Global Economic Outlook

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Illustrations by Stephanie Dalton Cowan

Introduction

By Dr. Ira Kalish

As we head into the new year, there are factors that are bound to have a substantial impact on the path of the global economy. Among these are the decisions that will be made by the US Federal Reserve, the European Central Bank, the Bank of Japan, the People's Bank of China, and the petroleum authorities of Saudi Arabia. Policy decisions by these and other governments, including those of the big emerging markets, will affect the path of exchange rates, commodity prices, inflation, and, ultimately, economic growth. For now, the world seems to be characterized by relatively strong growth in the United States, disappointing but improving growth in Europe and Japan, slowing growth in China, and weakness in many other emerging markets—the one big exception being India, where growth is actually quite impressive. The world is also characterized by very low inflation in the developed world, strengthening consumer spending in oil-importing countries, rising private sector debt in emerging countries, and weak business investment almost everywhere.

In the first-quarter edition of *Global Economic Outlook*, our far-flung economists examine the global economic environment and offer their thoughts on the current situation and the likely future path.

We begin with Alexander Boersch, who examines the Eurozone economy. Alex reports that, despite headwinds from emerging-market weakness and geopolitical tensions, the European economy has lately benefitted from strong tailwinds. These include lower energy prices, an aggressive monetary policy by the European Central Bank, a declining euro, and a neutral fiscal policy. The result is that Europe's economy is on track for favorable growth in 2016. Growth is especially strong in Spain and Ireland and is picking up in Italy. Alexander notes, however, that risks remain for Europe, and that business investment is weak. He discusses various policy levers that might boost investment in the future.

Next, Patricia Buckley offers her thoughts on the US economy. She notes that the recent decision by the Federal Reserve to raise short-term interest rates for the first time in nearly a decade reflects growing confidence in the strength of the US economy. Although the United States faces headwinds from weak exports, itself the result of a strong dollar, Patricia points to a variety of mostly favorable influences driving better growth. These include historically low oil prices, continued strong job growth, the positive impact of a high-valued dollar on import prices, and pent-up demand for housing. She says that the US economy "has returned to a state of health that warrants a more normal monetary policy stance—which should be viewed as a positive."

China is the subject of my contribution to the quarterly outlook, where I point to evidence that the slowdown in China's growth has been getting worse. However, I note that, given the level of policy interest rates, the central bank actually has plenty of room to act in order to stimulate more growth. On the other hand, it might be reluctant to promote even more capital outflows from China. Rather, it may decide to engage in more fiscal stimulus. Meanwhile, the International Monetary Fund has granted China's currency reserve status, setting the stage for more integration of China into the world's financial system. I discuss what this action might imply for the future direction of the currency.

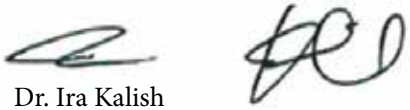
Next, Rumki Majumdar writes about the Indian economy. Rumki notes the relative strength of India's economy, with fast growth and modest

inflation. She says that consumer spending has led growth, but that it cannot be sustained going forward absent more investment and employment growth. She takes particular note of the external environment facing India's economy, examining India's trade with the rest of the world, including new trade agreements, as well as the environment for cross-border capital flows. She notes that inbound investment has been healthy, but that the trend toward less direct investment could be counterproductive.

In his article on Japan, Akrur Barua points to new data indicating that Japan did not experience a recession in 2015 after all. Yet he notes that consumer spending and business investment are "far from impressive." Given the weakness of neighboring China, he concludes that, going forward, Japan will have to do more to boost domestic demand in order to keep growth at a favorable level. He concludes that this will require implementation of structural reforms, also known as the "third arrow of Abenomics." He offers hope that completion of the Trans-Pacific Partnership will provide the impetus for the government to move on structural reforms.

In our next article, Ian Stewart notes the resilience of the domestic side of the British economy. He discusses all of the various headwinds that Britain's export sector faces and concludes that domestic demand will be key going forward. This seems likely given "a combination of falling unemployment, rising real wages, low inflation, and cheap credit." On the other hand, the corporate sector has been hit by reduced willingness to invest, largely because of concerns about the external environment. Finally, Ian discusses the hot political topic of the upcoming referendum on UK membership in the European Union. He notes the uncertainty about the outcome stemming from troubles in renegotiating Britain's relationship with the European Union as well as the impact of the refugee crisis.

Our last article, by Rumki Majumdar, looks at how emerging markets are likely to be affected by the change in US monetary policy. She examines the past experience of emerging-market responses to shifts in advanced-market financial conditions in order to infer what might happen next. She offers insights into the possible path of exchange rates, interest rates, and equity prices. Moreover, she notes that the likely outcome will be driven not only by US monetary policy but also by factors such as oil prices, China's slowdown, and major market exchange rates. She concludes that the key to resilience for emerging markets lies in structural reforms that provide confidence to investors.



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Strengthening the recovery

By Dr. Alexander Börsch

Looking back at 2015 . . .

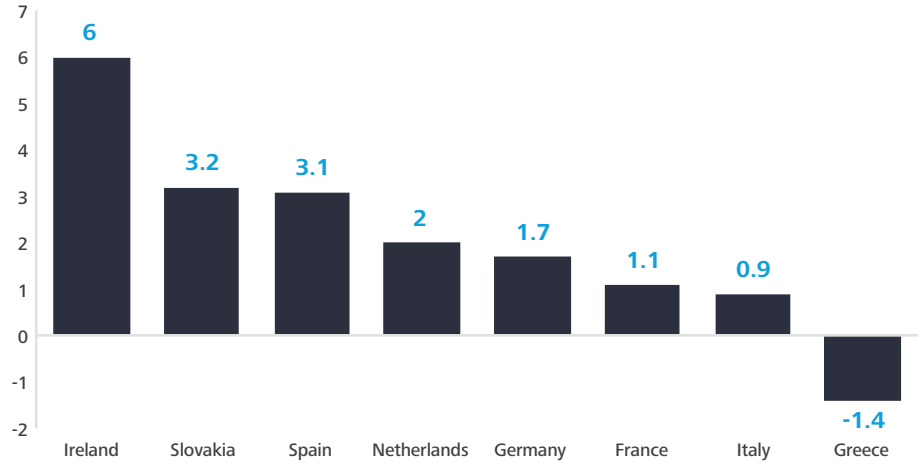
The end of 2015 marks the beginning of the third year of the recovery for the Eurozone. The Eurozone economy was supported by a variety of tailwinds in 2015. These include rapidly falling energy prices, a very expansive monetary policy by the European Central Bank, slowly receding unemployment, and a relatively weak euro value coupled with neutral effects from fiscal policy.

These supporting factors and their effects on exports and private consumption were enough to offset headwinds such as the economic weakness in emerging markets and geopolitical tensions, so that the recovery has been largely on track. While the initial phases of the recovery depended highly on exports and therefore on growth dynamics outside Europe, the current phase is based predominantly on private demand. Consumers were the main driver of the recovery in 2015, thanks to higher household spending and lower unemployment. This helped the Eurozone withstand the slower-than-expected global trade dynamics.

However, not only has the recovery continued but so have its weak underlying dynamics, making this recovery much slower than previous ones. In 2015, the Eurozone as a whole grew at 1.6 percent, after 0.9 percent in 2014.[1]

Not only has the recovery continued but so have its weak underlying dynamics, making this **recovery much slower** than previous ones.

Figure 1. GDP growth 2015 (percentage; forecast)



Source: European Commission.

Graphic: Deloitte University Press | DUPress.com

However, this average contains substantial differences (figure 1). The former crisis countries Ireland and Spain bounced back in spectacular fashion. Ireland's strong recovery was based initially on strong exports performance but has since broadened to include private demand and investment; the same is true for Spain. Germany grew very slightly above the Eurozone average, while Italy and France failed to reach the Eurozone average by a substantial margin. The variance of growth rates is very wide, indicating that the Eurozone continues to diverge instead of converge, contrary to the initial aim of the currency union.

. . . And forward to 2016

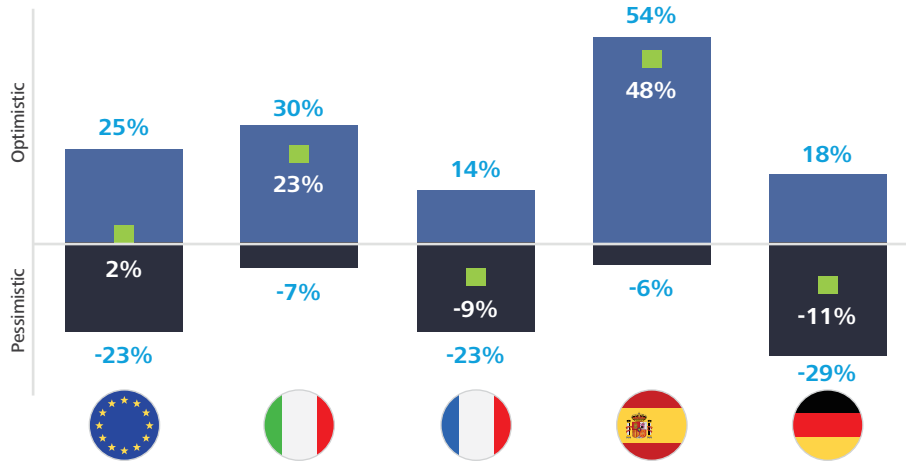
Corporate expectations at the end of 2015 are not clear cut but demonstrate cross-country differences similar to the 2015 growth rates. The Deloitte European CFO Survey (figure 2) shows that across the EMEA region, corporate sentiment is positive, but, at an index value of 2 percent, only slightly so. Among the big Eurozone countries, the sentiment differs in unexpected ways. Whereas German and Dutch CFOs are fairly pessimistic about their current outlook, the CFOs of big Italian and Spanish firms are much more optimistic. A big part of the pessimism of German CFOs, especially in manufacturing, has to do with their high export orientation and their focus on China and the emerging markets in the few last years.

In 2016, some of the growth drivers will likely continue to have a positive impact. Even if oil prices increase, they will probably do so gradually, so that on average they should have a positive effect; the same goes for the continuing expansive monetary policy of the European Central Bank. On the other hand, continuing weakness in China would drag on Eurozone exports.

Another risk factor is a potential return of the Greek crisis. European CFOs are quite pessimistic in that regard. Almost half of them believe that the compromise between Greece and the Eurozone countries has actually damaged the prospects for a stable and closely integrated Eurozone in the longer term; one-third of the CFOs are neutral, while 17 percent think it will have a positive impact.[2]

The impact of the refugee influx is difficult to predict. In the short term, the effect will likely be positive as public expenditure will have to rise. In the longer term, the effects depend on the integration of migrants into the labor market and their skill sets. The short-term impact will be most visible in Germany, which has registered almost 1 million immigrants in the first 11 months of 2015.

Figure 2. Financial prospects



■ **Index value:** Net balance of positive (optimistic) and negative (pessimistic) answers

Source: Deloitte LLP, *European CFO Survey: Confidence heads south*, November 2015, http://www.deloitteresearchemea.com/survey-pdf/deloitte-e-cfo-survey-q3-2015.pdf.

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What could spur investment activity?

One of the key questions, if not the most important one, for the Eurozone's growth in 2016 and beyond will be whether corporate investment activity will finally recover. Despite very favorable financing conditions in 2015 and an ongoing recovery, corporate investment has developed much slower than in previous recoveries and remains below precrisis levels. The low investment activity of European corporates is the main reason for the very modest recovery, and it is a severe threat to long-term growth. Expansive monetary policy has been shown to not be enough to kick-start corporate investment activity. This holds even for Germany, where a combination of extremely favorable financing conditions, a long-lasting recovery, record-high employment, and rising demand have not resulted in an investment surge yet. According to the German Deloitte CFO Survey, the investment propensity of German corporates is positive but fairly low, even in comparison to the rest of Europe.[3]

Three policy levers

Three public policy levers have the potential to contribute positively to the investment propensity of European corporates in 2016. The first is the public investment plan of the European Commission. The European Fund for Strategic Investments comprises capital of 5 billion euros from the European Investment Bank and a 16 billion euro guarantee from the European Union's budget. Through coinvestments by private investors, the fund is supposed to mobilize more than 300 billion euros of investment money for areas such as infrastructure, education, innovation, and renewable energy. While the plan alone will not be able to overcome investment weakness, it could provide valuable impetus.

Expansive monetary policy has been shown to **not be enough** to kick-start corporate investment activity.

The second lever is the Transatlantic Trade and Investment Partnership (TTIP). Negotiations are scheduled to finish by the end of 2016. While its exact form is controversial, the TTIP would create, by far, the biggest integrated economic area in the world. It could not only increase the flow of foreign direct investment to Europe; higher competition could also lead to higher investments by European firms in Europe. North America is also a key growth driver for exports from the Eurozone. For example, North America, and especially the United States, is the most important growth market in 2016 for German corporates in general, as well as the most important target for investments by the German manufacturing industry.[4]

Lastly, the creation of the digital single market could help investment activity recover. Investments in information and communications technology are much lower in Europe than in the United States, limiting the scale of the European digital economy and its growth potential.[5] Overcoming the current fragmentation of Europe's digital economy and creating a fully functioning digital single market could result in potential GDP gains of more than 400 billion euros per year, according to estimates by European institutions.[6]

In all, these policy levers could support and enable corporate investment on a European level. Using them alongside national measures to overcome the investment weakness would help transform the recovery from moderate to robust and self-sustaining.

Endnotes

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Outlook is solid—even the Fed thinks so!

By Dr. Patricia Buckley

AT its December meeting, the Federal Open Market Committee (FOMC) of the Federal Reserve (Fed) Board announced the first increase in the federal funds rate target since June 2006. Although the increase was small as anticipated (only 25 basis points), this move marked an important milestone in the recovery of the US economy, as the FOMC felt confident enough about the strength of the economy to start bringing to a close the period of very accommodative monetary policy that has kept the federal funds rate near zero for seven years.

So what changed between the October 27–28 FOMC meeting, where raising rates was held off, and the December 15–16 meeting? New data and data revisions indicated an economy that was stronger than it appeared seven weeks earlier. For example, the October estimate for third-quarter industrial production indicated a 1.8 percent increase; when that series was revised in November, it was estimated to have increased by 2.6 percent.[1] The apparent slowdown in employment growth particularly influenced FOMC members in October.[2] Figure 1 shows the most recent data available to the FOMC at the time of each meeting: The employment picture looked decidedly better at the December meeting, when the members had the much larger gains from October and November to factor into their deliberations.

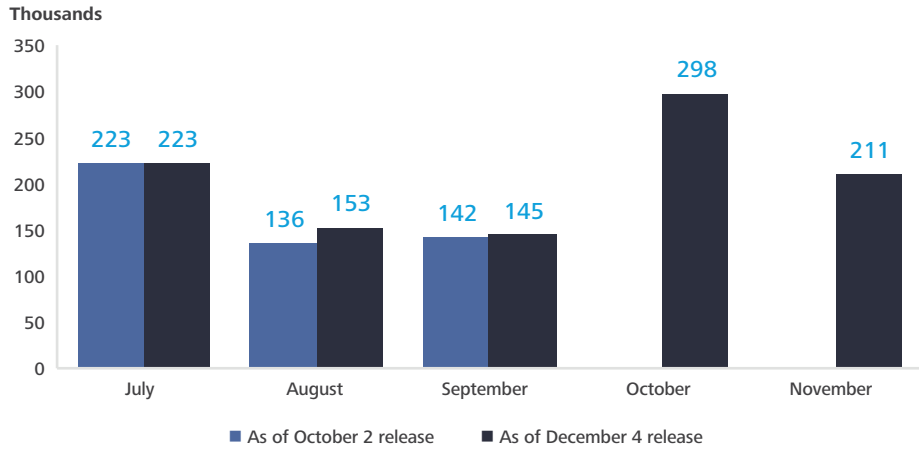
Although the first (or advanced) estimate of third-quarter GDP had not been released at the time of the October meetings, members had enough information from the monthly source data for at least part of the quarter (retail sales, real personal income, nominal shipments of nondefense capital goods excluding aircraft, housing starts, international trade, among others) to determine that real GDP was

increasing at a moderate pace, which proved to be quite accurate.[3] According to the most recent (second) estimate, US GDP increased 2.1 percent in the third quarter.

Factors shaping US growth

The two major trends that shaped growth in 2015, falling oil prices and the rising value of the dollar, should continue to exert similar pressures on the US economy in 2016. OPEC's December 4 decision, led by Saudi Arabia, to maintain its current stance of no production limits (in a bid to maintain market share and hopefully, from OPEC's point of view, drive US shale producers out of the market) and the prospect of increased Iranian production as sanctions are lifted will keep prices low.[4] The big question is, with oil prices currently at levels not seen since the depths of the recession, how low can prices go? Similarly, given the relative strength of the US economy, the prospect of higher interest rates, and the outflow of capital from emerging markets into the United States,

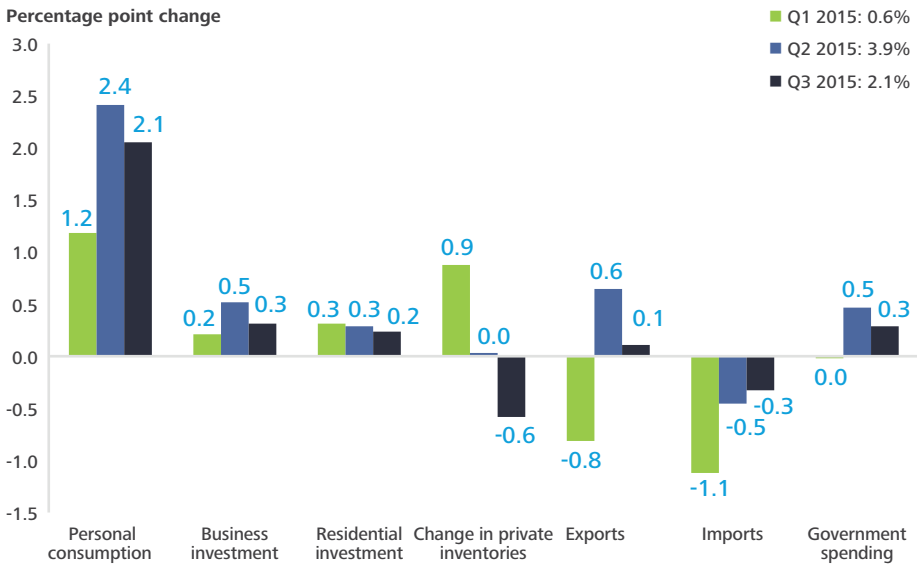
Figure 1. Different vintages of employment estimates



Source: US Bureau of Labor Statistics.

Graphic: Deloitte University Press | DUPress.com

Figure 2. Sources of growth in 2015



Source: Bureau of Economic Analysis.

Graphic: Deloitte University Press | DUPress.com

the value of the US dollar should continue to rise. Reinforcing both of these trends is the impact of slower growth in China. With China slowing, its falling demand for oil exacerbates the downward pressure on oil prices. China's slowdown is also a primary contributor to falling prices in most commodities—everything from platinum to cotton. This has been a shock to commodity exporters, including many emerging markets, which are facing downward pressure on their currencies as investors flee to safer havens, including the United States. This flight, in turn, further depresses their currencies relative to the dollar—a critical problem since much of their considerable debt is dollar denominated.

Therefore, most of the factors that shaped the first three quarters of 2015, shown in figure 2, should continue well into 2016, with the possible exception of government spending:

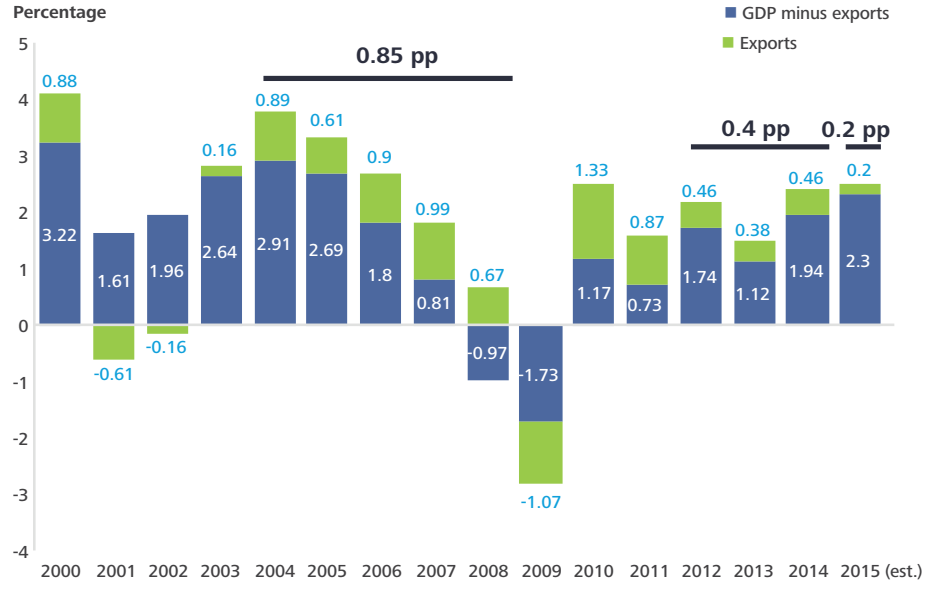
- With employment continuing to increase, gas prices likely to remain low, and a very strong dollar making imported goods cheaper, real personal consumption should continue to make substantial contributions to GDP going forward.
- Business investment has been constrained by the mining sector's slowdown in investment in each of the three quarters of 2015, and, with the price of oil remaining low, this drag will likely continue into 2016.
- The recovery in residential investment is set to remain on a moderate path, at least in the near term.

- The strong dollar makes nominal imports relatively cheaper, which should increase the growth rate of real imports—thus providing additional drag on the economy.
- There might be some pickup in government spending at the federal level, as the most recent budget deal provided some relief from the spending limits that were put in place in 2013 (sequestration).

Focus on exports

The contribution of exports to growth in 2015 was minimal; this is a shift from the recent past. As shown in figure 3, when the economy finally returned to a more normal footing during 2004–07 following the 2001 recession, exports contributed 0.85 percentage points per year on average to GDP. With the continued slow growth of US trading partners, that contribution dropped to 0.4 percentage points during the last few years (2012–14), as the US economy continued to recover from the 2008–09 recession. With the added headwind of a soaring dollar value, exports are on track to contribute only 0.2 percentage points to growth this year. Since the dollar is likely to continue becoming stronger, the prospects for exports to be a significant engine of growth in 2016 remain limited.

Figure 3. The contribution from exports has declined over time



Source: Bureau of Economic Analysis.

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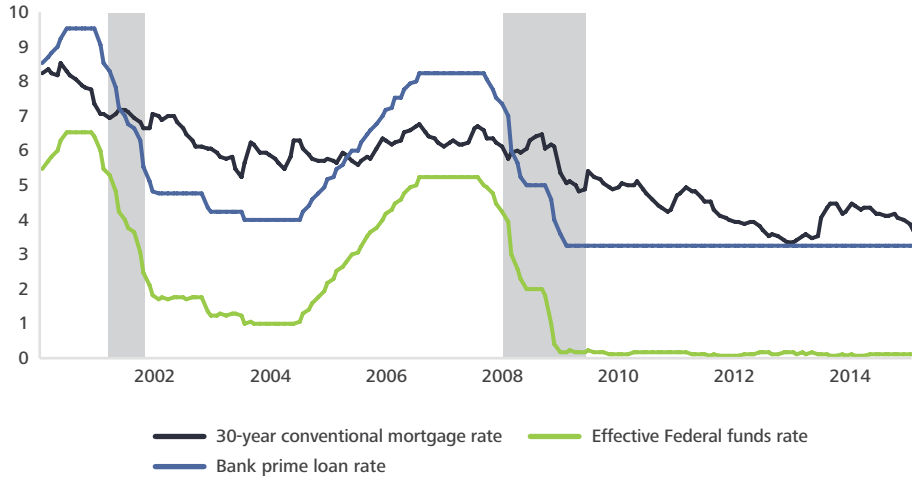
The two major trends that shaped growth in 2015, **falling oil prices** and the **rising value of the dollar**, should continue to exert similar pressures on the US economy in 2016.

So what happens with a higher federal funds rate?

The federal funds rate is the interest rate that banks charge each other for overnight interbank loans—they frequently need the loans to maintain their required nightly balances that must be held by the Fed. So how does this transmit through the broader economy? The most immediate impact of a change is felt through the prime rate and the London Interbank Offered Rate (LIBOR), which generally move in lockstep with the federal funds rate. The LIBOR is generally equal to the federal funds rate, and the prime usually is set at a premium of approximately three percentage points over the federal funds rate (figure 4). The prime and LIBOR are short-term rates that banks use to set rates on a variety of short-term commercial and consumer loans. For example, 62 percent of commercial and industrial loans made by small domestic banks (under $5 billion in assets) and 21 percent of such loans made by large domestic banks ($5 billion or more in assets) are tied to the prime.[5] These are also used as the basis for consumer loans, including adjustable rate mortgages, credit cards, and private student loans. Other loan types, such as 30-year conventional mortgage rates (figure 4), are less responsive to the movement in short-term rates; instead, they reflect the expectation of the longer-term economic outlook and specific market conditions.

The US economy, while not booming, has returned to a state of health that should warrant a more normal monetary policy stance—which should be viewed as a positive. Interest rates have been near zero since 2009. In acting now, the FOMC has allowed itself the opportunity for a slow, measured increase in interest rates—a pace unlikely to derail the recovery, but one that signals that price stability remains a focus. And with higher interest rates, the FOMC restores one of its most powerful levers: the space to reduce interest rates should a downturn develop.

Figure 4. Selected short- and long-term interest rates



Source: Federal Reserve Board and Freddie Mac, retrieved from FRED/Federal Reserve Bank of St. Louis.

Graphic: Deloitte University Press | DUPress.com

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No reversal of slowdown yet

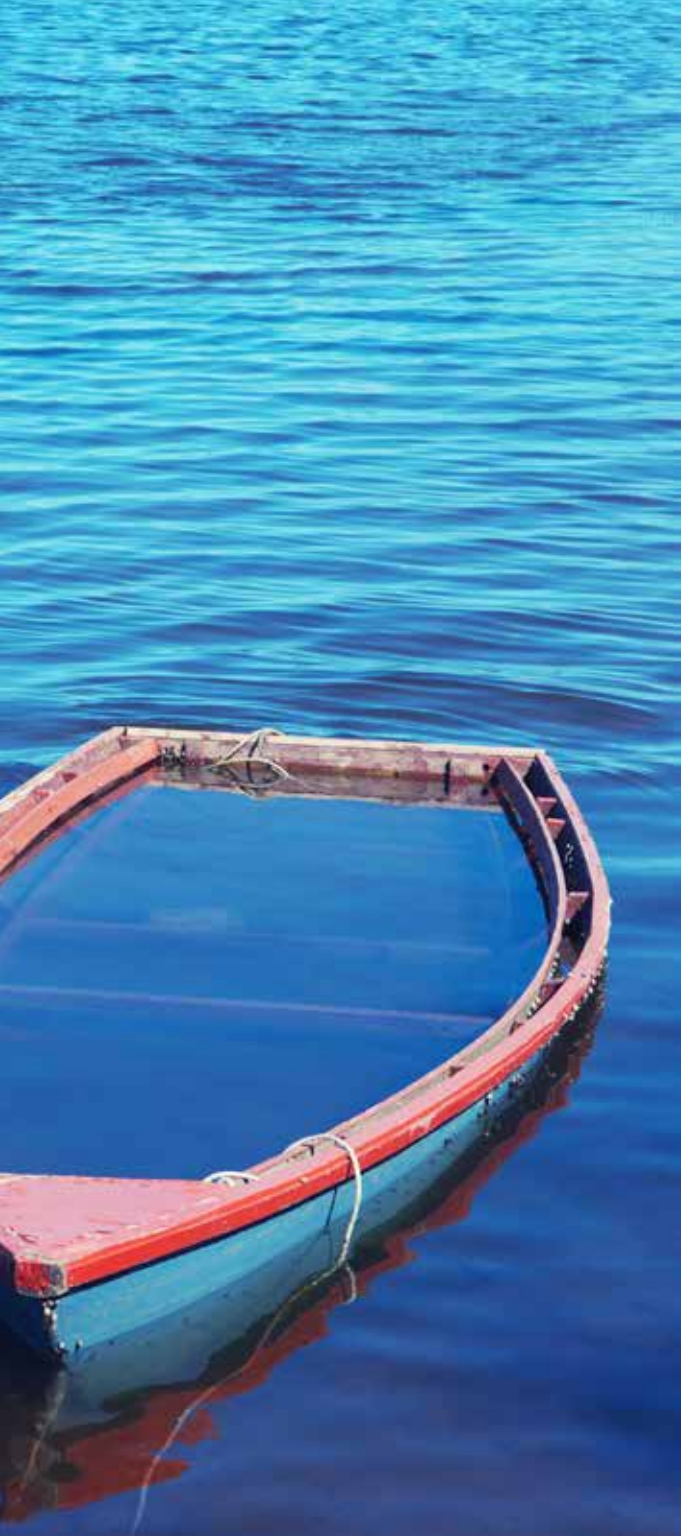
By Dr. Ira Kalish

Economic performance

In recent months, China's economy has continued to disappoint those observers who had expected that the slowdown would abate and possibly reverse. For example, industrial production was up only 5.6 percent in October, the slowest rate of growth since April and the second slowest in six years.[1] Although newer industries accelerated, older ones continued to decline. A statement from the government said that "the marginal fall in October's industrial production growth showed support from the rapid development of new industries was still insufficient, while traditional industries were having deep corrections."[2] Excess capacity in heavy industry remains a serious concern.

In addition, the government reported that fixed asset investment in the first 10 months of the year was up only 10.2 percent, the slowest rate of growth since 2000 and the 17th consecutive month that the rate of growth declined.[3] Given massive excess capacity, it makes sense that investment in new assets would decelerate. Notably, investment in property was up only 2.0 percent from a year earlier, the

Investments coming from the United States, Japan, and Taiwan declined. **Investments increased** from the European Union, ASEAN, Hong Kong, and Macau.



slowest pace since 2004. On the other hand, investment by local governments was up 10.6 percent, as Beijing seeks to use fiscal stimulus to reverse the downturn.[4]

On the positive side, the government reported that retail sales remained relatively robust. Sales were up 11.0 percent in October versus a year earlier, the fastest rate of growth this year. In addition, sales of automobiles increased 13.3 percent in October versus a year earlier, the fastest rate of growth in 17 months.[5] The strength of consumer spending was attributed to rising wages combined with low inflation. Wages are rising, in part, due to the demographically driven weak growth of the working-age population. Strong retail sales reflect a rebalancing of the Chinese economy away from a focus on exports and investment, and toward consumer demand. This is good news in that China badly needs to make this transition. But given that consumer spending remains roughly a third of GDP and investment is nearly half of GDP, it would take a very substantial boost to consumer spending to offset the slowdown in investment. As such, it is not surprising that economic growth has slowed considerably.

Foreign direct investment (FDI) into China was up 4.2 percent in October, a sharp slowdown from the previous month. For the first 10 months of the year, FDI was up 8.6 percent from the previous year.[6] A disproportionate share of the increase was in the services sector, especially high-tech services. Within manufacturing, a disproportionate share of the increase was in high-tech manufacturing. Investments coming from the United States, Japan, and Taiwan declined. Investments increased from the European Union, ASEAN, Hong Kong, and Macau. Finally, a rising share of FDI was due to merger and acquisition activity.

Inflation and monetary policy

Consumer price inflation in China continues to fall. In October, prices were up 1.3 percent from a year earlier, the lowest rate of inflation in five months and lower than investors had expected. Meanwhile, the government reported that producer (or wholesale) prices fell 5.9 percent in October versus a year earlier, the 44th consecutive month in which producer prices were down.[7] This wholesale price deflation has contributed to lower profit margins for debt-laden companies in heavy industry. Although the central bank has cut interest rates six times this year, the benchmark rate remains a relatively high 4.25 percent—much higher than the rate of inflation. As such, China's monetary policy is still not very aggressive. The real, or inflation-adjusted, interest rate remains quite high. This is very different from what is happening in the United States, Eurozone, Japan, or United Kingdom. In each of those locations,

central bank rates are lower than the rate of inflation, providing financial markets with negative real interest rates and a stimulus for credit market activity. In the case of China, the central bank has actually been rather reticent. On the other hand, and unlike in the world's other major economies, the Chinese central bank has plenty of room for more action. Given the evident and continuing weakness of the economy, it could, in fact, decide to take more action. However, the Chinese central bank might be averse to cutting rates further as that might lead to more capital outflows and, therefore, more downward pressure on the renminbi. Instead, the government may choose to stimulate the economy through fiscal policy, that is, through increased government spending. And, again unlike the world's other major economies, China has minimal government debt and can boost spending without creating any debt-servicing challenges.

Now that the IMF has designated the **renminbi as a reserve currency**, investors are curious about whether China will allow the renminbi to float.

Currency issues

The International Monetary Fund (IMF) announced that the Chinese renminbi can be considered a reserve currency. Specifically, the IMF will now include the renminbi in its basket of currencies that make up the special drawing rights that member countries can tap. The other currencies in the basket are the US dollar, the euro, the British pound, and the Japanese yen. The renminbi will have a weight of 10.92 percent in the basket. In the short term, this is likely to be largely symbolic, indicating that China's authorities have undertaken sufficient reforms to enable the IMF to add a country for the first time in 35 years. In the longer run, however, it will probably boost demand for the renminbi as central banks and fund managers adjust their portfolios to take account of the new status of the Chinese currency. That increased demand could boost the value of the renminbi above what would otherwise be the case.

Now that the IMF has designated the renminbi as a reserve currency, investors are curious about whether China will allow the renminbi to float. Deputy Central Bank Governor Yi Gang said that there will be no "sudden changes" in the value of the currency, and that "this decision [by the IMF] is a very important symbol that recognizes the stature of the renminbi and has made us very happy. Our attitude towards the exchange rate won't change, but our market reforms will continue nonstop. There is no basis for continued yuan depreciation. Our basic exchange-rate policy won't change [even as] market-oriented reforms move continuously forward."[8] Yet there could be a basis for yuan depreciation. Substantial capital outflows have put downward pressure on the currency. The only thing preventing further depreciation has been massive central bank sales of foreign currency reserves. Evidently, the central bank intends to continue these sales. However, the government has lately imposed new restrictions on capital movements and cracked down on illegal capital flows in order to lessen the need for such intervention.

Finally, many analysts expect China's central bank to gradually allow further depreciation. Indeed, the current outflow of capital is likely due to expectations of further depreciation. Yi, however, argues that the currency is likely to stabilize on its own as capital outflows will be offset by new purchases of renminbi due to

the rising importance of the currency. He said, "Renminbi reserves will be raised internationally by central banks and private institutions. Outward direct investment is also increasing very fast because Chinese people need international investment options. Net flows will be stable." He did say, however, that if there is "unusual activity in capital flows," the central bank will intervene to stabilize the currency.[9]

Two-child policy

China's government recently made global headlines when it announced that it will end the famous one-child policy and allow urban couples to have two children. A senior Chinese government official said that the adoption of the two-child policy will boost annual economic growth by 0.5 percentage points—although he didn't say when this would happen. Even if people begin to substantially boost fertility now, it will take a generation before that has a direct impact on the size of the labor force. However, there could be a more immediate impact due to increased demand for larger homes and for more food, clothing, education, and health care. Thus economic growth could accelerate fairly quickly—if people do, in fact, choose to boost fertility. The government says that its own survey suggests a strong desire to have more children. Yet whether people actually choose to act on their desire remains to be seen. The government official also said that, by 2050, the new policy will boost the size of the labor force by 30 million people and will reduce the elderly share of the population by 2.0 percentage points.[10] This is important as China currently faces the prospect of a sharp increase in the ratio of retirees to workers.

A senior Chinese government official said that the adoption of the two-child policy **will boost annual economic growth** by 0.5 percentage points—although he didn't say when this would happen.

Endnotes

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INDIA

Go beyond borders to grow beyond borders

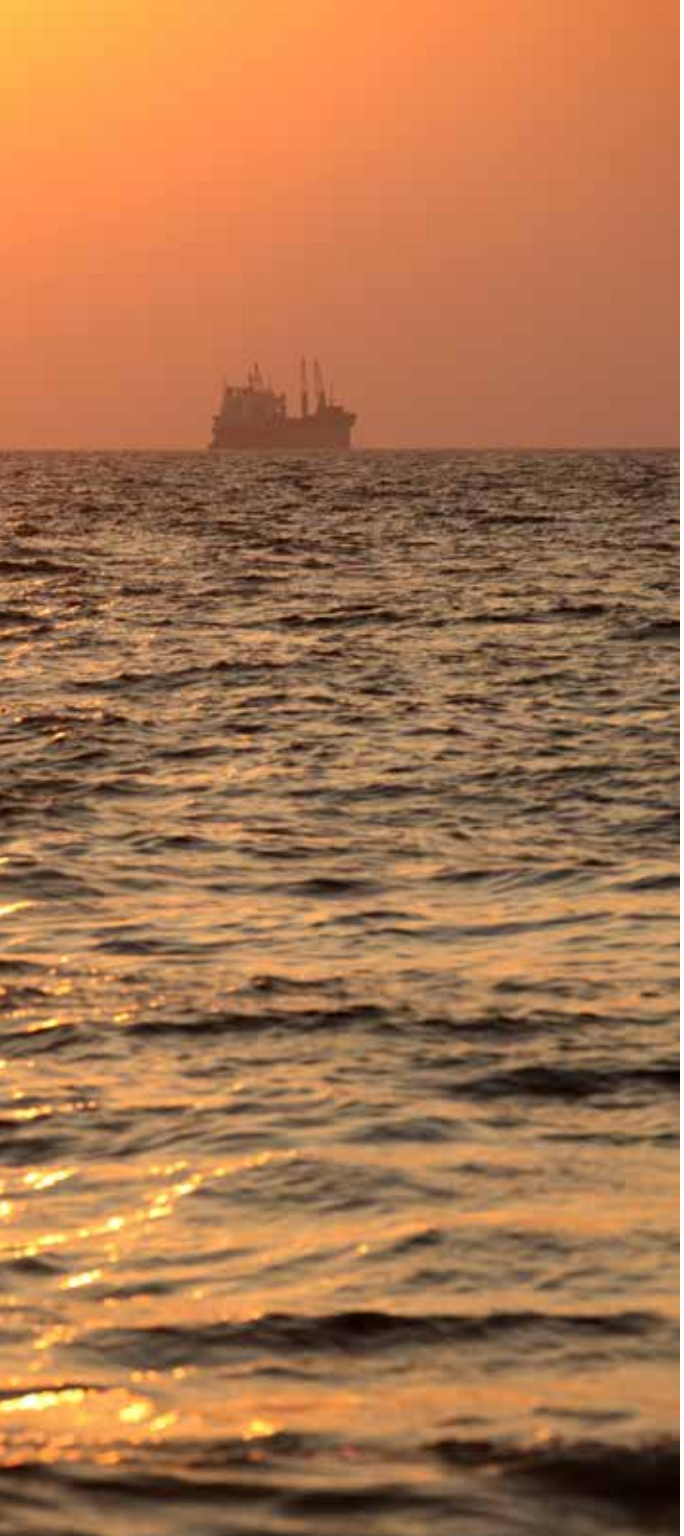
By Dr. Rumki Majumdar

INDIA'S growth story looks very optimistic: GDP grew at 7.4 percent in Q2 FY 2015–16, and the government expects growth to exceed 7.3 percent this fiscal year.[1] Inflation declined rapidly (thanks to falling commodity prices) in the past year and is expected to remain within the estimated range. India has managed to maintain a healthy current account balance since 2013, and the government is committed to bringing down its deficit steadily over the next two years.

On the policy front, the government is implementing a series of reforms and investing in infrastructure: Recently, the government eased the foreign direct investment (FDI) norms for 15 sectors, including mining, defense, civil aviation, and broadcasting, in a bid to boost investment and growth. The recent rate cuts by the Reserve Bank of India (RBI) indicate a shift in the monetary policy stance from controlling inflation to boosting growth. Overall, India is gradually firing up its engine to ensure long and sustained growth.

However, India's growth has primarily been consumption led, and the contributions of the external sector and investment to GDP have not changed much since the start of the millennium. With a rapidly growing population and an urbanizing economy, India will likely find it difficult to sustain growth in the long run if rising demand is not supported by increasing supply and employment.

In last quarter's *Global Economic Outlook*, we focused on the need to step up investment in India.[2] In this edition, we discuss India's integration with the world through the twin channels of trade and capital flows.

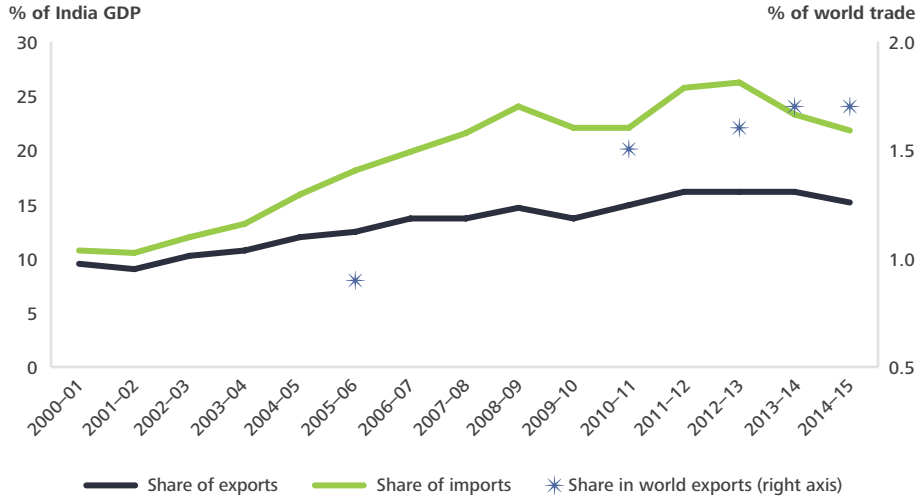


Trade

India is currently the 19th-largest exporter and 12th-largest importer of merchandise trade in the world. India's share in global merchandise exports has gone up from 0.7 percent in 2005 to 1.7 percent in 2014. Exports' contribution to India's GDP has increased from 9.5 percent to 15.7 percent during this period (figure 1). However, imports have increased at a faster pace, with total goods imports rising from 15.9 percent in 2004–05 to 26 percent in 2012–13, before falling to 21.7 percent in 2014–15.

Over the last decade, India's export and import destinations have moved away from advanced economies to emerging economies, particularly to Asia, Africa, and Latin America (figure 2). Asia alone accounted for 50 percent of India's exports and 59 percent of imports in FY 2014–15.

Figure 1. Trade in merchandise



Source: EXIM Bank; World Trade Organization; Ministry of Commerce and Industry, Government of India.

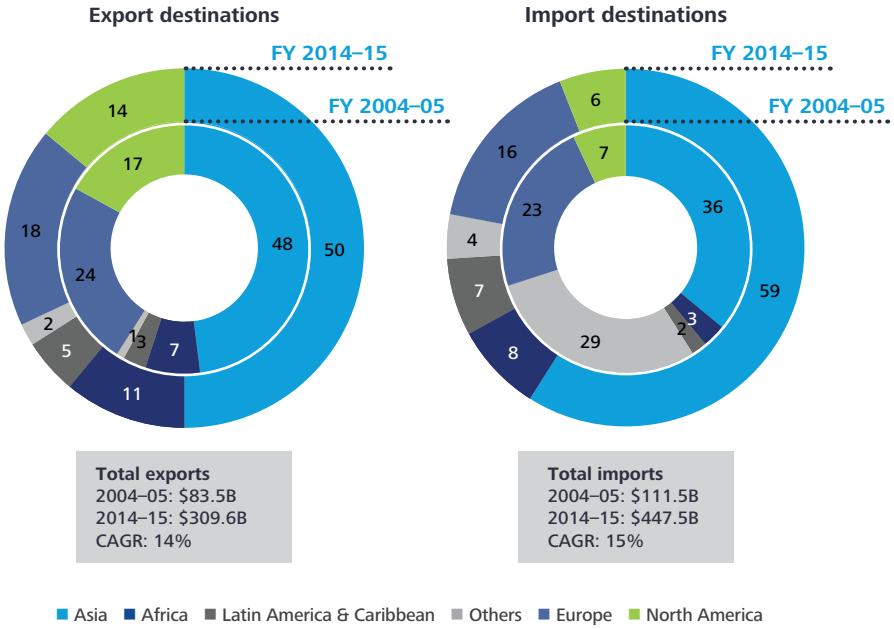
Graphic: Deloitte University Press | DUPress.com

The United States has been India's top export destination, followed by the United Arab Emirates, while China supplied 13.5 percent of total import demand in FY 2014–15. Petroleum products, precious stones, and jewelry are India's major exports, while crude petroleum accounts for 26 percent of total imports (figure 3).

India's export of services contributes 7.5 percent to GDP, of which 46 percent comes from software. In commercial services, India is the sixth-largest exporter (with a share of 3.3 percent of global services exports) and ninth-largest importer (with a share of 2.9 percent of global services imports).[3]

Over the last decade, India's export and import destinations have **moved away from advanced economies to emerging economies**, particularly to Asia, Africa, and Latin America.

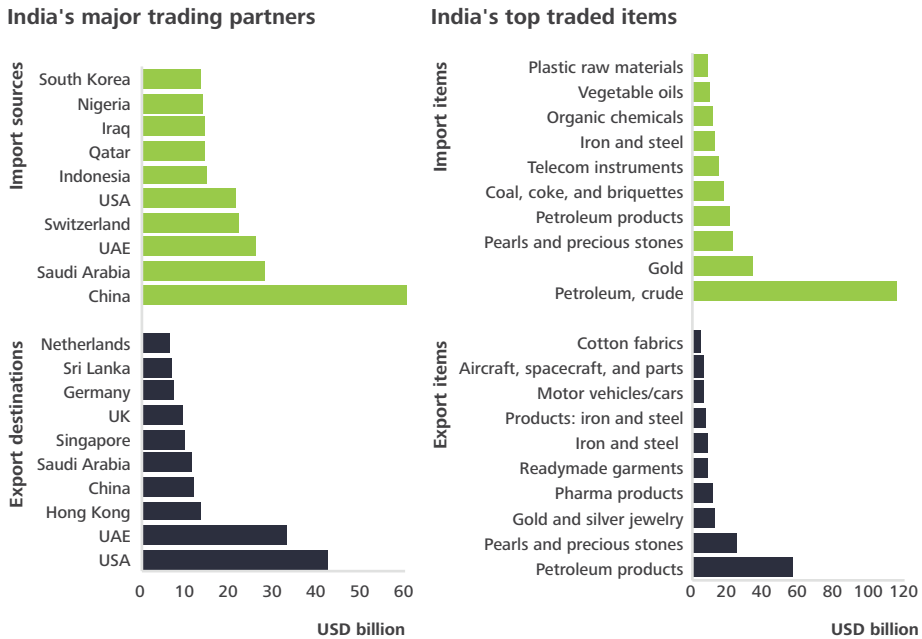
Figure 2. Trade destinations



Source: EXIM Bank.

Graphic: Deloitte University Press | DUPress.com

Figure 3. India's trading partners and trading basket in FY 2014–15



Source: EXIM Bank.

Graphic: Deloitte University Press | DUPress.com

Figure 4. Capital flows boost growth through demand-supply channel

Graphic: Deloitte University Press | DUPress.com

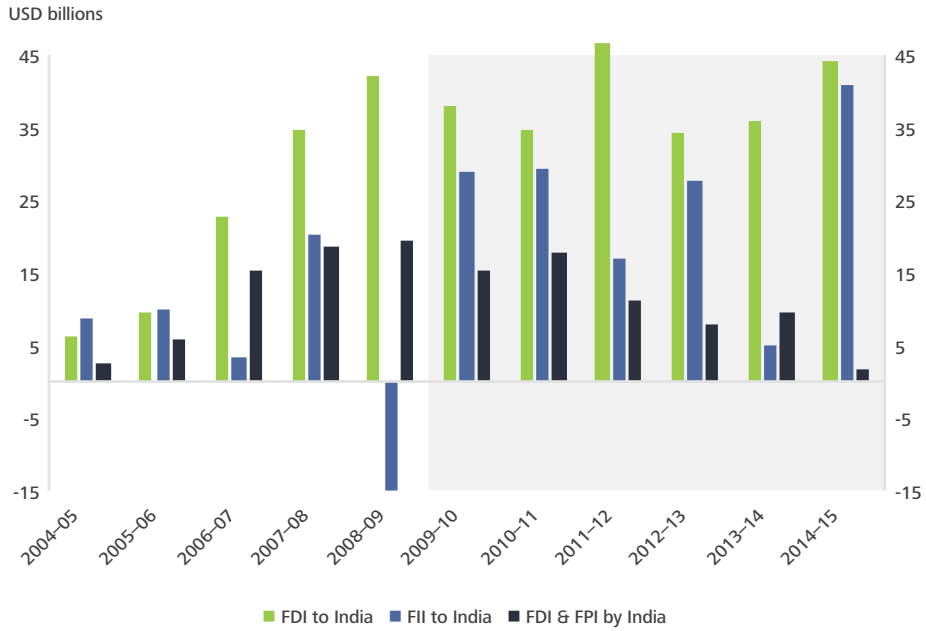
Investment

Although not significantly corroborated by studies, there is empirical evidence of strong capital inflows, particularly FDI, boosting growth in emerging economies through enhanced demand and supply (figure 4).

India's financial sector opened up gradually to foreign investments in the 1990s. However, the pace of capital inflows to India picked up after 2005–06. On the other hand, investment by India overseas declined sharply (figure 5a). So far, FDI has been the dominant form of capital inflows. However, the share of portfolio investment, particularly institutional investment (FII), has increased significantly after the 2008 crisis (except during 2013–14) owing to high global liquidity and an improving economic outlook.

Since 2000, Mauritius and Singapore have together accounted for approximately 50 percent of the total FDI into the economy; in FY 2014–15, the United Kingdom, Japan, Netherlands, and United States accounted for another 25 percent (figure 5b). The services sector has been the most favorable destination for FDI, followed closely by telecom, automobile, and computer software and hardware.

Figure 5a. Capital flows



Source: EXIM Bank; Ministry of Commerce and Industry, Government of India.

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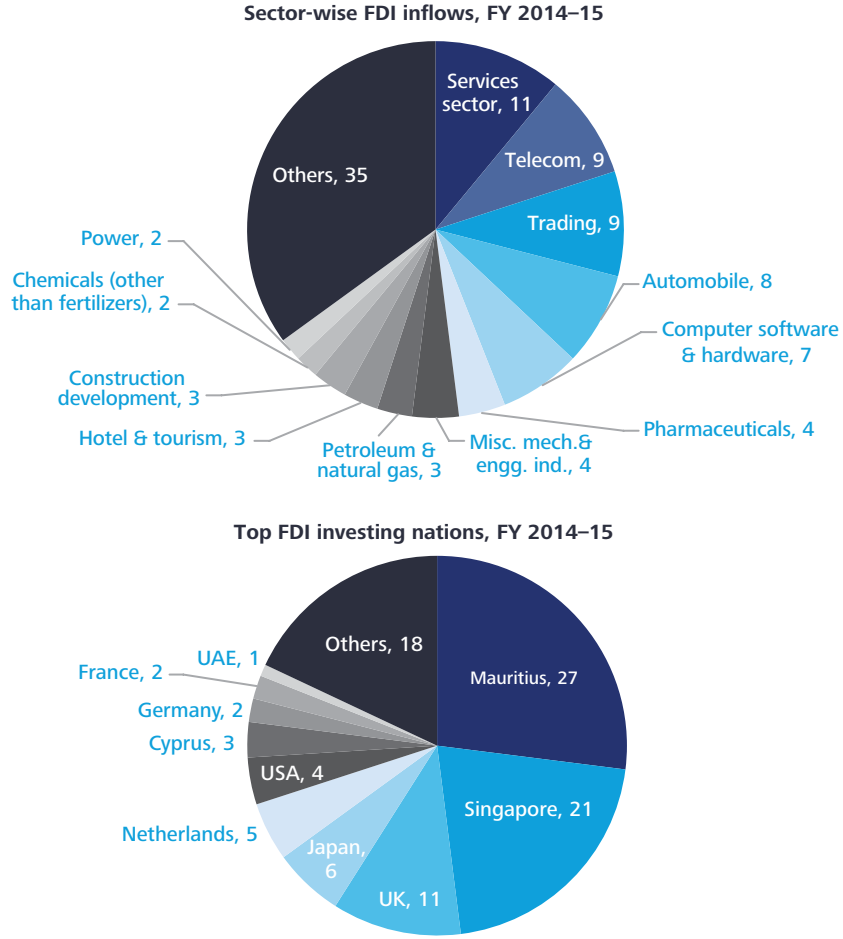
Figure 5b. India's FDI inflow at $30.9 billion in FY 2014–15



Source: EXIM Bank; Ministry of Commerce and Industry, Government of India.

Graphic: Deloitte University Press | DUPress.com

India has been signing trade agreements at a blistering pace in recent years. However, the **purpose of these agreements is not being met** for several reasons.

India's participation in trade pacts

In FY 2013–14, exports of goods and services together accounted for 23 percent of GDP and amounted to $465.9 billion.[4] The government now aims to increase exports to approximately $900 billion and raise India's share in world merchandise exports from 1.7 percent to 3.5 percent by FY 2019–20. With this objective, the Foreign Trade Policy (FTP) of 2015–20 has laid the framework of rules and procedures for exports and imports. Various schemes, such as tax rationalization, export basket diversification, tariff policy optimization, and cost reduction, are being implemented to enhance exports. In addition, efforts are being made to link procedures and incentives for trade with initiatives in order to promote India as an investment destination.

Lately, India has aggressively operationalized trade agreements with countries and trading blocs. Arrangements such as free-trade agreements (FTAs) have helped India access other nations' markets by eliminating tariff and nontariff barriers. India has preferential access, economic cooperation, and FTAs with about 54 individual countries, and it has signed bilateral and regional trade engagements with about 20 groups or countries.[5]

Three mega agreements under negotiation are transforming the global trading landscape: the Trans Pacific Partnership (TPP), Trans-Atlantic Trade and Investment Partnership (TTIP), and Regional Comprehensive Economic Partnership (RCEP). Given their coverage and scope, these trading arrangements go beyond trade in goods and services into areas such as investment, competition, intellectual property, the labor market, environment, government regulations, operations and transparency, and dispute settlement.

India is part of RCEP negotiations.[6] If the RCEP is implemented, India will likely benefit from lower trade barriers, larger markets for its products, and better integration with other major Asian regions. The agreement will also open up better investment opportunities within the region.

However, India's absence from the TPP and TTIP has stirred a debate on whether India has failed to pursue opportunities that could substantially improve its competitiveness and productivity. These mega agreements are expected to challenge India's industry by eroding existing preferences for Indian products in established traditional markets such as the United States and European Union, and by establishing a more stringent and demanding framework of rules for trade.

NOT JOINING TPP: A LOST OPPORTUNITY?[7]

Among the three agreements, the TPP appears to be at the most advanced stage of development. Not being a part of the negotiation may put India at a disadvantage. Many of the signatories, such as Singapore, the United States, and Japan, are India's top trading partners, and India would have to compete against other signatories, such as Vietnam, which is one of the lowest-wage, fastest-growing economies. According to a study by Petersen Institute, "India could experience huge exports gains of more than $500 billion per year from joining an expanded TPP or participating in a comprehensive free-trade area of the Asia Pacific."[8] Below are the possible advantages and disadvantages of India joining or not joining the TPP trading bloc.

If India does not join TPP

Possible advantages

- More investment opportunities with the bloc and prospects for developing its own global value chain (GVC)
- More flexibility around a few restrictive provisions, such as investor-state dispute settlements, and incentives for state-owned enterprises

Possible disadvantages

- Reduced market access to some top trading partners due to trade diversion and low trade creation
- Restricted terms of trade, lower export competitiveness, and limited participation in GVCs

If India joins TPP

Possible advantages

- Better market access, intellectual property protection, and economies of scale for sectors
- Better reforms and less monopolistic practices

Possible disadvantages

- Imports increasing more than exports, with a worsening trade deficit outweighing GDP gains
- Increased dependence on imports and limited domestic value addition, output, and employment, due to increasing GVCs and trade in intermediate products

INDIA-JAPAN CEPA

One of the many objectives of the bilateral Comprehensive Economic Partnership Agreement (CEPA) was to enhance trade and deepen economic ties between India and Japan. After it came into effect in 2011, bilateral trade reached $18.5 billion in FY 2012–13 from $13.7 billion in FY 2010–11.

However, since then trade has slipped to $15.5 billion in FY 2014–15, with India's share being only $5.4 billion. India's trade deficit with Japan, which was $3.5 billion in 2010–11 before CEPA implementation, almost doubled to $6.3 billion in FY 2012–13. Inflows of Indian goods into Japan have remained restricted because of certain nontariff barriers imposed by the latter.

Some Indian companies have been able to invest in Japan. For instance, Lupin acquired a 90 percent stake in an Osaka-based generics firm, Kyowa Pharmaceutical Industry Co.[10]

However, India's ability to harness Japan's technological prowess has remained limited. While Japan has shared a few technologies, such as those related to renewable energy, it has hesitated to share high-end technologies related to civil nuclear technology, amphibious aircrafts, and Soryu-class submarines.

Still a long way to go

India has been signing trade agreements at a blistering pace in recent years. However, the purpose of these agreements is not being met for several reasons.

Weak domestic fundamentals: Since Q3 2014, exports have been steadily falling. While poor global demand and falling commodity prices have been cited as reasons for the decline, domestic factors such as poor export competitiveness, a weak manufacturing sector, infrastructure bottlenecks, special economic zones not reaching their full potential, and India's poor link to GVCs are also hurting its export ability. In addition, exports of goods and services are not diversified enough; the top two exported items—petroleum products; pearls, precious stones, and gold—significantly depend on the imports of these products' raw materials. Consequently, India has to depend on foreign intermediaries for production and export.

Signing FTAs not enough: Despite the rising number of FTAs in recent years, poor domestic infrastructure and lack of awareness among industries and exporters, especially those in the medium and small-scale enterprises, have limited the benefits of FTAs. Market access opportunities for business and industry have remained restricted due to the absence of a uniform goods and services tax (GST), lack of appropriate technology and standardization of products, and poor nurturing of sectors with significant export potential. In addition, the inability of the manufacturing sector to produce high-quality merchandise has restricted India from enhancing exports.

Increasing imports: Rising FTAs have resulted in the stronger presence of enterprises from partner countries in the Indian market. A rapid rise in the middle-class urban population and its increasing appetite for imported goods have increased imports and adversely affected the trade balance, domestic producers, and employment.

Rising share of FII in capital flows: On the investment front, India's position in total capital flows is relatively comfortable; it has been one of the fastest-growing destinations for FDI and has surpassed both China and the United States in the FDI league tables in 2015.[9] The share of FII is significantly trending up. However, unlike FDI, FII does not bring in better technology, technical knowhow, and management practices, and it often causes volatility in the stock market and currency.

Steps forward

India is a growing market with a vast customer base. Thus it will always be an attractive destination for other nations, whether for trade or investment. However, if India wants to grow beyond its borders, it has to decide whether to participate in new forms of trading arrangements, as well as the pace and extent of such participation. The state of the external environment, the changing global trading

landscape, and GVCs will profoundly affect India's trade and investment. The good news is that India is gradually making progress in the desired direction.

Addressing constraints: The government's emphasis on a strong manufacturing sector with technological sophistication and specialized niche products will likely boost value-added exports. The intention to improve the ease of doing business, taxation systems such as GST reforms, and the state of infrastructure will likely facilitate global trade engagement and increase competitiveness.

Diversifying strategy and scope: India is trying to deepen its economic and trade relations with east-Asian, African, and Latin American nations, apart from the United States and European Union. These relations not only encompass trade and investment but also capacity development and technical assistance. In addition, diversifying its export basket by including products with higher value addition, exporting services, and promoting employment-generating sectors will likely enhance India's export ability.

GVC and e-commerce: India's participation, its moving up the GVC, and the sale and purchase of Indian goods and services over e-based platforms could be crucial to boosting exports and thereby growth.[11] In 2011, India's share in value-added exports was a mere 2.4 percent of total world exports.[12] On the other hand, the services sector has used the telecommunication revolution better than the merchandise goods sector has to rapidly expand techniques of promotion and markets for selling and buying. Faster integration with the changing world production structure and with other economies through GVCs and e-commerce will likely help India reap the benefits of growth in value-added products and services.

Whole-of-government approach: The government is designing the FTP to proactively link trade with initiatives such as Make in India, Digital India, and Skills India. This can leverage India as a manufacturing hub for GVCs and attract FDI into the country. In this process, the government is coordinating all its departments to reduce transaction time and costs, and to better manage border controls and procedures. In addition, it is trying very hard to organize several FTA outreach programs in order to create awareness among exporters.

Endnotes

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11. A country's participation in a GVC can be assessed by estimating the percentage of a country's exports as a part of GVCs. The participation is of two types: backward participation (use of foreign intermediaries in the country's exports) and forward participation (use of the country's intermediaries in other countries' exports). In the case of India, backward participation is higher than forward participation (OECD-WTO Trade in Value Added).
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Uneasy is the economic tide

By Akrur Barua

The flip-flop on GDP growth figures, though, **casts some doubts** on the reliability of national accounts data, a complication Japan could do without at this stage.

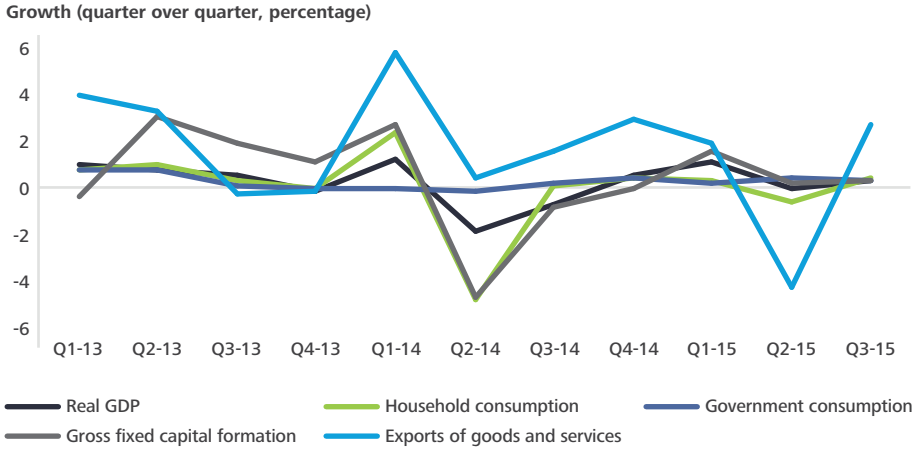
POLICYMAKERS in Japan can likely breathe a little easier. In December 2015, revised estimates of national accounts data showed that the economy did not enter a technical recession in Q3. Earlier, initial estimates had pointed to GDP declining for the second straight quarter in Q3. The revised data show that GDP actually grew in Q3, although growth in key components such as household consumption and investment is still far from impressive.

With external demand likely to be weighed down by a slowing China, Japanese policymakers will have to rely more on domestic sources of growth, especially investments, but that is where trends have been disappointing this year. Despite healthy profits, Japanese corporations have been loath to increase capital expenditure—possibly due to factors such as uncertainty in the global economy and subdued domestic demand.

Saved by a data revision

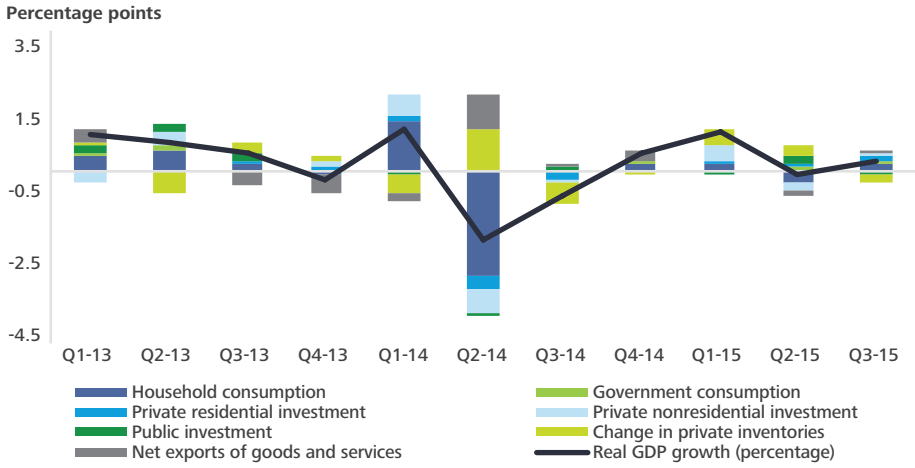
The economy expanded 0.3 percent quarter over quarter in Q3, according to revised official figures. Initial estimates had pointed to a 0.2 percent decline, indicating that the economy would enter a technical recession for the fifth time since 2008; GDP had contracted 0.1 percent in Q2 (figure 1). Thankfully, that was not the case. The flip-flop on GDP growth figures, though, casts some doubts on the reliability of national accounts data, a complication Japan could do without at this stage.[1]

Figure 1. Japan avoided a technical recession in Q3



Source: Haver Analytics; Deloitte Services LP economic analysis.

Figure 2. Private inventories and public investments dented GDP growth in Q3



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

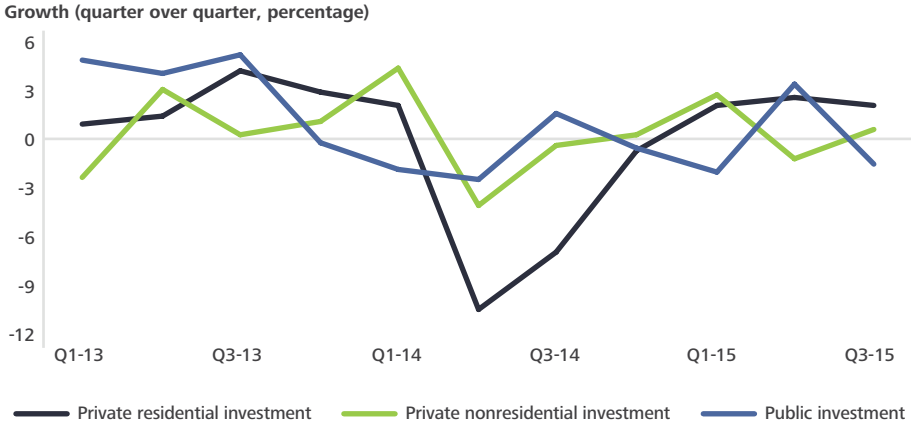
Household consumption was a key growth driver in Q3, expanding 0.4 percent, in contrast to a 0.6 percent contraction in Q2. The economy also received support from investments, with gross fixed capital formation growing 0.3 percent. However, the figure is less than required for Japan's economy to move into a trajectory of stable growth without strong monetary and fiscal support. There was good news on the exports front in Q3. Exports grew 2.7 percent, reversing from a 4.3 percent decline in Q2. With imports growth also strong, the contribution of net exports to GDP growth was a mere 0.1 percentage point. Inventories were the other factor that weighed on growth in Q3, cutting 0.2 percentage points off GDP growth (figure 2).

What's with investments these days?

The moderate recovery in gross fixed capital formation in Q3 must have come as a welcome relief to policymakers. Nevertheless, within the expansion there lie some worries. Private nonresidential investment, which accounts for two-thirds of total gross fixed capital formation, has been subdued despite two years of strong monetary and fiscal support to the economy (figure 3). Moreover, a weak Japanese yen (due to quantitative easing) has aided exports, thereby pushing up corporate profits (figure 4). Yen earnings from investment income also have been healthy (figure 5).

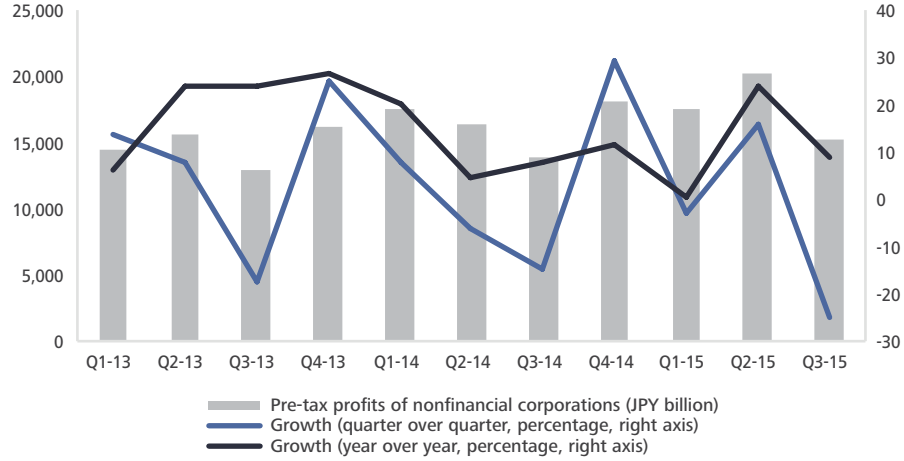
There are likely a number of reasons weighing on Japanese companies' capital expenditure. First, exporters are wary of slowing external demand due to weak growth in China. Second, as the yen relatively stabilizes, Japanese exports do not have the same benefits of a weak yen as they did when quantitative easing started (figure 5). Third, exporters are likely to evaluate the impact of any rate hike by the US Federal Reserve (Fed) on global currency markets before deciding to expand capacity. Finally, Japanese companies might also be concerned about domestic demand, which has barely grown in the last two quarters (0.1 percent in each quarter).

Figure 3. Despite a moderate recovery in Q3, private nonresidential investment remains subdued



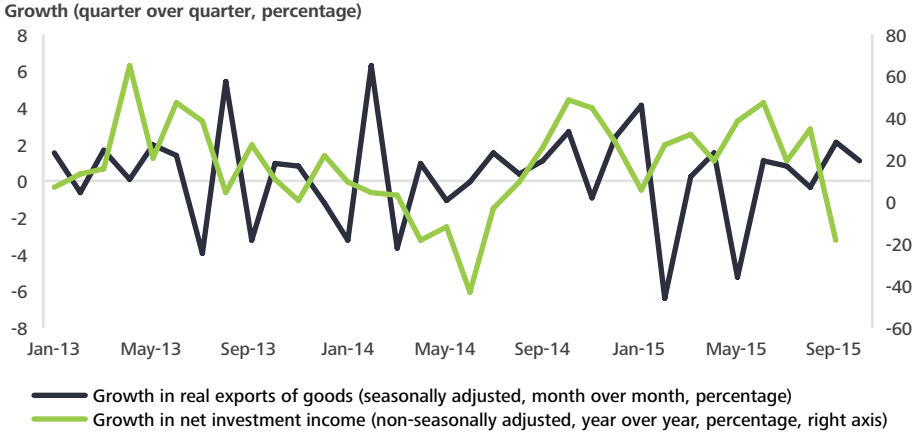
Source: Haver Analytics, Deloitte Services LP economic analysis.

Figure 4. Corporate profits have been relatively strong, despite a decline in Q3



Source: Haver Analytics, Deloitte Services LP economic analysis.

Figure 5. Exports have slowed down, while net investment income growth is relatively positive

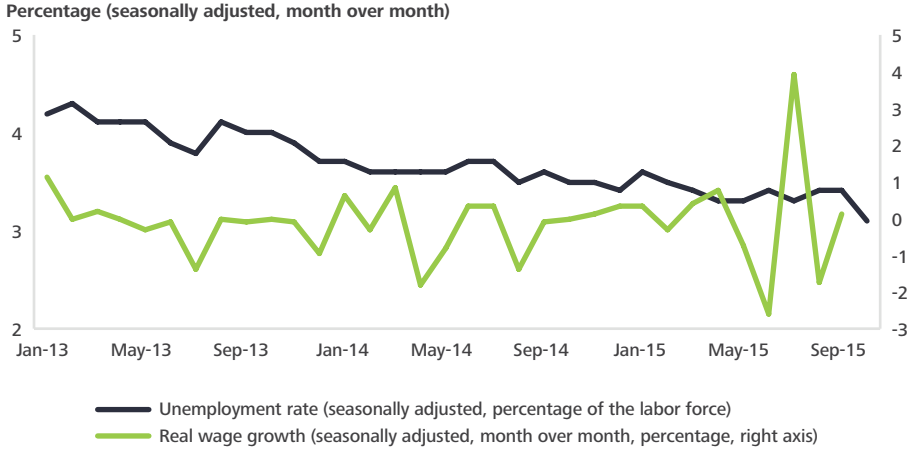


Source: Haver Analytics, Deloitte Services LP economic analysis.

Figure 6. Orders of private core capital goods grew in September

Source: Haver Analytics, Deloitte Services LP economic analysis.

Figure 7. Real earnings growth has been sluggish despite a strong labor market



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

On a positive note, recent data suggest that Japanese corporations might just be scaling up investment activity. For example, private sector orders of core capital goods went up 7.5 percent month over month (seasonally adjusted) in September (figure 6). This is, however, not likely to be the start of a secular upward movement in investment, given the current bout of uncertainty in the global economy.

Consumers remain wary in the absence of real wage growth

Household consumption recovered in Q3 but, at 0.4 percent, can at best be described as modest. A key factor that is weighing on consumer spending is earnings. Real earnings have been sluggish (figure 7) and are not set to strengthen this year unless year-end bonuses surprise on the upside. Surprisingly, earnings growth is slow despite a strong labor market. In October, unemployment fell to 3.1 percent from 3.4 percent in September; October's figure was the lowest in about 20 years.

Prices are yet another concern for consumers, with Japan not yet out of the woods regarding deflation. It's no wonder, then, that consumer confidence continues to be in negative territory, although a slight recovery in seasonally adjusted retail sales volumes will give policymakers some degree of relief in the short term (figure 8). The strong impact of the consumption tax hike in April 2014 has forced the government to postpone the second phase of the tax hike to April 2017 from October 2015. This will soothe immediate consumer concerns. By that time, the economy is likely to be in much better shape to handle the impact of the tax hike.

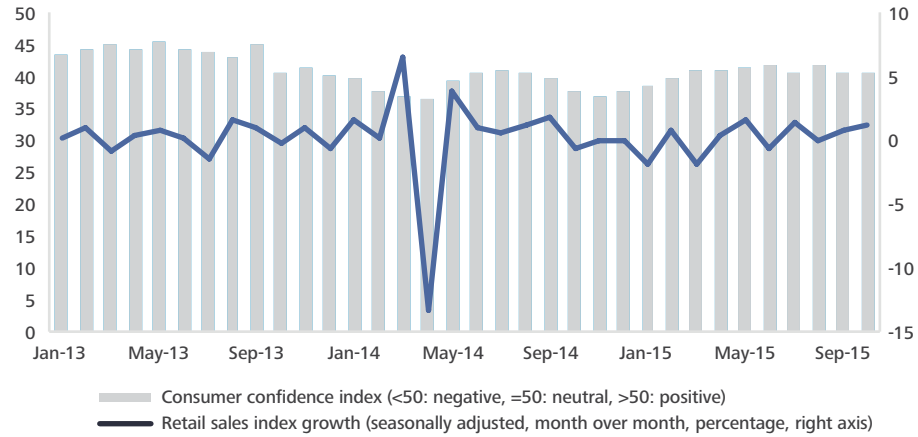
BOJ holds onto monetary stance

In November, the Bank of Japan (BOJ) kept its pace of quantitative easing unchanged (at about $648 billion a year), citing improving economic fundamentals and positive trends in long-term inflation expectations.[2] In particular, the BOJ expects investments to go up (due to strong corporate profits) in the next few quarters, thereby benefitting the economy. All eyes will now be on key investment indicators such as orders and shipments of core capital goods in the next quarter or two.

The BOJ, however, expects to take more time (until March 2017) to bring inflation up to its target of 2 percent. Target inflation (excluding fresh food) was at -0.1 percent for the third straight month in October (figure 9), with low oil prices continuing to play spoilsport. On a positive note, core inflation (excluding food and energy) has been edging up and was 1.2 percent in October. This could have been an important factor behind the BOJ's decision not to expand quantitative easing in October.

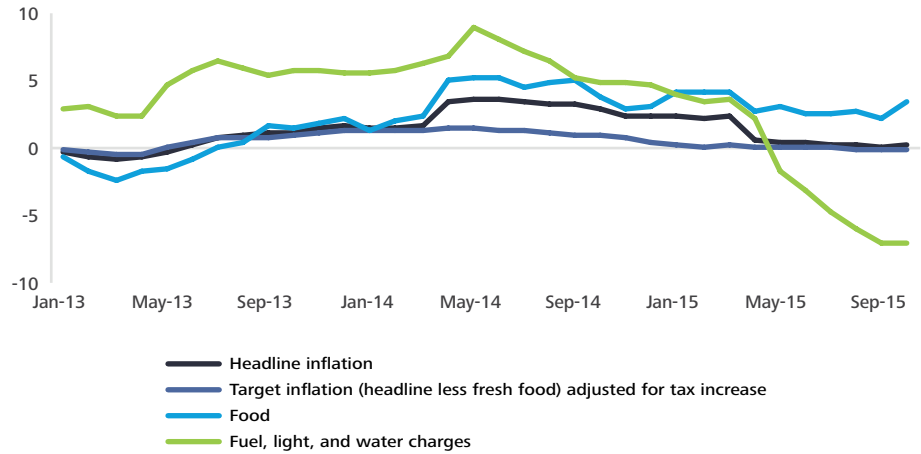
The yen will be less of a concern for the BOJ (figure 10), given that any rate hike by the Fed will widen the interest rate differential with the United States. In such a scenario, the BOJ is not likely to change its policy stance in the next two to three quarters. The central bank will, however, be concerned that a long bout of quantitative easing has not pushed up credit and broad money growth (figure 11).

Figure 8. Consumer confidence continues to be negative; retail sales moderately recover



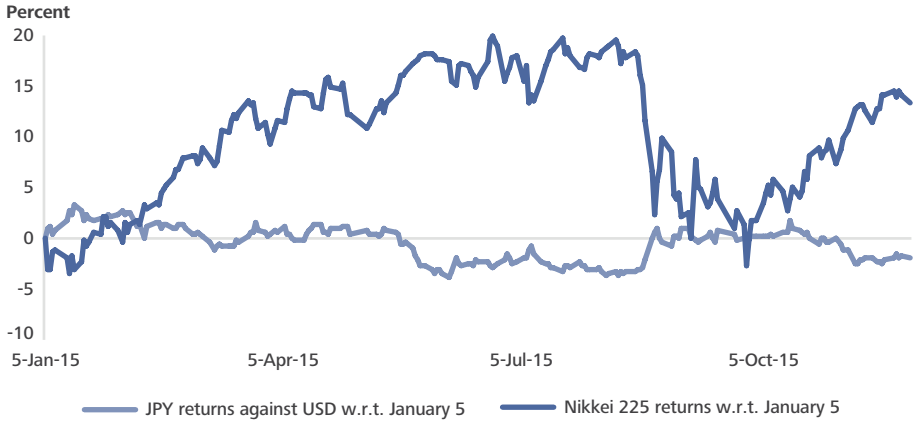
Source: Haver Analytics, Deloitte Services LP economic analysis.

Figure 9. Target inflation remains much below the BOJ's desired levels



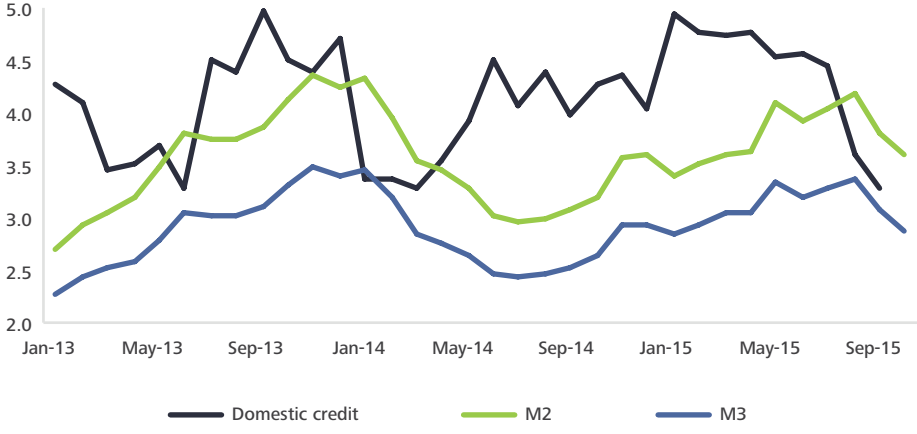
Source: Haver Analytics, Deloitte Services LP economic analysis.
Graphic: Deloitte University Press | DUPress.com

Figure 10. Yen is relatively stable against US dollar; equities have recovered from the China scare



Source: Haver Analytics, Deloitte Services LP economic analysis.

Figure 11. Despite quantitative easing, money and credit growth have slowed



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

Time for the third arrow

The twin arrows in Abenomics—fiscal stimulus and monetary easing—have had some success. But much also depends on the third arrow: structural reforms. Prime Minister Shinzo Abe will continue to face strong opposition to reforms in key sectors such as agriculture, health care, and retail. He also has not made much headway (despite promises) in reforming corporate governance and the labor market.

The scenario is also clouded by the lack of detail in recent promises. For example, Abe has not given a time frame within which he intends to increase nominal GDP by 22 percent, as he promised in September.[3] Without clear strategies and a roadmap to address key issues, confidence in the Japanese economy will remain subdued. Now, more than ever, Abe needs to reduce the gap between expectations and reality. Maybe the recent agreement on the Tran-Pacific Partnership—a free-trade deal between the United States, Japan, and 10 other Pacific Rim countries—could just be the impetus Abe needs.

The twin arrows in Abenomics—fiscal stimulus and monetary easing—have had some success. But much also depends on the **third arrow: structural reforms**.

Endnotes

1. Robin Harding, "Japan GDP revised from recession to growth in Q3," *Financial Times*, December 8, 2015, http://www.ft.com/cms/s/0/8aebcfc6-9d41-11e5-8ce1-f6219b685d74.html#axzz3tjeNMkRf.
2. Toru Fujioka and Masahiro Hidaka, "BOJ keeps policy unchanged after recession, weak inflation," *Bloomberg*, November 19, 2015, http://www.bloomberg.com/news/articles/2015-11-19/boj-keeps-policy-unchanged-even-after-recession-weak-inflation.
3. "Abenomics: Less of the same," *Economist*, September 26, 2015, http://www.economist.com/news/asia/21668283-japans-new-three-little-arrows-shinzo-abe-tweaks-his-economic-programme-japan.

Counting on the consumer

By Ian Stewart

THE slowdown in emerging-market economies has been the central preoccupation for the Bank of England through 2015. Activity in many emerging economies has softened through the year, and Brazil and Russia have fallen into recession. While growth in the advanced economies has continued and broadened, the balance of global growth as it affects UK export demand has moderated. Against a backdrop of the sterling's rise in the last two years, this moderated growth does not bode well for UK export demand. Survey measures of UK export confidence have dropped in recent months, and, in common with the experience of the United States and Germany, growth in manufacturing output, much of which is exported, slowed through 2015.

Faced with rising external risks, the Bank of England has, once again, pushed back the timing of raising interest rates. The result is that the cost of mortgage borrowing has fallen to new lows. With core inflation at just 0.8 percent and headline inflation widely expected to remain below its 2.0 percent target into 2017, the Bank of England can afford to take its time in raising interest rates. As of mid-December, financial markets are assuming that the Bank of England will wait until the second half of 2016 to raise interest rates and that the pace of tightening will be slow, with three-month interest rates, currently at 0.6 percent, rising by just 100 basis points by the end of 2018.

Despite the uncertainty, momentum in the UK domestic economy remains resilient. In particular, the consumer sector has been lifted by a combination of falling unemployment, rising real wages, low inflation, and cheap credit. The volume of household expenditure rose 3.1 percent in the year up to the third quarter, the fastest rate of growth in eight years. Cheap and increasingly plentiful credit has boosted consumer and mortgage borrowing, and car sales are buoyant.

The picture in the corporate sector is more mixed. Export orders, both for services and manufactured products, have weakened. Deloitte's

survey of chief financial officers shows that corporate risk appetite and optimism fell away in the second half of the year, and cost control has emerged, once again, as the top priority for major corporates.[1] Investment intentions have weakened in the corporate sector, and it seems likely that, while continuing to easily outpace growth in the wider economy, growth in business investment will slow in 2016.

The coming year, 2016, may well be the year in which the United Kingdom holds a referendum on membership in the European Union. That referendum must occur before the end of 2017. To avoid the risk that the UK vote becomes an issue in French and German general elections in 2017, the UK government may well hope to hold the referendum in June or September of 2016. Since June, opinion polls have a shown a narrowing of the lead for those favoring continued UK membership, reflecting the effects of the migration crisis, the terrorist attacks in Paris, and weak growth in the euro area.

The prime minister hopes to achieve a successful renegotiation of the United Kingdom's relationship with Europe—repatriating some powers from Brussels to Westminster, guaranteeing UK access to the single market, and reducing the entitlement of EU migrants to UK welfare benefits. Manifest success in these negotiations, likely to come to fruition in February or March, would enable the prime minister to make an enthusiastic bid to voters for the United Kingdom to stay in the European Union. But how willing the United Kingdom's partners are to make material concessions to the country is uncertain, particularly at a time when they are preoccupied with the reform of the European Union itself.

The most likely outcome is that the United Kingdom will stay in the European Union. But public opinion is changeable and, as the migrant crisis demonstrates, responsive to events outside the United Kingdom. As the vote gets closer, concerns and uncertainties are likely to mount, especially if the opinion polls remain close.

Yet despite such risks and the many unknowns, a buoyant consumer sector should sustain respectable, if unspectacular, UK growth of around 2.5 percent in 2016.

Endnote

1. Deloitte UK, *CFO Survey, fourth quarter 2016*, January 4, 2016.

Fed rate hike and economic instability in emerging markets

By Dr. Rumki Majumdar

WHEN an apple fell on young Isaac Newton's head, he sought to understand the reason behind the fall and devised the theory of gravity. However, when a falling acorn hit Chicken Little, the chick believed that the world is coming to an end. Both stories started with a similar event, but while the first event led to one of the greatest discoveries, the second event only caused panic.

In today's financial world, investors' reactions to any undesirable event often resemble Chicken Little's. Be it the US Federal Reserve's (Fed's) "taper tantrum" in the summer of 2013 or Greece's bailout drama, the initial market response has been paranoia. Sadly, the capital and currency markets of emerging economies (EMs) face the brunt of such hysteria, although advanced economies don't remain unscathed either.

Since late 2014, EMs have been witnessing a rapid increase in capital outflows, primarily due to weak economic activity, the global interest rate outlook, and geopolitical factors. According to a report by the Institute of International Finance, in 2015, private capital inflows to EMs are projected to fall to their lowest levels since 2009.[1] Data released for August and September confirm that EMs witnessed $40 billion portfolio outflows in Q3 2015, marking it as the worst quarter for capital outflows since the global financial crisis.[2] The pace of outflows is expected to accelerate once the Fed tightens its policy rate; if the tightening is aggressive, EMs might need to wait for a long time before they see a rebound in capital flows.

What complicates the matter further is that, although imminent, the rate hike is not the only risk that investors are nervous about. Given that global economic activities

are skewed to the downside, a number of short- and long-term risks are lurking ahead. Any of these risks swinging in an undesirable direction may result in a "sky is falling" reaction among investors. The question is whether a tighter monetary policy in the United States will trigger a domino effect in the global financial world.

Fed up with tantrums—what to expect

Will it, or will it not? This guessing game over whether US monetary policy tightening will push other global risk events over the edge has been going on for some time now. Before every Federal Market Open Committee (FOMC) meeting held in the last few months, investors' speculations have caused repeated bouts of volatility in EMs' financial sectors.

In last quarter's *Global Economic Outlook*, we analyzed the economic and financial performance of the five EMs—Brazil, India, Indonesia, Turkey, and South Africa—that have been most affected by the Fed's taper tantrum in 2013.[3] Excluding China, these five economies together accounted for over a third of total nominal GDP of all EMs in 2014. In this article, we try to gauge the possible impact of a Fed rate hike on the financial sectors of these five EMs—first, by simply ignoring that downside risks to global events exist, and then accounting for them along with the Fed rate hike in our analysis.

Before every Federal Market Open Committee (FOMC) meeting held in the last few months, investors' speculations have caused **repeated bouts of volatility** in EMs' financial sectors.

A simple exercise was carried out to track similar earlier Fed rate hikes and their impact on stock market indices, currencies, and interest rate movements of these five EMs. Our aim was to predict the possible impact if the Fed decides to hike rates after keeping them low for nine years, based on past events. From 1990 on, the Fed raised its policy rates thrice before bringing them down to historically low levels in 2008 (table 1).

However, it is often argued that the post-2008 world is very different from the precrisis one. The depth and the complexity of the 2008

crisis have had a lasting impact on the economic structure and behavior of economic entities across nations. The skeptic behavior of investors and their hysteric response to the slightest hint of bad news are cases in point.

Since there has been no instance of a policy rate hike post the 2008 crisis, our ability to accurately predict investors' response and the impact on EMs' financial sectors is limited. That said, on one occasion during 2012–14, the 10-year Fed rate rose for a considerable period. In general, the Fed's policy rate and the 10-year Fed rate have often moved in tandem, except for this period. We use this period of increasing long-term Fed rates as a proxy for a rising policy rate in order to assess investors' reaction to a tighter monetary policy post the 2008 crisis.

Table 1. US policy rate hike

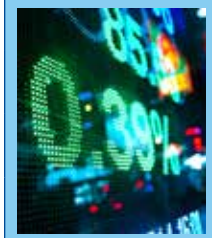
Duration of policy rate hike	Rate hike (%)
Feb 4, 1994–Feb 1, 1995	2.8
Jun 30, 1999–May 16, 2000	1.5
Jun 30, 2004–Jun 29, 2006	4.0
Duration of policy rate hike	**Rate hike (%)**
Q4 2012 to Q1 2014*	1.1

*Note: There was no policy rate hike during this period.

Source: FOMC meetings.

More often than not, the stock market indices of these EMs brushed off the initial impact and **climbed steadily** through the end of the US monetary policy tightening cycle, even during 2012–14.

Figure 1. Impact of a Fed rate hike on stock market, currency, and bond market of the five EMs

Financial sector	EMs	1994–95	1999–00	2004–06	2012–14
 Stock market indices	Brazil	↑	↑	↑	↔
	India	↓	↑	↑	↑
	Indonesia	↓	↓	↑	↑
	South Africa	↔	↔	↑	↑
	Turkey	↑	↑	↑	↔
 Real effective exchange rate	Brazil	↔	D	A	D
	India	A	A	A	↔
	Indonesia	↔	↔	↔	↔
	South Africa	↔	D	D	D
	Turkey	D	A	↔	D
 Interest rate spread	Brazil	N/A	–	–	+
	India	–	–	+	–
	Indonesia	N/A	N/A	↔	+
	South Africa	+	–	–	+
	Turkey	–	–	–	+

Long-term impact

Stock markets brushed off the impact

Currencies in Brazil, South Africa, and Turkey saw turbulence

Interest risk spread reduced, but trend reversed post 2008 crisis

Note: "D" refers to depreciation, and "A" refers to appreciation in the real effective exchange rate. "Interest rate spread" is defined as the 10-year bond yields of these economies minus the 10-year Fed rate. A plus sign refers to an increase in spread, while a minus sign refers to a narrowing of spread.

Source: Haver Analytics; Deloitte Services LP.

Figure 2. Reflecting on past experience to map future expectations

Stock market

- Initial bout of volatility in all EMs is probably inevitable
- Stock market is expected to be stable after a few weeks
- Conditional on pace of reforms, capital market in India might perform relatively better

Currency

- Currency in India might appreciate due to relatively better economic funda-mentals
- Commodity-export-depen-dent Brazil and South Africa may see currency depreciation
- External-debt-ridden Turkey may witness currency depreciation

Interest rate spread

- Investors may show reluctance to hold EM bonds that are perceived to be risky
- As the US economy strengthens, investors may prefer to move their assets to the US bond market, which is perceived to be a safe haven in times of uncertainty
- India's bond market may remain a preferred destination

Graphic: Deloitte University Press | DUPress.com

Reactions of EMs' stock markets and cur-rencies to a Fed rate rise in the past have been noteworthy. More often than not, the stock market indices of these EMs brushed off the initial impact and climbed steadily through the end of the US monetary policy tightening cycle, even during 2012–14 (figure 1).

The impact on the domestic currencies, however, varied across these five EMs. The real exchange rate appreciated in India every time the Fed raised its policy rate, while Indonesia's domestic currency remained more or less stable. When a hike in the Fed's policy rate coincided with stress in the external sectors of Brazil and South Africa, their currencies depre-ciated. Lately, Turkey's domestic currency has been vulnerable to tighter US monetary policy because of high external financing requirements and high dollar-denominated debt (figure 1).

While a US rate hike often led to a nar-rowing of the long-term interest rate spread in the EMs (relative to the US long-term rate) prior to the global financial crisis, this trend reversed when yields for 10-year bonds rose in the United States during 2012–14.[4] Except for India, the interest rate spread widened for the other four EMs. In other words, investors were demanding a premium to hold bonds of those EMs whose economic fundamentals were relatively weak (figure 1).[5]

If the past could be any indication of the future, figure 2 summarizes what one may expect if the Fed decides to raise its policy rate.

But that's not the whole story

If only investment decisions were simple with known challenges. While the biggest imminent risk that markets may be facing is the Fed's interest rate hike, that's not the entire story. The decision to hold EM assets is often influenced by several other global events (figure 3); most risks associated with these are currently skewed to the downside.

Such events include:

- *China slowdown:* Disappointing economic data and volatility in China's stock markets continue to worry investors. Credit and property markets are showing signs of a bubble. The government has intervened on occasion to stymie volatility in the financial market. China has been easing its monetary policy as well as its lending standards since a year, and in August it devalued its currency in order to spur the economy.

- *Oil price volatility:* Geopolitical tensions in Russia, the deal between Iran and six powerful economies, the economic slowdown in the Eurozone, increased US domestic production of crude oil, and uncertainties regarding capital investments by major energy companies all have helped increase volatility in oil prices. A fall in global oil prices by approximately 50 percent in the last year has been a welcome relief for oil-importing economies such as India. At the same time, the price drop has severely hit revenues of oil-exporting economies such as Brazil and has aggravated risks of deflation in the United States and Eurozone.

- *Eurozone crisis:* Risks of a financial contagion due to the Greece crisis may have receded for now, but the issue is far from being over. Leaders of the Eurozone agreed to bail out Greece on the condition that the present Greek government implements serious reforms, which are likely to push Greece into a deeper recession in the next few years. Whether the present government will continue to implement austerity measures and reforms amid economic crisis and social unrest is anyone's guess, but uncertainty over Greece's exit from the Eurozone still exists.

- *US dollar appreciation:* The recent strengthening of the US economy, poor global growth, and expectations about a policy rate hike have led to a sharp appreciation of the US dollar. An appreciating dollar has created balance-sheet challenges for countries whose debts are dollar denominated.

Figure 3. Investors' dilemma

Graphic: Deloitte University Press | DUPress.com

- *Excess global liquidity:* Ultimately, only central banks can create official liquidity. The massive quantitative easing programs by the United States, Japan, and the Eurozone since the crisis have resulted in the balance sheets of these nations' central banks ballooning. On average, advanced nations' central-bank balance sheets have grown from 10 percent to 20 percent of the world GDP since 2007.[6] Abundant global liquidity has encouraged global investors to flock to emerging markets to seek higher returns, making it easier for the latter to access skittish foreign investments to finance their growth sans any structural reforms.

Risks associated with each these events, along with a hike in the Fed's policy rate, have impacted the financial sectors of the five EMs. However, the significance of each event and the extent of the resulting volatility in their financial sectors differed substantially across these EMs. Here we analyzed two questions:

1. How have global risk events impacted the stock prices and currencies of the five EMs during 2007–15? Which event has had a profound impact on the EMs?

2. How vulnerable are the five EMs to the downside shocks of each of these global risk events?

Our findings are summarized in figures 4 and 5.

Figure 4. How have global risk events impacted the stock prices and currencies of the five EMs during 2007–15?[7]

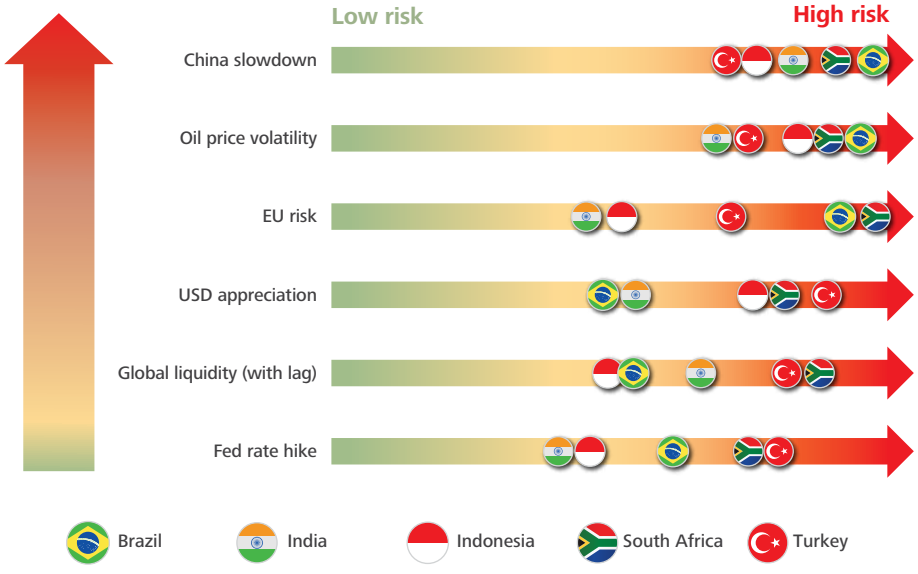
Risks	Countries impacted	Extent and significance
China slowdown	• Stock market: All five EMs • Domestic currency: Brazil, Indonesia, South Africa	
Rising oil price volatility	• Stock market: All five EMs • Domestic currency: Brazil, South Africa, Turkey	
USD appreciation	• Stock market: Brazil, Indonesia, Turkey • Domestic currency: Brazil, Indonesia, South Africa, Turkey	
EU risk	• Stock market: Brazil • Domestic currency: Brazil, Indonesia, South Africa	
Rising global liquidity	• Stock market: India, Indonesia, South Africa • Domestic currency: India, South Africa	
Fed rate hike	• Stock market: Brazil, India • Domestic currency: Brazil, Indonesia, Turkey, South Africa	

- Any downside risk led to a fall in stock market indices and depreciation of EMs' real exchange rates.
- Stock market indices of EMs were more sensitive than currencies.
- China's economic slowdown and oil price volatility appeared to have had a profound impact on all EMs, although the magnitude of the impact differed.
- The impact of the US dollar appreciation and risks in the euro area were limited to a few economies.
- Effects of changes in global liquidity were felt with a lag.
- In most cases, the impact of a Fed rate hike turned out to be insignificant. This could be because of the limited sample period and a strong correlation with some of the above events. Thus, conclusions should be taken with a pinch of salt.

Note: The impact of a Fed rate hike has been represented by the rise in 10-year bond yields during 2012–14. Global liquidity is measured by the statutory deposit ratio reported by the International Monetary Fund.

Graphic: Deloitte University Press | DUPress.com

Figure 5. How vulnerable are the five EMs to the downside shocks to each of these global risk events?[8]



Graphic: Deloitte University Press | DUPress.com

Lurking threat

While the conclusions derived from the above analysis are not infallible, they provide insight into EMs' vulnerability to different global episodes. The Fed rate hike has been hogging the headlines, probably because, unlike other events, investors associate this event with a probable date (subsequent FOMC meetings). More than the fact that US monetary policy is tightening after nine years, it is the possible domino effect that worries investors. Consequently, around every impending meeting, curiosity and speculation on possible outcomes keep investors busy. In comparison, all the other events are less perceptible. However, that does not take the edge off the fact that the EMs are equally, or probably more, susceptible to events such as China's economic slowdown and oil price volatility.

Our analysis suggests that in the medium term, India may have less to worry about, while Brazil might be in the red zone if global risk events go south. That said, none of these economies are prepared to counter long-term risks. When it comes to implementing structural and meaningful economic reforms, which is key to building resilience, the governments in all these five economies have somewhat failed to impress investors. These nations have hesitated to implement reforms over the last few years. For now, they can only hope that no potential crisis halts their growth path.

Endnotes

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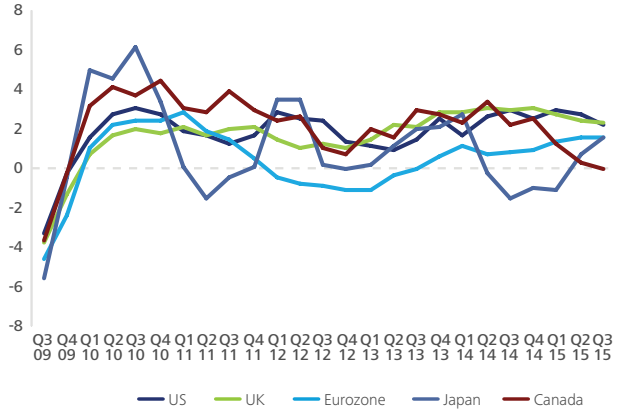
3. Rumki Majumdar, "Are emerging markets prepared for the Fed rate hike storm?" *Global Economic Outlook, Q4 2015*, Deloitte University Press, http://dupress.com/articles/global-economic-outlook-q4-2015-emerging-markets-fed-rate-hikes/.
4. "Interest rate spread" is defined as the 10-year bond yields of these economies minus the 10-year Fed rate.
5. Majumdar, "Are emerging markets prepared for the Fed rate hike storm?"
6. Committee on the Global Financial System, *Global liquidity—concepts, measurements and policy implications,* Bank for International Settlements, CGFS paper no. 45, November 2011, http://www.bis.org/publ/cgfs45.pdf.
7. A simple regression analysis was carried out for the period 2007–15. The numbers represent the magnitude of the partial impact of an independent variable (the risk variables, logged and differenced in some cases) on the logged differenced dependent variable.
8. An error correction model using an impulse-response function was developed to analyze the impact of the shock of any of these events on the stock market indices and currencies. In other words, a shock of one standard deviation magnitude was given to these global events. The significance of an immediate impact of that shock and the duration it took for the market indices and currencies to get back to a new equilibrium were measured. Based on these two responses, the five nations were categorized into the indicated risk zones.

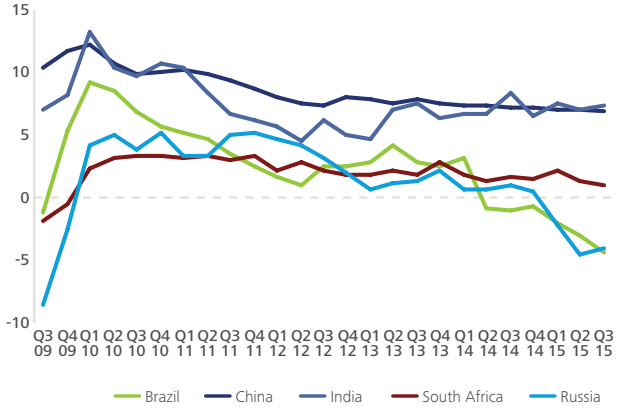
Economic indices

GDP growth rates (percentage, year over year)



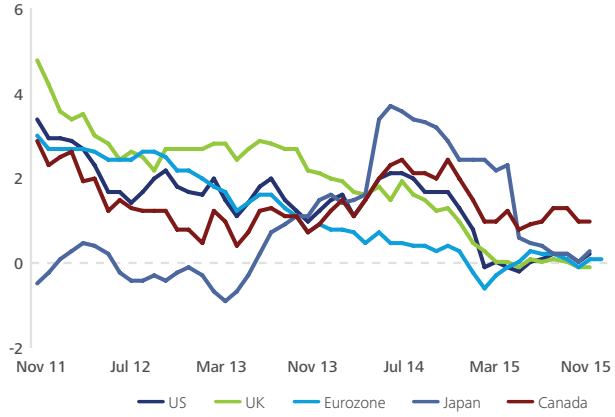
Source: Bloomberg, Haver Analytics.
Graphic: Deloitte University Press | DUPress.com

GDP growth rates (percentage, year over year)



Source: Bloomberg, Haver Analytics.
Graphic: Deloitte University Press | DUPress.com

Inflation rates (percentage, year over year)



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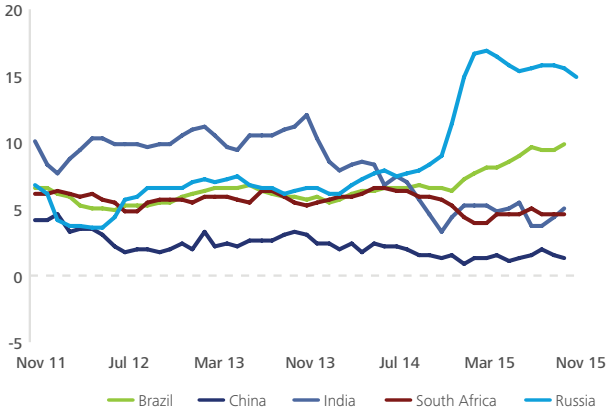
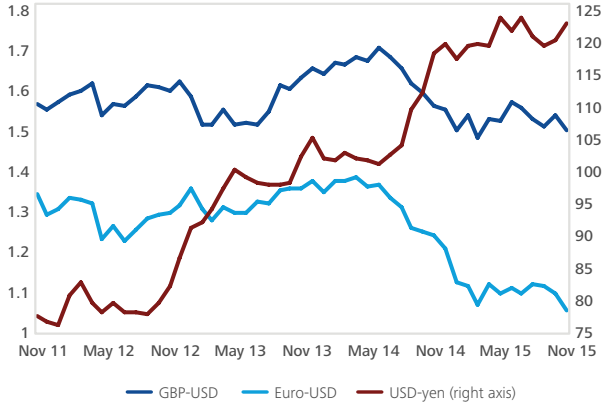
Inflation rates (percentage, year over year)



Source: Bloomberg, Haver Analytics.
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 8, 2015)*

	US Treasury Bonds & Notes	UK Gilts	Eurozone Govt. Benchmark	Japan Sovereign	Canada Sovereign	Brazil Govt. Benchmark	China Sovereign	India Govt. Bonds	South Africa Sovereign	Russia*‡
3 Months	0.23	0.55	-0.29	-0.07	0.46	14.22	2.57	7.14	6.35	10.38
1 Year	0.64	0.45	-0.27	-0.02	0.54	15.47	2.66	7.27	-	10.41
5 Years	1.67	1.18	-0.07	0.05	0.88	15.73	3.02	7.75	8.32	10.16
10 Years	2.23	1.80	0.58	0.33	1.52	15.69	3.10	7.76	8.76	9.73

Composite median GDP forecasts (as of December 8, 2015)*

	US	UK	Eurozone	Japan	Canada	Brazil	China	India	South Africa	Russia
2015	2.5	2.4	1.5	0.6	1.2	-3	6.9	7.4	1.4	-3.8
2016	2.5	2.3	1.7	1.1	2	-1.2	6.5	7.9	1.6	0
2017	2.5	2.2	1.8	0.7	2.2	1.4	6.3		2.2	1.4

Composite median currency forecasts (as of December 8, 2015)*

	Q1 16	Q2 16	Q3 16	Q4 16	2015	2016	2017
GBP-USD	1.51	1.5	1.51	1.52	1.51	1.52	1.55
Euro-USD	1.05	1.04	1.05	1.05	1.06	1.05	1.1
USD-Yen	124	125	125	125	123	125	124.5
USD-Canadian Dollar	1.35	1.35	1.34	1.34	1.34	1.34	1.29
USD-Brazilian Real	4.09	4.15	4.15	4.15	4	4.15	4.1
USD-Chinese Yuan	6.5	6.5	6.55	6.6	6.4	6.6	6.59
USD-Indian Rupee	66.9	67	67	67.13	66.6	67.13	66
USD-SA Rand	14.3	14.43	14.5	14.5	14.1	14.5	13.8
USD-Russian Ruble	67.75	68.02	68.69	67.8	67	67.8	64.75

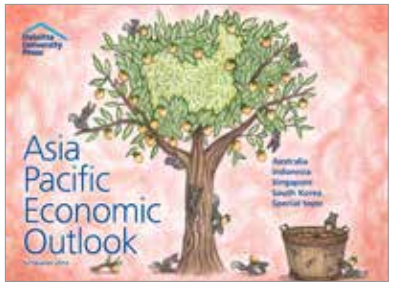
OECD composite leading indicators (Amplitude adjusted)†

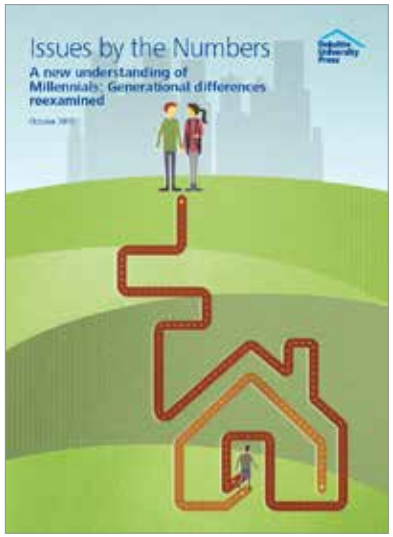
	United States	United Kingdom	Euro area	Japan	Canada	Brazil	China	India	South Africa	Russian Federation
Jan 13	100.0	99.9	98.8	99.7	99.5	100.7	100.6	99.4	100.7	99.5
Feb 13	100.1	99.9	98.9	99.9	99.5	100.5	100.7	99.3	100.7	99.4
Mar 13	100.2	99.9	99.0	100.1	99.5	100.3	100.7	99.1	100.7	99.3
Apr 13	100.2	100.0	99.1	100.4	99.5	100.0	100.7	99.0	100.6	99.2
May 13	100.3	100.1	99.2	100.6	99.5	99.8	100.8	98.9	100.6	99.2
Jun 13	100.4	100.2	99.4	100.7	99.6	99.5	100.8	98.8	100.6	99.3
Jul 13	100.5	100.5	99.5	100.9	99.7	99.4	100.9	98.7	100.6	99.4
Aug 13	100.5	100.7	99.7	101.0	99.8	99.3	100.9	98.6	100.6	99.5
Sep 13	100.5	101.0	99.9	101.2	99.9	99.3	100.9	98.6	100.6	99.7
Oct 13	100.5	101.1	100.1	101.3	100.0	99.3	100.8	98.5	100.6	99.8
Nov 13	100.4	101.2	100.3	101.4	100.0	99.4	100.8	98.5	100.5	100.0
Dec 13	100.4	101.3	100.4	101.4	100.0	99.4	100.7	98.4	100.4	100.1
Jan 14	100.4	101.3	100.5	101.3	100.0	99.3	100.6	98.4	100.3	100.3
Feb 14	100.4	101.3	100.5	101.2	100.0	99.3	100.4	98.5	100.2	100.4
Mar 14	100.5	101.4	100.5	100.9	100.0	99.3	100.3	98.5	100.0	100.6
Apr 14	100.6	101.4	100.5	100.7	100.1	99.3	100.2	98.5	99.9	100.8
May 14	100.6	101.4	100.4	100.4	100.1	99.3	100.1	98.6	99.9	101.0
Jun 14	100.6	101.3	100.4	100.2	100.2	99.4	100.0	98.7	100.0	101.1
Jul 14	100.6	101.2	100.3	100.1	100.2	99.6	99.9	98.8	100.1	101.1
Aug 14	100.6	101.1	100.2	100.0	100.2	99.7	99.8	98.8	100.2	101.0
Sep 14	100.6	101.0	100.2	99.9	100.2	99.9	99.6	98.9	100.3	100.7
Oct 14	100.5	100.9	100.2	99.9	100.1	99.9	99.4	99.0	100.3	100.4
Nov 14	100.5	100.8	100.2	99.9	100.1	99.9	99.2	99.1	100.3	100.0
Dec 14	100.4	100.7	100.3	100.0	100.0	99.9	99.0	99.1	100.2	99.6
Jan 15	100.2	100.6	100.4	100.0	99.9	99.7	98.8	99.2	100.1	99.3
Feb 15	100.1	100.5	100.5	100.0	99.8	99.5	98.7	99.3	100.0	99.2
Mar 15	100.0	100.4	100.5	100.0	99.7	99.3	98.6	99.4	100.0	99.3
Apr 15	99.9	100.3	100.6	100.0	99.6	99.1	98.5	99.5	100.0	99.4
May 15	99.8	100.1	100.6	100.0	99.6	98.9	98.4	99.6	99.9	99.4
Jun 15	99.6	100.0	100.6	100.0	99.6	98.8	98.3	99.7	99.8	99.5
Jul 15	99.5	99.8	100.6	100.0	99.6	98.8	98.2	99.9	99.7	99.4
Aug 15	99.3	99.6	100.6	99.9	99.6	98.9	98.0	100.0	99.5	99.4
Sep 15	99.1	99.4	100.6	99.8	99.6	99.1	97.9	100.1	99.4	99.3

*Source: Bloomberg ‡MICEX rates †Source: OECD

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

Additional resources





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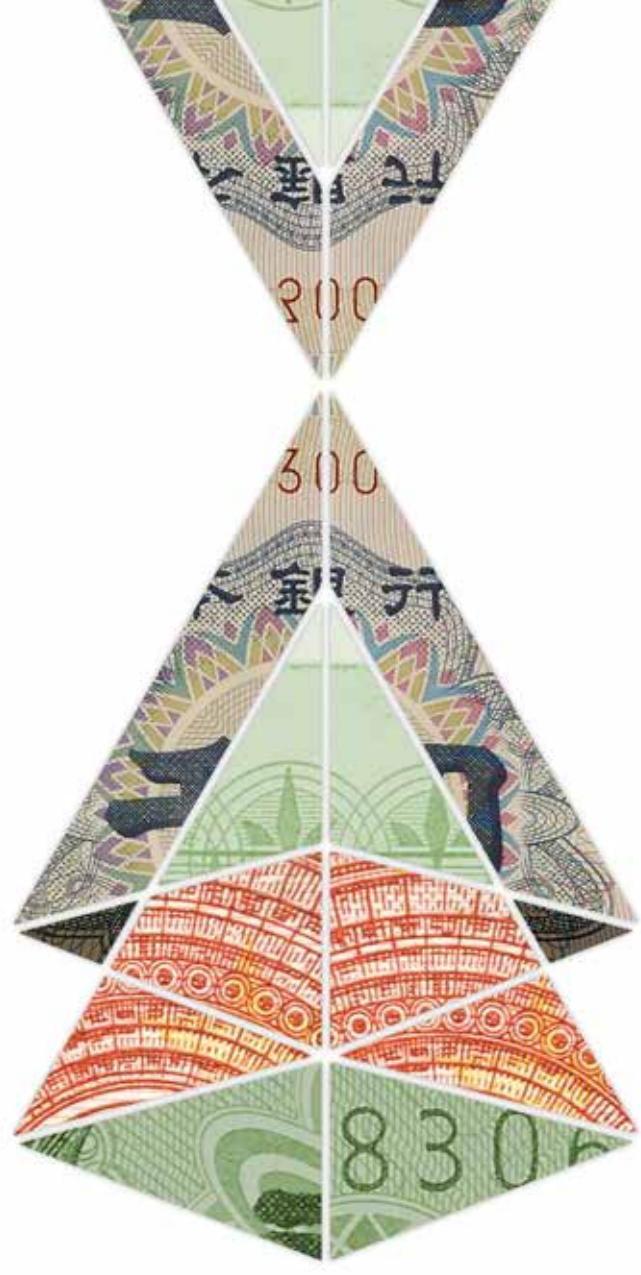

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