eurozone as a whole, this adds up to a moderate recovery. Whether a moderate recovery is reason to cheer or to be disappointed depends on the basis of comparison. It is a more-than-welcome development when compared to the previous recession; however, the recovery is developing much more slowly than usual recoveries due to the legacies of the financial crisis. The return to strong growth will be a long and windy road, but a consolidating recovery is a good basis.

Endnote

1. For details, see “The EEAG Report on the European Economy: The road towards cohesion” by CESifo's European Economic Advisory Group and "European economic forecast: Winter 2014" by The European Commission.

China

A tough balancing act

By Dr. Ira Kalish

THE economic slowdown in China continues, raising questions about the appropriate direction of government policy. First, consider the numbers. In the first two months of 2014, industrial production was up 8.6 percent from a year earlier, the slowest rate of growth since the start of 2009 when the world was in the midst of the global financial crisis. In addition, retail sales for the first two months were up only 11.8 percent from a year earlier, a considerable slowdown compared with the past few years. Additionally, exports were actually down 1.7 percent in the first two months compared with a year earlier, which reflects the impact of weak demand in Europe as well as rising wages and an increased currency value in China. Finally, the growth of fixed asset investment, while still strong at 17.9 percent in the first two months of 2014, has decelerated considerably.

The economic slowdown has been brought about by weakness overseas as well as a tightening of credit market conditions by the Chinese authorities. In recent months, the government has indicated that it is more interested in addressing fundamental structural problems in the economy rather than focusing on growth. It has said that it is content with growth in the neighborhood of 7.5 percent, which is quite slow compared to recent years.[1] And yet the continuing and perhaps unexpected deceleration in the economy has evidently caused concern. Consequently, Premier Li Keqiang said in March that the government will boost the growth of fixed asset investment in order to stabilize the economy.[2]

It is interesting that the government is focusing on investment rather than consumer demand. One serious criticism of the government is that it has allowed far too much investment, much of it wasted and much of it leading to excess capacity and, consequently, low or negative returns. The result is likely to be serious trouble for the financial industry, which has funded much of this investment. Consequently, the new emphasis on investment can be seen as

The economic slowdown has been brought about by weakness overseas as well as a tightening of credit market conditions by the Chinese authorities.

a setback for the cause of reform. Or it can be seen as a compromise by the government, which is trying to balance a desire for reform with a desire to maintain growth. The problem with allowing a sharp slowdown in economic growth is that it could exacerbate excess capacity, suppress profit margins, and cause further stress in financial markets.

With credit growing faster than GDP, the economy is becoming more dependent on credit to drive growth, thus setting the stage for trouble down the road. China faces a tough balancing act. It can attempt to keep the economy growing by allowing more expansion of credit. Yet this risks trouble in the future when servicing debts becomes more problematic, especially if many debts go bad as expected. The other option is for the government to try to solve the credit dilemma by cracking down on credit creation. Yet doing so creates the risk of a slowdown in economic growth. By allowing a default in the domestic private sector recently, the government sent a message that there is risk in lending money foolishly. This may help to restrain excess credit growth as well as shift toward more realistic pricing of credit. Indeed, risk spreads have increased lately. On the other hand, the government's indicated direction may lead to a sharp tightening of credit market conditions, slower economic growth, and more defaults.

Shadow banking

The big question now is to what extent the government will continue efforts to slow the growth of credit through the shadow banking system. Doing so will be critical in reducing the risk of bad debts. There has indeed been a slowdown in the growth of nonbank credit in the so-called shadow banking system. Yet, at the same time, there has been a commensurate boost to traditional bank lending. It appears that the government has encouraged banks to bring assets back onto their balance sheets. As such, bank loans accounted for 64 percent of new credit in the first two months of 2014, compared with 55 percent of credit during all of 2013. Trust company lending fell from 11 percent of new credit in 2013 to 5 percent in early 2014. Evidently, the government has made it more difficult to shift money from the interbank lending market to off-balance-sheet lending vehicles. Yet while the government has slowed the growth of shadow banking, it has been averse to slowing the growth of overall credit lest this lead to a further slowdown in economic growth. Consequently, it apparently has allowed for accelerated formal bank lending.

A big part of the shadow banking system in China has involved trust products. Specifically, large banks have raised funds by selling trust products with high returns to wealthy individuals. The money raised is loaned to companies and individuals who lack access to cheap credit through the formal banking system. This, of course, resulted in a massive increase in credit and, it is feared, a massive increase in potentially bad debt. After all, many of the loans went to property speculators who built ghost towns and empty shopping centers. In March it was reported that some Chinese banks were curtailing their involvement in this market, although this could not be confirmed. Trust products in circulation increased 46 percent in 2013, reaching 10.9 trillion yuan (roughly $1.7 trillion). About half of the trust products will mature this year. If some banks have chosen not to sell more trust products, it could reflect fears that defaults on loans will force the banks to bail out the trust products. The result would be lower bank profitability.

If China is to grow through innovation and entrepreneurship, then capital markets will have to operate on a more market-oriented basis and channel funds to start-ups and small businesses.

Despite the slowdown in shadow banking, there has been a rush into Internet-based money market funds that offer depositors a high rate of return with the ability to withdraw at any time. Formal bank deposits offer a return capped by the government. Such funds are not regulated, nor are the deposits insured. As such, some analysts worry that they represent yet another risk to China's financial health. China's government has pledged to deregulate bank deposit rates. Once they do this, the allure of nonbank vehicles will diminish. As such, it was noteworthy that, recently, the governor of China's central bank said that deposit rates will be freed within one to two years, a pace faster than many analysts had expected.[3]

In addition, the Chinese government has approved trial plans for the establishment of five privately owned banks. These banks would compete with the large state-run banks and would be the start of larger plans to create a more market-based system of financial intermediation. Also, Premier Li said recently that he intends to promote Internet banking in China. The head of China's bank regulator said that "while private banks are subject to the same regulation as other banks, they should have also their own characteristics, especially focusing on serving small and medium-sized companies."[4] Interestingly, almost 90 percent of bank capital in China is now supplied by the government. One of the frequent complaints about China's banking system is that, due to the overwhelming dominance of state-run banks, smaller businesses have often been starved of capital. If China is to grow through innovation and entrepreneurship, then capital markets will have to operate on a more market-oriented basis and channel funds to start-ups and small businesses.

Currency

The Chinese government has doubled the band around which the currency can move before government intervention takes place. This is part of a gradual move toward a more freely floating currency, which in turn is part of a larger effort at financial market liberalization. The move was expected. Until recently, most analysts would have expected this to mean more room for appreciation of the currency. Earlier there was substantial upward pressure because, with an external surplus, China was experiencing a large inflow of capital—which has only accelerated recently in anticipation of further appreciation. Yet the central bank recently allegedly engineered a drop in the currency, causing uncertainty on the part

of currency traders. This action means that the currency could go in either direction—just as the government probably hopes.

Specifically, the move allows the currency to move up or down by as much as 2 percent against a basket of currencies. If the renminbi hits that limit, the government will intervene to prevent further movement. Yet it is a rare day when a floating currency moves that much. As such, the move effectively makes the Chinese currency a floating currency, except during periods of unusual stress. The US government, long a critic of Chinese currency policy, welcomed this action. However, investors now face a more uncertain environment, especially as there is now risk of depreciation. It is interesting that, while the action is meant to remove the government from currency valuation, the fact that the government may have pushed the currency down means that it effectively remains a player. The current downward pressure on the renminbi may no longer involve the government directly. Rather, it may simply reflect market fears of further intervention by the government. More will need to be done in order to create a more truly liberal financial system. The government will have to ease capital controls, free deposit interest rates, and become more transparent about monetary policy.

Endnotes

1. Reuters, "Instant view: China aims for 7.5 percent economic growth in 2014," March 4, 2014, http://www.reuters.com/article/2014/03/05/us-china-parliament-instantview-idUSBREA2404D20140305.
2. Reuters, "WRAPUP 1-China says plans to speed up investment, stabilise demand," March 20, 2014, http://www.reuters.com/article/2014/03/20/china-economy-idUSL3N0MH1CS20140320.
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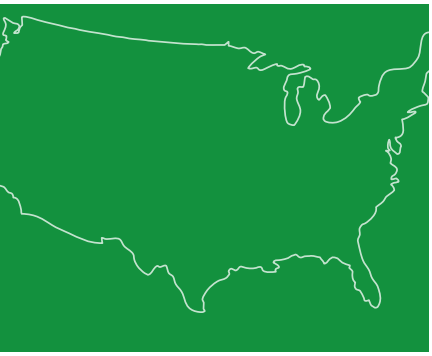
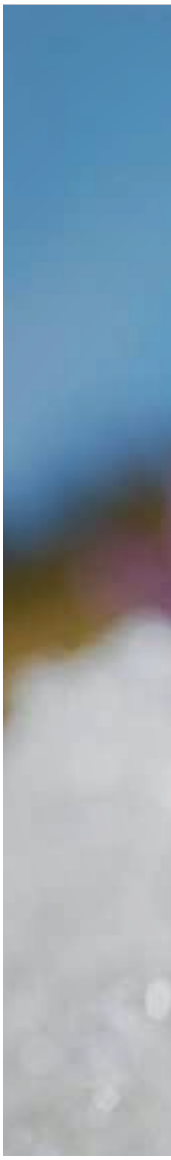
4. Sophie Song, "China banking reform: 10 private companies including Alibaba and Tencent allowed to set up private banks," *International Business Times*, March 11, 2014, http://www.ibtimes.com/china-banking-reform-10-private-companies-including-alibaba-tencent-allowed-set-private-banks.



United States

Spring thaw should give way to a summer surge

By Dr. Patricia Buckley



With fiscal fights put on hold for a year, the US economy finally has the breathing room it needs to get firmly back on its feet.

SINCE the recession officially ended in mid-2009, the US economy has experienced only moderate growth. The reasons for this are many, including the causes, depth, and duration of the downturn followed by repeated confrontations between the Administration and the Congress that shook business and consumer confidence. However, with more people getting back to work and the excess housing inventories gradually coming down, the United States should see a resurgence of its usual drivers of growth: personal consumption and investment. In addition, the US economy could see an additional bump in growth from an unusual quarter—its international trade position.

A slowly normalizing economy

Figure 1 illustrates a US economy making slow but steady progress toward normalizing. Although relatively consistent, personal consumption has made less of a contribution to GDP growth in the four calendar years since the end of the last recession than was typical during the last expansion: an average of 1.5 percentage points during 2010–2013 as compared to an average of 2.0 percentage points during 2002–2007. This is consistent with the relatively slow pace of job creation over the period. Only now, as we approach the fifth anniversary of the end of the recession, are employment levels approaching their prerecession peaks. Given a growing population, this translates into more people remaining unemployed or dropping out of the workforce altogether—factors that would cause a drag on the growth in personal consumption expenditures.

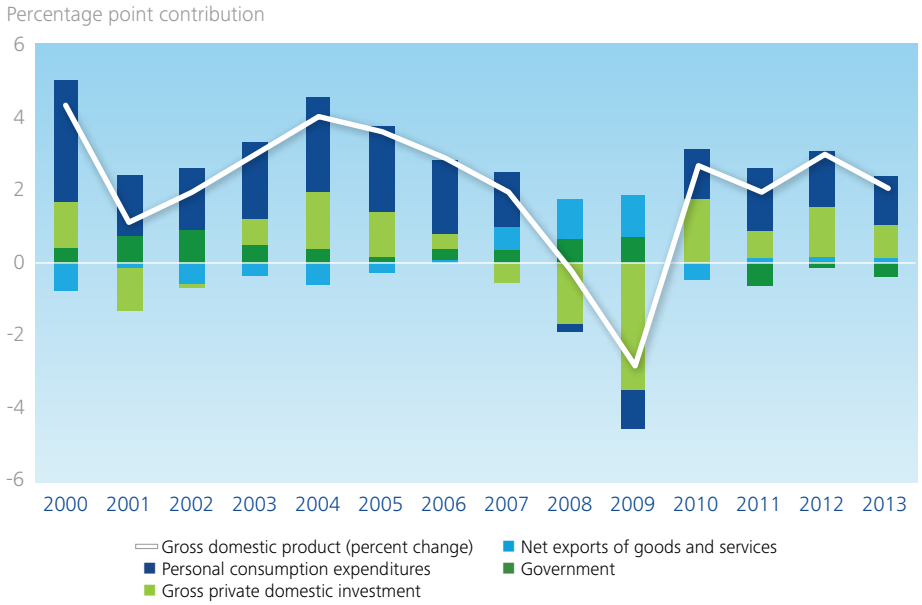
Investment was one of the categories hit hardest by the recession. In 2009, it subtracted 3.5 percentage points from GDP growth. The three primary categories of gross private domestic investment are two categories of fixed investment, residential and business, and changes in inventories. The downturn hit the residential market first and hardest (see figure 2) as the housing bubble burst under the weight of inflated housing prices supported by subprime mortgages and negative to no equity positions on the part of too many borrowers. Because of the time it has taken to work off of the excess inventory bloated by foreclosed properties, it has only been in the last two years that we have seen investment pick up in this sector. After a severe contraction in 2009, business investment has also been slow to recover. Through 2013, businesses

have held back on scaling up investment in buildings, equipment, and intellectual property even though many have very strong cash positions because of uncertainty about future demand. Private inventories relative to sales have returned to the low levels of the mid-2000s.

With housing imbalances greatly lessened and individual and business balance sheets in better shape, we should see the reemergence of a stronger "virtuous cycle" of more jobs, more spending, more investment, leading to still more jobs…and so on.

Although neutral in 2010, reductions in government spending have been a drag on economic growth over the last three years (see figure 1) as deficit reduction moved ahead of economic stimulus as the political priority. However, there is little doubt that government actions and inactions including fiscal cliffs, debt ceiling standoffs, and government shutdowns (threatened and actual) have had additional negative impact on personal consumption and investment by shaking confidence.

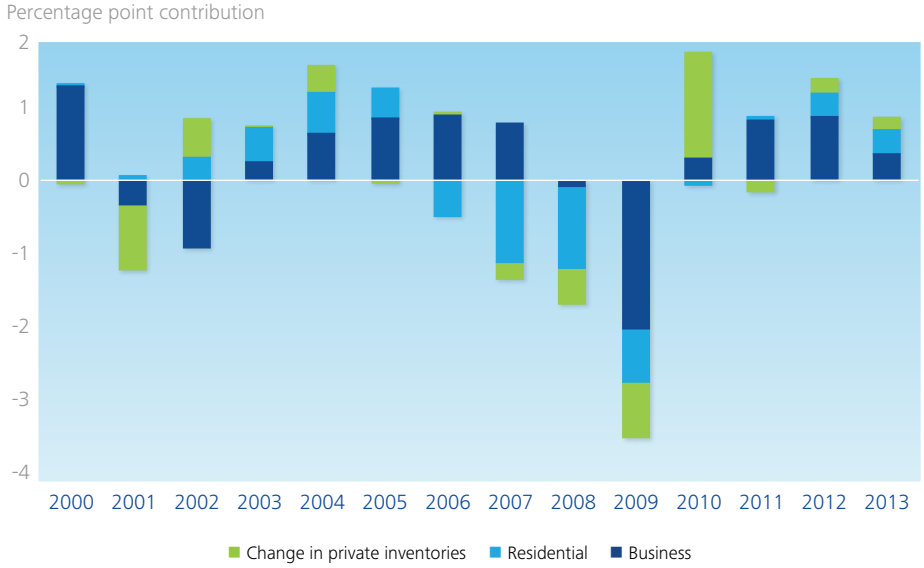
Figure 1. Decomposition of US GDP



Source: Bureau of Economic Analysis, US Department of Commerce.

Graphic: Deloitte University Press | DUPress.com

Figure 2. Contributions to GDP from investment



Source: Bureau of Economic Analysis, US Department of Commerce.

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US trade: A new era?

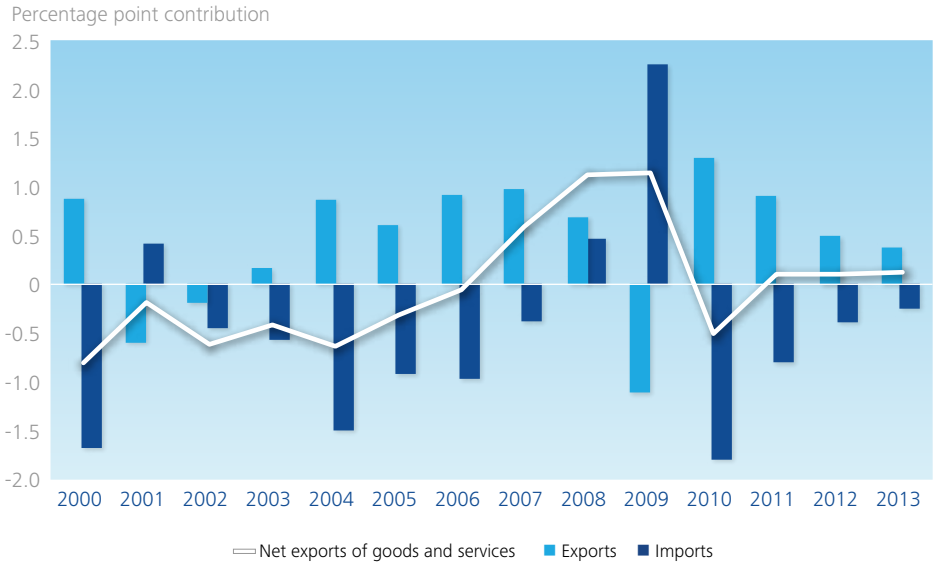
For most of the past 20 years, imports have subtracted more from GDP than exports have added. While exports and imports both tend to contract during recessions, the size of the contraction was particularly large in the last recession, with imports falling sooner and more quickly than exports as the United States' growth began to slow before most of our major trading partners (see figure 3).

Since the conclusion of the recession, a new pattern appears to be emerging. Over the last three years, exports have grown faster than imports in real terms—sufficiently faster for exports to add more to GDP than imports subtract, even with the dollar amount of exports being smaller (exports are approximately 80 percent as large as imports). This resulted in trade being a net positive for the US economy in this most recent period.

However, figure 3 also shows that the growth of both imports and exports has slowed in recent years. So the question is "will US export growth continue to surpass US import growth in coming years if growth of both picks up?" There are some reasons to think the answer to this question may be yes.

A slowing of imports is often a sign of slowing overall growth. After all, the imports get distributed throughout the economy as personal consumption, business investment, inventories, and even combined with other inputs and sent back out of the country as exports. The major categories of imports are shown in figure 4 and each of these categories, in general, has grown more slowly during recent years than they did during the prior expansion. As growth in personal consumption and investment pick up, it would be expected that imports in categories such as capital equipment, consumer goods, and industrial supplies also rise—with one important exception: petroleum and other energy imports.

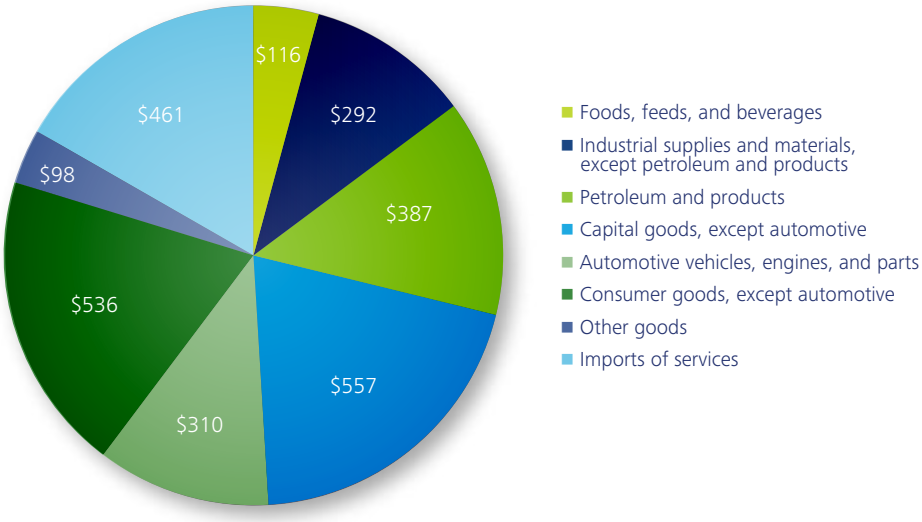
Figure 3. Contribution of trade to growth



Source: Bureau of Economic Analysis, US Department of Commerce.

Graphic: Deloitte University Press | DUPress.com

Figure 4. Imports by type, 2013 (in billions)



Source: Bureau of Economic Analysis, US Department of Commerce.
Graphic: Deloitte University Press | DUPress.com

As shown in figure 5, the decline in petroleum imports has been an offsetting factor to growth in other types of imports in the last three years. In 2013, the decline in petroleum imports kept the growth of imports 80 percent lower than it otherwise would have been. This decline reflects the substantial increase the United States has experienced in domestic production. According to the Energy Information Agency (EIA) of the US Department of Energy, "the share of total US liquid fuels consumption met by net imports peaked at more than 60 percent in 2005 and fell to an average of 33 percent in 2013. EIA expects the net import share to decline to 25 percent in 2015, which would be the lowest level since 1971."[1]

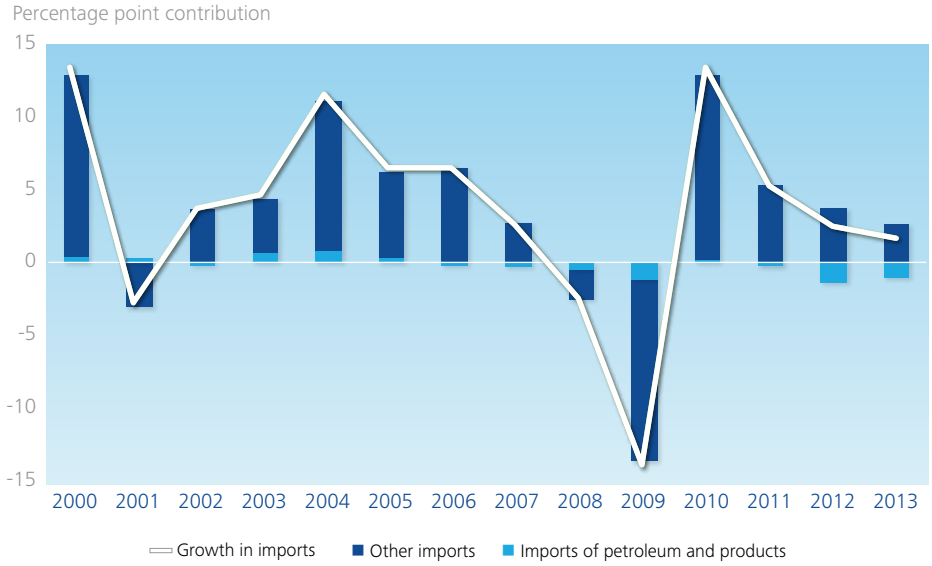
EIA further notes that liquefied natural gas (LNG) imports, a component of industrial supplies not broken out separately in figure 4, have also declined over the past several years as growing domestic production has displaced some pipeline imports from Canada.[2]

Growing energy production is also improving the US export position. LNG pipeline exports to Mexico have been increasing. Over the longer term, EIA's Annual Energy Outlook 2014 projects the United States will be a net exporter of natural gas beginning in 2018.[3] Coal is also an important US energy export, and it has hovered at near-record levels over the last four years.[4]

However, beyond energy being a trade bright spot going forward, the United States should expect stronger export growth as its trading partners' strength improves. For example, the European Union (EU) is the United States' largest export market, accounting for over 20 percent of total US exports. Between 2011 and 2013, the European Union as a whole had slipped back into recession, with negative to very low rates of growth. As a result, US exports to the European Union underperformed the US world average. With the return of stronger growth to the European Union, and other trading partners, the United States should expect a concurrent rise in exports.

Table 1 shows another interesting feature of the post-recession world: the growing importance of trade in services. Although smaller in size, trade in services is growing more rapidly and appears to be more resilient in the face as economic downturns, as illustrated by the comparatively stronger growth in US services exports to the European Union. Over the last three years, services exports have accounted for just over 30 percent of total export growth on average.

Figure 5. Petroleum's contribution to import growth



Source: Bureau of Economic Analysis, US Department of Commerce.

Graphic: Deloitte University Press | DUPress.com

Table 1. US exports to the EU

	2011	2012	2013	2012	2013
	Billions of US $			Annual percent change	
European Union (28) GDP growth rate				-0.4%	0.1%
Exports of goods and services to the EU	469	470	476	0.2%	1.2%
Goods	273	269	266	-1.3%	-1.5%
Services	196	200	210	2.2%	4.9%
Total US exports					
Goods and services	2,113	2,211	2,271	4.6%	2.8%
Goods	1,496	1,561	1,590	4.4%	1.8%
Services	617	649	682	5.2%	5.0%

Source: Eurostat and the Bureau of Economic Analysis, US Department of Commerce.

With the Fed continuing its accommodative stance, the improvements in fundamentals of the US economy, aided by a stronger trade position, has the United States positioned for stronger growth going forward.

The evolving Fed stance

As prospects for US growth continue to improve, the challenge for the new Federal Reserve Board Chair, Janet Yellen, will be how to continue to transition the Fed to a more traditional stance—by tapering asset purchases and eventually moving interest rates to more normal levels—without causing the economy to revert to a slow growth path.

The Federal Open Market Committee (FOMC) noted in its March statement that, "growth in economic activity slowed during the winter months, in part reflecting adverse weather conditions." However, the economy remains on track for moderate growth, and the labor market continues to improve.[5] Reflecting this view, the FOMC decided to continue to taper its program of asset purchases another $10 billion to $55 billion per month ($25 billion per month in mortgage-backed securities and $30 billion per month in longer-term Treasury securities). This will be the third reduction in this round of the Fed's program of quantitative easing. If conditions remain favorable, the FOMC will continue to taper, with the end of the purchases expected in late 2014. The question then turns to when the Fed will begin to move interest rates higher.

In prior discussions, the FOMC pointed to an unemployment rate of 6.5 percent as a possible signal that the economy was strong enough for rates to move above the 0–0.25 percent target for the federal funds rate. Chairman Bernanke was clear that this unemployment rate was not a trigger that would cause the Fed to act. With unemployment nearing the 6.5 percent mark, in March, the FOMC (as expected) moved further away from the unemployment rate as a primary focus, stating that they would "take into account a wide range of information, including measures of labor market conditions, indicators of inflation pressures and inflation expectations, and readings on financial developments."[6] The FOMC further stated that they fully expect the current target range to stay in place for a "considerable time" after the asset purchase program ends.

With the Fed continuing its accommodative stance, the improvements in fundamentals of the US economy, aided by a stronger trade position, has the United States positioned for stronger growth going forward. And with the Congress and Administration having already agreed to overall spending levels for the fiscal year that begins on October 1, 2014 and suspending the debt ceiling until March 2015, it is unlikely that there will be a major fiscal bump in the road to constrain progress.

Endnotes

1. US Department of Energy, Energy Information Agency, "Short-term energy outlook," p. 6, March 11, 2014, http://www.eia.gov/forecasts/steo/pdf/steo_full.pdf.
2. Ibid, p. 7.
3. Ibid.
4. Ibid, p. 8.
5. Board of Governors of the Federal Reserve System, press release, March 19, 2014, http://www.federalreserve.gov/newsevents/press/monetary/20140319a.htm.
6. Ibid.

Japan

Obstacles to recovery

By Dr. Ira Kalish

A weak fourth quarter

The Japanese government's latest estimate is that the economy grew at an annual rate of only 0.7 percent in the fourth quarter, a very weak reading. The earlier estimate was growth of 0.9 percent. Weak export growth meant that Japan had its largest current account deficit on record. Business capital spending was also weaker in the fourth quarter than previously estimated. The uncertainty about the potential impact of the upcoming tax increase is likely hurting business willingness to take risks. Many analysts expect a strong first quarter of 2014 in anticipation of the April 1 tax increase. This is expected to be followed by a sharp decline in GDP in the second quarter.

First-quarter hopes

As for the first quarter, there is a mix of data so far. Japan's exports were up 9.8 percent in February versus a year earlier, which was weaker than market expectations. In part, the weakness may have reflected weak demand in the United States during a period of very bad weather. Still, investors were concerned that exports are not doing better. There had been hope that a robust export sector might play a role in offsetting the negative impact of the April tax increase. After taking inflation into account, the volume of exports was up only 5.4 percent. It had been hoped that the sharp drop in the value of the Japanese yen would have helped to boost export growth. However, a weaker currency only helps if exporters reduce their prices. Evidently this is not happening to the degree expected. In addition, the government reports that imports were up 9.0 percent, more than anticipated. A weaker yen does cause an increase in import prices, which could have a negative impact on consumer spending. On the other hand, a weaker yen helps to boost inflation, one of the government's goals.

Many analysts expect a strong first quarter of 2014 in anticipation of the April 1 tax increase. This is expected to be followed by a sharp decline in GDP in the second quarter.

As for Japan's critical manufacturing sector, the purchasing manager's index for the first two months of 2014 was strong, suggesting that the sector continues to grow at a robust pace. The government reported that industrial production increased 4.0 percent from December to January, the biggest one-month increase in three years and a good deal faster than most analysts expected. There were other favorable indicators. The government reported that household spending increased 1.1 percent from December to January.

Retail sales increased 4.4 percent in January versus a year earlier, the fastest January increase since 1980. It is widely expected that, because of the tax increase in April, economic activity will ultimately plummet in the second quarter after surging in the first. The data suggest that GDP may have increased rapidly in the first quarter, despite the slowdown in export growth. The main uncertainty is how much of a decline will take place in the second quarter, and how much the government can do to limit the damage.

On the other hand, one worrisome sign is that the purchasing manager's index for the nonmanufacturing services sector fell into negative territory in February, indicating that the broad services sector may have stopped growing altogether.

Confidence in inflation

Meanwhile, Bank of Japan (BOJ) Governor Haruhiko Kuroda said that he remains confident that Japan is moving in the direction of 2.0 percent inflation.[1] Indeed, the government reported that consumer prices excluding volatile food prices were up 1.3 percent in January versus a year earlier. While below the BOJ target of 2.0 percent, this rise is clear progress from the deflation that existed just a year ago. Kuroda also expressed confidence that, following a brief disruption from the tax increase in April, the economy will continue to grow at a strong pace. However, he noted that the BOJ will adjust policy if necessary.[2] Many analysts are more worried about the tax increase than Kuroda appears to be. Indeed, there had been speculation as to whether the BOJ would take more aggressive actions, yet in March the BOJ announced that it will continue its program of asset purchases at a constant pace, leading to a rise in the value of the yen. A survey found that 73 percent of economists believe that the BOJ will indeed boost the pace of asset purchases later this year. Kuroda said, "We will adjust policy without hesitation if achieving 2 percent inflation becomes problematic or if smooth progress isn't made toward the goal." He also indicated that he is not concerned about the

slow pace of export growth, saying that this was due to temporary factors.[3]

What next?

What can be expected of the Japanese economy in the wake of the large tax increase that went into effect on April 1? The second quarter is expected to involve a sharp drop in GDP—that is a given. The real question concerns what follows: Will the economy bounce back? Will fiscal and monetary policy be sufficient for Japan to avoid another recession?

It is too early to answer these questions with any certainty, but there are a number of factors that will play a role in determining growth for the remainder of the year.

First, a rise in wages would help. So far, wages have stagnated even as prices have risen. This concerns the government. It means that the real purchasing power of wages is declining, which bodes ill for consumer spending. It could be that businesses have held back on wage increases prior to the tax increase. If wages are boosted in the coming year, it would go a long way toward reviving consumer spending.

Second, the rest of the world matters. If the European, American, and Chinese economies do well, it will boost Japanese export growth. Although Japan is attempting to move away from export dependence, trade remains a critical element in success.

Third, much will depend on the policy reaction to the tax increase. If the BOJ becomes more aggressive in response to faltering spending, it would be helpful.

Finally, much will depend on the attitude of business. And that, in turn, could depend on the government's commitment to implementing the third arrow of Abenomics: deregulation. If the government announces significant regulatory reforms by the summer, it could have a big positive impact on business investment.

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Endnotes

1. Stanley White, "BOJ's Kuroda: High chance BOJ to meet its inflation target," Reuters, March 20, 2014, http://www.reuters.com/article/2014/03/20/us-japan-economy-boj-kuroda-idUSBREA2J0CC20140320.
2. Leika Kihara, "BOJ Kuroda repeats vow to adjust policy when needed," Reuters, April 16, 2014, http://www.reuters.com/article/2014/04/17/japan-economy-boj-idUST9N0N603Z20140417.
3. Ibid.

India

Sailing through challenges, India awaits election outcomes for a respite

By Dr. Rumki Majumdar

WITH each quarterly economic outlook, India seems to be struggling with a new set of economic challenges. But while a few challenges are sporadic and some of them are completely new, certain challenges are persistent and recurring. Regardless of their traits, these challenges have heavily weighed on growth in the last few quarters as is evident from recent revisions of the growth numbers for FY 2012–2013 and the latest GDP growth in Q3 of FY 2013–2014. That said, economic data suggests that the worst is probably over, and economic growth may have bottomed out. Economic growth will likely improve in the coming quarters, but the pace of growth may remain gradual because of persistent challenges. The growth outlook will also hinge on the national election outcomes in May 2014.

Economic growth will likely improve in the coming quarters, but the pace of growth may remain gradual because of persistent challenges.

Sporadic challenges

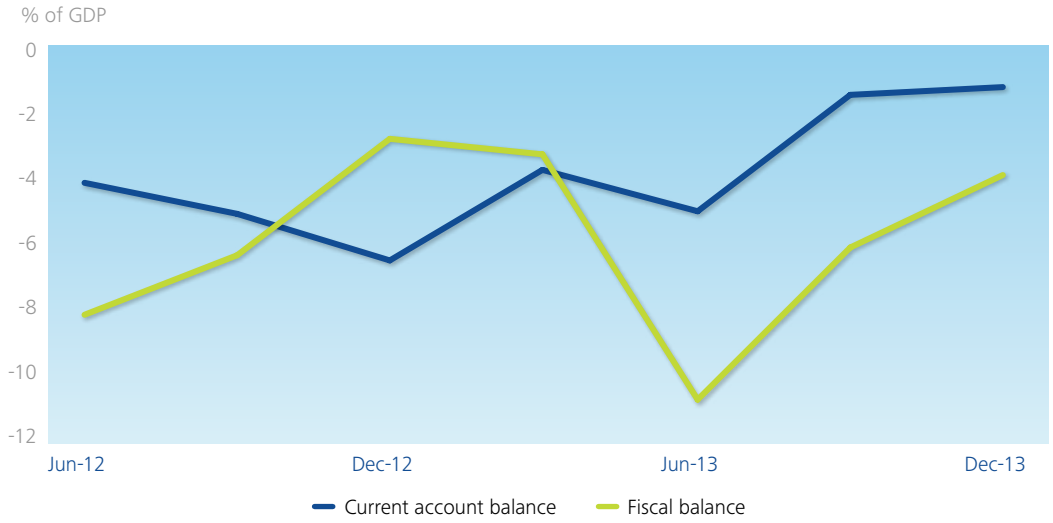
A year ago, India was mired in problems of external and internal account imbalances. The country's current account indicated a record-breaking deficit in FY 2012–2013 of 4.8 percent of GDP because of high crude oil and gold imports in addition to falling exports. At the same time, the government registered a fiscal deficit of 4.9 percent of GDP in FY 2012–2013. The fiscal account deficit worsened to 8.5 percent of GDP[1] in H1 of FY 2013–2014 due to increased government expenses and less-than-expected tax revenues.

Last summer, India faced an additional challenge of reversal of capital inflows after the US Federal Reserve's hint of tapering its monetary policy. This was aggravated by speculations by institutional investors whose confidence in the economy was low due to poor fundamentals. The sudden capital outflows resulted in a sharp depreciation in India's currency, sending it down by 24 percent in a span of four months from April to August 2013. The Reserve Bank of India (RBI) had to step in to contain the exchange rate volatility and the current account deficit. Prompt monetary measures along with tighter credit conditions helped stabilize currency.

By the end of 2013, significant corrections were made to the fiscal and the current account imbalances as seen in figure 1. The fiscal deficit was contained to 3.8 percent of GDP in Q3 of 2013–2014, though the government has already exhausted 95.2 percent of the budget estimate of fiscal deficit for FY 2013–2014. Current account deficit also improved to less than a percent, helped by improving trade account. Slowdown in imports, particularly gold, and improvements in global trade helped India's trade deficit to contract continually since May 2013. The volatility in currency and capital flows also stabilized as investors' perceived risks about the implications of the US monetary policy tapering started diminishing (see figure 2). While the downside risks are still high, these challenges are no longer the biggest concerns now.

Political uncertainty is the latest concern as India elects its government at the center in May 2014. The assembly election results in five states of India in December 2013 affirmed the widely felt dissatisfaction with the current ruling government. The involvement of several

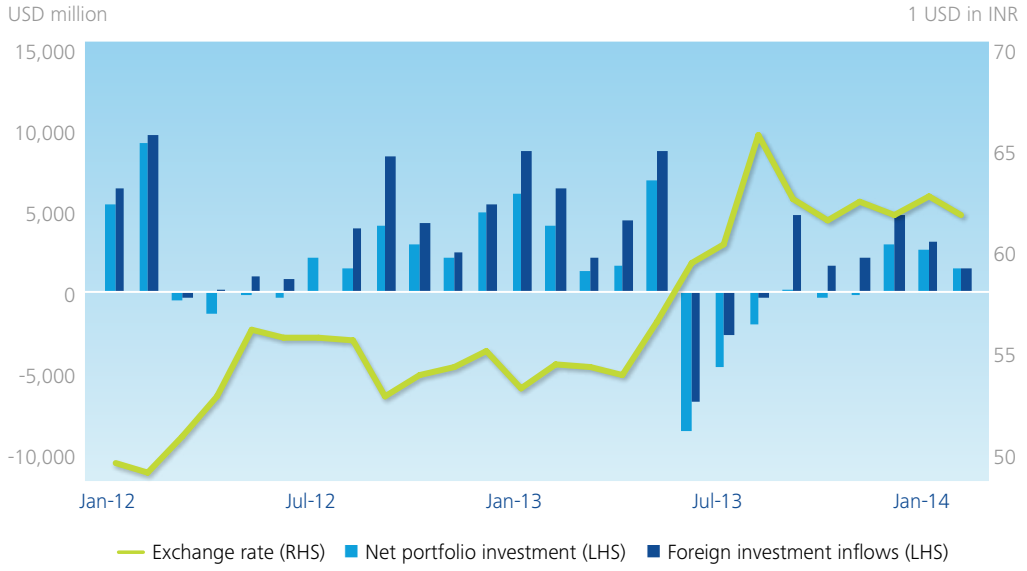
Figure 1. Correction in twin deficit



Source: "Public debt management," quarterly report October–December 2013, Ministry of Finance, February 2014; Ministry of Statistics and Programme implementation, Press Information Bureau, government of India, February 2014; Reserve Bank of India bulletin, April 2014; Deloitte Services LP economic analysis.

Graphic: Deloitte University Press | DUPress.com

Figure 2. Currency and capital flows stabilize



Source: Database on Indian economy, Reserve Bank of India, January 2014; Reserve Bank of India bulletin, April 2014; Ministry of Statistics and Programme Implementation, Press Information Bureau, government of India, February 2014; Deloitte Services LP economic analysis.

Graphic: Deloitte University Press | DUPress.com

senior government officials in multiple corruption scandals, lack of clear leadership, and poor policy initiatives to boost growth have tarnished the image of the ruling party. In addition, the stunning entry of the Aam Aadmi Party (the "Common Man Party," or AAP) in the Delhi state assembly elections in December 2013 marked a shift in the political arena. The rising significance of regional parties suggests a rising demand for accountability from the government in a manner that was not so pervasive earlier. However, at the same time, the presence of regional parties makes it very difficult to predict the election outcomes, adding to uncertainty.

The persistent challenges

Some challenges have been more persistent in nature. One such recurring challenge has been high and rising inflation, which has afflicted India for more than half a decade. Barring a few months, the consumer price inflation remained in double digits for the whole of calendar year 2013 (see figure 3).

Policy uncertainties have been another challenge in the economy. The government's efforts to undertake meaningful reforms have been followed by disappointing implementation. In the past, reforms have been repeatedly watered down, which continues to frustrate business fraternity and impact investor sentiments. However, the biggest challenges of all are the structural bottlenecks like poor infrastructure, complicated tax structures, and poor investment environment that underlie all the problems stated above.

The government has taken several initiatives to tackle structural deficiencies. About 50,000 MW of thermal and hydel power capacity are under construction after receiving clearances and approvals. Several nuclear power plant projects are under construction, and a few are already generating power. FDI policies in telecommunication, pharmaceuticals, civil aviation, power trading exchange, and multi-brand retail have been liberalized to attract large investments. However, the initiatives are not enough for India's growing market, and the pace of improvement is very poor.

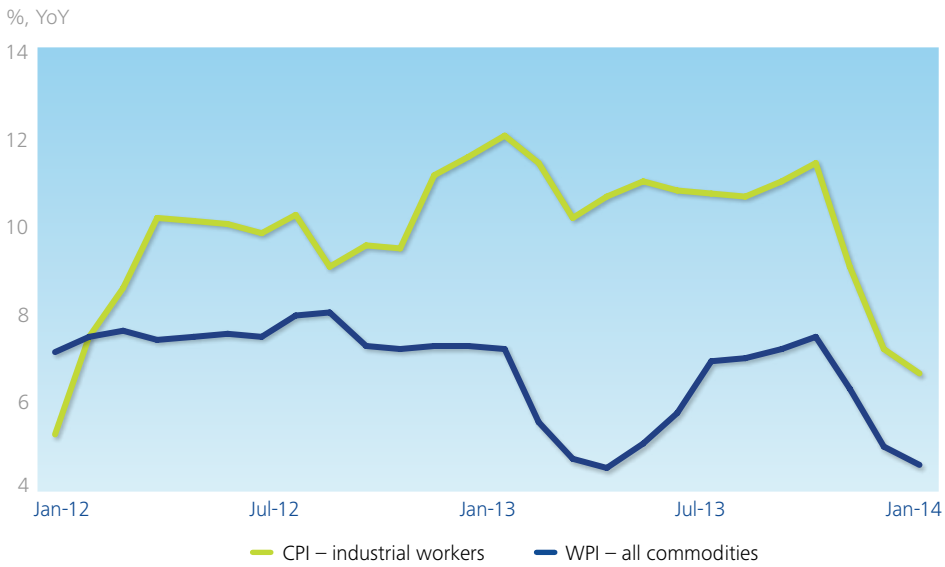
Previous editions of the *Global Economic Outlook* have addressed structural deficiencies; this article will focus on the RBI's fight to contain inflation and its justification for its policy actions.

Fighting inflation

Tackling inflation has become a test for the RBI as it fights to reduce the demand-supply gap and check pressure on prices by impacting the demand side. Recent data points to a rise in the aggregate demand from certain quarters as indicated by the pickup in capacity utilization, decline in inventories retention to sales, increase in order books, and rise in prices of intermediates in conjunction with rise in bank credit. Rise in core prices and services are indicative of wage pressures.

The RBI has made it a priority to check rising prices and anchor inflation expectations among its monetary policy objectives, and it is determined to bring it down slowly and steadily. It raised its key policy rate by 25 basis points to 8 percent for the third time in five months. The tightening of monetary policy in January 2014 surprised the investors and the industrialists, who have been demanding a rate cut. However, the raise in policy rates is in line with the recommendations of an expert committee, the Patel Committee, set up by the RBI governor to adopt consumer price inflation as the nominal anchor

Figure 3. Inflation is a persistent challenge



Source: Office of the economic advisor, March 2014; Labor Bureau of India, April 2014; Deloitte Services LP economic analysis.
Graphic: Deloitte University Press | DUPress.com

The RBI has assured that once inflation is low, it will start cutting interest rates to generate a sustained increase in demand and thus, growth.

for monetary policy framework with a target of 4 percent and a range of 2 percent around it in the long term.

Tackling inflation at the expense of growth?

The RBI recognizes that the economic growth is currently weak, but lowering interest rates is not a feasible option when inflation in the economy is in double digits. Any reduction in interest rates will generate more demand for goods and raise their prices. Elevated prices will, thereby, increase the risks of currency depreciation, erode household budgets, and constrict the purchasing power of consumers. This, in turn, will discourage investments and will result in falling consumption. In other words, under a high-inflation scenario, reducing interest rates will boost demand, but only for a short period. In the long run, prices will spiral up and impact growth sustainability. Besides, high inflation taxes the poor more than the rich, so it will increase income inequality.

The RBI's move to keep interest rates high is justifiable. Tighter monetary conditions will discourage investment, and consumers will postpone consumption and save more. A lower domestic demand, in turn, will help contain inflation as the supply-demand gap reduces. Once prices start descending, people will expect inflation to stay low and raise their consumption demand.

Slow and steady rate hikes

So far, the key policy rates have been hiked by only 25 basis points in three of the four policy meetings since September. Given that inflation is largely a structural problem and an outcome of supply shortages, the impact of this rate hike on prices will likely be slow. The RBI has made it clear that it prefers to influence inflation slowly over time rather than abruptly. This is because any sharp rise in interest rates may reduce inflation drastically, but it will likely impact demand adversely, causing significant damage to the economic growth.

Tightening credit has slowly started impacting inflation, as evident from the fall in both consumer and wholesale prices in recent months. The RBI has assured that once inflation is low, it will start cutting interest rates to generate a sustained increase in demand and thus, growth. However, the RBI has also assured that it is prepared to do what is necessary if the economy

deviates from the projected inflation path or if there is any threat to financial stability.

Impact of challenges on growth

The challenges noted above, regardless of their traits—sporadic or persistent, domestic or external—had a significant impact on both the demand and production, bringing down growth, as evident from the recent releases. The economy grew at 4.7 percent year over year[2] in Q3 of FY 2013–2014. The average growth in the first three quarters of FY 2013–2014 has been 4.6 percent.[3] Weaker-than-expected growth in the third quarter implies that it will be a challenge to meet the government's estimated annual growth rate of 4.9 percent.[4]

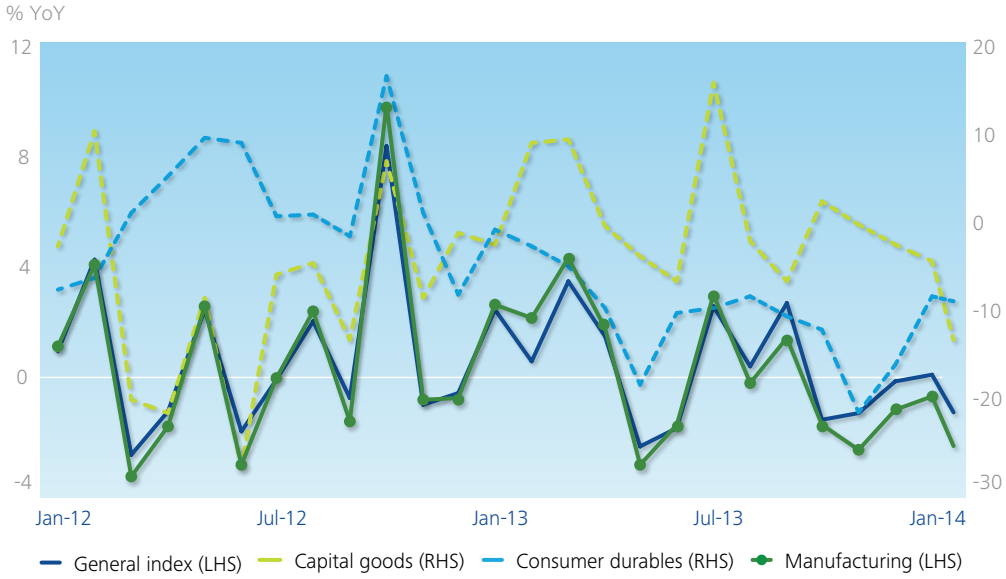
Growth in the services industries improved in Q3 of FY 2013–2014, but growth in the agriculture, manufacturing, and construction sectors slowed significantly, weighing down the overall economic growth. The fall in growth in the manufacturing and the construction sectors was probably a combined effect of low business confidence, poor investment growth, slowing domestic demand, and tightening monetary policies by the Reserve Bank of India (RBI).

Industrial production (IIP) growth indicators point to weak fundamentals in the industrial sector. Production in the manufacturing sector contracted for the fifth consecutive month. Growth in the capital goods and consumer goods industries declined as well, while growth in the production of consumer durable goods remained highly negative (see figure 4). This has been the fifteenth consecutive month of negative growth in the consumer durable goods industry, which shows a sustained decline in domestic consumption demand.

The growth in private consumption expenditure was a mere 2.5 percent, which further substantiates the fact that consumers are postponing their consumption decisions due to high economic uncertainties and tighter credit conditions. Growth in investment also turned negative due to negative business sentiment as consumers decide to postpone their investment decisions.

The annual real GDP growth estimates for FY 2012–2013 were revised down from 5 percent to 4.5 percent, which is the slowest annual growth in a decade, due to lower-than-expected growth

Figure 4. Declining industrial production numbers



Source: Ministry of Statistics and Programme Implementation, Press Information Bureau, government of India, April 2014; Deloitte Services LP economic analysis.

Graphic: Deloitte University Press | DUPress.com

in the primary and secondary sectors (see figure 1). Growth in the secondary sector (which constitutes manufacturing, electricity, gas and water supply, and construction) was reduced to half its earlier estimate due to poor performance in all its subsectors. On the demand side, growth in consumption demand has been revised up marginally for a few quarters. However, downward revisions to growth in investment spending were substantial.

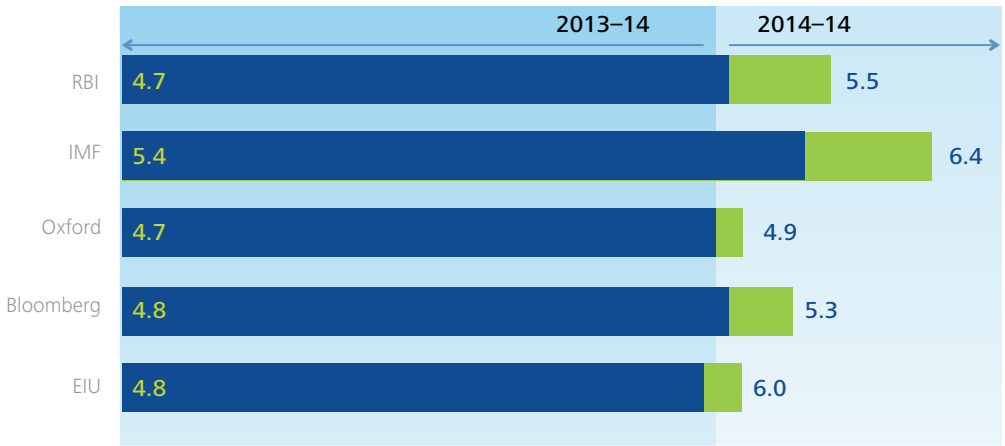
Election outcome critical to growth outlook

The downward revision of earlier growth estimates and weaker growth in the latest quarter indicate that the economy has been on a path of a sustained slowdown. While the underlying economic growth trends are weak, the downside risks to the economy have reduced substantially compared with 2013. The consensus forecast shown in figure 5 indicates that the worst is probably over and economic growth may have bottomed out. Economic growth will likely improve in the coming quarters, but the pace of growth may remain gradual because of the persistent challenges.

That said, the growth outlook for the economy will primarily hinge on the election outcomes. A better government with a clear mandate will likely boost business and investors' confidence. Since 1984, there have been eight national elections, of which, five elections were followed by a stable government. As shown in figure 6, growth gained momentum after these five elections. In the quarters prior to elections, both average economic growth and average IIP fell due to political uncertainties. However, in the quarters after the elections, both IIP and growth picked up momentum. The impact of a stable

Growth will likely improve in the second half of FY 2014–2015 once there is more political and policy certainty.

Figure 5. Consensus forecast of India GDP growth



Source: World Economic Outlook, IMF, Table 1, April 2014; Survey of Professional forecaster, RBI, April 2014, Global Data Services, Oxford Economics, April 2014, Bloomberg Finance LP, March 2014, Economic Intelligence Unit, April 2014; Deloitte Services LP economic analysis.

Graphic: Deloitte University Press | DUPress.com

government on business sentiment was more prominent as evident from the immediate rise in the IIP numbers after elections; growth, however, followed the trend with a lag.

Growth will likely improve in the second half of FY 2014–2015 once there is more political and policy certainty. Coordinated, defined monetary and fiscal policies will likely mitigate risks as the economy continues on its path to gradual growth. However, rapid reforms and substantial improvements in structural bottlenecks will likely remain a low possibility even after elections.

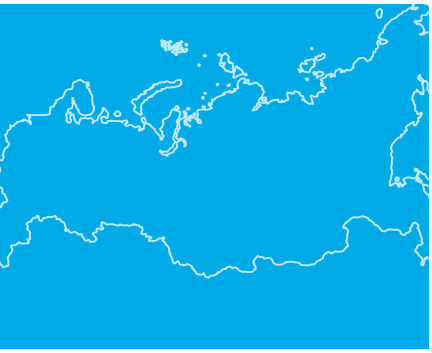
Figure 6. Average growth in quarters prior to general elections, 1984–2009

Source: Ministry of Statistics and Programme implementation, Press information bureau, government of India, March 2014; Ministry of Statistics and Programme implementation, Press information bureau, government of India, February 2014; Deloitte Services LP economic analysis.

Graphic: Deloitte University Press | DUPress.com

Endnotes

1. Fiscal deficit as a share of GDP is calculated from fiscal deficit figures by Ministry of Finance and GDP figures by Press Information Bureau, government of India. The ratio is tentative and will be revised along with revisions in GDP estimates.
2. Growth mentioned in the article refers to year-over-year growth, unless otherwise specified.
3. The growth numbers for Q1 and Q2 of FY 2013–14 have not yet been revised as per the revision policy.
4. "Key features of budget 2014–15," http://indiabudget.nic.in/ub2014-15/bh/bh1.pdf.



Russia

Marching backward

By Akrur Barua

RUSSIA'S intervention in Crimea has dominated airwaves in the past few weeks. It has raised tensions in Europe and forced geopolitical risks back to the center stage of the global economy. For Russia's economy, the move could not have come at a worse time. Economic growth declined for the third straight year in 2013 and was also much lower than President Putin's 5 percent target set in 2010. The scenario looks bleak this year as well, especially due to the Crimean venture. Equities are down, the ruble is much weaker, interest rates are up, and inflation is still high. In fact, things could get worse if sanctions are imposed by the West. While growth will be a casualty in that case, of greater worry is a possible isolation of Russia in the global economic order.

Growth disappoints yet again

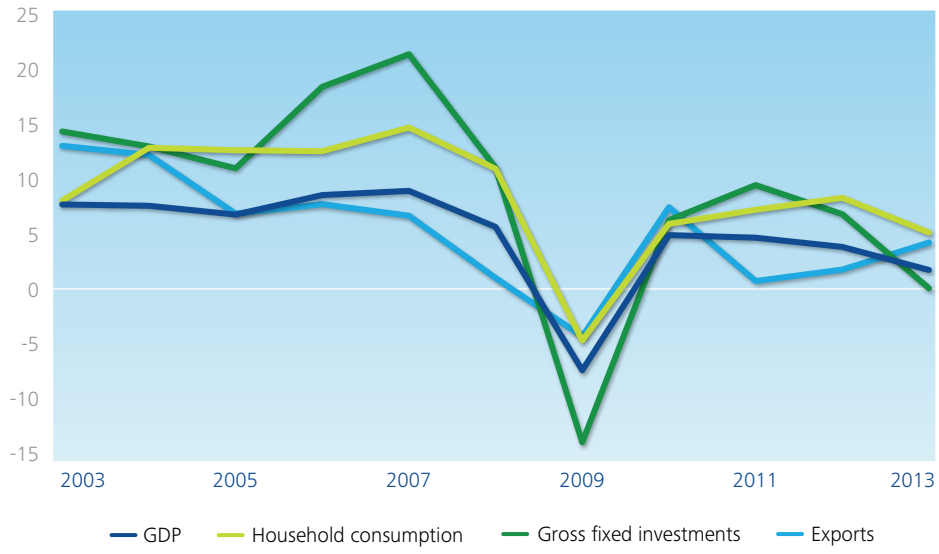
In Q4 2013, Russia's economy grew only 1.2 percent year over year, pulling down annual GDP growth for 2013 to just 1.3 percent from 3.4 percent in 2013. A subdued commodities sector was one of the key contributors to slowing growth in 2013. For example, the price of Urals crude dipped by 2.2 percent in 2013 compared to a 1.1 percent rise in 2012. During the same period, commodity exports growth (in dollar terms) fell to –0.9 percent from 2.4 percent.

Slowing investments have not helped the economy either; gross

Economic growth declined for the third straight year in 2013 and was also much lower than President Putin's 5 percent target set in 2010.

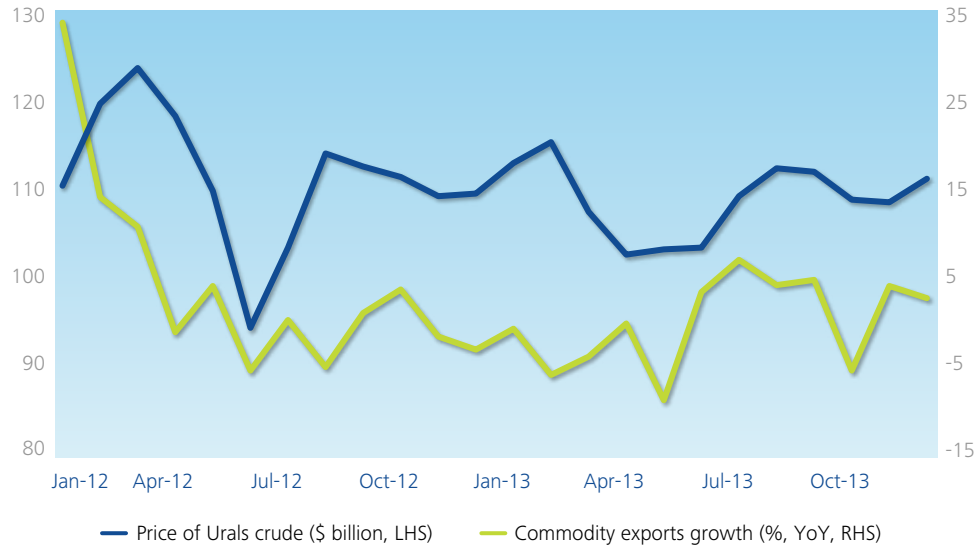
fixed investments fell last year after a strong rise of 6.4 percent in 2012. Investments suffered due to lower spending close to the Sochi Olympics, reduced investment by state-owned companies (SOEs), poor company profits, and lower foreign direct investment (FDI). Most worryingly, household spending—a key growth driver in recent years—expanded by just 4.7 percent in 2013, down from 7.9 percent in 2012. Households seem worried by high inflation, rising debt, tight monetary policy, and slowing economic growth.

Figure 1. Real GDP growth and key components (%)



Source: Federal State Statistics Service (Russian Federation), March 2014.
Graphic: Deloitte University Press | DUPress.com

Figure 2. Price of Urals crude and commodity exports growth



Source: Bank of Russia, March 2014.
Graphic: Deloitte University Press | DUPress.com

Prospects not bright for consumers

High inflation is a major factor weighing on consumer spending. Annual inflation in 2013 was 6.8 percent, up from 5.1 percent in 2012 and way above RCB's 4 percent target. High price pressures have dented real wage gains despite a rise in nominal wages due to a relatively tight labor market (unemployment was 5.6 percent in January 2014). Real disposable income grew 3.3 percent in 2013, down from 4.6 percent in 2012. This, in turn, weighed on consumer confidence, which fell in Q4 2013 for the second straight quarter.

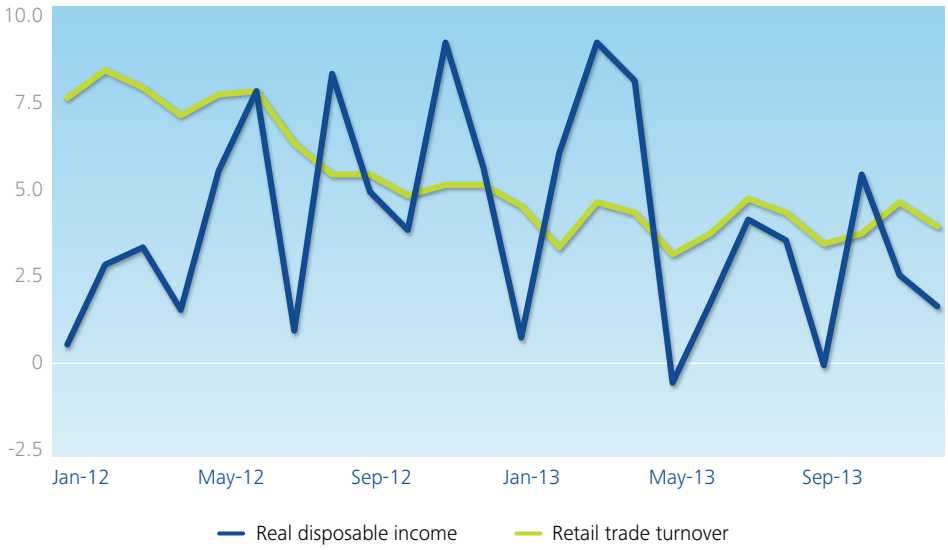
Sentiments have not improved this year, and things are likely to get worse given current tensions in Crimea. The ruble's fall is likely to keep inflation high while the Bank of Russia's (BOR's) rate hike will dent credit demand. Economic sanctions by the United States (US) and the European Union (EU) would make the situation worse. In such a scenario, household spending will remain subdued in 2014; it will likely grow at just 2.0–2.5 percent with strong downside risks if the conflict in Crimea escalates.

A falling ruble forces monetary tightening

On March 3, the day Russia intervened in Crimea, the ruble fell 2 percent against the US dollar (see figure 4). Currently down 10 percent, the ruble is one of the worst performing emerging market currencies this year. The ruble's fall has forced BOR to intervene (see figure 5). On March 3, it hiked the policy rate by 150 basis points (bps) and changed the rules for the ruble's managed float. It also spent an estimated $10 billion of reserves to defend the ruble. BOR's intervention in currency markets is not surprising given that a weak ruble kept inflation high in 2013 despite tight monetary policy.

Late last year, it seemed likely that BOR would lower its policy rate (then at 5.5 percent) in 2014. In contrast, rates were hiked with more tightening likely if possible sanctions lead to further capital flight. Even if normalcy returns to financial markets, BOR is not likely to ease rates by more than 50 bps. From an institutional perspective, the recent crisis has dented BOR's progress on two critical objectives: a pure inflation targeting mechanism by 2015 and a flexible exchange rate system.

Figure 3. Growth in real disposable income and retail sales (%, YoY)



Source: Bank of Russia, March 2014.

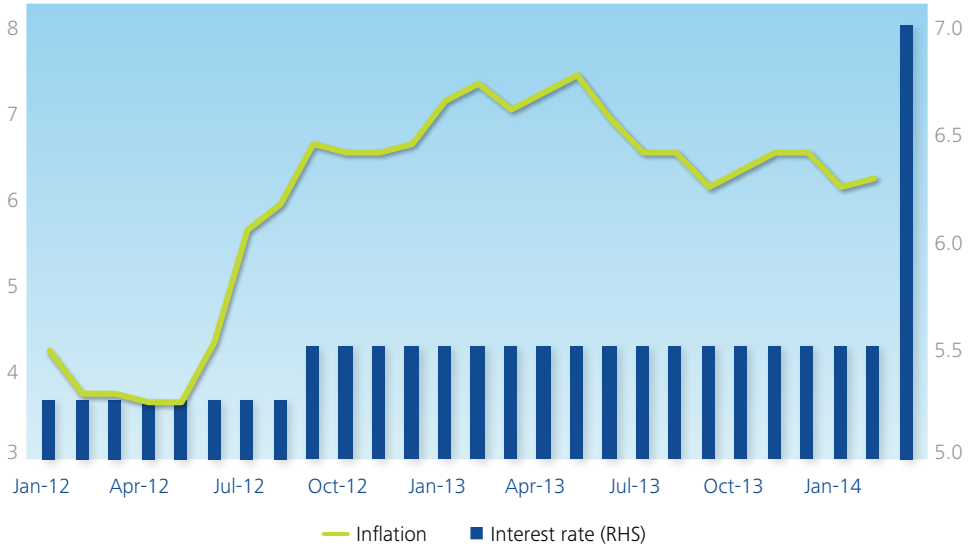
Graphic: Deloitte University Press | DUPress.com

Figure 4. The ruble's fortunes against the US dollar and the euro

Source: Bloomberg, March 2014.

Graphic: Deloitte University Press | DUPress.com

Figure 5. Inflation (%, YoY) and policy rate (%)



Source: Bank of Russia, March 2014.

Graphic: Deloitte University Press | DUPress.com

Rumble in equity markets

The ruble is not BOR's only worry. The impact of the Crimean crisis on financial markets has been equally bad. For example, on March 3, the benchmark MICEX fell 11 percent, leaving investors poorer by $60 billion. By March 14 (two days before the Crimea referendum), the MICEX fell to its lowest level since October 2009 (see figure 6). By that time (from February 28), the top 50 companies has lost about $110 billion in market capitalization.[1] The downtrend is not expected to end there; an escalation of the conflict will push equities much lower.

The vulnerability of Russian equities is due to the large share of foreigners (more than two-thirds) in freely traded shares; the United States, which favors sanctions, accounts for 40 percent of these. According to the Deputy Economy Minister, capital outflows from Russia could amount to $70 billion in Q1 2014; this is higher than the $63 billion figure for the whole of last year.[2] Any escalation of the conflict and resultant sanctions could make this worse while also making it harder for Russian companies to raise funds abroad.

Bond yields move up, but healthy fiscal and external balances will help

Bonds markets have not escaped the Crimean turmoil. The benchmark February 2027 security saw its yield rise on March 14 (two days before the Crimean referendum) to a record 9.6 percent. Yields have risen by more than 120 bps so far this year. Credit default swaps for Russian federal government debt has also risen during this time. This is not surprising given market anxiety over the current tensions. In fact, among the 31 countries in the Bloomberg's Emerging Market Local Sovereign Index, Russia has fared the worst this year.

For now, despite rising yields, Russia can breathe easy due to healthy public finances and external balances. Total public debt is low (8 percent of GDP in 2013) with the government budget at a small deficit (–0.5 percent of GDP in 2013). External debt is manageable (25 percent of GDP in 2013) with average maturity relatively long at about 15 years. On the external front, the current account is still in surplus (1.5 percent of GDP in 2013) despite deterioration in the last few years. Foreign reserves are also high at more than $500 billion, offering imports cover for 16–17 months.

Figure 6. Movement in key equity indices

Source: Bloomberg, March 2014.

Graphic: Deloitte University Press | DUPress.com

Figure 7. Government bond prices and CDS spreads

Source: Bloomberg, March 2014.

Graphic: Deloitte University Press | DUPress.com

Negative scenario for FDI and investments

The crisis in Crimea has also reinforced opinion that Russia is a difficult place to do business. In 2013, net foreign direct investment (FDI) outflow was about $12 billion, down from a net inflow of $2 billion in 2012 (see figure 8). This year, outflows will increase if the West imposes sanctions and Russia reacts by nationalizing foreign assets. This does not bode well for investments in the country, given that major SOEs have slashed their capital expenditure plans. The private sector is not likely to step in, given the political climate and rise in interest rates.

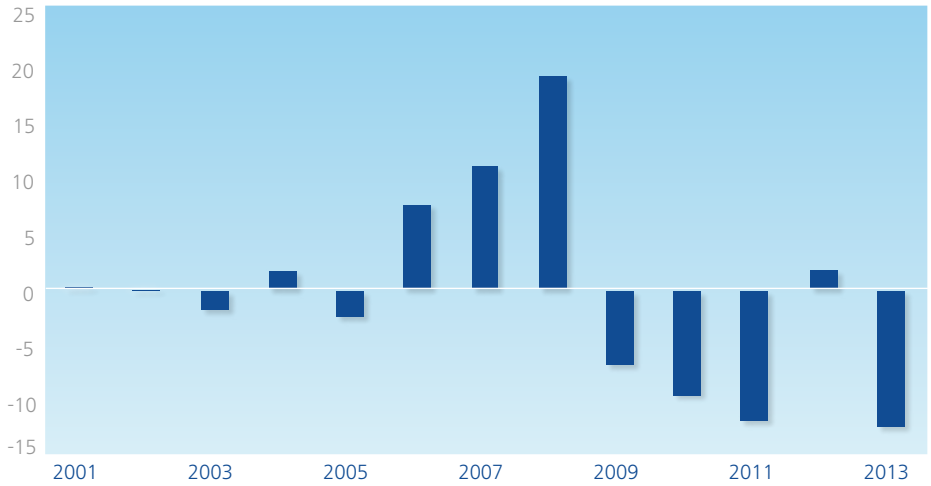
In such a scenario, fixed investments will likely rise by a mere 0.5–1.0 percent this year. This, in turn, will impact industrial production, which fell 0.2 percent year over year in January 2014, reversing a mild gain in the previous month. While rising global growth could have been a positive for domestic industry and investments, Russian firms (especially in manufacturing) will not benefit given their declining competitiveness. In such a scenario, growth in industry will be subdued at 1.5–2.0 percent in 2014.

Trade links under threat

The Crimean misadventure does not augur well for Russia's exports, especially if sanctions are imposed. Currently, the European Union accounts for more than half of Russia's exports; if the European Union imposes sanctions, exports will be hit. The crisis will also negate the gains Russia made after its accession to the World Trade Organization (WTO). Already, the United States has put trade and investment related talks with Russia on hold with Europe likely to follow suit.

Russia could react to possible sanctions by restricting natural gas exports to Europe. Currently, Russia accounts for more than 25 percent of Europe's demand.[3] However, any restrictions on gas exports to Europe are likely to be counterproductive. First, natural gas stocks are currently high in Europe after a relatively mild winter. Moreover, other gas-rich European countries are likely to pitch in to reduce the shortfall. Second, Russian threats could just be the catalyst that prompts US lawmakers to ease natural gas exports; this is likely to benefit both Europe and the United States while denting Russia's long-term prospects. Finally, foreign funds and expertise in Russia's oil and gas sector will be hit,

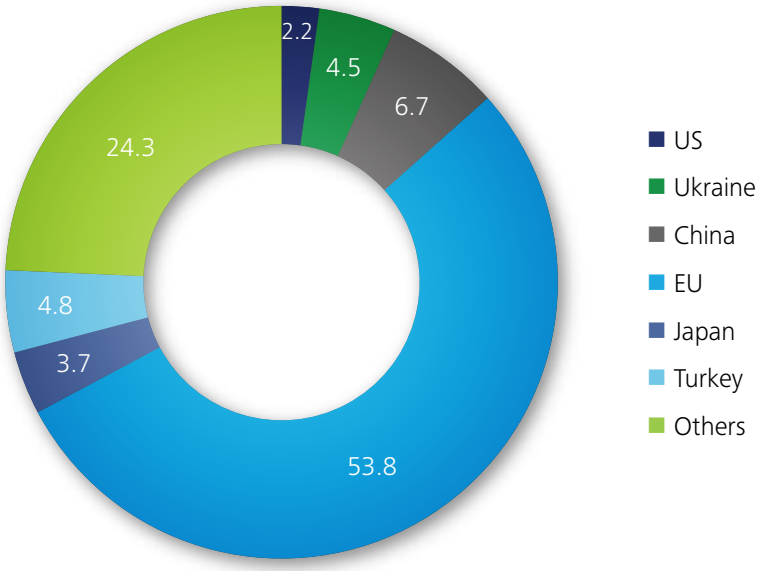
Figure 8. Net FDI ($ billion)



Source: Oxford Economics, March 2014.

Graphic: Deloitte University Press | DUPress.com

Figure 9. Shares of key destinations (%) in Russia's exports in 2013



Source: Oxford Economics, March 2014.
Graphic: Deloitte University Press | DUPress.com

For the past few years, economists have been sounding the alarm bell for the Russian economy.

thereby making exploration and production in areas like the Arctic more difficult, especially at a time when oil production in Russia has peaked.

Not much to hope for the short term

For the past few years, economists have been sounding the alarm bell for the Russian economy. Key concerns include the country's overreliance on commodities, its low share of investment in GDP, adverse business conditions, and unfavorable demographics. So it was not much of a surprise when in January 2014, the RCB forecasted a growth of just 1.5–1.8 percent for 2014. But, the crisis in Crimea is likely to push growth further down to 0.5–1.0 percent this year; sanctions could force the economy into a contraction. In addition to slowing economic activity, Russia's policymakers should be more worried about the crisis's long-term impact on the country's position in the global economy. Any isolation in the global economic community will mean that Russia cedes further ground to more agile competitors, and it will be hard to reverse these losses.

Endnotes

1. "Russians fret about economic impact of sanctions over Ukraine," *Wall Street Journal,* March 2014.
2. "Russia Faces Recession Risk as Capital Outflows Bleed Economy," Bloomberg, March 2014.
3. "Europe less reliant on Russian gas through Ukraine," Reuters, March 2014.

Brazil

No smooth ride

By Dr. Rumki Majumdar and Akrur Barua

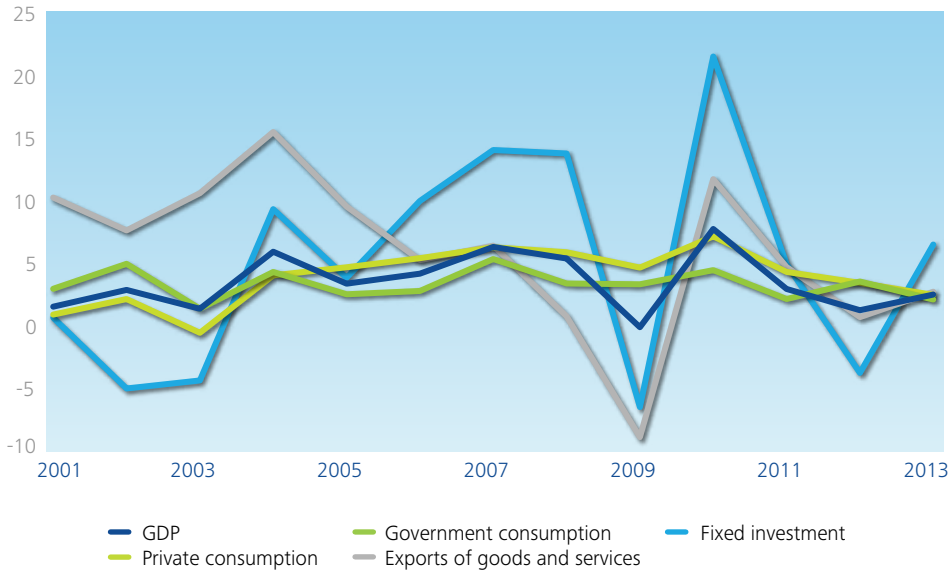
BRAZIL'S economy continues to face multiple challenges from all quarters of the economy. The binge in private consumer spending has ended as households face rising indebtedness and high inflation. At 18 percent of GDP, fixed investment is still below that of key emerging economies and much lower than the 25 percent deemed critical for productivity enhancement and sustainable growth. The structural deficiencies and lack of reforms have resulted in weak economic fundamentals. In addition, global uncertainties and risks are adding to the domestic woes. The country faces slowing external demand for its commodities as economic growth slows in China.

A return to growth in Q4 2013

Brazil's economy grew 0.7 percent quarter over quarter in Q4 2013, up from a 0.5 percent contraction in Q3. This pushed up annual GDP growth to 2.3 percent in 2013 from 1 percent in 2012. Both investments and exports posted a recovery in 2013; while the former grew 6.3 percent, the latter expanded 2.5 percent. The modest recovery in exports was expected, given an uptick in global growth, although a slowing Chinese economy dented the rise in commodity exports. After a contraction in 2012, fixed investment growth in 2013 was encouraging, especially given that a key factor behind this was higher private sector participation in infrastructure (roads and airports).

Despite these two encouraging trends, Brazil's economic growth continues to remain low relative to the previous decade and to key emerging-economy peers. This year, the economy is likely to face numerous headwinds, the most important one being slowing private consumption growth. Exports are also not likely to accelerate much (despite a weaker currency), given slowing commodity demand from China and lack of competitiveness

Figure 1. Real GDP growth and key components (%)



Source: Oxford Economics, March 2014.
Graphic: Deloitte University Press | DUPress.com

Brazil's economic growth continues to remain low relative to the previous decade and to key emerging-economy peers.

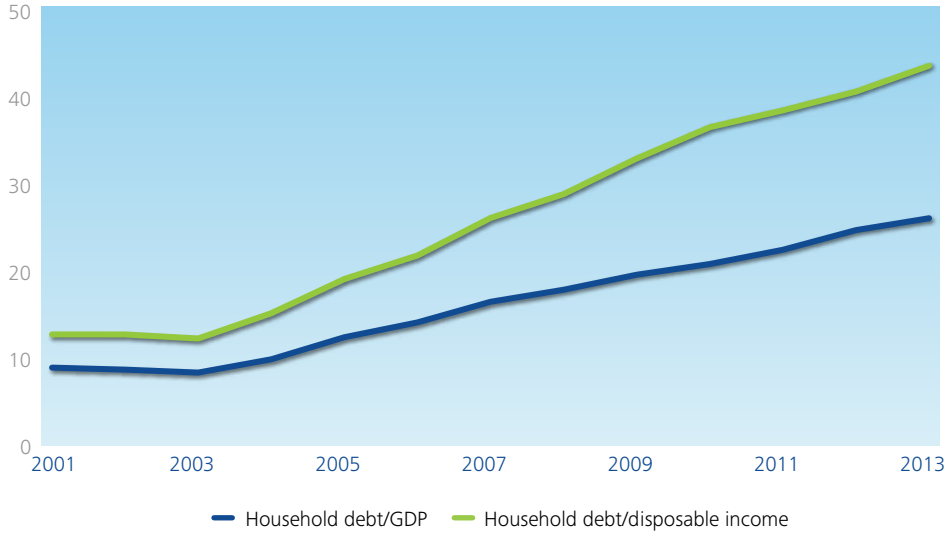
in manufacturing. Meanwhile, investments will have to cope with tight monetary policy, lack of reforms, and slow domestic demand growth.

Private consumption will no longer be the key growth driver

Consumers currently face two major problems—rising indebtedness and high inflation. Household debt as a share of disposable personal income rose to 43 percent in 2013 from 10 percent in 2010. Most of this debt is concentrated in the middle class, a key driver of spending. The composition of household loan portfolios is also a worry. Only 20 percent of the portfolio is mortgages, a segment with higher tenures and lower interest rates.[1] For the rest, interest rates range from 30 percent for some consumer loans to as high as 175 percent for overdrafts.[2] As a result, debt servicing costs in Brazil (23 percent of disposable income) are much higher than Latin American peers and the United States.[3]

Brazilian consumers have also been facing high inflation, which currently is still above the mid-point of the central bank's wide target range. Price pressures are not likely to ease soon, thereby weighing on real wage gains and consumer confidence; the latter, in February 2014, fell to its lowest level since May 2009. Other indicators do not look rosy either. In 2013 retail sales growth was lower than that in the past two years, while car sales declined for the first time in a decade. All in all, private consumption growth is expected to edge lower this year to 1.5–2.0 percent from 2.3 percent in 2013, with any sharp upturn not likely in the next couple of years.

Figure 2. Household indebtedness (%)



Source: Oxford Economics, March 2014.
Graphic: Deloitte University Press | DUPress.com

Investments will also face problems this year

Investments also face headwinds in 2014 as monetary policy is expected to remain tight, and critical reforms (especially in labor markets) are not expected in an election year. The latter, in particular, will continue to weigh on investments in manufacturing, which reported another disappointing quarter in Q4 2013, with production declining 0.9 percent quarter on quarter. Lack of reforms is also likely to hit foreign direct investment (FDI). Despite steady inflows, FDI growth has eased in recent years (1 percent in 2012 and -1 percent in 2013) and is not expected to pick up much in 2014. Meanwhile, slowing growth in China will dampen investments in mining.

On the fiscal side, the government is more likely to focus on subsidies and related spending before elections than on investments. For example, drought-related energy subsidies are expected to rise in 2014 by BRL 18 billion (up from BRL 10 billion in 2013) as the government compensates power producers for not raising tariffs amid rising production costs due to a drought. Given all the above factors, fixed capital investment is expected to grow by only 1.0–1.5 percent this year, with the figure not likely to rise by more than 3.5 percent in 2015.

Monetary policy to remain tight

To counter high inflation and a declining real, the Banco Central do Brasil (BCB) has hiked its policy rate by 350 basis points (bps) since April 2013 with the latest rate hike of 25 bps coming in February 2014. Despite this bout of monetary tightening, inflation (5.7 percent in January 2014) is still above the mid-point of the central bank's 2.5–6.5 percent range. Price pressures will not ease sharply in the near term, although government subsidies to keep power tariffs in check will likely help. However, tariffs are likely to rise after the elections this year, thereby exerting upward pressure on consumer prices in 2015.

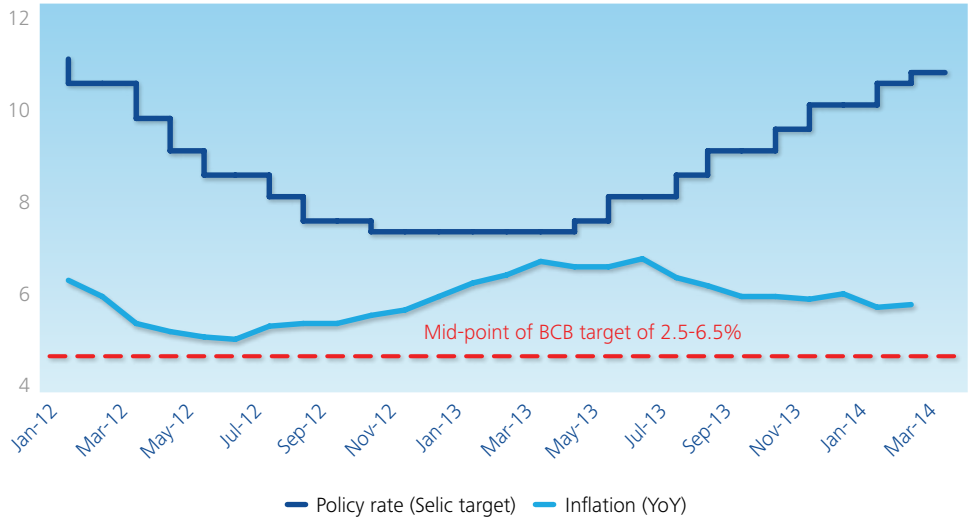
A key driver behind rising inflation has been the weakness in the domestic currency; the real fell by a little more than 13 percent in 2013 without making solid gains this year. While the US Federal Reserve's tapering decision is one big reason behind the real's weakness, structural weaknesses in the economy have not helped either. These issues are discussed at length later in the article.

Figure 3. Net FDI ($ billion)

Source: Oxford Economics, March 2014.

Graphic: Deloitte University Press | DUPress.com

Figure 4. Inflation and interest rate (%)



Source: Bloomberg, March 14.

Graphic: Deloitte University Press | DUPress.com

The central bank's credibility in targeting inflation has also come under scrutiny. Post the hyperinflation of the early 1990s, BCB had done a credible job of getting inflation back on track. That appears to have been partially undone in 2011–12 when BCB loosened policy despite inflation staying above the mid-point of its target range. Moreover, the inflation target itself has been subject to criticism, with experts deeming the upper band (6.5 percent) as too high. Amid these challenges, BCB will be eager to bring down inflation and restore confidence. So, it is not likely to loosen policy any time soon; if required, it is likely to raise rates by 50–75 bps this year.

The economy's structural inadequacies

The weak macroeconomic fundamentals, aggravated by poor macroeconomic policy implementations and their management, and ineffective government interventions have contributed the most to the steady economic deterioration. The economy repeatedly lost opportunities to revamp its growth by implementing structural reforms when the external environment was favorable. Instead, the government focused more on short-term fixes to boost demand, kicking the can of reforms further into the future.

Brazil has a highly inflexible labor market. The labor laws are rigid, labor productivity is low, and generous public policies and high minimum wages contribute to high production costs. While the unemployment rate in the economy has remained low despite slow growth, it is more likely an outcome of rigid labor markets and burdensome tax laws at the expense of costly business operations and poor private investments.

The other problem is that of infrastructure bottlenecks. According to the World Economic Forum's Global Competitiveness report, Brazil ranks 114 among 144 countries assessed for the quality of infrastructure.[4] Not only does that put Brazil below every other BRIC nation, its ranking is lower than almost every other emerging economy (figure 5). A partial energy blackout across many states in February 2014 is one of the many instances that point to the inability of the country's infrastructure to cope with the rising demand. The other factor is the inadequate schooling and lack of vocational trainings for the labor force, making it hard for businesses to move up the value chain and unfavorable for innovative economic growth.

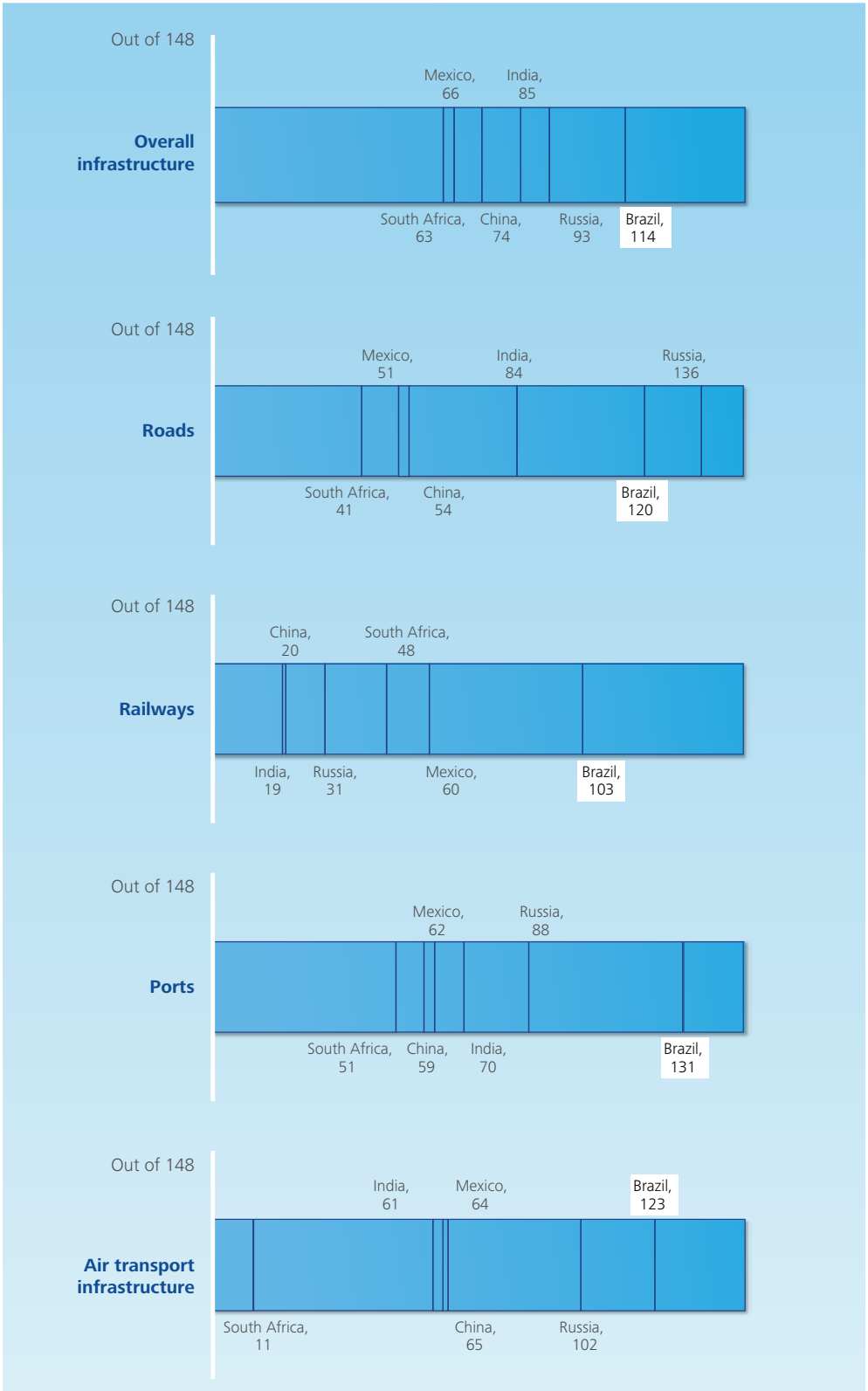
Lately, the government has taken several initiatives to improve the infrastructure. The president announced her decision to upgrade Brazil's infrastructure through private sector concessions and involvements in the energy sector. There have been some successes as well, like auctions in several major airports; however, achievements have been modest in road, railroads, and ports. The corrective measures have, so far, fallen short of what is needed to build quality infrastructure in the economy.

Lack of fiscal consolidation

The Brazilian government has failed to address the structural bottlenecks for years. Instead, it has embarked on ambiguous policies, which have resulted in high and persistent inflation, lowered the potential for growth, and led to the deterioration of public finances. The government's expansionary fiscal policy since the global financial crisis has widened the fiscal deficit and has increased the government's debt burden with limited impact on growth. The government missed its fiscal target in 2013 as government spending outpaced revenue by the widest amount on record. The government reported a primary fiscal surplus of 1.9 percent of GDP in 2013, failing to reach its target of 2.3 percent.

In addition, the government's continuous interventions with unclear policy signals have dampened business confidence and constrained the attractiveness of the business environment. The rising fiscal indiscipline has lately concerned global investors, and a few credit-rating agencies have factored this as one of the primary reasons to lower their outlook for Brazil. Due to external pressure, the government announced a few spending cuts in 2014. Nevertheless, with the

Figure 5. Brazil fares poorly in infrastructure compared to other emerging economies



Source: "The global competitiveness report, 2013-14," full data edition, World Economic Forum, IMF; Deloitte Services LP economic analysis.

Graphic: Deloitte University Press | DUPress.com

election around the corner, the likelihood of the government tightening fiscal discipline substantially is low. This suggests that fiscal corrections will likely follow after the elections in October 2014, if at all it happens.

The economy faces external risks

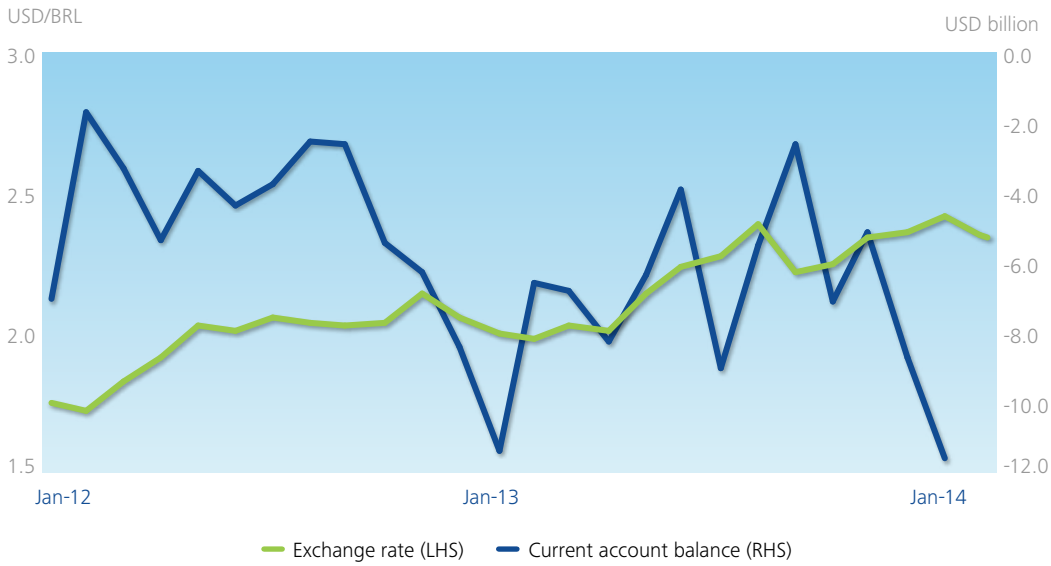
In addition to domestic factors, the Brazilian economy has been severely affected by global uncertainties. The economy has failed to contain its current account deficit over the past few years. Fall in global demand for semi-manufactured and manufactured goods have impacted export growth, while growth in imports have outpaced the growth in exports due to high imports of consumer goods and fuel products. The current account balance rapidly deteriorated to record levels of $11.6 billion in January 2014, up from $8.7 billion in December 2013 and $11.4 billion a year ago.

Brazil has also been highly vulnerable to volatile capital flows due to its overdependence on such funds to finance growth in the past few years. Data suggests a high net outflow of portfolio investment in Q4 2013. This has been further aggravated by investors' concerns over deteriorating economic fundamentals and the government's continuous and ineffective interventions. Brazil recorded a $23.4 billion outflow in its financial account in 2013, which includes foreign direct and portfolio investment. This led to a net foreign exchange outflow of $12.3 billion, the first decline since the global financial crisis of 2008.

Consequently, currency has steadily depreciated in the last one year (figure 6). Downward risks to currency are likely to remain high this year, if global uncertainties persist, and especially if the banking crisis in China intensifies. China is Brazil's largest trading partner and also one of its biggest sources of investment. Besides, a fall in commodities demand from China will likely impact prices and may deteriorate Brazil's terms of trade.

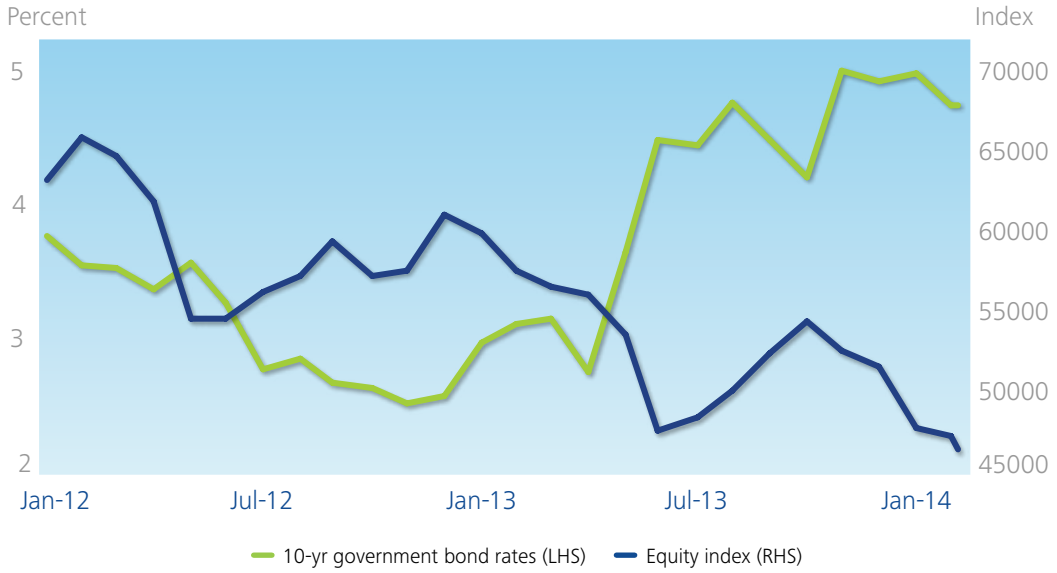
However, foreign direct investment (FDI) remains strong in Brazil, financing a large part of the current account gap. Brazil is expected to remain attractive to FDI due to its large natural resources and growing domestic demand due to a rising middle income class. The country is a net external creditor and has enough foreign reserves to cover its external debt.

Figure 6. Currency depreciates as current account imbalance and capital volatility increase



Source: Oxford Global Data Services, Oxford Economics, March 2014; Deloitte Services LP economic analysis.
Graphic: Deloitte University Press | DUPress.com

Figure 7. Impact of falling investors' confidence on equity index and sovereign bond rates



Source: Oxford Global Data Services, Oxford Economics, March 2014; Deloitte Services LP economic analysis.
Graphic: Deloitte University Press | DUPress.com

The impact of sudden capital outflow and current account imbalance has also been evident on the equity index and sovereign bond rates. The equity index fell during most of 2013, except for a few months. Since October 2013, there has been a steady fall in the index. The 10-year government bond rates have increased by more than 50 percent in one year; most of this increase was after global uncertainties intensified the past summer (figure 7).

Growth will stay low in the absence of reforms

Domestic and external risks to the economy are high and will likely impact growth in 2014. Given slowing investments and consumer spending growth, overall GDP growth is expected to decline this year to 1.5–2.0 percent, despite increased spending by football fans and massive investments as the country hosts the football World Cup 2014. Sadly, things are not likely to improve much, given no policy commitment to tackle long-term structural deficiencies in the economy.

To escape from this gloomy scenario, what Brazil needs is long-term strategies to address the economy, not quick fixes. What would help is a strong dose of economic liberalization coupled with fiscal discipline. This is not unattainable—it just requires the government to embrace some tough economic reforms. It is a path that the government has not treaded on for some time.

Endnotes

1. "Brazil: Technical note on consumer credit growth and household financial stress," IMF, June 2013.
2. Ibid.
3. Ibid.
4. Klaus Schwab, "The global competitiveness report, 2013-14," full data edition, country economic profile: Brazil, World Economic Forum, IMF, p. 135.

The United Kingdom

Outperforming, at last

By Ian Stewart

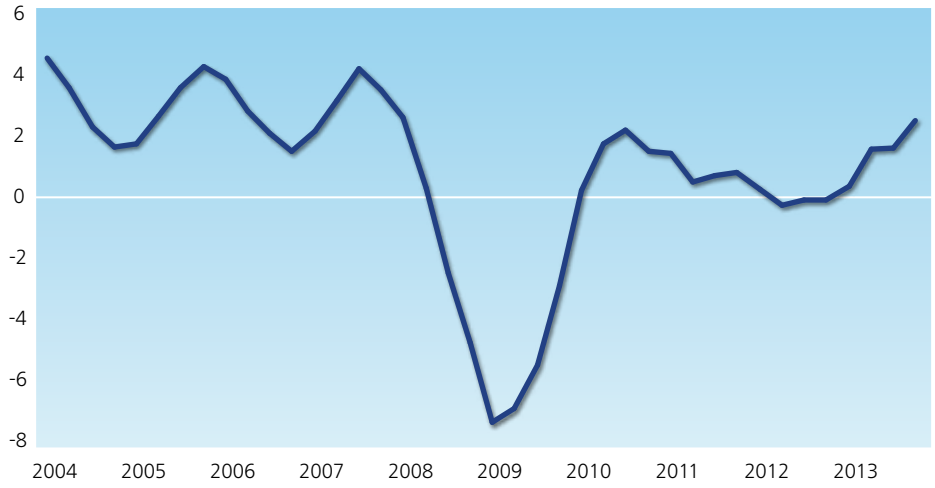
THE timing of Mark Carney's arrival at the Bank of England as governor has proved fortuitous. Since he took the reins at the bank last July, growth has accelerated, inflation has dropped like a stone, and the economy has created over a quarter of a million new jobs. The United Kingdom is now being talked of as the fastest growing economy in Europe (see figure 1).

The bank, like everyone else, has been caught out by the pace of the recovery. Last August, the bank expected the unemployment rate to stay above 7.0 percent until the second half of 2016. Since then, unemployment has dropped sharply; it seems almost certain to fall below 7.0 percent in the coming months, two-and-a-half years ahead of the bank's forecast just eight months ago.

In its latest *Inflation Report*, the bank forecasts that UK growth will accelerate to a very strong 3.4 percent this year.[1] It would

The United Kingdom is now being talked of as the fastest growing economy in Europe.

Figure 1. UK GDP, % annual change



Source: Office for National Statistics.

Graphic: Deloitte University Press | DUPress.com

be the fastest rate in seven years and above the average rates seen in the decade before the financial crisis. Not only would it make the United Kingdom the fastest growing major economy in the industrialised world, it would also mean that the United Kingdom outpaces a number of developing world economies, including Brazil and Russia.

The bank's economic forecasts tend to be fairly middle-of-the-road. Its latest, very non-consensus view, relies on a sharp upswing in UK investment and consumer spending. The bank believes that the United Kingdom is on the verge of an investment boom, and it is forecasting a 43 percent increase in UK business investment between now and 2016.

We do not think this outlandish. A host of indicators suggest that we are at a turning point on investment. Firms do not seem to have very much spare capacity. The CBI, for instance, reports that capacity utilization in small- and medium-sized firms is running at the highest level in 25 years. A worn-out capital stock and growing demand means that, at today's low borrowing costs, returns on corporate investment are likely to be attractive.

Corporates also have the wherewithal to invest. Corporate cash levels are high, albeit

heavily concentrated in larger firms. More importantly, firms are finding it easier to raise funding from banks and from capital markets. Banks report that demand for credit to fund capital spending is at the highest level in six years. Deloitte UK's latest *Survey of Chief Financial Officers* found that the top corporate priority is now expansion. A record 72 percent of respondents believe this is a good time to take risk (see figure 2).[2]

The other factor behind the economic rebound forecast by the Bank of England is a continued recovery in consumer spending. The bank believes that after a four-year squeeze on earnings, 2014 will be the year in which consumer spending power recovers. The bank expects the growth rate of average earnings to accelerate significantly and for inflation to drift lower, delivering a boost to consumer spending power.

The UK economy's changing fortunes had two pronounced effects on the financial market.

A recovering economy fuelled speculation that the bank could tighten monetary policy sooner rather than later. Financial markets are currently working on the basis that the bank will raise rates in the first quarter of 2015, but speculation that it could be earlier has increased.

A stronger economy has also boosted the pound. On a trade-weighted basis, against a broad basket of currencies, the pound has risen 9.3 percent in the last year and now stands at its highest level since November 2008 (see figure 3). Much of the pound's rise reflects strong gains against the US dollar, up by 11 percent in the last year.

The financial and external risks, which have buffeted the UK economy in the last six years, have abated. But the recovery also faces internal risks. Perhaps the most significant is the possibility that UK productivity remains lacklustre, hampering the recovery and fuelling inflationary pressures.

A record 72 percent of respondents believe this is a good time to take risk.

Figure 2. Deloitte CFO Survey: Corporate risk appetite

Source: Deloitte CFO Survey.

Graphic: Deloitte University Press | DUPress.com

On a trade-weighted basis, against a broad basket of currencies, the pound has risen 9.3 percent in the last year and now stands at its highest level since November 2008.

Figure 3. Trade-weighted sterling

Source: Thomson Reuters.

Graphic: Deloitte University Press | DUPress.com

Britain's recession collapsed output, but it had far less effect on employment. That softened the human impact of the recession, but with more people producing less, productivity plummeted. Productivity measures the efficiency of the production process. In the long run, it is a major determinant of growth and of inflation. Higher productivity is the key to sustained expansion in both average earnings and in investment. Without an upturn in productivity, the sustained recovery the Bank of England and most forecasters expect is not realistic.

Endnotes

1. See Deloitte CFO Survey, "Unternehman erhöhen die schlagzahl," February 2013, http://www.deloitte.com/assets/Dcom-Germany/Local%20Assets/Documents/18_ Growth%20Platforms/CFO-Services/CFO_2-2013.pdf.
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Special topic

Revival in international trade and the resurgence of bilateralism

By Akrur Barua and Sunandan Bandyopadhyay

FOR a long time, international trade has been a driver and indicator of global economic growth. It has become more prominent in the past decade or so due to rapid integration of the global economy, including large cross-border investments, distribution of production lines across continents, innovations in information technology and communications, and advancement in transportation. For example, during 1991–2008, global trade volumes grew at an average annual rate of close to 7 percent, up from a corresponding figure of 5 percent during 1981–1990.

The dip in trade in 2009: Emerging economies to the rescue

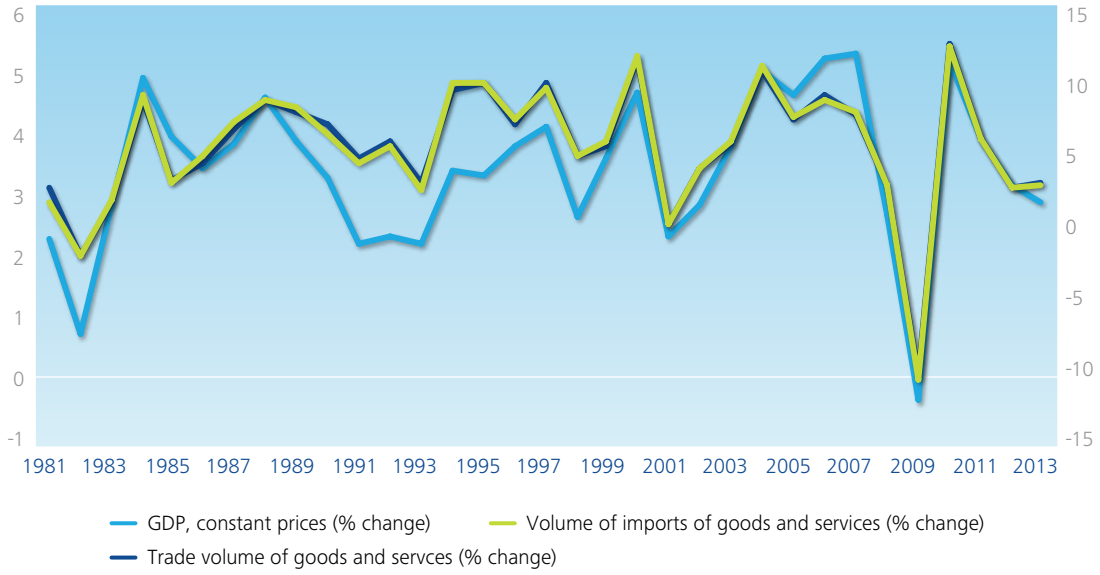
The global financial crisis of 2008–2009 played spoilsport to the flow of goods and capital across the world. With key advanced economies slipping into recession, global demand was negatively impacted, which in turn, took its toll on trade volumes. In 2009, global trade volumes dipped 11 percent, a much sharper dip than the previous two slowdowns in 1990–1991 and 2000–2001 (see figure 1 and figure 2). This was not surprising, given the decline in demand in key advanced economies. For example, according to the International Monetary Fund (IMF), real GDP in advanced economies dipped 3 percent in 2009 while growth remained flat during 1991–2001.[1]

The contraction in international trade would have been much lower, had it not been for emerging economies. Thanks to strong growth in markets like China, India, and Brazil, global demand recovered in 2010. In that year, imports of emerging economies went up 17 percent; in contrast, advanced economies' imports were almost flat (see figure 3).

This was not the first time that emerging economies were making their presence felt in the global trade arena. Strong growth in these economies prompted a sharp rise in global commodity demand and prices since the start of the new millennium. For example, between 2001 and mid-2008, the price of crude oil rose by about 300 percent while the price for metals grew by 200 percent (see figure 4). For commodity producers, this was a big boon. It propped up GDP

Despite a couple of supply disruptions—the earthquake in Japan and floods in Thailand in 2011—global trade flows seem to be on an upward trend since 2009.

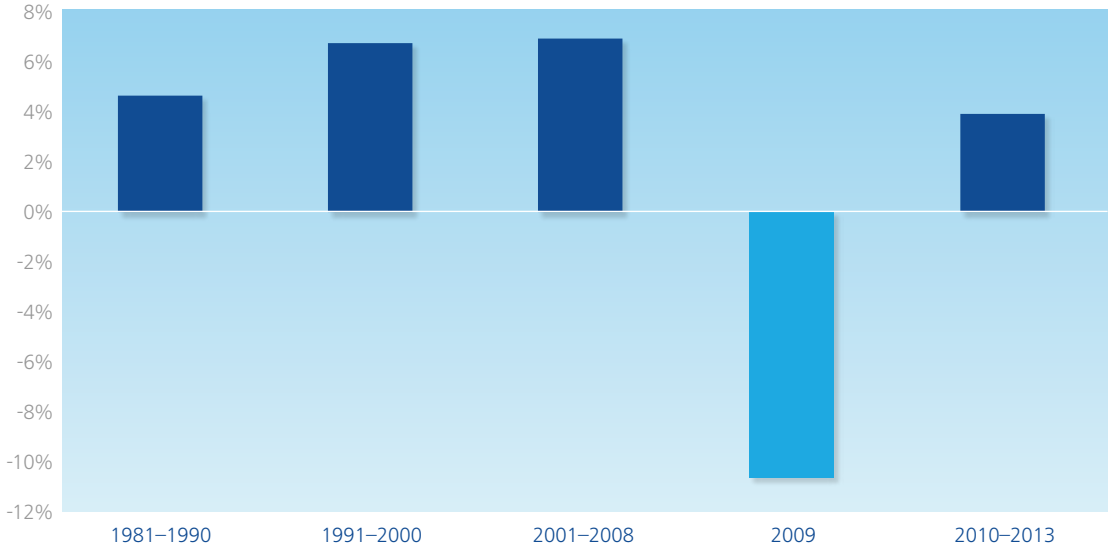
Figure 1. Trends in global GDP and trade since 1981



Source: IMF, March 2014.

Graphic: Deloitte University Press | DUPress.com

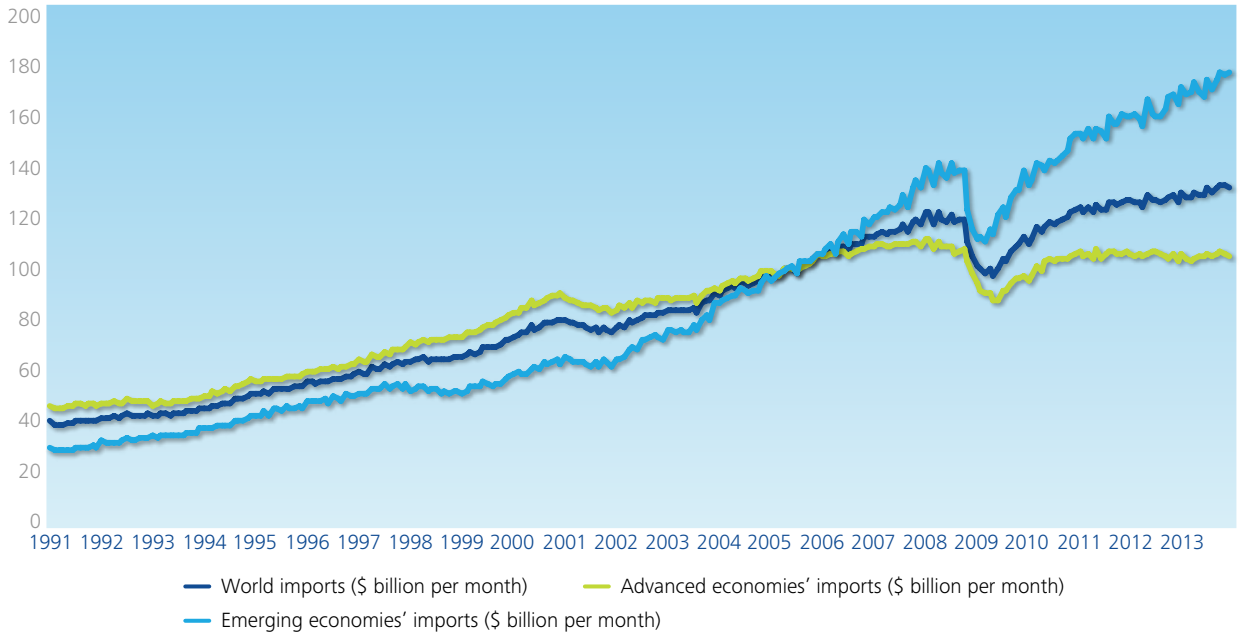
Figure 2. Average annual growth rate in global trade volumes across different periods



Source: IMF, March 2014.

Graphic: Deloitte University Press | DUPress.com

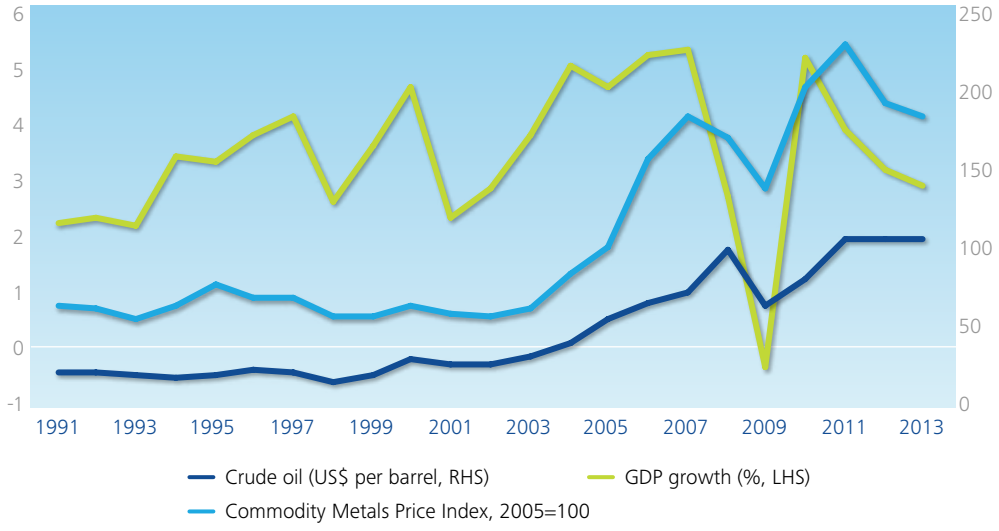
Figure 3. Trends in imports across advanced and emerging economies



Source: CPB Netherlands Bureau of Economic Policy Analysis.

Graphic: Deloitte University Press | DUPress.com

Figure 4. The trend in GDP growth and global commodity prices, since 1991



Source: IMF, March 2014.

Graphic: Deloitte University Press | DUPress.com

growth in these countries and improved their terms of trade.

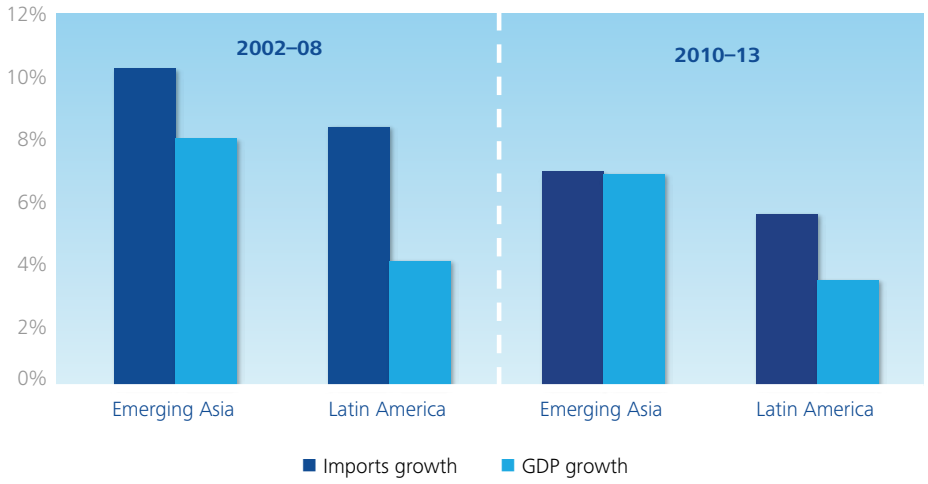
A steady upward trend since 2010

Despite a couple of supply disruptions—the earthquake in Japan and floods in Thailand in 2011—global trade flows seem to be on an upward trend since 2009. The recovery would have been sharper if not for sluggish growth in the West. Certainly, Europe's debt crisis and muted economic growth in the United States have not helped the cause of international trade. And although imports in Asia and Latin America are back on a rapid growth trend as in 2002–2008 (see figure 6), trade enthusiasts will be worried that key economies in both regions have run out of steam.

Interestingly, the post-crisis trade expansion is more in line with the relatively slower growth trend of 1991–2001 than the one in 2002–2008. This is natural given that global economic growth has moved to a lower trajectory since 2010. The trend becomes more apparent from the global commodity price cycle. The pace of rising prices has steadied in the past couple of years relative to 2002–2008, especially in key emerging market importers. However, for oil, this is also because of increasing supplies (or supply prospects) due to shale extraction. The slowing pace of trade growth relative to 2002–2008 also raises questions about whether protectionism has increased. Encouragingly, this does not seem to be the case, but it is possible that the period prior to the

So far, the WTO has played a critical role in streamlining global trade policies and facilitating critical negotiations among governments.

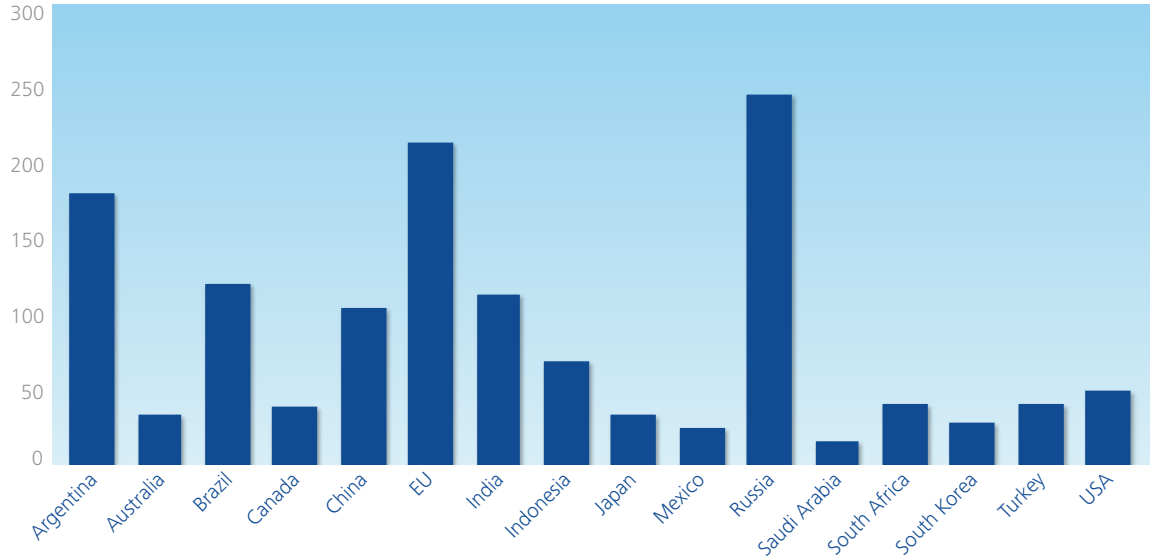
Figure 5. The growth trend in Asia and Latin America along two time periods



Source: IMF, March 2014.

Graphic: Deloitte University Press | DUPress.com

Figure 6. Number of trade-restrictive measures implemented since 2009 in G20 members



Source: Global Trade Alert database, March 2014.

Graphic: Deloitte University Press | DUPress.com

global economic crisis enjoyed some immediate gains from economic and trade liberalization across the world.

Protectionism is not on the rise, thanks to the WTO and global coordination

In the past, it was often observed that deteriorating domestic economic conditions forced trade protectionism. Sadly, this created a situation where countries retaliated against each other. This was evident during the Great Depression of 1929, when competitive trade restrictions pushed economies further down. Consequently, when the global financial crisis of 2008–2009 hit economies across the world, a big worry was whether countries would indulge in trade restrictive measures. Thankfully, that did not happen. The World Trade Organization (WTO) deserves credit for this; it ensured that countries did not resort to protectionist measures. Policy coordination among major economies also helped; for example, G20 leaders repeatedly pledged not to construct trade barriers that discriminate against foreign producers.[2]

Nevertheless, like many regulatory mechanisms, the current system is not a perfect one. And countries have managed to exploit some of the imperfections that exist in many WTO policies. For example, the upper bound of WTO tariff levels can be set at such levels that individual countries can raise tariffs (and thereby indulge in some degree of trade protectionism) without breaching any trade obligations.[3] Also, since the recent financial crisis, economies have created non-traditional barriers, which are difficult to detect and beyond the reach of WTO agreements. These measures are intermingled with domestic economic policies, mainly through health, safety, and technical regulations. The US Federal Reserve's asset purchases program also faced criticism in certain quarters. Some countries (like Brazil) alleged that the Fed's actions strengthened their currencies, thereby making them less globally competitive. Japan also faced similar criticism from Asian exporters (like South Korea) after the launch of an aggressive quantitative easing program since Shinzo Abe took over as prime minister.

Interestingly, among the G20, emerging economies were at the forefront of trade-restrictive policies after 2009 (see figure 6). For

example, emerging economies like Argentina, Brazil, India, Indonesia, Russia, South Africa, and Turkey accounted for 60 percent of all trade-restrictive measures over 2009–2013 while having a share of only 13 percent in total G20 imports. Among these, Russia and Argentina were the biggest offenders.[4] On the other hand, despite having a share of 59 percent in G20 imports, G20 EU countries, and Japan together accounted for just 22 percent of trade-restrictive measures during that time. However, it's important to keep in mind that many advanced economies intervened in their economies in a big way during the downturn of 2008–2009. These included asset purchases by central banks, discount windows for credit, and state aid (and stake purchases) for troubled firms.

Despite restrictive moves, international trade is more free today than at any time in the past. According to a study by the World Bank, the rate of implementation of trade-restrictive measures has not accelerated since the financial crisis, compared with the pre-crisis period. Following a temporary spike in 2008 and 2009, the number of temporary trade barriers implemented by G20 economies fell quickly.[5]

The Doha round of WTO talks and lessons learned

So far, the WTO has played a critical role in streamlining global trade policies and facilitating critical negotiations among governments. The Doha Development Agenda (or Doha round of negotiations), initiated in 2001 after the failure of the Singapore round, tries to push trade liberalization further. It focuses on the implementation of the agreement on Trade Related Aspects of Intellectual Property Rights (TRIPS), which is aimed at patent protection and compulsory licensing of medicines. The Doha round also focuses on a more inclusive agenda, especially by offering assistance to developing economies and removing barriers in farming (mainly in advanced economies). In addition to that, the Doha round is trying to help developing economies implement the trade obligations of the Uruguay round in the fields of market access, trade-related investment measures, safeguards, rules of origin, subsidies, and countervailing measures. According to the World Bank, a successful conclusion to the Doha round could increase net welfare gains by $84–287 billion by 2015.[6]

The discussions, however, have gone on for too long, frequently breaking down on the issue of agriculture. This has not changed much, but there was positive news on trade facilitation during discussions in Bali, Indonesia, in December 2013. In particular, countries agreed to streamline customs processes. This has the potential to reduce the cost of shipping by 10 percent, increase global output by over $400 billion per year, and create 21 million jobs.[7]

Countries nowadays prefer to ally with partner countries in a bilateral agreement, which is mutually beneficial and quick to negotiate.

Key takeaways from the Doha round

The Doha round has led to a number of concerns regarding multilateral trade negotiations. First, the current consensus building process makes the negotiations long, tiring, and indecisive. Initial negotiations kept breaking down due to differences between developed and developing economies, especially on issues of non-discriminatory market access. And even after 12 long years, the success that was achieved in Bali was limited relative to the initial agenda.

Second, the negotiations were often dominated by contentious issues, be it major or minor. Consequently, other agendas were either neglected or delayed. For example, agricultural subsidies and special safeguard mechanisms (which allow countries to temporarily raise tariffs to deal with import surges or price falls) became the most dominant agenda in successive rounds. In this standstill, other important points such as cotton and banana exports from Africa or poverty alleviation measures linked to least developed economies took a backseat.

Third, the advent of emerging economies like China, India, and Brazil in the global stage has resulted in greater power for them in the negotiation process. For example, spearheaded by India, developing countries could get the peace clause implemented with respect to farm subsidies, which provide countries with a four-year immunity to subsidize staple crops. This was despite stiff opposition from developed economies. Although the rise in emerging economies makes for a more balanced global economic order, it makes discussions more difficult given that many of them often exhibit strong streaks of protectionism, owing to domestic political compulsions. This makes comprehensive trade liberalization a difficult objective to achieve.

Finally, as a few emerging economies assert themselves on the world stage, many underdeveloped countries have lost their influence. This raises the threat of greater economic isolation for these economies. Moreover, delays in multilateral trade negotiations might pressurize these economies to move toward generous bilateral agreements with other major economies (developed or emerging), which might not be beneficial to them in the long term.

Has multilateralism given way to selective bilateralism?

The delay and collapse of the Doha round has somewhat weakened the penchant for multilateral trade agreements. Consequently, bilateral agreements (or between select countries) seem to be back in favor. While multilateral discussions are more comprehensive and beneficial at a global level, bilateral agreements are faster. Partner countries can focus purely on their requirements without having to build common negotiating goals among blocs of countries. Moreover, achievements from bilateral discussions can be gradual, thereby enabling some of the benefits of reduced trade restrictions to filter in instead of waiting for multilateral discussions to conclude. Bilateral negotiations also enable countries to factor in their regional and socio-political conditions, something that is not feasible in multilateral trade agreements. The North American Free Trade Agreement (NAFTA) and the Australia New Zealand Closer Economic Agreement (ANZCERTA) are two great examples of bilateral agreements where partner countries

from a region have successfully removed a plethora of trade barriers, including tariffs, export subsidies, and antidumping penalties in a relatively short period.[8]

As countries temporarily look beyond the WTO, a flurry of bilateral discussions is underway (see table 1). While some of these discussions pertain to expanding current blocs within the region (like ASEAN), others are aimed at a higher level of economic integration within existing blocs (like the Eurozone). Still others are wider in scope, and if successfully concluded, they would herald new dynamics in global trade. Of these, arguably the most prominent are the Trans-Pacific Partnership (TPP) and the Trans-Atlantic Trade and Investment Partnership (TTIP). The United States is part of both discussions, and it could stand to gain the most if both

Table 1. Some prominent bilateral style trade discussions underway other than TPP and TTIP

Trade pact	Member countries	Current status and objectives
Comprehensive Economic and Trade Agreement (CETA)	Canada and EU	• Agreement reached on key points in October 2013, planned conclusion in mid-2014 • Will be the second-largest trade agreement for Canada after NAFTA (excluding TTIP)
EU–ASEAN	EU, Singapore, Malaysia, Vietnam, and Thailand	• In 2009, the EU agreed to pursue FTA negotiations in a bilateral format with key ASEAN countries • Negotiations with Singapore concluded in December 2012; ongoing talks with the other three partners
EU–Japan free trade agreement	Japan and EU	• Negotiations stated in March 2013 and four rounds of talks have taken place so far; fifth round will take place in the spring of 2014 • Aims to boost growth and jobs in the EU and Japan; will address non-tariff measures and railways
EU–ANDEAN	Colombia, Peru, and EU	• Conceptualized in 2010, the first round of negotiations was held in Ecuador in January 2014 • Aims at bringing Ecuador and Bolivia also on board
EU–MERCOSUR	Argentina, Brazil,	• Negotiations restarted in 2010 after brief suspension; nine rounds completed • Focuses on trade in industrial and agricultural goods, intellectual property, customs and trade facilitation, and removal of technical trade barriers
Paraguay, Uruguay, Venezuela, and Bolivia	China and Taiwan	• Agreement signed in June 2011; has run into protests, the most recent being in March 2014 • Opening up of services sector and development of cross-strait exchanges
US–Morocco	US and Morocco	• Conceptualized in 2006 and signed in November 2013 • Will boost Morocco's economic competitiveness; focuses on Internet publication, transit, and transparency with respect to penalties
USA and South Korea (KORUS)	US and South Korea	• Started in 2006, agreement concluded in March 2012 • Will eliminate 95 percent of each nation's tariff on goods within five years; second-largest FTA for South Korea after the pact with the EU
Korea–China	China and South Korea	• Second round of negotiations underway • Planned completion within 2014
EU–India	EU and India	• Negotiations started during 2007; 11 rounds are over with an expected completion in 2014 • Focuses on market access for goods, services, and government procurement

negotiations are speedily concluded under the current objectives.

The Trans-Pacific Partnership (TPP)

The TPP is a free trade pact that is under negotiations between the United States, Canada, and 10 countries of the Asia Pacific region. It was originally conceptualized by four countries: Brunei, Chile, New Zealand, and Singapore. Currently, after 19 formal rounds, eight more countries—Australia, Canada, Japan, Malaysia, Mexico, Peru, United States, and Vietnam—are also included. These countries are collectively responsible for 40 percent of global GDP and 26 percent of global trade.[9]

The main objective of the pact will be to create jobs, increase the standard of living, and improve welfare in all the participating countries. The pact will not only focus on getting market access and eliminating tariffs and non-trade barriers, but it will also harmonize a broad range of legal and regulatory issues. As estimated by Peterson Institute, TPP will create additional global income of around $223 billion per year by 2025 and additional exports revenue of $305 billion per year. The United States alone will get income benefits of around $77 billion per year and additional $123.5 billion per year in exports.[10] In 2012, the US-TPP trade was $1.8 trillion, which had grown by 46 percent during the period 2009–2012. An estimated 4 million jobs were created by US exports to TPP countries in 2012.

The TPP has already set forth a flurry of bilateral negotiations among other countries while at the same time stoking the interest of other major economies (like China) in the proposed bloc. This is likely to aid dynamism to trade activity in the Asia-Pacific region. Interestingly, this agreement is also in tune with President Obama's greater focus on Asia. It will allow the United States to enhance economic cooperation with economies where strategic partnerships are already on a rise.

There are, however, differences among the member states that are delaying negotiations. One of the main sticking points is market access. For example, Vietnam, Australia, and Japan want access to US markets for textiles, sugar, and automobiles, respectively, while Japan is resisting tariff cuts in some of its agricultural products.

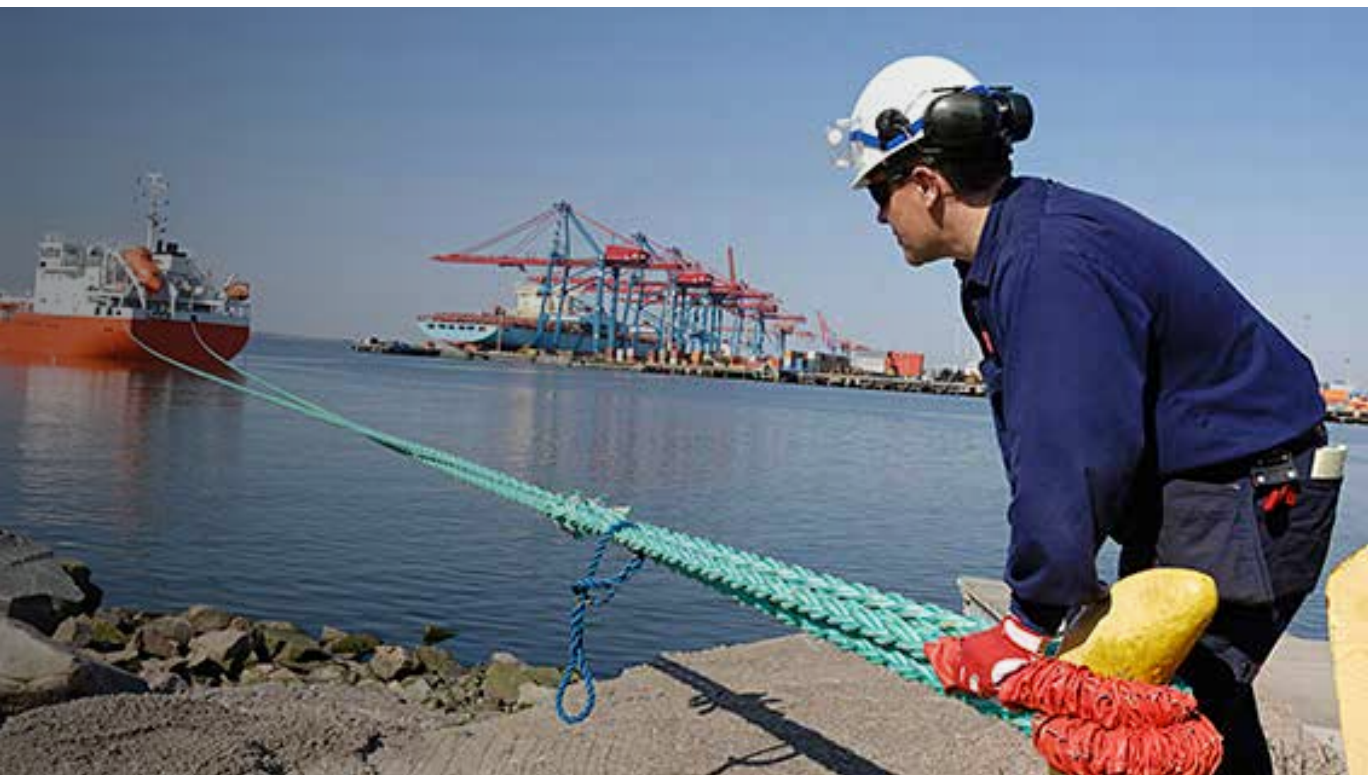
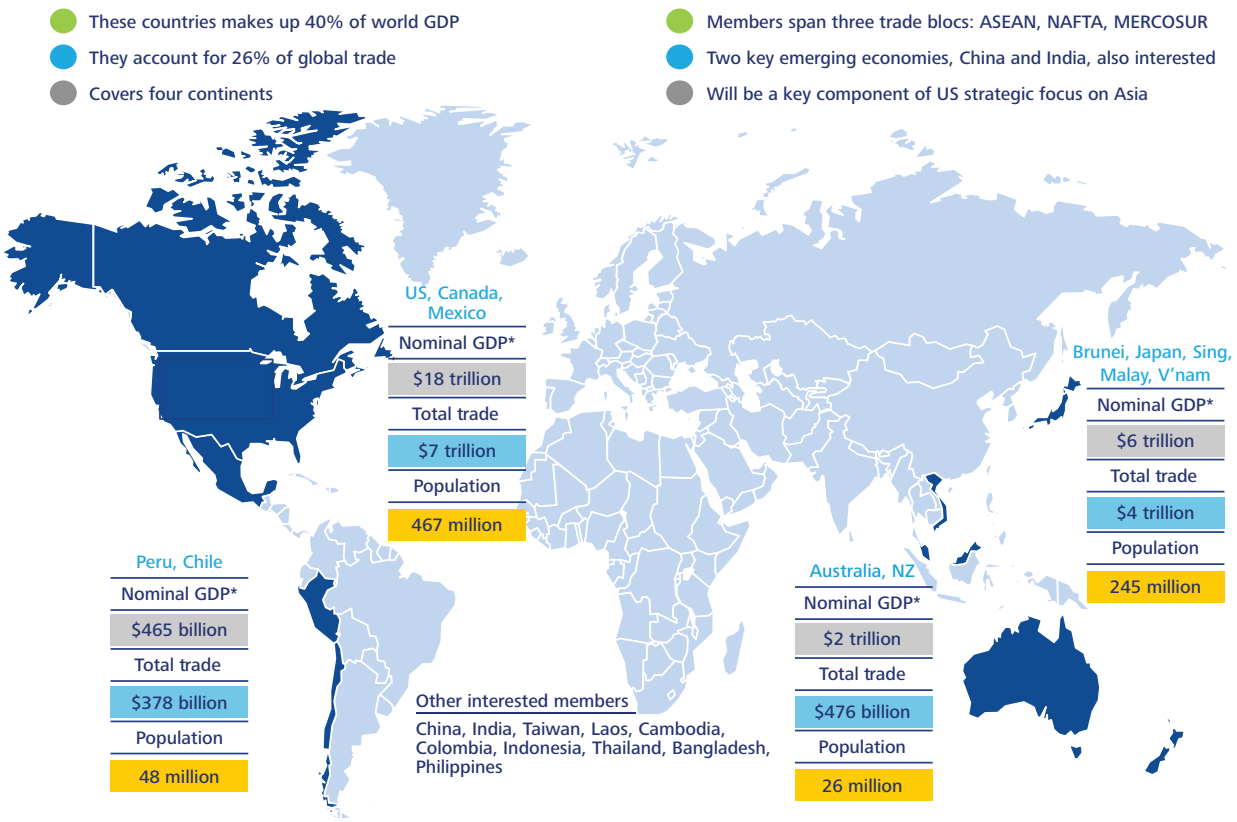


Figure 7. Members of the proposed Trans-Pacific Partnership



* Nominal GDP data is from 2013 while population and total trade data are from 2012

Source: IMF, WTO, March 2014.

Graphic: Deloitte University Press | DUPress.com

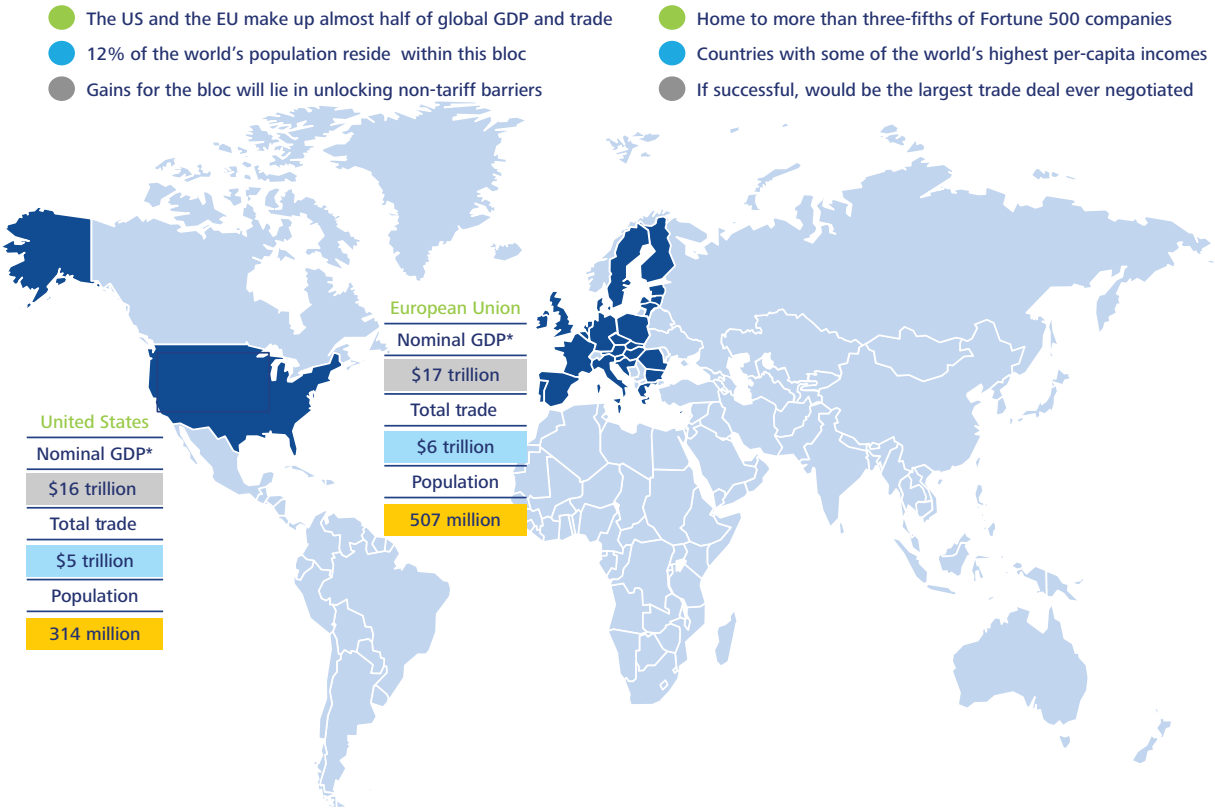
Other sticking points include Canada's agriculture and dairy business policies, trade in tobacco, and intellectual property restraints. Moreover, some public interest groups are also questioning the discretion and confidentiality of the negotiations, especially on intellectual property.

Transatlantic Trade and Investment Partnership (TTIP)

The TTIP is a treaty under negotiation between the European Union and the United States since July 2013. The fourth round of negotiations was held in Mar 2014. The United States and the European Union make up close to half of global GDP and trade, but they have only 12 percent of the world's population.[11]

The main focuses of the pact are to drive growth, create new jobs, remove tariffs and non-tariff barriers, and abolish custom charges. According to an assessment by the European Commission, TTIP once fully implemented, will prop up EU and US economies annually by €120 billion each; it will also boost the rest of the world by €100 billion. It will create 400,000 jobs in Europe with 100,000 of them in Germany alone.[12] Also, imported goods will get cheaper and boost the purchasing power of the average household in the European Union by €545 per year. The proposed treaty also aims to unify standards and licensing procedures. For example, a car approved in the European Union currently needs to get an approval again from United States even though the safety standards are similar.

Figure 8. Members of the proposed Transatlantic Trade and Investment Partnership



* Nominal GDP data is from 2013 while population and total trade data are from 2012

Source: IMF, WTO, March 2014.

Graphic: Deloitte University Press | DUPress.com

In theory, the TTIP pact—for two of the largest economies to come together and boost their mutual trade and also unify the standards and licensing procedures—looks extremely logical. But significant political and cultural hindrances lurk beyond the figures and policy details. The biggest political challenge is for President Obama to get the trade bill cleared by US lawmakers before the upcoming elections while the house is completely divided and Democrats have been raising concerns regarding domestic industries. There are also fears in Europe that the pact will bypass EU safety and environmental standards, including the impact of imported GM crops on health.[13] Another major hurdle is streamlining the duplication of rules and regulatory policies within the two regions, when there is a major cultural difference in consumer patterns and consumer protection ideas.[14]

The need for some caution amid the bilateralism euphoria

Over the years, the WTO has greatly supported the smooth flow of international trade and discouraged countries from protectionism. But with the shift in the global economic landscape toward emerging markets and the changing trade environment, multilateral agreements have become more difficult to come by. Countries nowadays prefer to ally with partner countries in a bilateral agreement, which is mutually beneficial and quick to negotiate. So, bilateralism seems to be the buzzword in the trade arena. Potential blocs like the TPP and TPIP have made this even more apparent.

However, bilateral agreements are not the best way to claim the benefits of free movement of goods and capital. Trade theory tells us that efficient production and exchange of goods happens only when there are no barriers. Many times, bilateral agreements block out more efficient producers who are not in the requisite bloc. Moreover, countries involved in bilateral agreements face challenges in practical enforcement of dispute settlement, compliance, and regulatory measures as each agreement is negotiated with different sets of rules. Also, too often, policymakers involved in bilateral negotiations offer the argument that such agreements are a stepping stone for more multilateral discussions. The truth is up for debate.

Endnotes

1. IMF World Economic Outlook Database, March 2014.
2. "Five years of G20 pledges on trade," GTA report, http://www.globaltradealert.org/sites/default/files-GTA14_0.pdf.
3. In Australia, for example, the boundary tariff level for automobiles is 40 percent ad valorem, but the applied rate is just 10 percent. This means that Australia could quadruple its level of protection for autos and still not be in trouble at the WTO.
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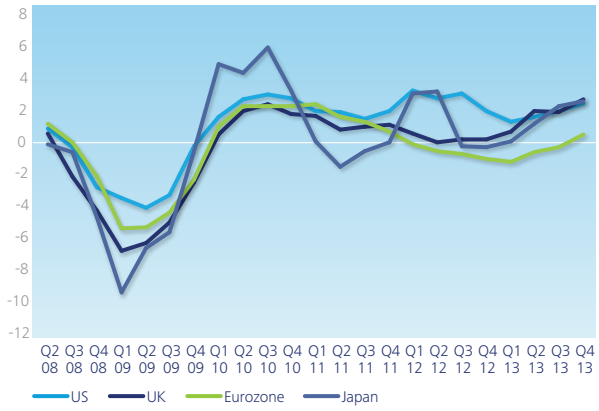
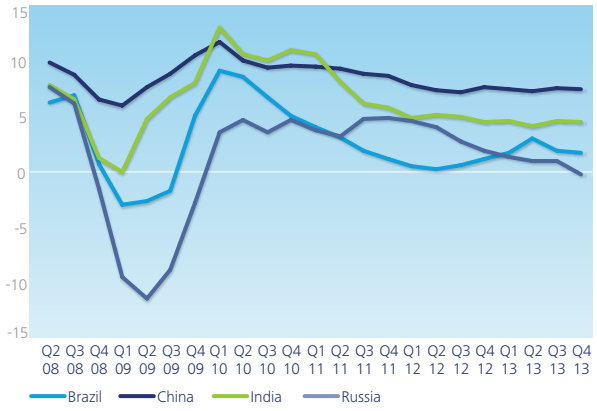
Economic indices

GDP growth rates (YoY %)



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

GDP growth rates (YoY %)



Source: Bloomberg.
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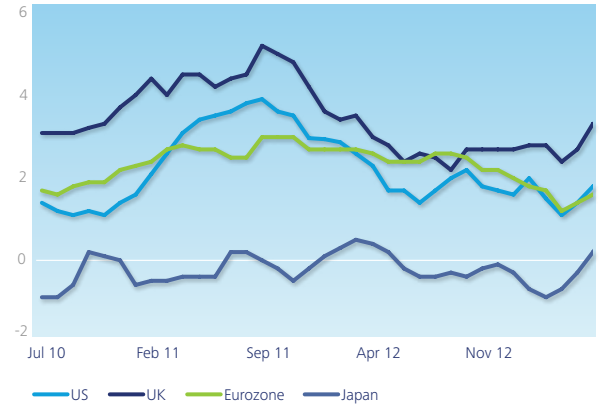
Inflation rates (YoY %)



Source: Bloomberg.
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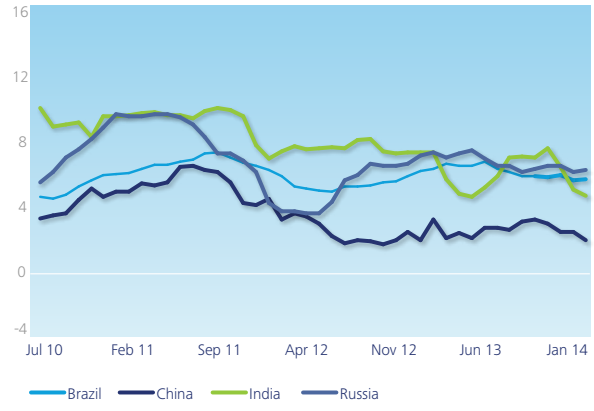
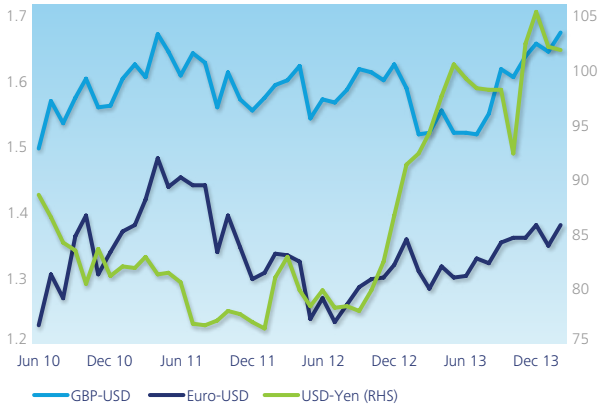
Inflation rates (YoY %)



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

Major currencies vs. the US dollar



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

Yield curves (as of December 24, 2013)*

	US Treasury bonds & notes	UK gilts	Eurozone govt. benchmark	Japan sovereign	Brazil govt. benchmark	China sovereign	India govt. actives	Russia‡
3 months	0.05	0.42	0.19	0.03	10.93	3.50	9.18	6.84
1 year	0.13	0.40	0.20	0.05	11.58	3.30	8.71	7.07
5 years	1.71	1.90	0.64	0.20	13.03	4.19	8.91	8.96
10 years	2.77	2.70	1.60	0.61	13.34	4.48	8.78	9.19

Composite median GDP forecasts (as of December 24, 2013)*

	US	UK	Eurozone	Japan	Brazil	China	Russia
2014	2.7	2.7	1.1	1.4	1.9	7.4	2
2015	3	2.5	1.5	1.2	2.5	7.2	2.5
2016	3	2.4	1.5	1.2	3.25	7.3	3.6

Composite median currency forecasts (as of December 24, 2013)*

	Q1 14	Q2 14	Q3 14	Q4 14	2015	2016	2017
GBP-USD	1.64	1.65	1.64	1.63	1.61	1.6	1.62
Euro-USD	1.35	1.35	1.33	1.3	1.29	1.28	1.28
USD-Yen	104	106	107.5	110	115	113	103
USD-Brazilian real	2.4	2.4	2.45	2.47	2.55	2.36	2.26
USD-Chinese yuan	6.05	6.06	6.02	6	5.9	5.83	5.78
USD-Indian rupee	62.66	62	62.5	63	64	61.75	58
USD-Russian ruble	34.68	35.68	35.99	36	35.9	36.12	35.29

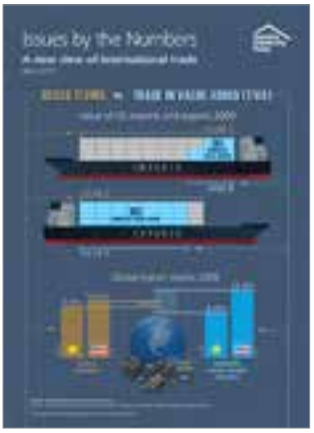
OECD composite leading indicators (amplitude adjusted)†

	US	UK	Eurozone	Japan	Brazil	China	India	Russia Federation
Dec 11	99.77	98.82	99.75	100.04	98.51	99.96	100.07	102.61
Jan 12	99.96	98.85	99.70	100.09	98.66	99.88	99.99	102.43
Feb 12	100.08	98.91	99.67	100.11	98.93	99.89	99.91	102.17
Mar 12	100.12	98.96	99.61	100.09	99.19	99.87	99.81	101.77
Apr 12	100.08	99.00	99.53	100.03	99.41	99.79	99.69	101.25
May 12	99.99	99.05	99.42	99.92	99.57	99.73	99.56	100.69
Jun 12	99.90	99.14	99.29	99.79	99.73	99.72	99.41	100.20
Jul 12	99.85	99.29	99.17	99.67	99.86	99.76	99.24	99.83
Aug 12	99.85	99.47	99.06	99.58	99.95	99.85	99.07	99.58
Sep 12	99.92	99.66	99.00	99.52	99.98	99.92	98.91	99.41
Oct 12	100.02	99.84	99.00	99.52	99.95	100.00	98.75	99.27
Nov 12	100.13	99.97	99.07	99.57	99.86	100.06	98.59	99.15
Dec 12	100.25	100.05	99.19	99.69	99.73	100.10	98.45	99.06
Jan 13	100.36	100.10	99.34	99.87	99.62	100.10	98.30	99.01
Feb 13	100.48	100.13	99.50	100.09	99.54	99.96	98.16	99.02
Mar 13	100.57	100.17	99.64	100.30	99.45	99.75	98.03	99.06
Apr 13	100.65	100.25	99.77	100.50	99.36	99.50	97.90	99.13
May 13	100.74	100.36	99.93	100.65	99.28	99.27	97.79	99.23
Jun 13	100.81	100.52	100.10	100.77	99.23	99.13	97.69	99.34
Jul 13	100.84	100.75	100.29	100.87	99.25	99.08	97.62	99.48
Aug 13	100.84	101.01	100.50	100.99	99.34	99.11	97.58	99.60
Sep 13	100.82	101.24	100.72	101.13	99.48	99.21	97.57	99.70
Oct 13	100.77	101.42	100.92	101.27	99.53	99.35	97.57	99.74

*Source: Bloomberg ‡MICEX rates †Source: OCED

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

Additional resources



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***United States Economic Forecast*, Volume 1 Issue 2**

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