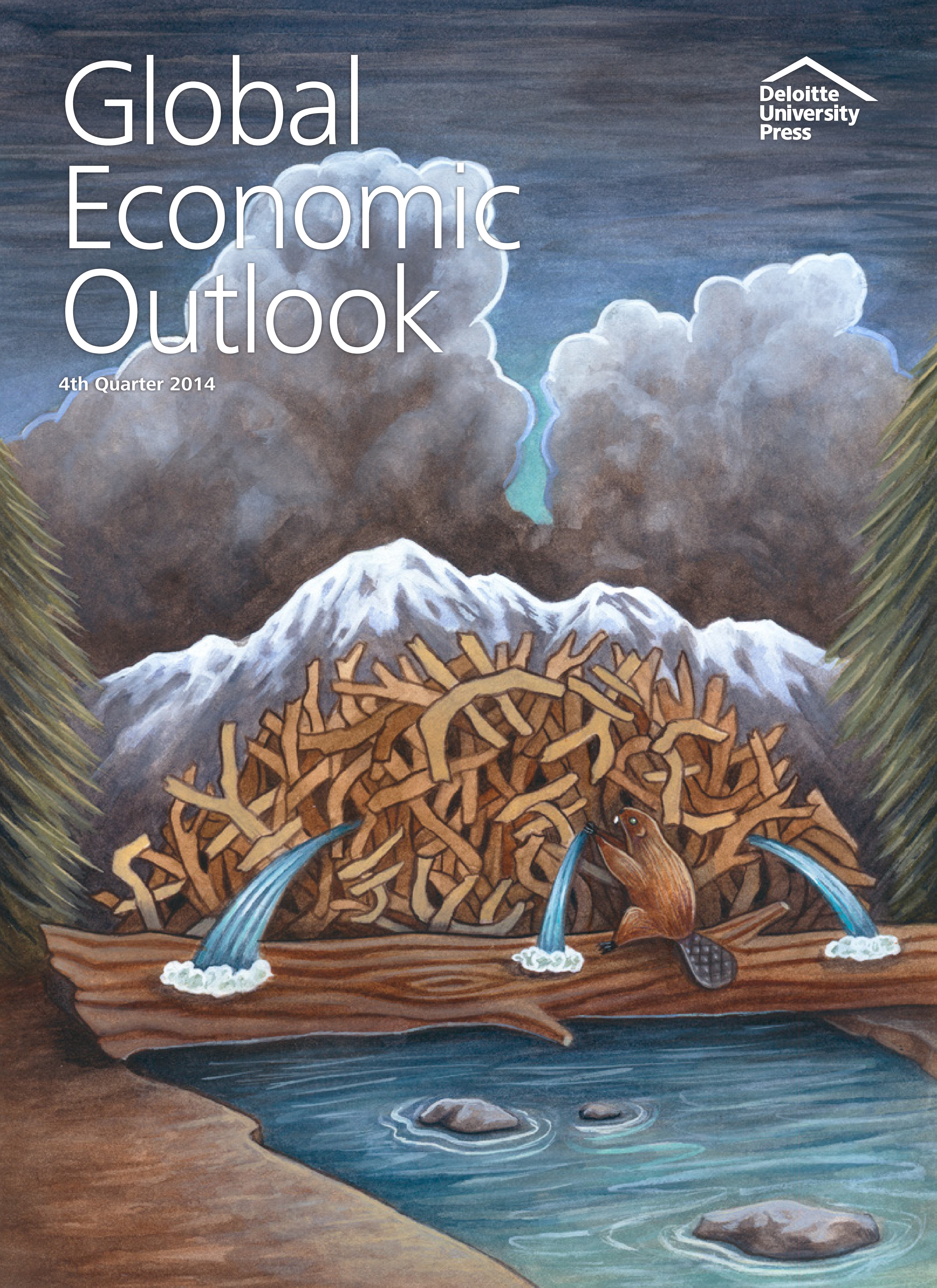
Global Economic Outlook

4th Quarter 2014

Deloitte University Press



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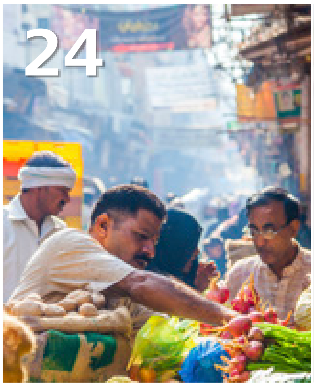
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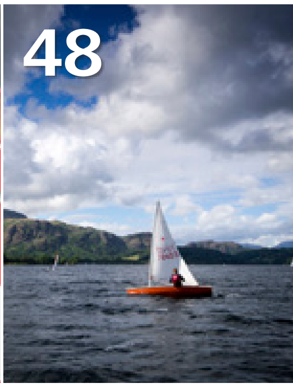
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Global Economic Outlook

4th Quarter 2014

Introduction by Dr. Ira Kalish

As we enter the fourth quarter of 2014, the global economy continues to show a few signs of strength and several signs of weakness. The greatest strength appears to be in the US economy, which may finally be on a sustainable and healthy growth path. Europe, on the other hand, continues to struggle, just barely staying above water. In China, the deceleration of growth continues amid growing concerns about the stability of credit markets. And in Japan, early euphoria following the implementation of Abenomics has dissipated in the wake of a steep tax increase. Finally, big emerging markets are mostly struggling to recover from a series of troubles, some self-inflicted, that have caused a marked slowdown in growth—although India appears to be rebounding to some extent. In this edition, our far-flung economists offer their views on how all of this is likely to unfold.

In his analysis of the Eurozone economy, Alexander Boersch says that "it is unrealistic to expect a substantial rebound" in the Eurozone economy. He points to the crisis in Ukraine as having created increased uncertainty, thereby suppressing business investment. He discusses the ECB's new monetary policy and wonders whether it can have a significant impact on the regional recovery without structural reforms. He also points to recent weakness in Germany, traditionally Europe's engine of growth. Yet he expects the German economy to modestly pick up speed in the second half of this year.

Next, Patricia Buckley maintains her optimism about the US economy. In a detailed analysis of the US job market, she notes that job growth has picked up, boding well for overall economic growth. Yet she also points to structural problems in the labor market that have held back recovery. Still, the recent acceleration in job growth is helping to reduce the number of long-term unemployed and stimulate discouraged workers to return to the labor force. However, uncertainty continues to keep the pace of hiring from rising as fast as the pace of job openings. In other words, the recovery is not complete.

My discussion of the Chinese economy highlights an unexpected degree of weakness. The government has been keen to focus on structural reforms rather than short-term stimulus, but it recently decided to loosen monetary policy in order to stem the slowdown in economic activity. Whether this will exacerbate problems in the credit markets remains a contentious issue. The trick for the government will be to boost credit-market activity without boosting activity in the off-balance-sheet shadow banking system.

Next, I offer my thoughts on the Japanese economy, which is confronting two big issues. First, the government must decide whether to go through with a planned second tax increase next year while the economy continues to reel from the first increase that took place in April of this year. The economy minister appears to believe that the effect of the next increase can easily be offset by other stimulus measures. Second, the yen has fallen sharply, in part, because of the strength of the dollar. Yet not all businesses are thrilled; import prices have risen, and exports have not responded to the expected extent.

Rumki Majumdar's outlook on the Indian economy notes that a number of positive things have happened since the country's last round of elections. Economic growth has rebounded moderately, capital inflows have increased, exports have accelerated and helped the trade balance, confidence has increased, bond yields have declined, and equity prices have risen. Nonetheless, challenges and uncertainty remain. Inflation remains high (although it has decelerated), the budget deficit remains a problem with subsidies still not addressed, and the government has moved slowly on its reform agenda.

In his article on Russia, Akrur Barua says that “the sanctions could not have come at a worse time.” The economy is decelerating, inflation is high, interest rates have risen, and capital flight remains a problem. Now, with new sanctions, Russia is increasingly “edging toward isolation.” Moreover, Russia faces an environment of declining oil prices, stagnant production, lost access to external financing and technology, and the possibility that Europe will find alternative sources of energy. Thus, an uncertain outlook is creating unpleasant choices for policymakers.

Akrur also provides this quarter’s outlook on Brazil, which notes the country’s weak economic performance and the impact it is having on Brazilian politics; as we write, a contentious presidential election is underway. Moreover, Akrur discusses several sources of weakness: the high level of household debt, high inflation and the consequent tight monetary policy, the end of China’s commodity boom, structural problems in the labor market, and the failure of the government to address these problems through regulatory changes. The result has been weak business investment.

Finally, Ian Stewart provides his analysis of the British economy. He notes that strength is coming from rebounding manufacturing in addition to financial services and government spending. Strength stemming from professional and business services coincides with a strong acceleration of business investment, which demonstrates a rebound in confidence despite a spate of worrisome events in Ukraine and the Middle East. On the other hand, Ian notes excesses in the housing market, weakness of exports, troubles in export markets, and a continuing drop in real consumer incomes. Thus, the outlook for next year is modest at best.

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

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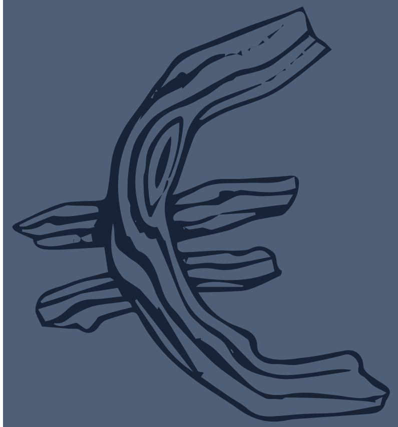
Editor-in-chief
Dr. Ira Kalish

Managing editor
Ryan Alvanos

Contributors
Dr. Patricia Buckley
Dr. Alexander Börsch
Ian Stewart
Dr. Rumki Majumdar
Akrur Barua

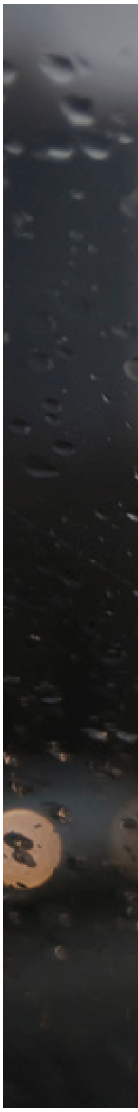
Editorial address
350 South Grand Street
Los Angeles, CA 90013
Tel: +1 213 688 4765
ikalish@deloitte.com



Eurozone

Recovery stalled

By Dr. Alexander Börsch



THE Eurozone's recovery has suffered several setbacks recently. In the second quarter, the region as a whole stagnated. Its biggest economies either stagnated (France) or contracted slightly (Germany and Italy). Geopolitical tensions in Ukraine have weighed heavily on economic sentiment, creating the kind of investment-inhibiting uncertainty that the Eurozone just escaped. Apart from their concrete effects, these setbacks demonstrate that the recovery is still highly vulnerable to external influences. In this situation, the European Central Bank (ECB) further eased its monetary policy, testing its outer limits.

The recovery is still highly vulnerable to external influences.

Two questions will be decisive for the rest of the year and beyond: First, how effective can these monetary policy measures be? And second, is Germany's stagnation temporary or a sign that it is ceasing to be the Eurozone's growth engine?

Further easing monetary policy

If evidence was needed that the recovery in the Eurozone was far from self-sustaining, the recent actions of the ECB delivered it. Not waiting for the effects of its June monetary policy accommodation, the ECB eased monetary policy again in September. The September package further lowers the ultra-low interest rates: The main refinancing rate and the deposit rate have been cut to 0.05 percent and –0.20 percent, respectively. The second pillar of the program covers the purchase of asset-backed securities and covered bonds. While the purchase of these securities is not quantitative easing in a strict sense, which would mean buying sovereign bonds, it can nevertheless be seen as a form of quantitative easing because the ECB creates money to buy these securities.

There were two main reasons behind the ECB's further policy easing. First, the inflation rate in the Eurozone continues to be very low. In August, it stood at 0.4 percent, and the core inflation rate excluding food and energy was 0.9 percent. There are also signs that medium-term inflation expectations are beginning to undershoot the ECB's inflation target. Second, the ECB intends to overcome stagnation and lasting high unemployment by improving credit conditions, particularly in southern Europe.

The continuous easing of monetary policy in the Eurozone has had one main effect so far: It has weakened the euro (figure 1), thereby helping Eurozone exports.

While this is welcome news for Eurozone exporters, whether the ultra-loose monetary policy can jump-start growth is a controversial topic. While in a normal business-cycle downturn, loose monetary policy helps to increase investments and consumption, the current business cycle in the Eurozone is hardly normal.

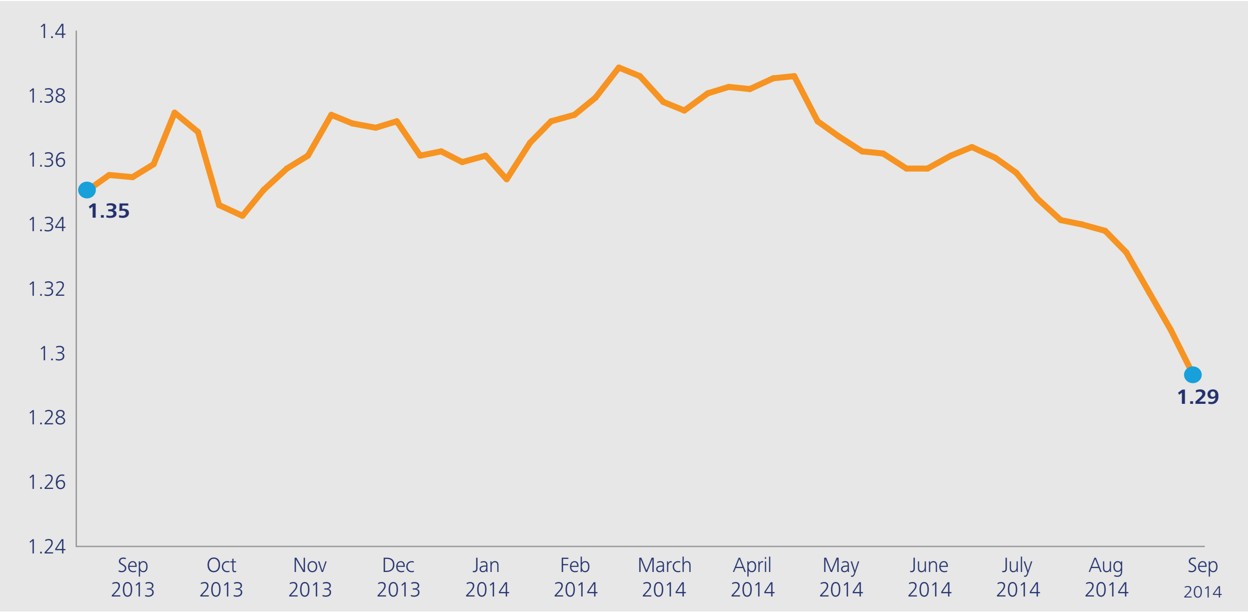
The Bank for International Settlements, the central bank of the world's central banks, notes that advanced economies have seen an unusually

sluggish recovery despite unseen monetary accommodation. It suggests that monetary policy has been relatively ineffective in engineering a recovery in the current situation, mainly because traditional tools of demand management are ill-suited for a balance sheet recession with large debt overhangs.[1] Seen through this lens, loose monetary policy alone cannot jump-start a recovery in the Eurozone. It needs support from economic policy and productivity-enhancing reforms that induce corporate investments. Germany is a case in point that a loose monetary policy alone is not enough to jump-start investment, even though the country has been facing a benign economic situation so far.

Germany is losing momentum . . .

Germany has been growing at a much higher rate than the Eurozone average over the last few years, and it has acted as an anchor for the Eurozone's growth. However, the figures from the second quarter show that Germany's economy contracted 0.2 percent quarter over quarter. Consumer spending increased just 0.1 percent, while investment in equipment decreased 0.4 percent. Furthermore, the business climate, as measured by the Ifo Business Climate Index, has been on the decline since May, and the manufacturing industry's outlook is at its lowest since summer 2013. Industrial production fell

Figure 1. Exchange rate EUR/USD (1 year)



Source: OANDA.com.

Graphic: Deloitte University Press | DUPress.com

in the second quarter, and consumer confidence also decreased slightly. All in all, the German economy clearly lost momentum over the last few months.

Tensions in Ukraine account for a large share of the worsening business climate. German exports to Russia have been affected by EU sanctions, dropping around 15 percent in the first half of 2014. The crisis and the sanctions accelerated an ongoing decline that started with the weakening of the Russian economy. While exports to Russia account for only 3 percent of total German exports (though there are sector-specific variations), the crisis increased uncertainty and therefore the unwillingness of German businesses to invest. At the beginning of 2014, there was hope that investment will rebound strongly and the investment strike will come to an end, but this hope has not materialized yet.

. . . but its growth path remains intact

Despite the negative momentum, the fundamental growth trend in Germany remains positive, and the dip is likely to be temporary, due to three reasons. First, the negative growth rate in the second quarter was partly due to weather effects. Thanks to a very mild winter, a substantial number of investments, particularly in construction, were advanced to the first quarter. Second, the weakening euro should help German exporters. Moreover, with the world economy forecast to have a stronger second half of the year, foreign demand should increase.[2] Third, private consumption is facing favorable conditions (figure 2). Employment is still increasing, unemployment is very low at around 5 percent, and wages are rising.

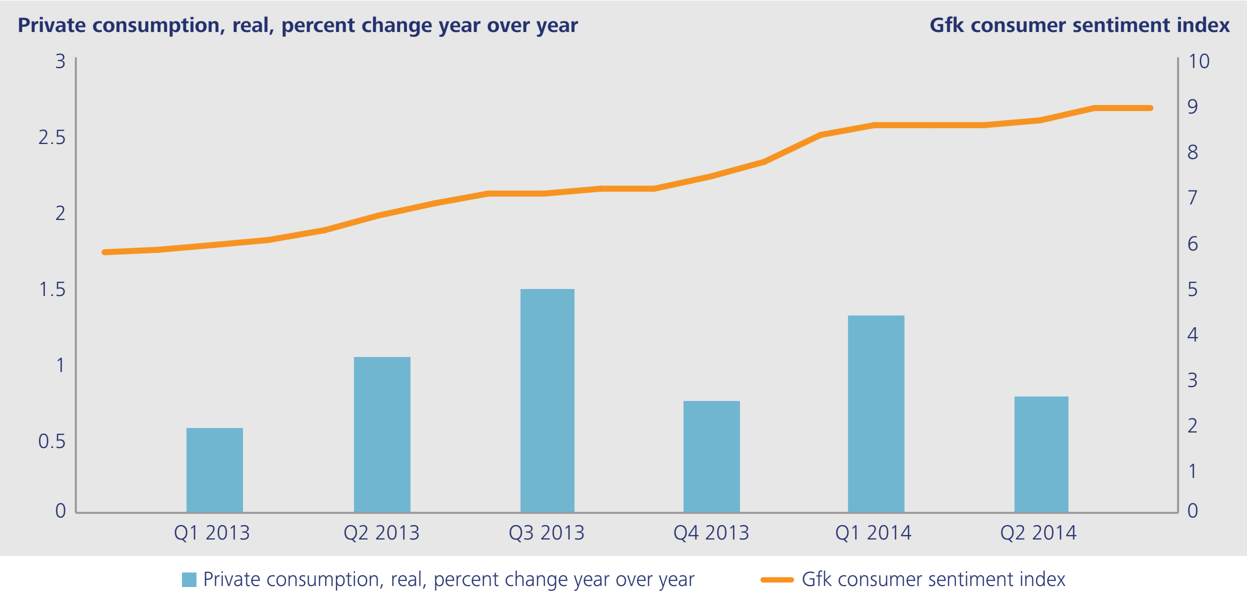
Given these factors, the German economy should return to growth in the third and fourth quarters and achieve an overall growth rate of around 1.5 percent for 2014. The big unknown going forward is the future development of investment, which is crucial for a sustained recovery.

Apart from flat investment activity, there are two main risk factors that could affect the stability of Germany's recovery. The main, immediate factor is an escalation of the Ukraine conflict. The second, more structural factor stems from the real estate sector. Traditionally characterized by moderate price increases and a low ownership ratio, real estate prices in Germany have risen substantially, driven by ultra-low interest rates, uncertainty due to the Eurozone crisis, and good economic and employment situations. While the price increases so far indicate no overheating for the overall market, big German cities have seen unusually hefty price increases in recent years. The Deutsche Bundesbank states that certain segments in these cities faced substantial overvaluations last year.

For the Eurozone as a whole, recent events and the anatomy of the recovery so far imply that it is unrealistic to expect the substantial rebound hoped for at the beginning of the year. The bumpy recovery is likely to continue.

The big unknown going forward is the future development of investment, which is crucial for a sustained recovery.

Figure 2. Favorable private consumption



Source: Oxford Economics; GfK; statista.

Graphic: Deloitte University Press | DUPress.com

Endnotes

1. Bank for International Settlements, *84th annual report*, June 2014.
2. International Monetary Fund, *World economic outlook update*, July 2014.

United States

Back on track after first-quarter detour

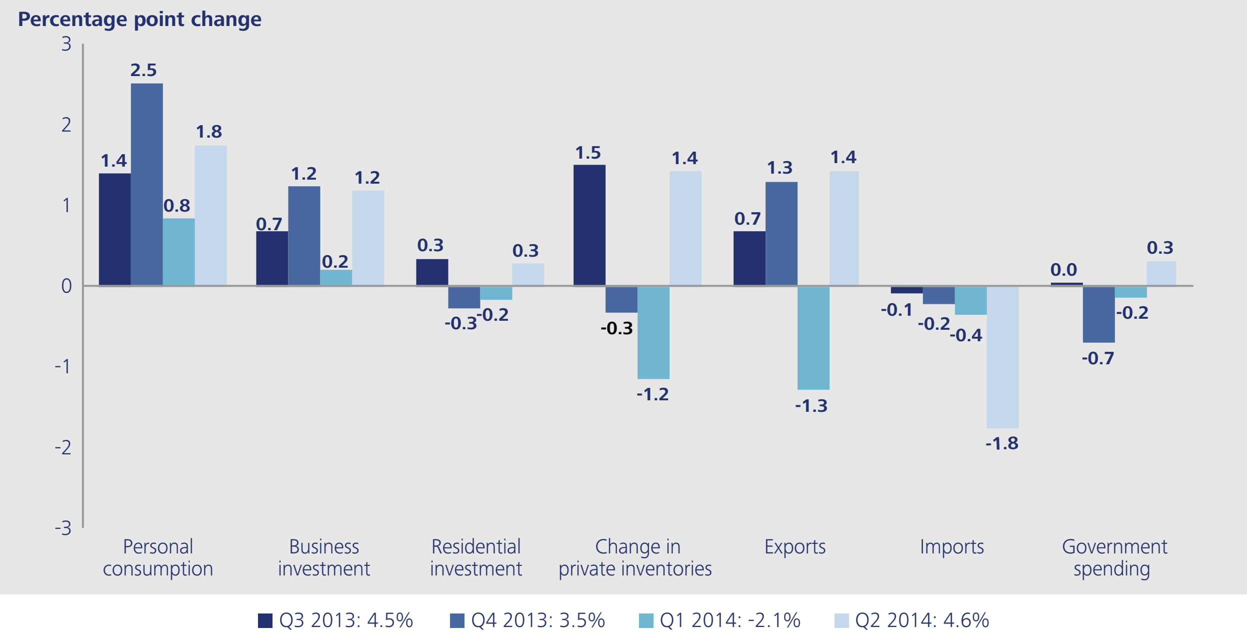
By Dr. Patricia Buckley

THE recovery in the United States continues to solidify as growth in the second quarter more than erased the first quarter's decline. Importantly, although some significant imbalances remain, the labor market is reflecting this improvement across all major dimensions.

The strong rebound in the second quarter (annualized growth of 4.6 percent) confirmed speculation that the 2.1 percent decline in the first quarter was a temporary aberration largely caused by extremely cold weather in many parts of the United States during the period. Although the annualized growth rate for the first half came in at a less-than-stellar 1.2 percent, the growth rate for the past 12 months (between Q2 2013 and Q2 2014) has been a respectable 2.6 percent. We continue to expect the US economy to show strength in the second half of 2014, continuing into 2015.

As shown in figure 1,the second quarter of 2014 saw substantial positive contributions from consumption, fixed investment (both business and housing), and inventories. International trade netted a slightly negative contribution as imports subtracted more than exports contributed. Although reduced government spending at the federal level continued to be a drag on the economy, there was increased spending at the state and local levels that pushed the overall contribution of government spending into positive territory. In most respects, the second quarter of 2014 resembled the last two quarters of 2013 rather than the first quarter of 2014.

Figure 1. Contributions to percent change in real GDP



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

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Employment's long, slow crawl out of the depths of the recession

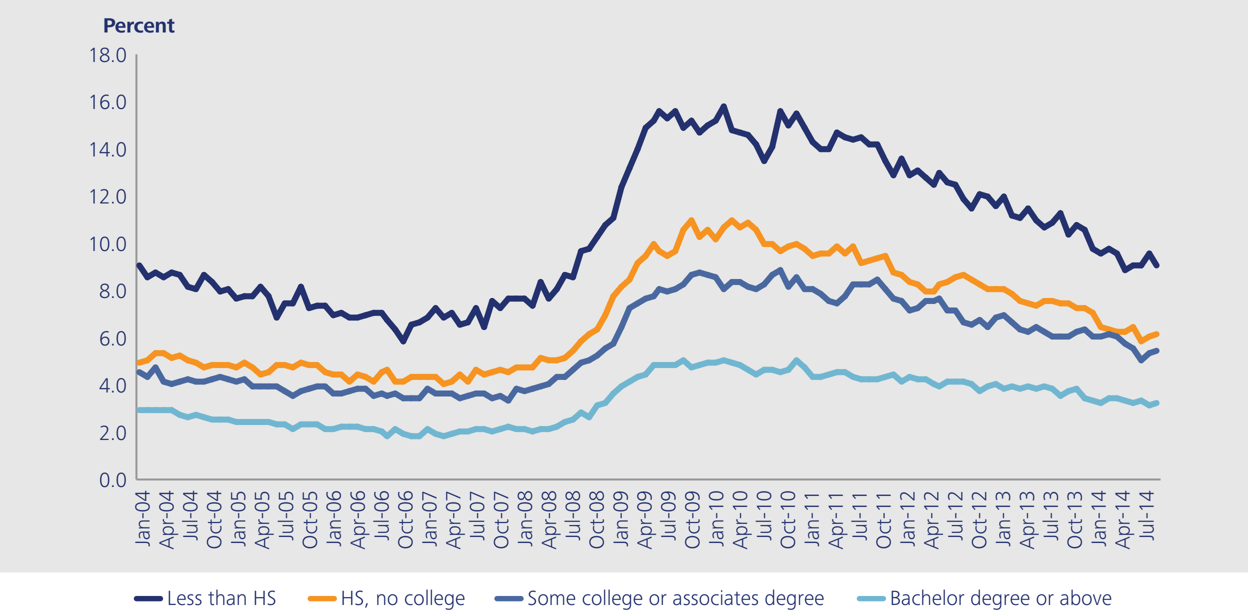
One of the most painful manifestations of the recession and the slow recovery has been the enormous number of people who lost their jobs and how long it has taken for new jobs to be created. Even after the recession came to an official end in June 2009, the labor market continued to deteriorate for several more months until October when the number of unemployed crested at 15.4 million and the unemployment rate hit 10.0 percent. Improvement since that point has been exceptionally slow—much slower than previous recoveries. It took five years after the end of the recession for the US economy to regain the employment level it had when the recession began in December 2007. Progress has been slow and uneven, but there has been progress nonetheless. But more improvement is necessary before the US labor market can be declared "recovered."

Unemployment rate

Over the past three years, the unemployment rate has been declining by approximately one percentage point per year after very little improvement during the first two years of the recovery, and was at 6.1 percent as of August. However, just as the recession hit with unevenness across industries and geographies, its impact on various populations was also very uneven.

We continue to expect the US economy to show strength in the second half of 2014, continuing into 2015.

Figure 2. Unemployment rates by educational attainment (population age 25 and above)



Source: US Bureau of Labor Statistics.

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For example, figure 2 shows the unemployment rate by educational achievement where it is clear that the impact of the recession was especially harsh on those without a high school diploma. Fortunately, for the overall health of the US economy, at 8 percent, the group without a high school diploma is a small proportion of the labor force (age 25 and above). College graduates with at least a bachelor's degree are the largest proportion at 37 percent, followed by those with some college (28 percent) and those with a high school diploma (27 percent).

Long-term unemployed

Not only were the sheer number of unemployed a concern throughout the recession and recovery, the growing duration of unemployment was also a concern. During the recession, people were remaining unemployed for longer periods. Prior to the recession, the median duration of unemployment was less than 10 weeks. During the recession and the beginning of the recovery, the median duration more than doubled to around 22 weeks. Although the median duration is now almost down to 13 weeks, the number of long-term unemployed—people looking for a job for 27 weeks or longer—remains at a very high level. Prior to the recession, the long-term unemployed averaged around 18 percent of the total unemployed. During the recession, that proportion skyrocketed to over 40 percent. With just under 3 million people in this group, the proportion is now down to around one-third, and the number has fallen by more than half from its peak.

Exits from the labor force

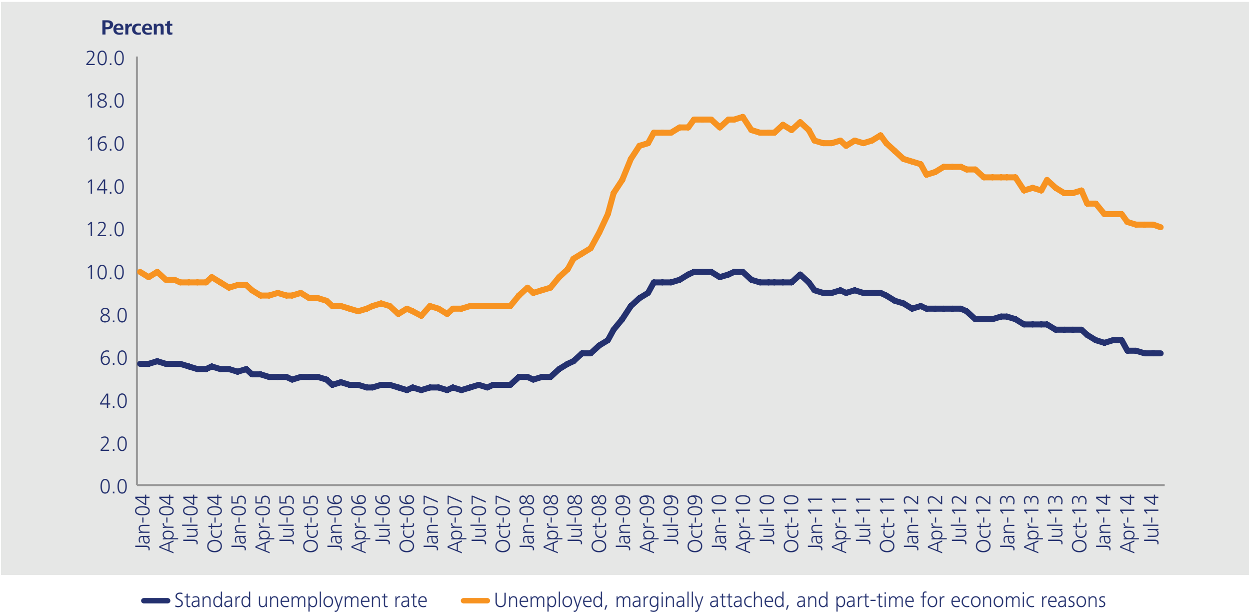
With the difficulty in finding work increasing, many people were forced to take part-time jobs or they just dropped out of the labor force. In addition to the standard unemployment rate (number of unemployed looking for work/number of people working or looking for work), the US Bureau of Labor Statistics (BLS) publishes several alternative unemployment series. Figure 3 compares the most expansive of the series, which adds people marginally attached to the workforce and those working part time for economic reasons to those actively looking for work, to the standard unemployment rate. According to the BLS, people marginally attached to the labor force are those who currently are neither working nor looking for work but indicate that they want and are available for a job and have looked for work sometime in the last 12 months. People employed part time for economic reasons are those who want and are available for full-time work but have had to settle for a part-time schedule. Prior to the recession, the difference between these two series generally stayed in the 3.5–4.0 percent range. However, during the recession and recovery, the difference between these two rose to over 7 percent before gradually declining to the still-elevated 6 percent range.

Exits from the labor force are also visible in the declining labor force participation rate. Prior to the recession, labor force participation had been around 66 percent for several years. Starting in early 2009, the rate began falling and only recently stabilized in the 62.8– 63.2 range in the last 12 months. Part of the decline was to be expected, given the large number of Baby Boomers moving into their retirement years. However, the extent of the decline in labor force participation is approximately twice what would have been expected from shifting demographics alone; the remainder is from other exits from the labor force, including discouraged workers.[1] Small movements in the labor force participation rate actually represent a sizeable number of workers. For example, if the labor force participation rate were to rise just one percentage point to 64 percent from the current rate, we would have approximately 3 million more people in the labor force.

Finally turning the corner on employment?

The good news is that employment gains appear to be accelerating. The average monthly employment gain for the first eight months of 2014 was 215,000, above the average of 194,000 in 2013. This acceleration of employment will be particularly important to not only reduce the number of those categorized as unemployed in the traditional sense, but also to accommodate those who stepped to the sideline as they decide to rejoin the job hunt. A separate BLS series on job openings suggests that job creation is set to at least maintain its current pace.

Figure 3. Measures of unemployment



Source: US Bureau of Labor Statistics.

Graphic: Deloitte University Press | DUPress.com

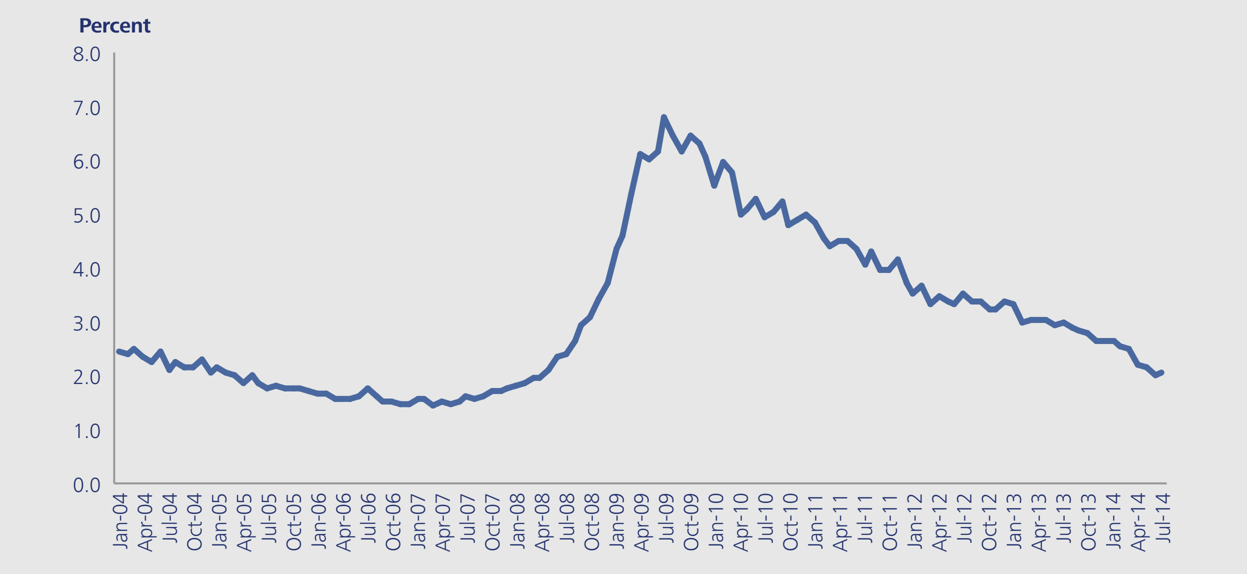
The good news is that employment gains appear to be accelerating.

Job openings are specific positions where work could start within 30 days and an employer is actively recruiting from outside the establishment. Excluded are jobs to be filled only by internal transfers, promotions, demotions, and recalls from layoffs. As shown in figure 4, the number of unemployed people per job opening quickly accelerated from 1.8 when the recession began in December of 2007 to a peak of 6.8 unemployed people per job opening shortly after the official conclusion of the recession. Post-recession, the ratio began trending down, reaching the current ratio of 2.1 unemployed people per job opening—a ratio very much in line with the pre-recession period.

Strength in the job market is further illustrated in figure 5, which shows the number of job openings now exceeding the pre-recession peak. In addition, the number of "quits" is also rising, an indicator that people either have been able to find another job or are relatively confident that they will be able to in the future. Quits are voluntary separations, excluding retirements. Figure 5 also points to a possible stumbling block to future job creation: The pace of hiring is not keeping up with the number of job openings. There are several possible reasons for this apparent disconnect, including employers that are certain enough to anticipate the need for additional workers by posting a job opening and perhaps interviewing candidates, but hesitating to actually make job offers because of continued uncertainty about the economy. Another, potentially more serious detriment to full economic recovery, could be that employers cannot find the workers with the skills they need and therefore job openings are going unfilled.

With rising employment continuing to support increases in overall demand, the outlook for the United States remains positive. But as the labor force continues to tighten, it remains to be seen how serious education and training mismatches are between the labor available and the skills demanded.

Figure 4. Number of unemployed persons per job opening (seasonally adjusted)



Source: US Bureau of Labor Statistics.

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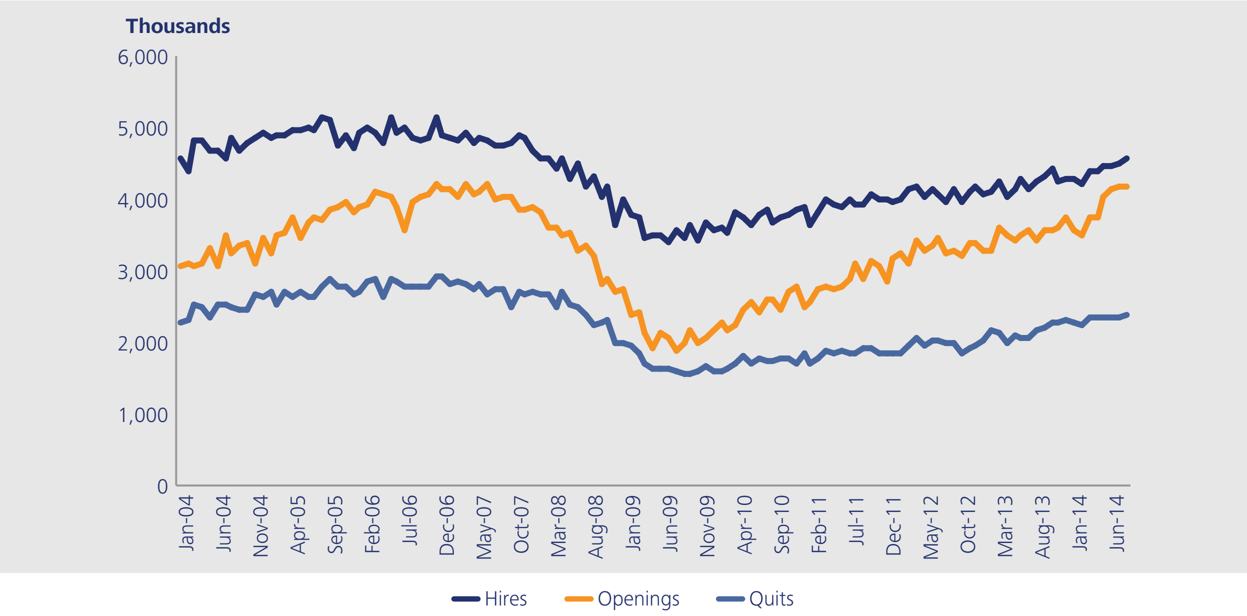
Figure 5. Total private job openings, hires, and quits (seasonally adjusted)



Source: US Bureau of Labor Statistics.

Graphic: Deloitte University Press | DUPress.com

Endnote

1. Daniel Bachman, "The potential for labor force participation," *Behind the Numbers*, July 2014, Deloitte University Press, http://dupress.com/articles/potential-labor-force-participation.

China

Signs of continuing weakness

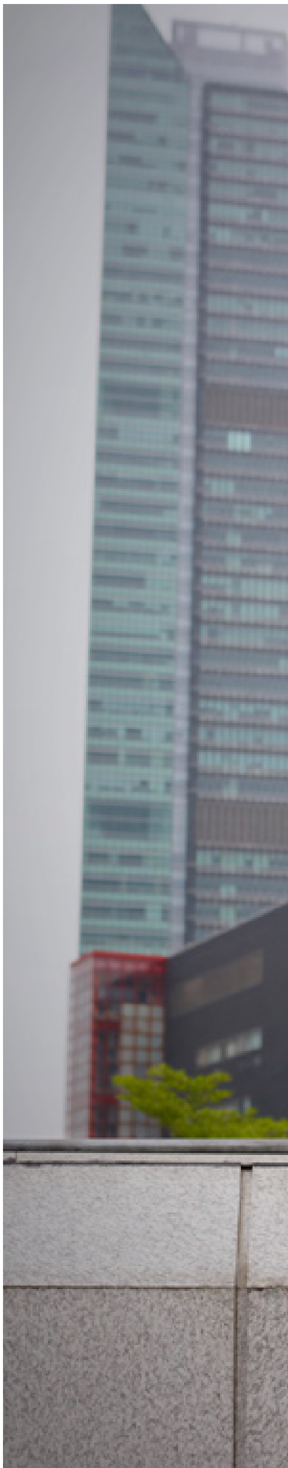
By Dr. Ira Kalish

THERE are continuing signs of weakness in the Chinese economy. In August, home prices fell in 68 of 70 cities that the government follows. Housing demand also is weak. Despite the fact that many local governments have eased restrictions on home purchases, the volume of home sales fell 11 percent in the first eight months of 2014 compared with a year earlier. The easing of restrictions boosted the number of people qualified to take on new mortgages, yet that didn't necessarily translate into willingness to do so. With prices falling, many potential buyers are waiting lest they lose money in the property market, making the drop in prices self-perpetuating. That is what happens when bubbles burst and when many market participants are speculators.

The easing of restrictions boosted the number of people qualified to take on new mortgages, yet that didn't necessarily translate into willingness to do so.

Factory output increased 6.9 percent in August versus a year earlier, the slowest growth since 2008. In addition, retail sales and business investment both grew more slowly than investors had anticipated. Property sales declined in August. Also, the government reported a drop in imports and a slowdown in credit creation. Perhaps most alarming was a 2.2 percent decline in electricity production in August, the first such drop in four years. Utility output is often seen as a more reliable indicator of underlying economic activity than the government's data on economic output. All of this suggests that underlying demand in China is weak and banks are being cautious, which in turn, hurts economic activity. Many analysts now believe that the government will miss its GDP growth target of 7.5 percent this year. However, they believe that as long as growth remains above 7.0 percent, the government will not necessarily engage in new fiscal stimulus measures. Indeed the latest report on government spending shows that stimulus measures are receding. In August, government spending was up only 6.2 percent from a year earlier. This compares with 9.6 percent growth in July and 26.1 percent growth in June.

In August, foreign direct investment (FDI) into China fell to a two-and-a-half-year low. Inbound FDI in August was $7.2 billion, a decline of 14 percent from a year earlier. This included a 15.7 percent drop in FDI in the manufacturing



sector. On the other hand, FDI in the smaller services sector increased 8.9 percent. As for sources of FDI, there was a big increase in FDI coming from South Korea and the United Kingdom, along with a large decline in FDI coming from Japan, the United States, and the European Union. The weak investment in manufacturing reflects rising concern among investors that China's export prowess is declining amid weak overseas demand, rising wages, and a rising currency. Moreover, investors are pessimistic about domestic demand in China, given weakening economic indicators.

Chinese inflation continues to decelerate. In August, consumer prices were up 2.0 percent from a year earlier, the slowest pace of inflation in four months. Producer prices were down 1.2 percent from a year earlier. While low inflation is generally good news, it also reflects the weakness of the Chinese economy. This was highlighted lately by a decline in imports, indicative of weak domestic demand.

The government has already implemented a set of mini-stimulus measures through fiscal expansion, including extra spending on rail construction and environmental protection. It may choose to do more should the economic weakness continue. Also, the decline in producer prices for the 30th consecutive month indicates continued excess capacity in Chinese industry. This is a problem that will not be resolved quickly and will surely require more economic reforms, including financial market liberalization and reform of state-owned enterprises. Premier Li Keqiang recently said, "We do not want to rely on 'strong stimulus' to push forward economic development, but rely on 'strong reform' to invigorate the market."[1] Yet he has not been specific about the details or timing of reform.

Easing monetary policy

In August, China's broad money supply, M2, grew at its slowest pace in five months. It was up 12.8 percent from a year ago, down from growth of 13.5 percent in July. Given weak economic conditions and low inflation, there has been considerable discussion about whether an easing of monetary policy would be appropriate. Li appeared to address that issue recently, saying, "There is already a lot of money in the pool, and we can't rely on monetary stimulus to spur economic growth."[2] In other words, don't worry about the slowdown in money supply growth. Lately monetary policy has been a tough balancing act for the government. On one hand, the central bank wants to keep the economy growing; on the other, it wants to avoid a credit bubble.

Recent indicators show that credit expansion has declined, especially in the shadow banking system. It has been suggested that Li intends to focus instead on reforms as long as the economy is growing at a minimal rate of 7.0 percent.

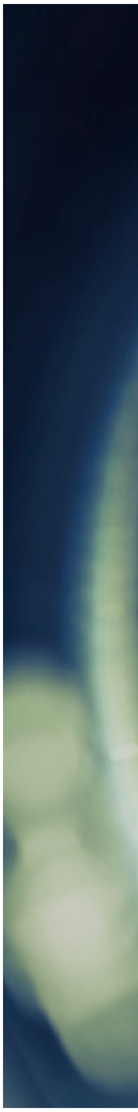
Despite concerns about credit market excesses, China's central bank has chosen to ease monetary policy. Specifically, it is providing 500 billion yuan (about $81 billion) in extra liquidity for five major commercial banks. For those who thought the government would avoid measures that might exacerbate worrisome growth of credit, this must have been a surprise. For others concerned that the economy is stalling, this probably was not much of a surprise. The fact that the easing of monetary policy is being done in a way that only benefits the five large state-run banks suggests that the government is eager to avoid stimulating the shadow banking system and focus on traditional bank lending instead. However, if state-run banks boost their lending to state-run companies, this will exacerbate the excess capacity found in many industries, thereby fueling further producer price deflation. At the least, however, this action will probably not stimulate the already frothy property sector.

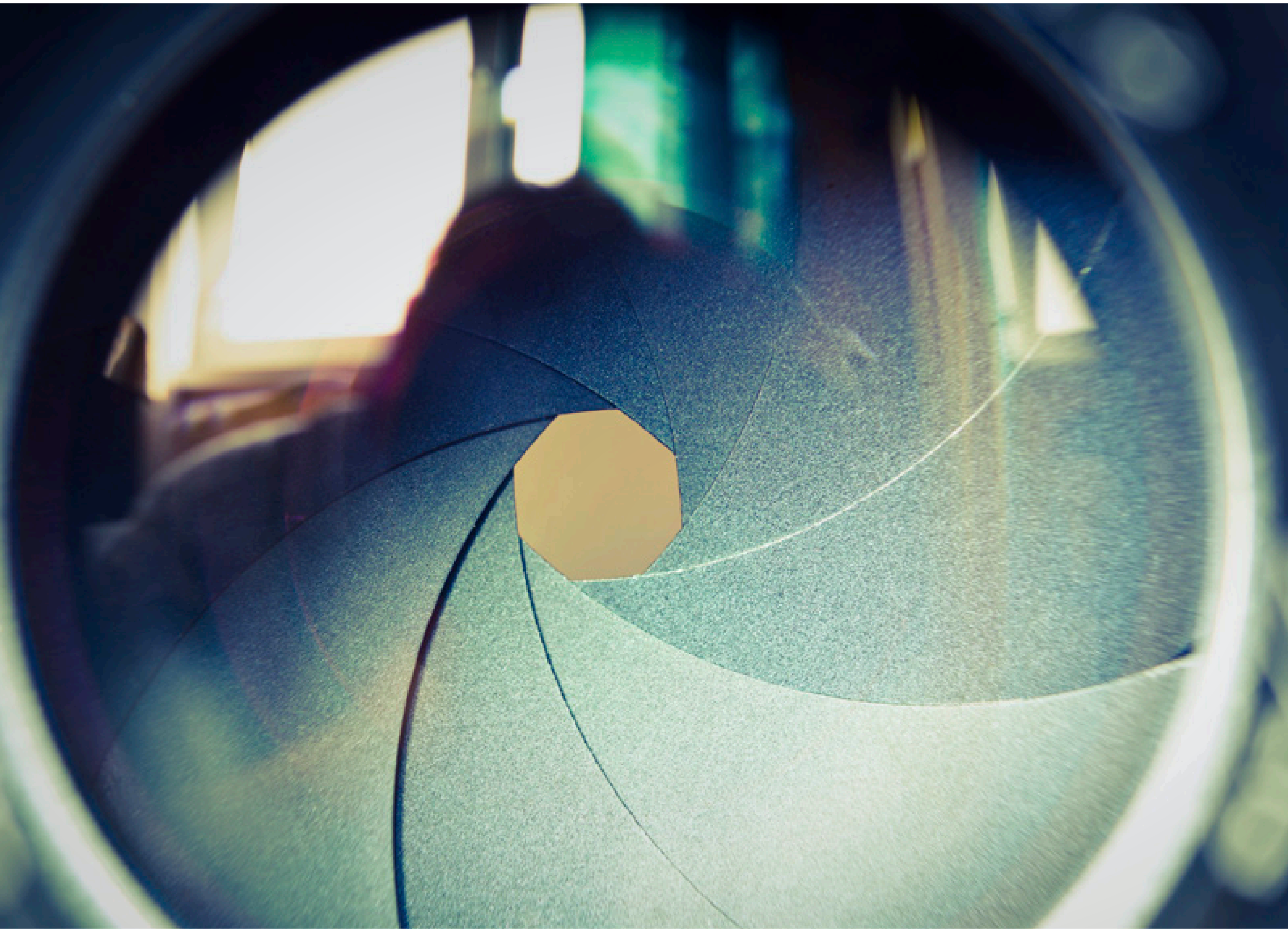
Despite concerns about credit market excesses, China's central bank has chosen to ease monetary policy.

Changing the focus

For years, China's far-flung officials have been under intense pressure to produce growth of output. This has often led to decisions that result not only in increased output but in reduced efficiency and increased waste. It has also led to the publication of statistics of questionable veracity. Producing growth was considered a sure path to promotion for many officials. To deal with this problem, the government announced that it will create a dashboard of varied indicators meant to focus not only on growth but also on the quality of growth. Specifically, the National Bureau of Statistics will publish 40 indicators that come under several buckets, including economic stability, economic security, optimized economic structure, industrial upgrading, profits and efficiency, innovation, the environment, and people's living conditions. The idea is to reduce the focus on growth and instead focus on indicators that are important for sustainable growth, risk aversion, and improvements in living standards. For example, one indicator will be the share of workers involved in research and development. The government will require many departments to report data in these categories.

Interestingly, a Standard & Poor's report says that China should no longer have economic growth targets.[3] The report says that the obsession with meeting targets has led officials to drive growth through ruinous credit creation, thereby creating risky financial conditions. It added, "This rise in debt has moved China from a position before the crisis where the financial sector was deemed to be reasonably sound to one where the fragility of the financial sector (as well as the sectors it has been financing, such as property) is seen as the biggest macro risk to China, if not the global economy." The report said that GDP growth should not be a target but rather the outcome of decisions about the best policy.





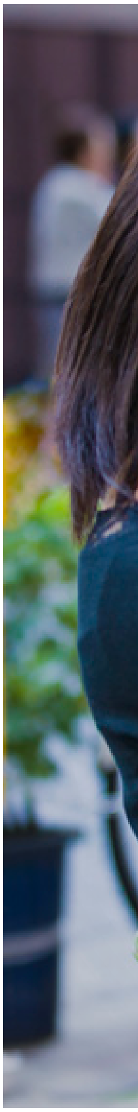
Endnotes

1. "China inflation stays subdued as producer prices extend decline," Bloomberg News, September 10, 2014, http://www.bloomberg.com/news/2014-09-10/china-inflation-stays-subdued-as-producer-prices-extend-decline.html.
2. Ibid.
3. David Tweed, "Is it time for China to scrap GDP targets? Yes, says S&P," Bloomberg News, September 17, 2014, http://www.bloomberg.com/news/2014-09-18/is-it-time-for-china-to-scrap-gdp-targets-yes-says-s-p.html.

Japan

Slow growth raises tax questions

By Dr. Ira Kalish



THE Japanese government recently provided an updated revision to second-quarter GDP growth. Previously, the government said that the economy shrank at an annual pace of 6.8 percent. Now it appears that the annual pace of decline was 7.1 percent, the worst decline since the global financial crisis during the first quarter of 2009. Of course the decline was largely due to the impact of the April increase in the national sales tax.

Plenty of economic activity had been pulled forward prior to the increase. Consumers spent prodigiously in the first quarter, especially on big-ticket items, to avoid the impact of the tax increase in the second quarter. Thus the second-quarter decline was not unexpected, but it was bigger than many people expected and suggests greater economic weakness. Moreover, the downward revision was largely due to a fall in business investment that was sharper than previously estimated. Consumer spending also fell more than previously believed. In addition, weak economic data for July and August suggest that the economy is not necessarily bouncing back quickly in the third quarter. Many analysts now expect weak growth for the year as a whole. This will increase pressure on Prime Minister Shinzo Abe to implement fiscal stimulus and deregulation as well as put pressure on the Bank of Japan (BOJ) to further ease monetary policy. Yet the BOJ has indicated intent to stay the course, and the government has indicated intent to stick with the next round of tax increases scheduled for October 2015.

The weak economic performance of Japan following the April tax increase has led many people to call for postponement of the next tax increase, set for October 2015. Yet recently Akira Amari, the minister of economy responsible for implementing "Abenomics," said that the tax increase should be implemented as planned, in order to ensure long-term fiscal probity as well as inspire business confidence. He said that the negative effects of another tax increase can easily be offset by appropriate monetary and fiscal policy stimulus. Yet this is what was also said before the recent tax increase. For now, the prime minister himself is being noncommittal about whether to raise the national sales tax from 8 percent to 10 percent next year. Finance Minister Taro Aso said, "The economy is constantly changing, and we need to prepare to be able to react immediately. A supplementary budget is one method." In other words, some fiscal stimulus may be in order. On the other hand, Aso indicated that, for the sake of long-term fiscal probity, it still makes sense to raise the tax again in 2015. BOJ

Consumers spent prodigiously in the first quarter, especially on big-ticket items, to avoid the impact of the tax increase in the second quarter.

Governor Haruhiko Kuroda concurred, saying, "There is a way to deal with the consequences of proceeding with the sales tax increase."

Business and government leaders appear to support the tax increase, fearing that investor confidence will be severely undermined by a failure to follow through. Yet surely investor confidence won't be helped by a weak economic environment. As in Europe and China, Japan would certainly benefit from implementing market-opening deregulation. Indeed this is the third "arrow" of Abenomics—yet it is the arrow on which the least action has taken place so far.

One area of weakness for the Japanese economy is exports. Japanese exports fell 1.3 percent in August versus a year earlier—despite the yen falling substantially, which should have boosted exports by improving the price competitiveness of Japanese exports. Yet it is evident that weakness in overseas demand, combined with increasing competition from other countries, has taken a toll. Exports to the United States were down 4.4 percent versus a year earlier, despite signs of improving US demand. Moreover, there are indications that, in order to take advantage of lower wages in some markets, many Japanese companies have shifted manufacturing capacity closer to the location of final demand. This process accelerated after the earthquake and tsunami. The failure of exports to grow poses a serious challenge for Abe. His economic policy, which has suppressed the value of the yen, was meant to spur more export growth.

Currency concerns

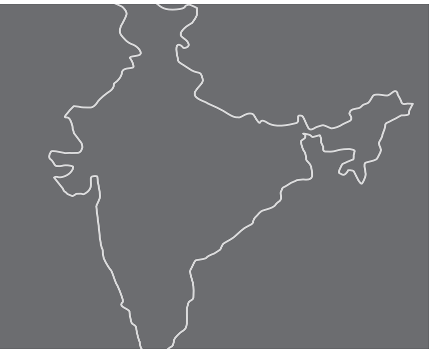
The yen has fallen to its lowest level against the US dollar since September 2008—109 yen to one dollar—more due to the strength of the dollar than weakness of the yen. The dollar's rise follows recent news of the US Federal Reserve forecast of higher short-term interest rates. The increasing expectation that the Federal Reserve will tighten monetary policy in early to mid-2015, combined with increasing evidence of strength in the US economy, has boosted the dollar. From Japan's perspective, a weak yen is good in that it boosts export competitiveness and contributes to the revival of inflation. From an American perspective, it is a political problem. A strong dollar hurts export competitiveness and strengthens the political position of those who support protectionism.

With the yen having fallen substantially lately, one would expect Japanese business leaders to be pleased—especially those who depend on exports. But a survey conducted by Reuters finds that only 25 percent of business leaders surveyed are happy with the extent of the yen's depreciation. The vast majority favor a higher-valued yen because they are concerned about the rising cost of imported commodities and components. Evidently, for many of these businesses, the impact of exchange rates on cost is more important than the impact on demand. Moreover, for those who sell their products mainly to the domestic Japanese market, a shrinking yen is an unambiguously bad thing. Still investors seem to be pleased by the weak yen. Japanese equity prices recently soared when the yen sank, with equity prices reaching their highest level since November 2007.

The government is hoping that stimulating spending to boost wealth will help to offset the negative impact of the April tax increase. The latter has been more onerous than the government expected.

Wealth effects

One of the effects of Abenomics' aggressive monetary policy has been to boost asset prices. Equity and property prices have increased, resulting in household wealth rising to a record level, according to the government. Yet it is not clear whether this will have a positive impact on the economy. That will depend on household behavior. Specifically, will consumers spend their increased wealth? Will they invest in riskier assets, thereby boosting the supply of funds available for business investment? For now, they appear to be parking that wealth in liquid assets, neither spending nor aggressively investing. Indeed household wealth has not risen nearly as rapidly as equity prices. This reflects the fact that consumers are being cautious with their money, perhaps still living with a deflationary mindset. The government is hoping that stimulating spending to boost wealth will help to offset the negative impact of the April tax increase. The latter has been more onerous than the government expected. How consumers behave in the coming year will inform the decision of whether to raise taxes again.



India

The economy after four months of Modi government

By Dr. Rumki Majumdar

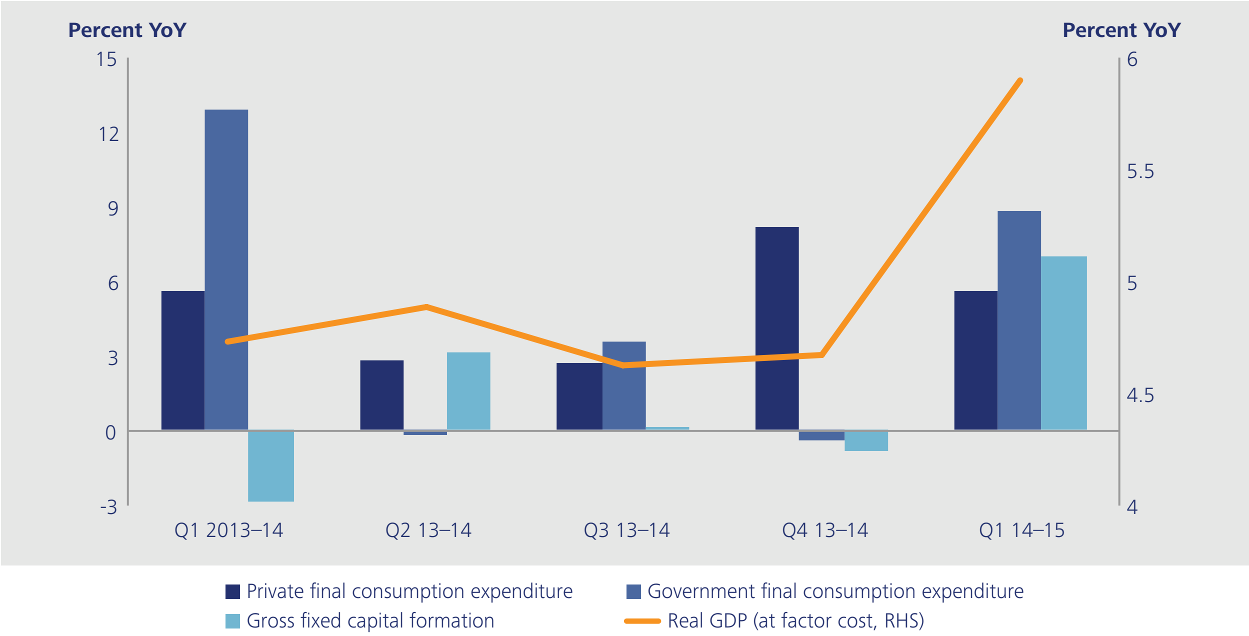
INDIA'S economy is probably showing early signs of recovery. The economy expanded at its fastest pace in two-and-a-half years at 5.7 percent year over year[1] in Q1 FY 2014–15.[1] External sector performance improved, the equity market reached an all-time high, and domestic investments improved significantly. Increased economic activity also improved consumer and business sentiment.

However, the Q1 numbers are not conclusive because a few challenges still continue to persist. Poor growth in the last two years has pushed the economy far below its potential, which implies that the economy has to strive harder to compensate for the loss in growth. That, in turn, will require a big push in the form of policy reforms, fiscal consolidation, coordinated monetary policy, and improved industrial performance. The question is whether the economy can sustain this turnaround going forward. The latest political and policy issues indicate that the government is serious about its commitment to bring back the country's prosperous years. However, there is much to be done before economic growth accelerates at a sustainable pace, and this might be just the beginning.

Improved economic outlook

Real economy: After disappointing GDP growth of 4.6 percent in the past two quarters of FY 2013–14, the new fiscal year began with stronger growth, primarily due to a boost from government spending and higher business investment. Government consumption expenditures grew 8.8 percent; they were expected to be high in Q1 because of the general elections that were held in April and May. However, a more sustainable driver of growth, that is., total fixed investment, also grew 7 percent after showing dismal performance for over a year. Negative stock building throughout the past year led to robust investment growth. Investment is expected to remain strong in the coming quarters as businesses expand their operations to cater to growing demand. Improved availability of financial resources to the private sector, fiscal consolidation, improved external demand, and stabilizing global commodity

Figure 1. Strong domestic demand helps economy grow in Q1 FY 2014–15



Note: Q1 refers to the fiscal year, which begins in April and ends in March of the following year.
Source: Reserve Bank of India, August 2014; Press Information Bureau, August 2014; Bloomberg, August 2014.
Graphic: Deloitte University Press | DUPress.com

prices will further provide impetus to economic recovery. Private final consumption expenditure growth remained modest at 5.6 percent, though it fell on a quarterly basis (figure 1). On the external front, exports of goods and services grew at a healthy rate of 11.5 percent, while imports fell 0.4 percent.

External sector: The balance of payment situation has improved significantly in the past year due to substantial improvements in both the current and capital account balance. The trade balance improved due to strong exports as global demand firmed and imports fell, owing to controls on imports of non-essential goods. Consequently, the current account deficit improved from 5.1 percent in Q1 FY 2013-14 to 1.7 percent a year later (figure 2). Though the current account deficit was slightly higher in Q1 FY 2014–15 relative to past three quarters due to a higher trade deficit, it was tracking below 2 percent of GDP and is still within the comfort zone. However, what is noteworthy is that the widening of the trade deficit was on account of an increase in oil and non-oil, non-gold imports during April–June 2014. Poor exports too have contributed to higher trade deficit lately. There could be an upward pressure on the current account deficit going forward, if economic activities improve further.

Capital inflows too improved in the last few quarters. Foreign portfolio investment started improving as early as Q4 FY 2013–14 as uncertainty with respect to the impact of the Federal Reserve's tapering of the US monetary policy on emerging economies, including India, decreased. In addition, there was growing optimism among investors who expected the current Prime Minister Narendra Modi to win the general elections. However, foreign direct investment (FDI) inflows reversed only after Modi's win. Net FDI picked up markedly in Q1 FY 2014–15 to levels not seen in the past three years (figure 2).

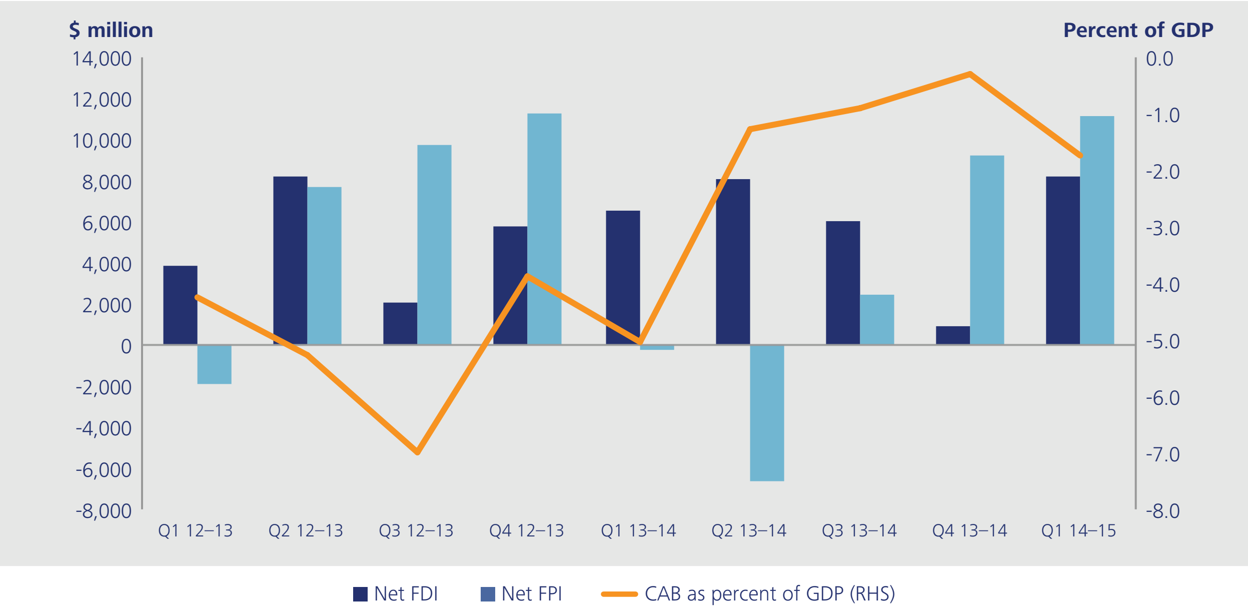
Financial market and sentiments: Optimism about an improving economy and expectations that the new government will likely usher in a period of significant fiscal and economic reforms are also reflected in the equity and bond markets. The equity market rose 20 percent since April 2014, and it touched a record-high level of above 27,000 in September. Government bond yields too fell 0.4 percentage points during this period. However, the impact on government bond yields has not been great due to the economy's high fiscal deficit concerns.

Consumer confidence and business sentiment have been on a rise since the elections. There has been a significant improvement in consumer confidence with respect to future expectations. The future expectations index improved due to an increase in positive perceptions of factors such as economic conditions, household circumstances, income, and employment. The business outlook for the Indian manufacturing sector—the business expectation index—improved in Q2 FY 2014–15 due to greater optimism on the overall business situation, production, order books, capacity utilization, imports, and exports. In addition, pessimism on the cost of finance, cost of raw material, and profit margins decreased among manufacturing companies.

Future outlook: India's economic growth is expected to improve in the forthcoming quarters. Some of the rating agencies have projected a better growth outlook against the backdrop of a new government coming to power with a single-party majority for the first time in three decades. The various policy initiatives by the new government to attract investments and to improve industry sector performance, among others, have helped improve sentiment and expectations. The Reserve Bank of India projects an annual growth of 5.3 percent in FY 2014–15 and 6.4 percent in the following year. As mentioned earlier, there could be a rise in the trade account deficit because of rising demand, but the capital account is likely to remain healthy. Expectations on interest rate movements in the United States and economic reforms in India will continue to drive growth in the financial market in the coming quarters. Overall, economic and market sentiment is expected to remain optimistic.

However, projected growth rates will likely remain below the levels seen earlier for a year or more. This is because the economy continues to struggle with persistent economic challenges that may weigh on the growth outlook of the economy.

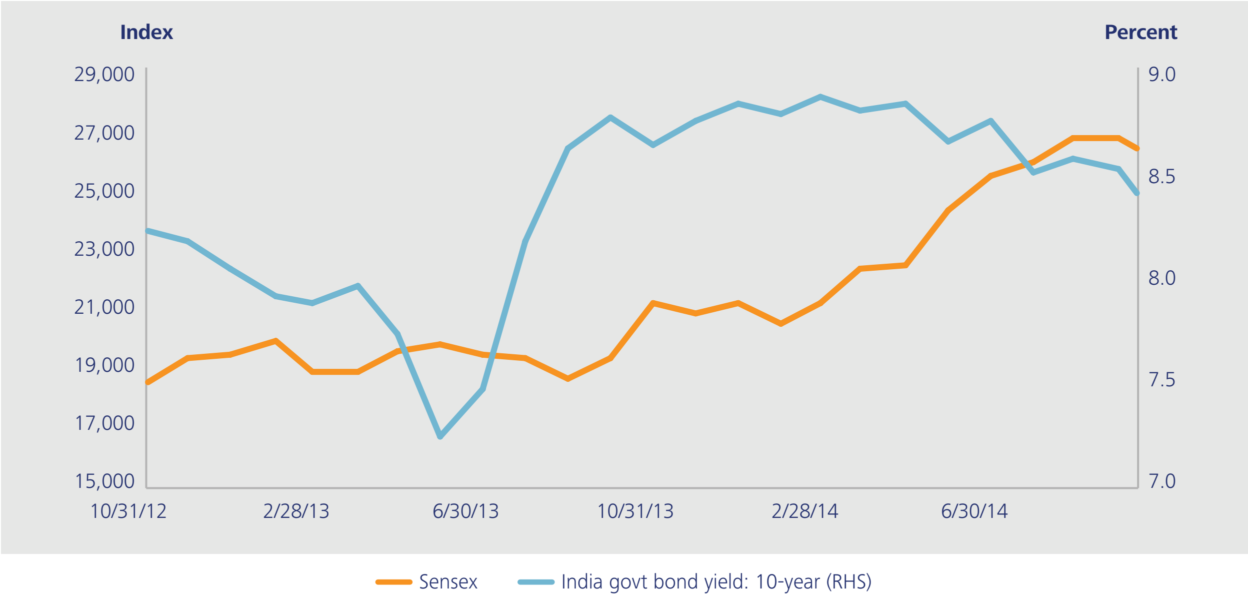
Figure 2. Improved balance of payments



Source: Reserve Bank of India, September 2014; Bloomberg, September, 2014.

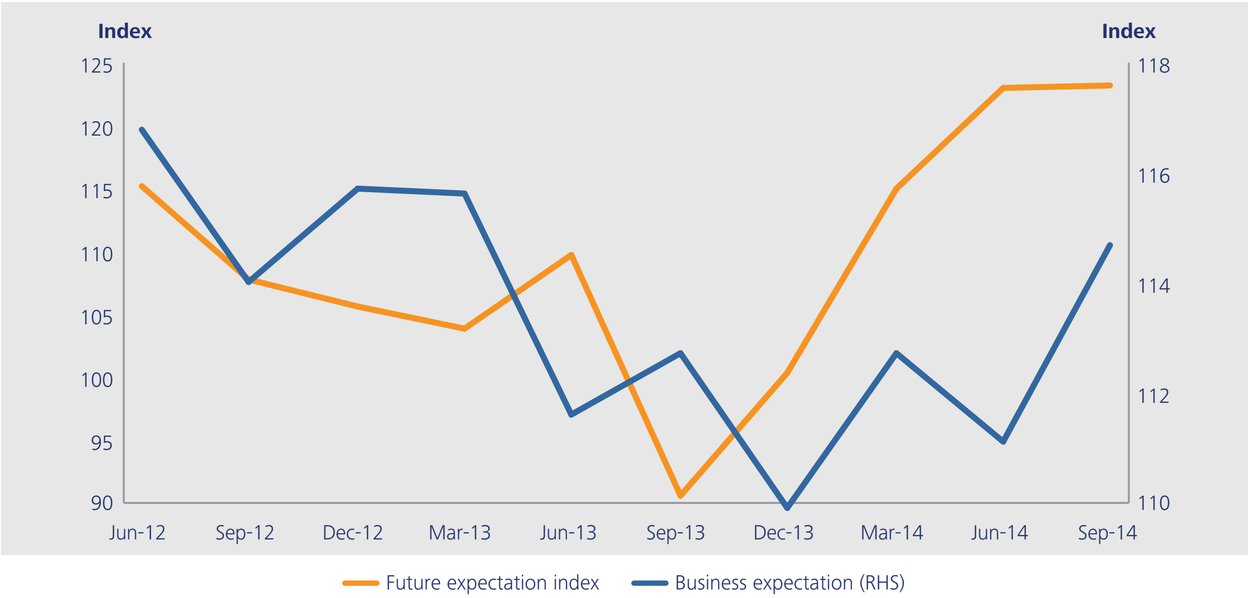
Graphic: Deloitte University Press | DUPress.com

Figure 3. Equity market at an all-time high



Source: Bloomberg, October 2014.
Graphic: Deloitte University Press | DUPress.com

Figure 4. Economic sentiments are improving



Source: Reserve Bank of India, September 2014.
Graphic: Deloitte University Press | DUPress.com

Challenges

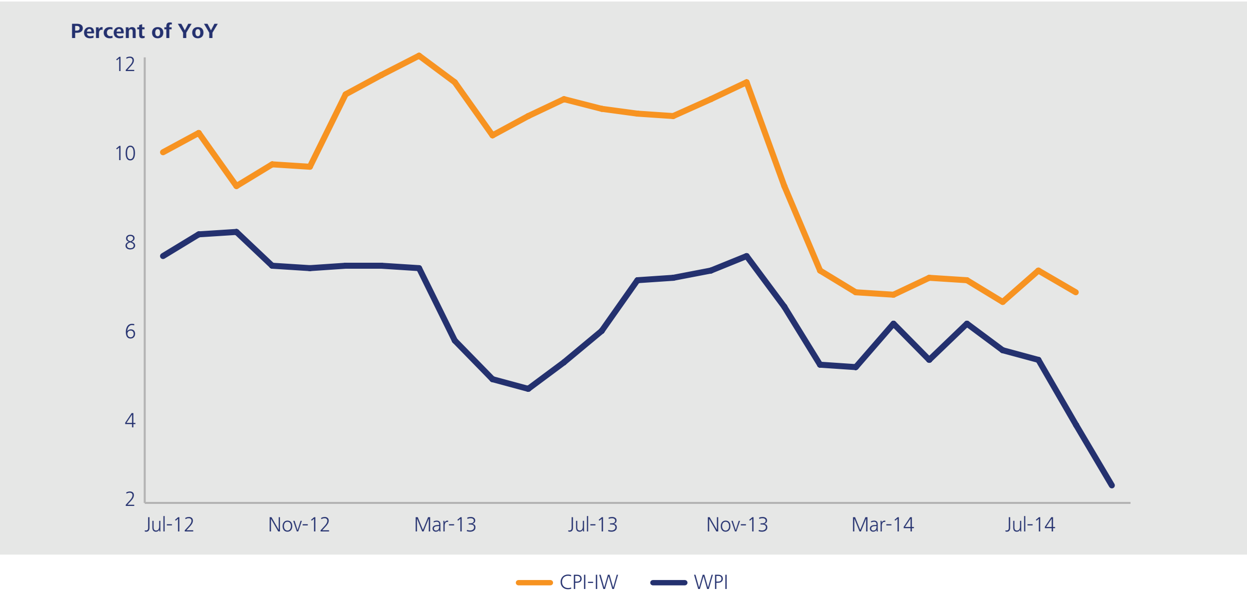
Manufacturing sector still unstable: The latest monthly data on the index of industrial production (IIP) indicate that the manufacturing sector remains highly vulnerable. After a promising growth rate of 5 percent in May, the IIP fell for the next three consecutive months. Strong growth in capital goods, which grew at the highest rate in three years at 23 percent in June, turned negative in the subsequent months. The manufacturing index fell over a percent in July and August after a strong 5.1 percent growth in May.

Growth in the consumer durables index has been the biggest drag; although it had turned positive in May after falling for the past 17 consecutive months, it resumed its falling trend post that month. The HSBC India manufacturing purchasing managers' index (PMI), which provides a more recent overview of business conditions in the manufacturing sector, suggests further moderation in manufacturing activity in September. The index fell to 51 in September from 52.4 in August. The poor IIP numbers indicate that industrial growth will remain a drag on economic performance in Q2.

Inflation still a concern: While there has been some relief with respect to inflation in 2014 relative to 2013, when it was hovering in the double digits, inflation still remains high. The latest data suggest that consumer price inflation (CPI) fell below 7 percent, yet remains more than the Reserve Bank of India's (RBI's) target range for inflation. Wholesale price inflation (WPI) has eased considerably from 3.7 percent in August to 2.4 percent in September, primarily due to favorable base effect (figure 2).

With growing concerns about an uneven rainfall across the country, it is expected that poor crop output will likely push inflation up in the coming months. Supply constraints—particularly in food and infrastructure—and high dependence on fuel imports will likely keep inflationary pressures high. However, the continuing fall in oil and commodity prices will ease inflation. According to a survey conducted by the RBI,[3] the proportion of respondents expecting double-digit inflation in the next three-month period has declined. Similarly, fewer respondents expect higher prices a year from now.

Figure 5. Inflation has eased down lately, though inflationary pressures remain high



Source: CSO India, Ministry of Statistics and Programme Implementation, August 2014.
Graphic: Deloitte University Press | DUPress.com

High fiscal deficit: The government's strategy of fiscal consolidation has repeatedly gone off course since 2008 due to a series of unfavorable developments. Faced with prospects of a sovereign rate cut and the crowding out of private investments in the economy, the government undertook a series of reforms, including fuel subsidies and rail fares, starting in September 2012. However, the momentum of fiscal consolidation slowed due to the general elections in May 2014. In addition, the continuing slowdown in economic growth, static industrial growth, a moderate increase in indirect taxes, the subsidy burden, and not-so-encouraging tax buoyancy made it difficult for the government to improve the deficit. The fiscal deficit for Q1 FY 2014–15 increased sharply to 11 percent after recording a marginal surplus in Q4 FY 2013–14. Part of the rise in the deficit was also due to higher government expenses from the general elections held in May.

The new government announced that it would strive to achieve a fiscal deficit of 4.1 percent in FY 2014–15 in the union budget. In addition, the finance minister announced a fiscal deficit trajectory of 3.6 percent in FY 2016 and 3.0 percent in FY 2017. However, the government has not laid down any specific roadmap on how it will achieve the target deficit. More importantly, no specific proposals to reduce subsidies were announced apart from expressing the need for more effective implementation of subsidies. While the explicit confirmation that the government will adhere to the fiscal plan is a positive step and may instill confidence, investors are awaiting concrete measures to be taken in this direction.

The first four months of the government's actions

Since the new government has come into power, there have been a few changes in the functioning of the administration. The government has emphasized "less government and more governance," and efforts are being made toward making ministries more accountable and streamlined. One favorable outcome of these actions has been speedy decision making in clearing some stalled projects. About 17 infrastructure projects, which had been pending since the previous government's tenure, have been cleared in the last three months. In addition, initiatives such as making online environmental and forest clearances for industrial projects available, focusing on skill development, amending labor laws, and allocating funds to the manufacturing sector, among others, have generated a lot of enthusiasm among the corporate sector and investors.

Improving farm productivity, building quality infrastructure, and boosting manufacturing in India are some of the other areas on which the government is currently focusing. Measures such as setting up farm credit, prize stabilization funds, and agriculture-tech infrastructure funds have been proposed to boost agricultural sector output and productivity. Strategies such as public-private partnerships and tax holidays in the transport sector, providing custom duty relief to the energy sector, digitalizing rural India, and building smart cities and metro infrastructure in some cities are expected to improve infrastructure. Policy strategies such as the revival of special economic zones, tax breaks for manufacturing units investing over INR 250 million, the revival of medium and small scale enterprises, and the building of an industrial corridor will likely provide much needed thrust to the manufacturing sector. The prime minister emphasized the need to strengthen the manufacturing sector and indigenize production by appealing "Come, make in India" to investors in his first Independence Day speech.

The government has also prioritized improving international trade and investment relations. The prime minister's recent meetings with the leaders of the three largest economies (the United States, China, and Japan) is being seen as a big step in that direction. In addition, during his US visit, Modi met a galaxy of top American corporate executives and nonresident Indians. The intention was to reinvigorate their interest in investing in the government's new initiatives related to smart cities, infrastructure, digitalization, education, and health. These diplomatic drives are expected to improve India's ties with other nations in the coming years and boost investment in the economy.

That said, the government has had limited success in resolving issues such as land acquisition and structural bottlenecks, which have impact on inflation and input prices.. Policies and plans laid out by the government are encouraging, but implementation has been very limited, with no clear roadmap to delivery. The fiscal deficit remains a concern, and no concrete actions have been taken to tackle subsidies. There has been criticism that, in order to expedite environmental clearances for industrial projects, the government is compromising justice and the well-being of the environment, natural resources, and communities.

So far, the performance of the new government has been a mixed bag. Although the government's approach to various issues have encouraged investors and improved optimism about economic outlook, actual measures have been incremental with limited consequences. There is much more to be done. That said, it has been only four months since the new government has taken up its responsibilities. The government is taking small steps toward fundamental changes. Once these policy changes start being reflected in action, they may have much more far-reaching effects on the economy.

So far, the performance of the new government has been a mixed bag.

Endnotes

1. All growth figures will be given in year-over-year figures unless otherwise specified.
2. FY refers to the fiscal year that begins in April and ends in March of the following year.
3. Reserve Bank of India, Inflation expectations survey of households: June, 2014, August, 2014, http://www.rbi.org.in/scripts/PublicationsView.aspx?id=15773.

Russia

Time for some contemplation

By Akrur Barua

IT is an anxious time for Russia's economy as the European Union and the United States launch fresh sanctions against key oil companies, banks, and individuals close to the Kremlin. Among the oil majors finding a place on the sanctions list (of the European Union, the United States, or both) are Rosneft, Transneft, Novatek, and Gazpromneft, while the banks on the sanctions list include Sberbank, Gazprombank, and Bank Rossiya.

The sanctions could not have come at a worse time for the Russian economy.

The sanctions could not have come at a worse time for the Russian economy. Growth has slowed, confidence is low, interest rates are high, the ruble is down, and capital flight is the worst since the global downturn of 2008–09. Add to this a number of long-term concerns, including low investment and an aging population, and the scenario gets even grimmer.

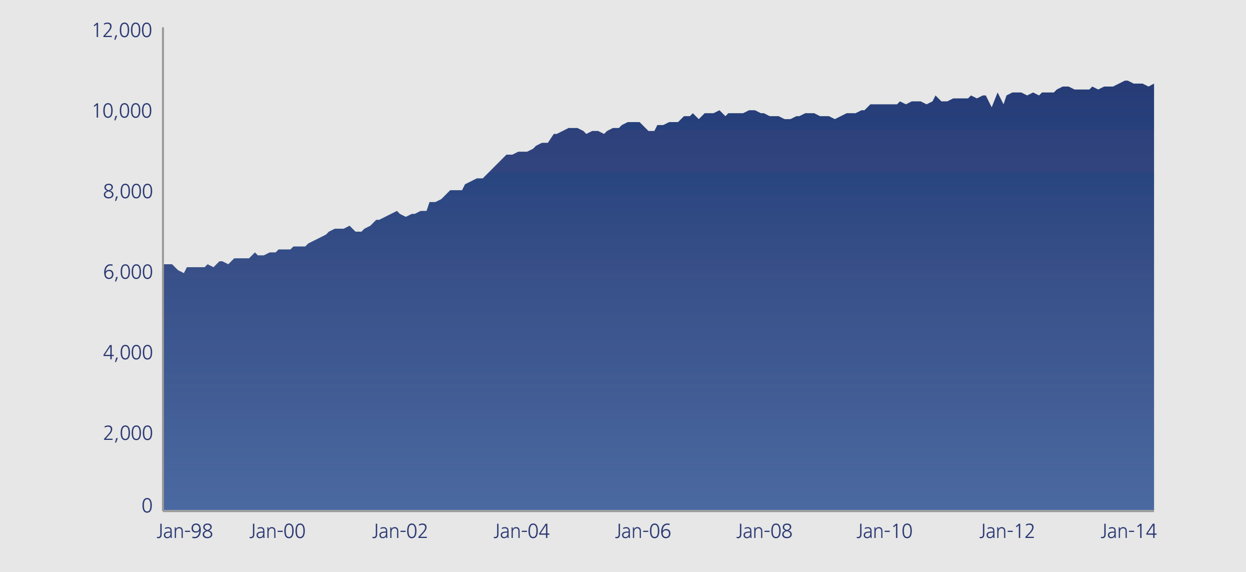
It is intriguing that a country that recovered strongly after the crisis of 1998 now finds itself in such a situation, despite being blessed with large reserves of oil and gas. Maybe the answer lies in a false sense of security born of Russia's hydrocarbon wealth. Add to that the lack of major economic reforms for a long period of time and misguided geopolitical ambitions, and what is left is an economy edging toward isolation. Of course, there is the dragon to dance with, but China is hardly a substitute for the rest of the global economy. It is just one among many major markets that Russia should be tapping.

Russian companies stare at a funds crunch

The companies under sanctions will not be able to raise money in Western capital markets. While some are looking at Asia, especially yuan-denominated bonds, markets in the continent are not as deep and liquid as their Western counterparts. Also, Asian markets might not be able to provide the numbers that Russian companies want.[1] Russian companies owe about $150 billion in debt payments this year; this is far higher than the $110 billion yuan-denominated bond market.[2] Duration will also be a problem in Asia: Russian companies will look for long-term debt, but Asian investors will most likely be interested in short- to medium-term debt.

Ironically, the sanctions come at a time when bond yields in Europe are at their lowest, with the European Central Bank embarking on a quantitative easing program. With sanctions in place, Asian investors will demand much higher yields from Russian companies than Western markets, especially Europe, would. Also, Asia's role in the sanctions on Russia is still not clear. Japan, for example, has imposed sanctions on Russia despite potential impacts on oil and gas trade.[3]

Figure 1. Monthly total oil supply in Russia ('000 barrels per day)



Source: International Energy Statistics, Energy Information Administration, September 2014.

Graphic: Deloitte University Press | DUPress.com

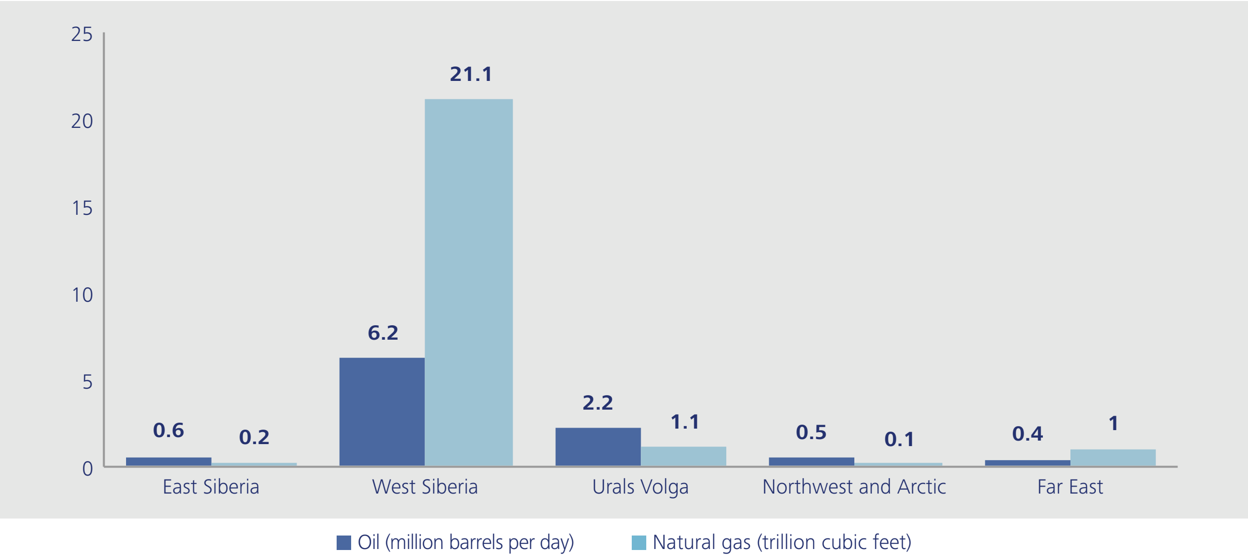
There are also governments, like Singapore's, that are neutral, yet have increased their scrutiny of inflows of private Russian funds.[4]

Russian companies have naturally turned to the state. For example, Rosneft is seeking about $42 billion in funding to cover its net debt.[5] The government is likely to oblige by meeting at least part of such demands. Rosneft and Novatek may get RUB 80–150 billion each; the money will be made available via bond purchases by the National Wealth Fund (NWF).[6] While this will cater to capital requirements in the short term, it is definitely not prudent in the medium term, given the increasing burden of plugging government finances and fulfilling tall social security commitments. As of now, however, the government has resources at hand to deal with the problem; while the NWF is worth about $88 billion, the country can also tap its large international reserves, valued at $465 billion.[7]

Long-term oil production runs into the sanctions wall

According to the US Energy Information Administration (EIA), Russia has 80 billion proven reserves of oil and 1,688 cubic trillion feet of gas.[8] The country was also the world's largest crude oil producer and the second-largest producer of dry natural gas in 2013.[9] No wonder, then, that hydrocarbons are a key part of the economy, driving much of the stellar growth of the previous decade. Currently, oil and gas accounts for 68 percent of the country's exports and 50 percent of government revenues. But worryingly for Russia, oil production appears to have peaked (figure 1), with the West

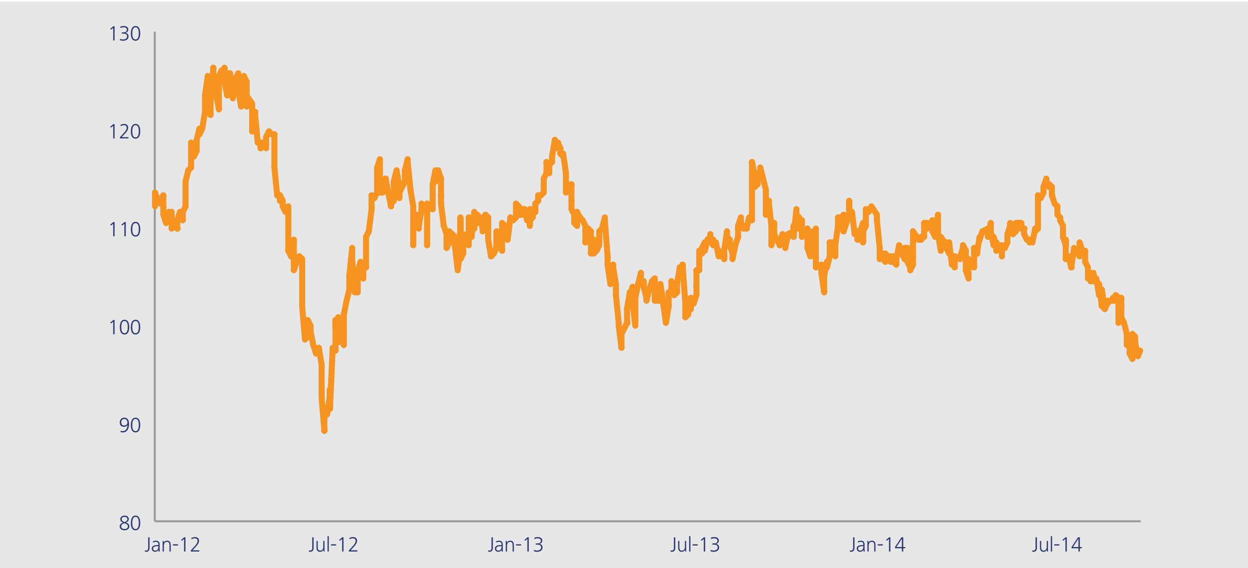
Figure 2. Major oil and natural gas producing regions in Russia*



Source: Energy Information Administration, September 2014; *excludes North Caucasus as it has a negligible share.

Graphic: Deloitte University Press | DUPress.com

Figure 3. Oil price movement since January 2012 (dated Brent, $ per barrel)



Source: Bloomberg, September 2014.

Graphic: Deloitte University Press | DUPress.com

Siberian reserves coming under increasing strain. That area accounts for 62 percent of Russia's oil production and 86 percent of natural gas production (figure 2).[10]

Consequently, Russia has been searching for oil in the Arctic, in the deep sea, and in shale formations.[11] This is where Western technology is critical; hence, Russian firms have been working with western counterparts. For example, ExxonMobil and Rosneft are exploring for oil in the Kara Sea in the Arctic; the companies say that this reserve might hold as much as 9 billion barrels of oil.[12] The sanctions, including restrictions on transfer of technology, have hit this partnership; there are reports that ExxonMobil has stopped work.[13] This will dent oil production in the medium to long term. Turning to China will not help, as only the West has the requisite technology—an opinion echoed by Alex Kudrin, Russia's former finance minister.[14]

Strangely, Russia's tensions with the West have not propped up oil prices, as it often does during geopolitical conflicts. Any hike would have been a welcome relief for Russia, especially with the economy struggling. However, prices remain relatively low due to a slowing China, a weak recovery in Europe, the growth of shale oil in the US, and a strong dollar. Brent, for example, has fallen by about 14 percent since the end of last year (figure 3).

The other worry for Russia's oil and gas sector is the possibility of Russia imposing potential retaliatory sanctions on Europe. Europe is heavily dependent on Russian hydrocarbons; 79 percent of Russia's oil exports and nearly all of its natural gas exports head to Europe. While retaliation by Russia looks politically attractive in the short term, it will have negative long-term consequences. Already, European governments are trying to diversify their energy imports; many of them have urged the United States to lift its oil export ban.[15] Any Russian action to block supplies will make this chorus louder, with a proposed free trade agreement between the European Union and the United States likely to add to pressure on the latter. For Russia, it would mean losing share in a very reliable market.

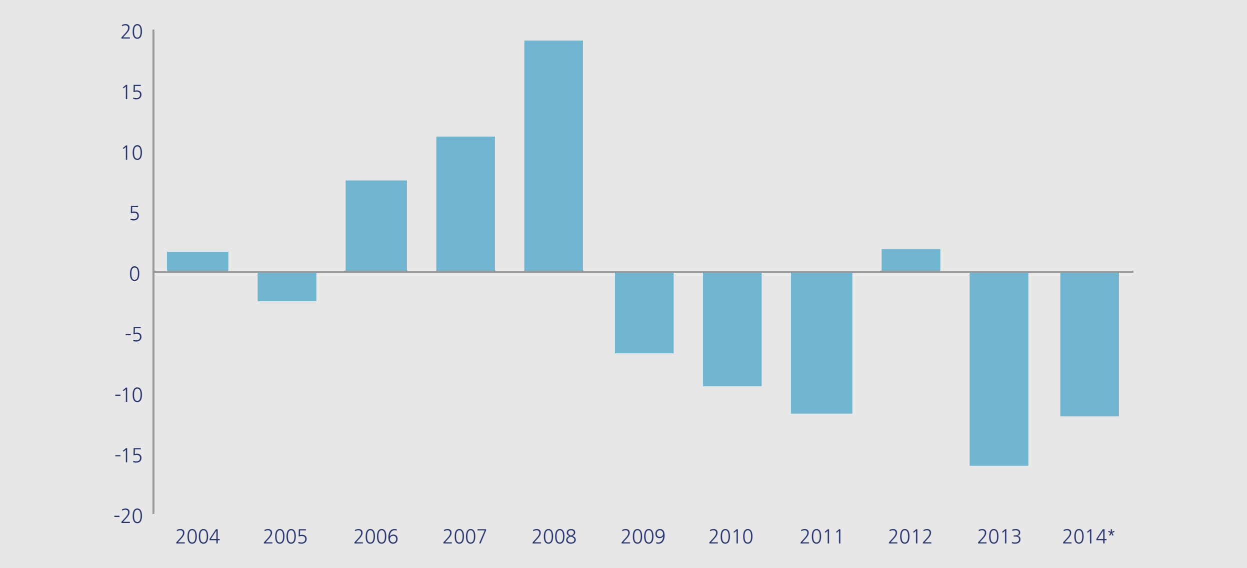
For foreign businesses, the "Russia cost" just went up

In the World Bank's latest "ease of doing business" rankings, Russia places 92nd out of 189 countries. Recent events will only make the situation worse—which is unfortunate, given that the country needs strong foreign direct investment (FDI) to prop up the share of investments in the economy. Russia also needs foreign capital and technology to boost competitiveness in manu-

facturing and services, essential for developing a more diversified economy. According to Oxford Economics, net FDI in Russia will be in negative territory in 2014, the same as last year (figure 4).[16]

Already, foreign portfolio capital is leaving Russia at a brisk pace. Bank of Russia (BOR) officials put the figure so far at about $75 billion, and they expect it to rise to $100 billion by the end of 2014, followed by $30–$45 billion in outflow in 2015.[17] Investors also seem rattled by recent domestic political developments,

Figure 4. Net FDI inflows into Russia ($ billion)



Source: Oxford Economics, September 2014; *estimate.
Graphic: Deloitte University Press | DUPress.com

including the recent arrest of billionaire Vladimir Yevtushenkov on money laundering charges.[18] This event shows the tenuous relationship between the state and businesses, and it has even the Russian economy minister worried.[19] Under current circumstances, investments will likely be hit yet again this year (a 6–7 percent decline), with recovery not likely before 2016.

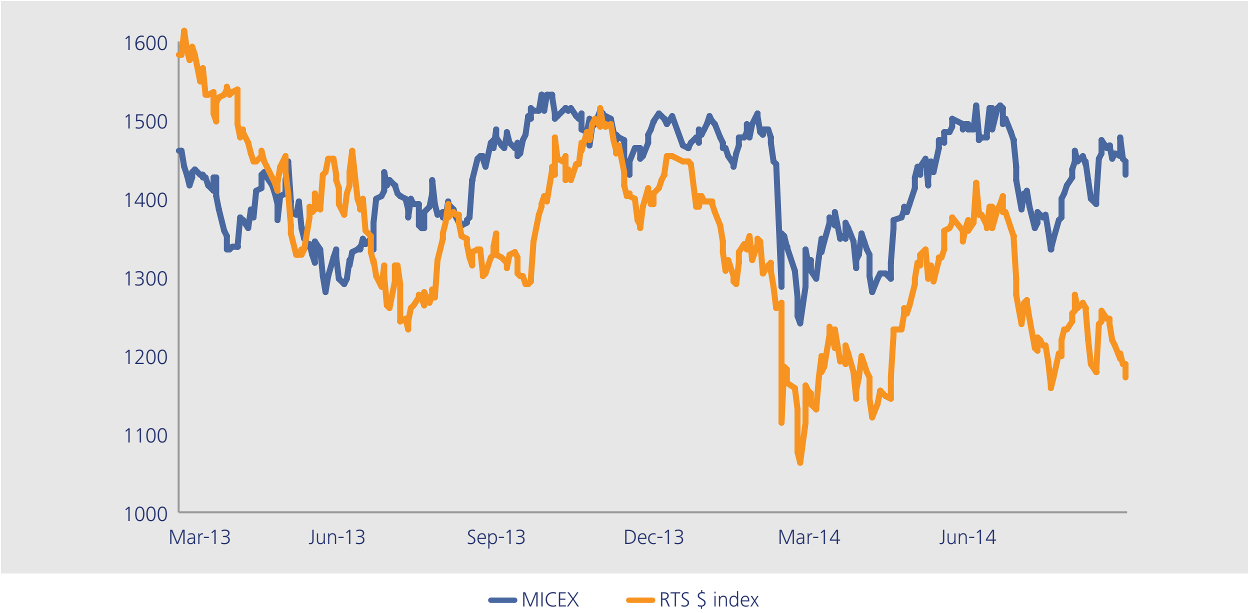
And down goes equities and the currency

The financial markets have borne the immediate impact of political tensions in Ukraine and sanctions by the West. The MICEX is down by about 5 percent this year, missing out on the rally in emerging market peers like India; the decline in the dollar-denominated RTGS is greater, at 20 percent (figure 5). Some Russian companies have seen their stock prices dive (figure 6), even as others see domestic demand slide due to slowing economic growth (auto companies are a good example).[20] The ruble, meanwhile, has shed 14 percent against the US dollar this year (figure 7). Excluding Argentina, the ruble is the worst-performing among 24 emerging market currencies tracked by Bloomberg.[21]

A depreciating ruble, in turn, has pushed up inflation. At 7.6 percent in August, inflation continues to remain above the central bank's medium-term target of 4 percent (figure 8). Price pressures are not likely to ease in the near term, since higher food prices are expected in the coming months as supplies lessen in the face of the government's ban on food imports from Europe.

BOR has responded well to the crisis. It has hiked interest rates three times this year (for a cumulative 250 basis points) to counter inflation and capital outflows. If inflationary pressures persist, it might be tempted to go in for another 25- to 50-basis-point hike either this year or early next year.[23] The bank is also wary about regional governments' plan to impose a sales tax of 3 percent next year, which will no doubt push up inflation.[22] BOR is, however, up against increasing pressure from the government to ease rates to stimulate growth. So far, it has not relented, and it has even reaffirmed its commitment to move to an inflation-targeting mechanism in 2015. Investors will certainly be hoping that BOR keeps its word.

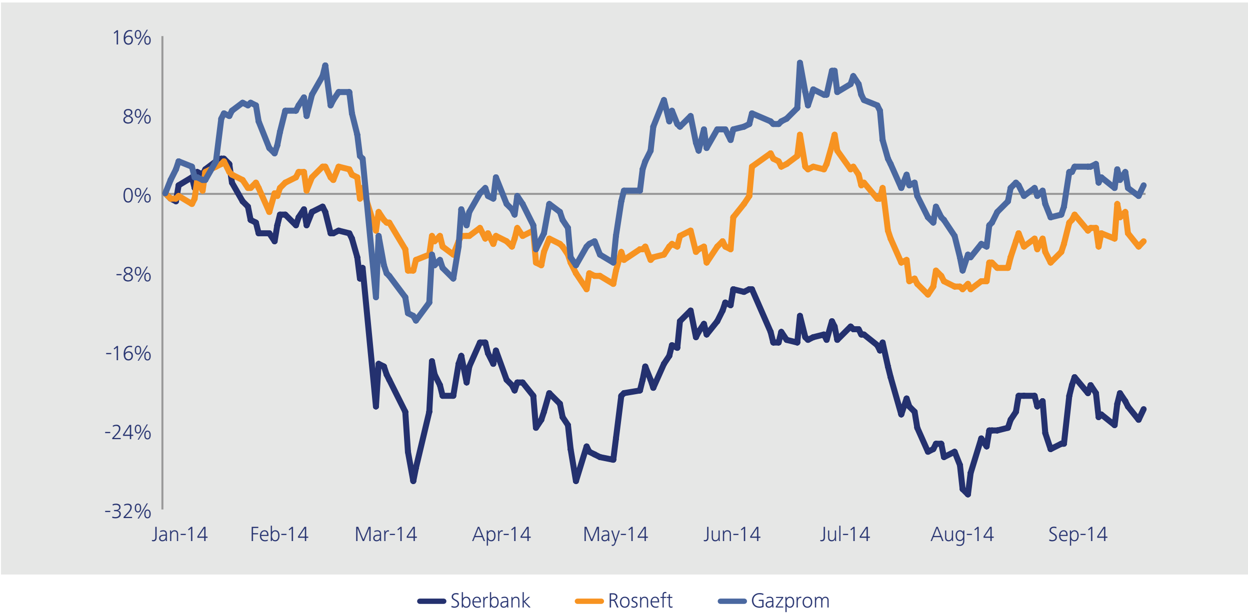
Figure 5. Movements in key equity indices



Source: Bloomberg, September 2014.

Graphic: Deloitte University Press | DUPress.com

Figure 6. Year-to-date equity price returns of key Russian companies



Source: Bloomberg, September 2014.

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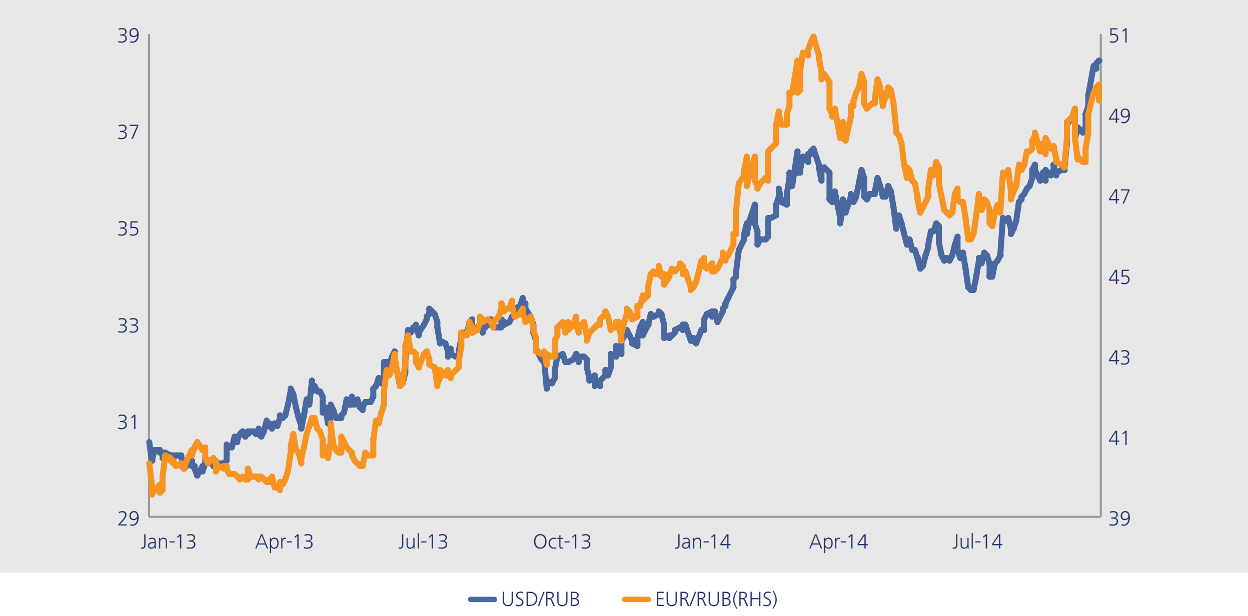
Figure 7. Ruble against the US dollar and the euro



Source: Bloomberg, September 2014.

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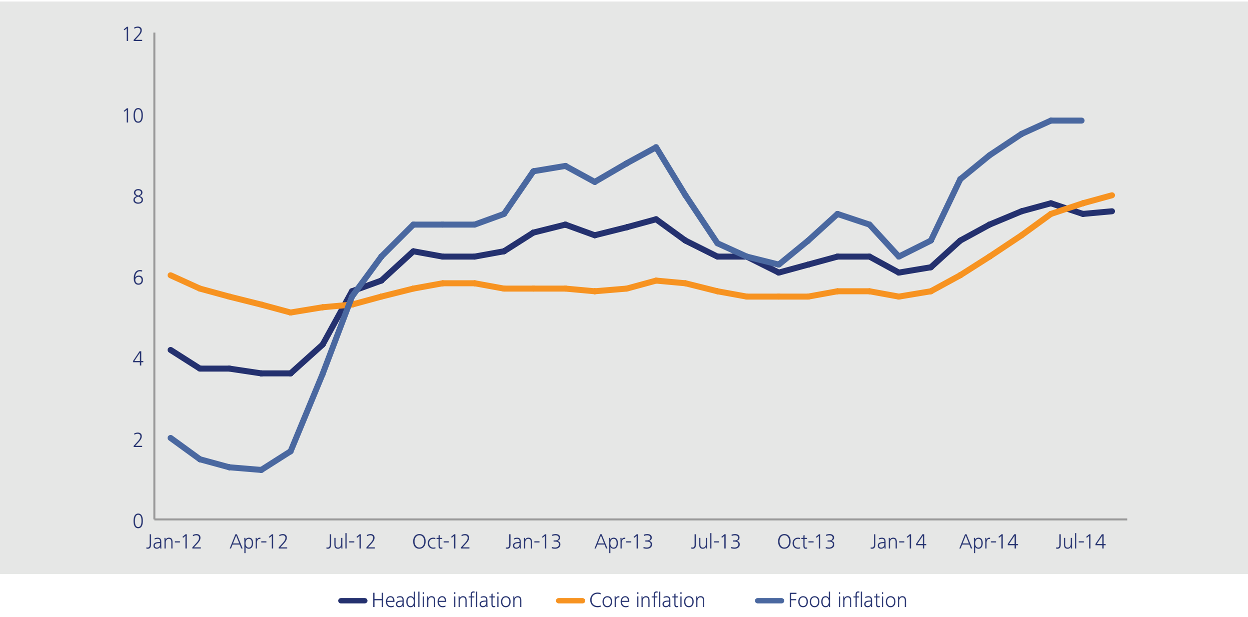
Figure 8. Inflation and key components (percentage)



Source: Bloomberg, September 2014.

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Time to set things right

Sanctions will no doubt weigh on GDP growth this year. BOR expects the economy to grow by 0.4 percent this year, followed by growth in the 0.9 to 1.1 percent range next year. Nevertheless, what is being currently overlooked is that Russia's economy was in trouble even before the West imposed sanctions. Investments were subdued, with both private businesses and state-owned enterprises cutting down on capital spending. Household consumption, a key growth driver in recent years, had also been slowing down due to high interest rates and rising inflation. The latter has hit real wage growth, which declined to 1.4 percent year over year in August from 5.2 percent in January.

For Russia's policymakers, now is a good time to sit back and reassess the economy's fundamental strengths and weaknesses. They need to think of ways to boost private sector participation, improve productivity, and enhance competitiveness to improve exports. For example, despite rising arms exports, Russia will find the going tough as some of its key markets cut down (China) or diversify (India).[24] The easiest way to shore up the economy would be to initiate some much-needed economic reforms. But, most importantly, Russia needs to reengage with the West and get back to the global community of nations of which it has been an important member. Given its resources and military clout, Russia should be part of the "developed" bloc, not the "emerging" one. That in itself is a stark reminder of how things have gone wrong in the country. President Putin needs to set that right, but not with the wrong choices.

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Brazil

It's the economy, Dilma

By Akrur Barua

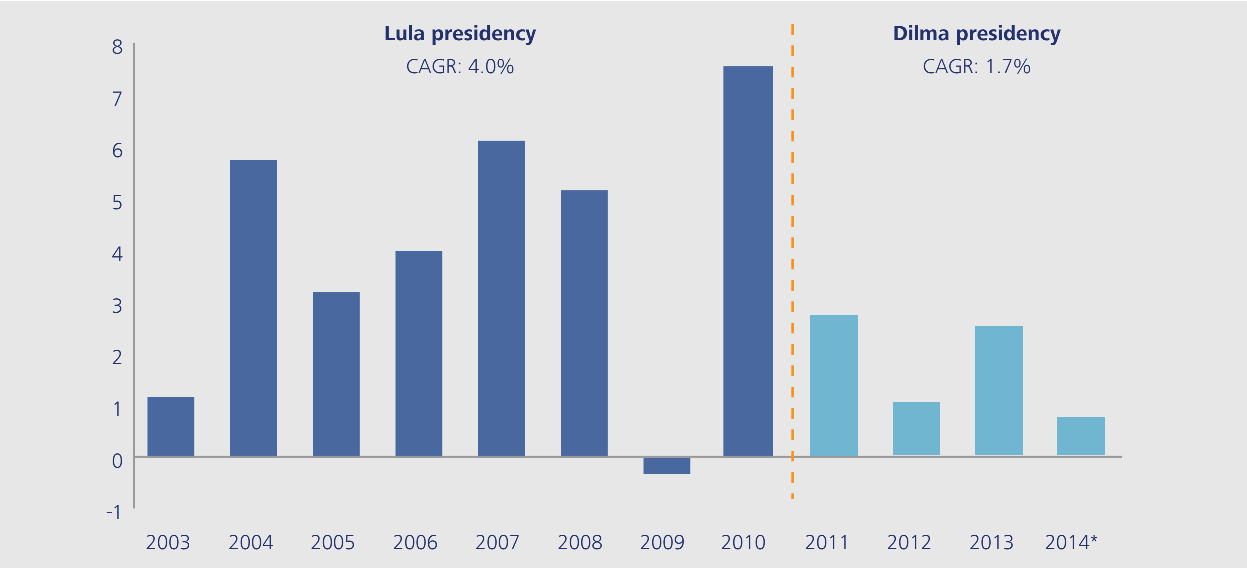
IN January 2011, Dilma Rousseff took over as Brazil's 36th president, the first woman to hold that office. The road to the Palácio do Planalto had not been very difficult. In the elections the year before, Rousseff had benefited from the popularity of her predecessor and mentor, Luiz Inácio Lula da Silva, who had presided over strong economic growth in 2003–10. Things, however, have not gone smoothly since then. Economic growth has slowed down due to subdued global commodity prices, Brazil's key export item. More worryingly for Brazil's economy, personal consumption—a key growth driver—is showing signs of fatigue as households face high indebtedness and weakening economic prospects.

With the economy slowing, Rousseff's popularity has taken a hit. While she led the three-cornered contest in the first round of elections, her 41.5 percent vote share was not enough to fend off a second round contest with centrist candidate Aecio Neves.[1] Worryingly for Rousseff, Marina Silva, the third placed candidate, has backed Neves in the second round, which could just turn the tide in Neves' favor.[2] Ironically, the middle class (35 million of them came out of poverty in the last decade), which forms a core support base for the president's party, seems to be upset with the government.[3] The middle class wants better public services and a more secure economic future; surely, news that the economy technically entered a recession in the first half of 2014 will not go down well among this constituency.[4]

Slide into recession

In Q2 2014, real GDP fell 0.6 percent quarter on quarter, worsening from a downwardly revised -0.2 percent decline in the previous quarter. Dragged down by subdued business confidence due to a lower-growth economic outlook and higher interest rates, investments fell 5.3 percent in Q2, a sharper drop than the 2.8 percent decline in Q1. For both GDP and investments, this second-quarter performance was the worst since Q1 2009, when the global economic downturn was underway. Government expenditures also fell in Q2 (-0.7 percent) due to some fiscal consolidation in the face of pressure from rating agencies. Overall GDP growth would have been lower had

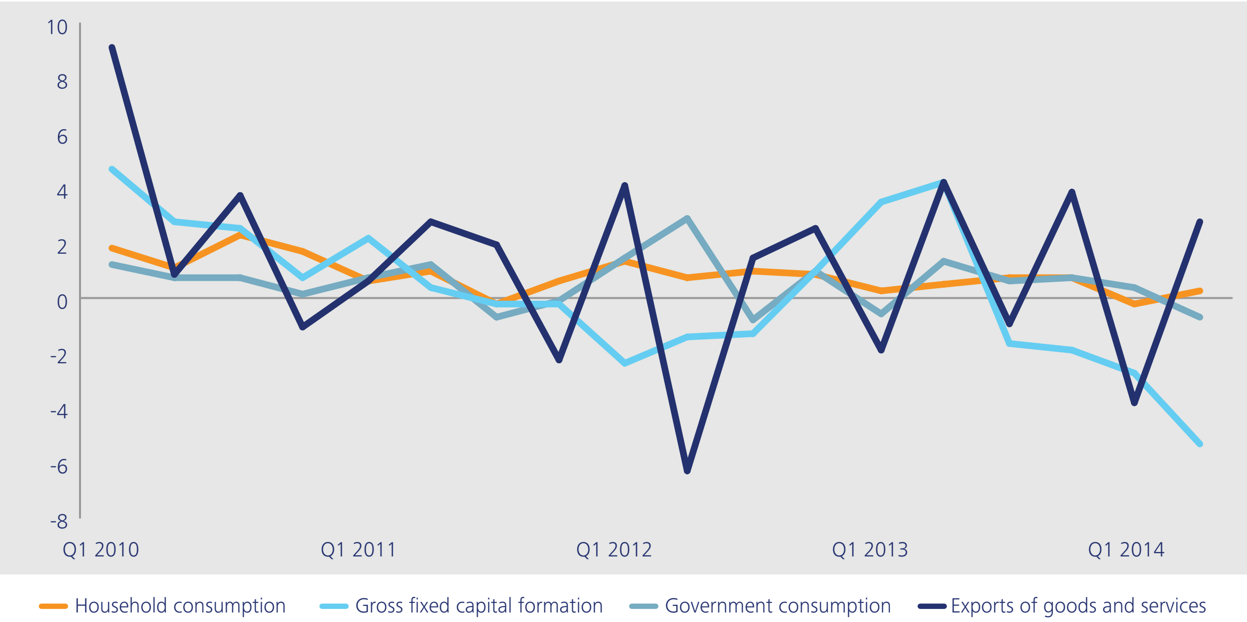
Figure 1. Annual real GDP growth under Lula and Dilma (percentage)



Source: Brazilian Institute of Geography and Statistics, September 2014; Oxford Economics, September 2014.
*2014 forecasts, Oxford Economics.

Graphic: Deloitte University Press | DUPress.com

Figure 2. Quarter-on-quarter growth in key components of real GDP (percentage)



Source: Brazilian Institute of Geography and Statistics, September 2014.

Graphic: Deloitte University Press | DUPress.com

it not been for a 2.8 percent rise in exports and a 0.3 percent increase in household expenditures. The latter, however, continues to remain relatively weak and will be a major headache for policymakers in the short to medium term.

A tale of wary consumers: A deeper look

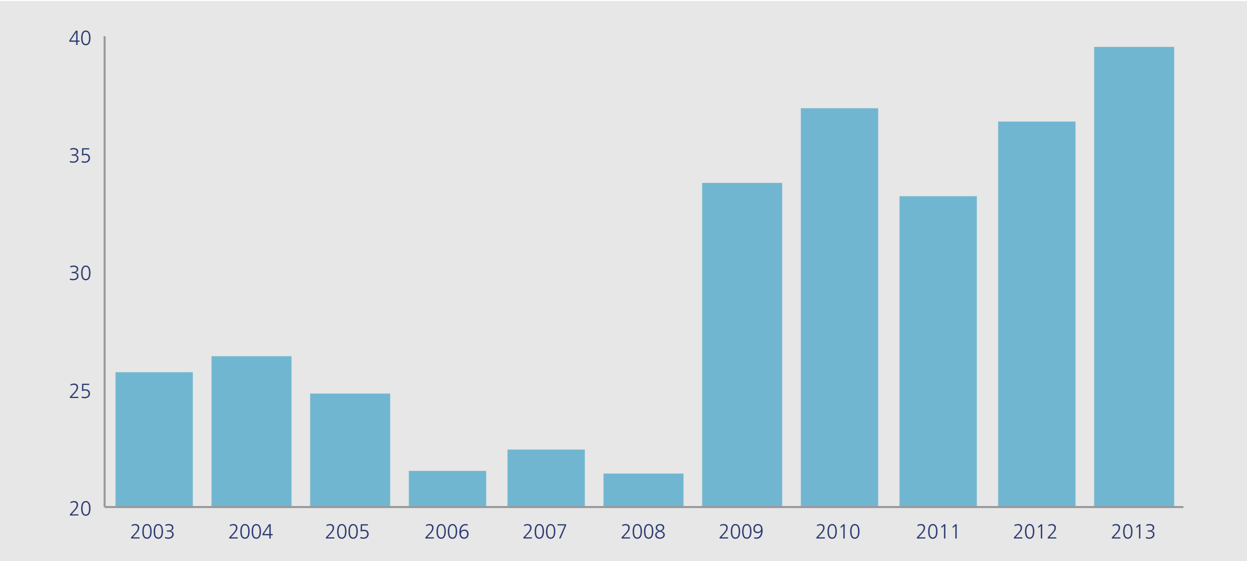
Brazil's consumers have been a key pillar of economic strength in the new millennium. During 2003–10 (Lula's tenure in office), growth in household consumption averaged 4.5 percent a year despite the global downturn of 2008–09. In fact, a 6.9 percent rise in private consumption in 2010 helped Brazil post record GDP growth of 7.5 percent in 2010. Strong growth in income was a key contributor to high household spending during those years. For example, according to the Brazilian Institute of Geography and Statistics' (IBGE's) monthly employment survey data, average nominal income went up by close to 90 percent between 2003 and 2010.[5] During this period, poverty fell by half due to strong economic growth and high welfare spending through programs such as the Bolsa Familia, which benefits about 13.8 million households.[6]

Strong welfare measures also brought down economic inequality. According to the World Bank, the Gini coefficient (a measure of inequality) fell to 54.7 percent from 59.4 percent between 2002 and 2009.[7] Consumer spending naturally benefited from these developments. What added to the binge was availability of subsidized credit through public sector banks and tax breaks on major consumer goods. For example, auto loans more than tripled to about $70 billion a year between 2004 and 2010.[8]

Just like movies where the plot changes suddenly, however, so has the tale of Brazilian households in recent years. Rising debt, slowing GDP growth, high inflation, and tight monetary policy have put the brakes on consumer spending:

- **Rising leverage and high debt servicing burden.** As they took credit to purchase anything from airline tickets to household appliances, Brazilian households slowly racked up debt. According to the Economist Intelligence Unit (EIU), household leverage (the ratio of total household liabilities to personal disposable income) rose to 40 percent in 2013 from 26 percent in 2003.[9] While this is low compared to household leverage in economies like the United States and the United Kingdom, what

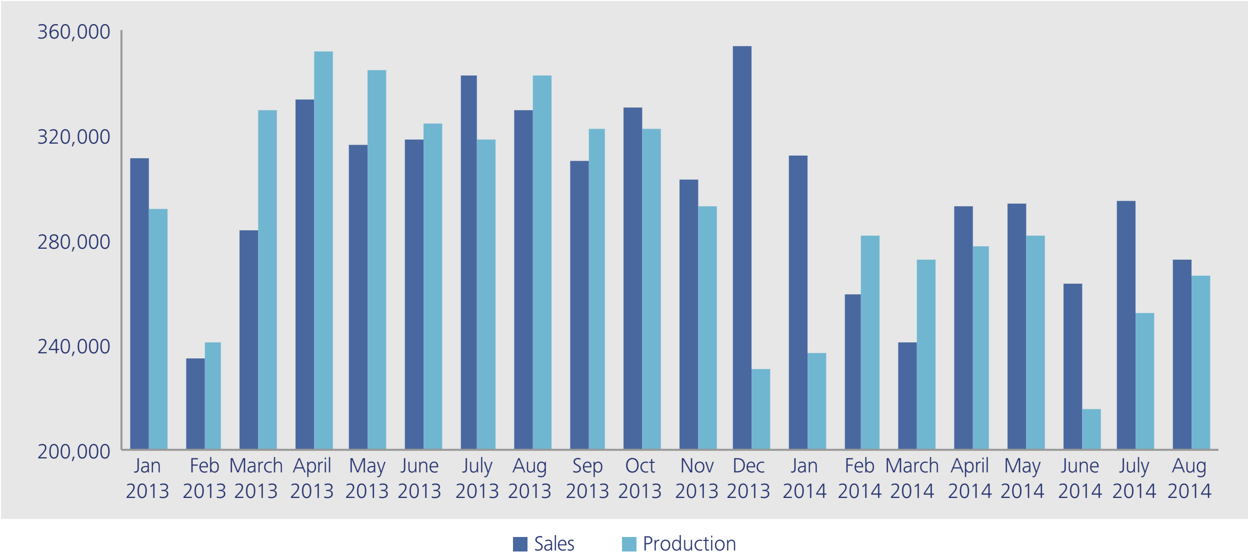
Figure 3. Household leverage (ratio of personal disposable income to household liabilities, percentage)



Source: Economist Intelligence Unit, September 2014.

Graphic: Deloitte University Press | DUPress.com

Figure 4. Automobile production and sales in Brazil



Source: National Association of Automobile Manufacturers (Brazil), September 2014.

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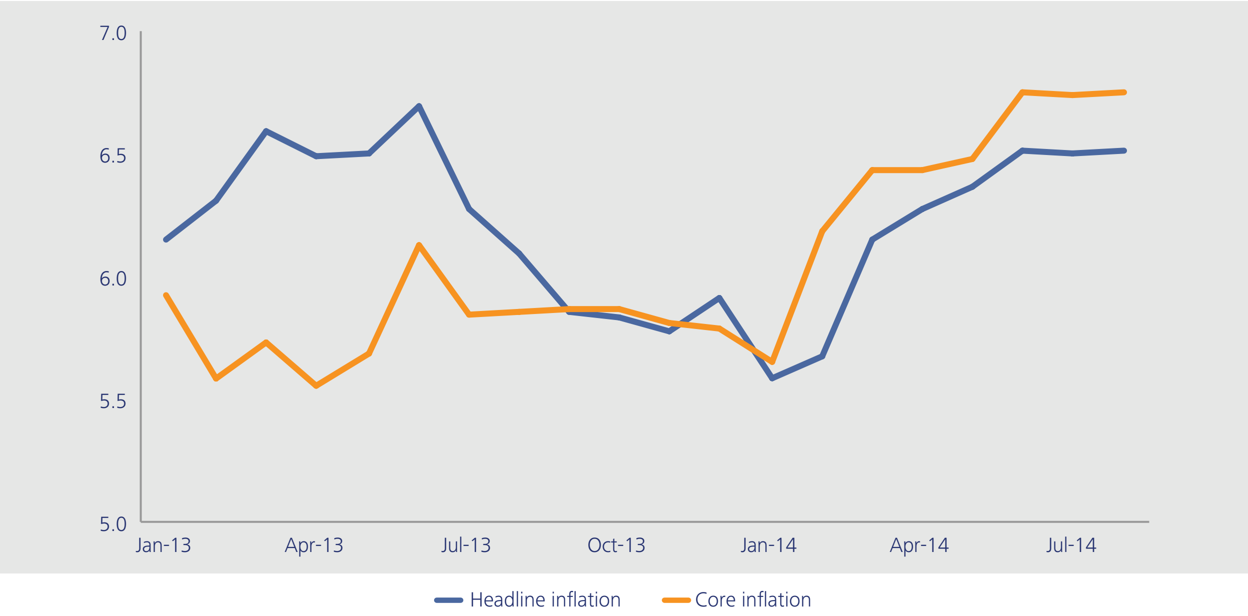
darkens the picture are Brazil's high debt servicing costs. With the interest rate on an average loan at about 37 percent, Brazilians spend more than one-fifth of their household income on debt servicing.[10] Rates on consumer loans will not go down in the medium term without reforms in the banking sector; a tight monetary stance in the near term to counter high inflation will not help either.

- **Is the labor market showing signs of stress?** Slowing economic prospects do not bode well for the labor market despite numerous safeguards for workers. For example, in the automobile industry, the government had kept sops in place to boost demand on the condition that companies would not cut down employees. That agreement is under strain as production and sales decline. For example, from January to August 2014, vehicle production fell 18 percent year over year while sales declined 9.7 percent.[11] The National Association of Automobile Manufacturers expects production and sales to decline by 10 percent and 5.4 percent, respectively.[12] As a result, automobile manufacturers have been cutting down on employees; the sector shed 5 percent of its jobs between January and July.[13] This trend is not confined to the automobile sector alone; overall job creation in the country has fallen, with July's figure turning out to be the lowest for any month since 1999.

- **Persistent high inflation is a worry.** Price pressures continue to remain elevated, thereby weighing on household purchasing power. At 6.5 percent in August, inflation continued to remain above the critical midpoint of the central bank's 2.5–6.5 percent range. And despite slowing aggregate demand, inflation will not ease soon, as long-delayed hikes in fuel and electricity prices are likely to be enacted after the elections in October. Meanwhile, high inflation has limited real wage gains. For example, growth in average real wages for households fell to 1.5 percent in 2013 from 4.3 percent in the previous year.

- **Rising cost of credit.** The monetary tightening spree (375 basis points in total) over nine months that ended in April 2014 has not helped consumer spending. The higher cost of borrowing has been weighing on consumer spending this year, and it is likely to impact

Figure 5. Headline and core inflation (year over year, percentage)



Source: Central Bank of Brazil, September 2014.

Graphic: Deloitte University Press | DUPress.com

demand in the near term as the lagging effect of higher interest rates plays out. The monetary authorities have also been wary of risks to the banking sector from bad loans and hence have tightened lending conditions. As a result, debt-driven personal consumption has slowed down.

Given this scenario, consumer confidence is low. In August 2014, consumer confidence, as measured by the Getulio Vargas Foundation, fell to its lowest level since April 2009. The survey shows that consumers were weary of both current economic conditions and future prospects. Weak household demand is evident from retail sales figures as well. In July, seasonally adjusted retail sales volume fell 1.1 percent month on month, the largest decline in nearly six years; July was also the sixth straight month of decline.

In August 2014, consumer confidence, as measured by the Getulio Vargas Foundation, fell to its lowest level since April 2009.

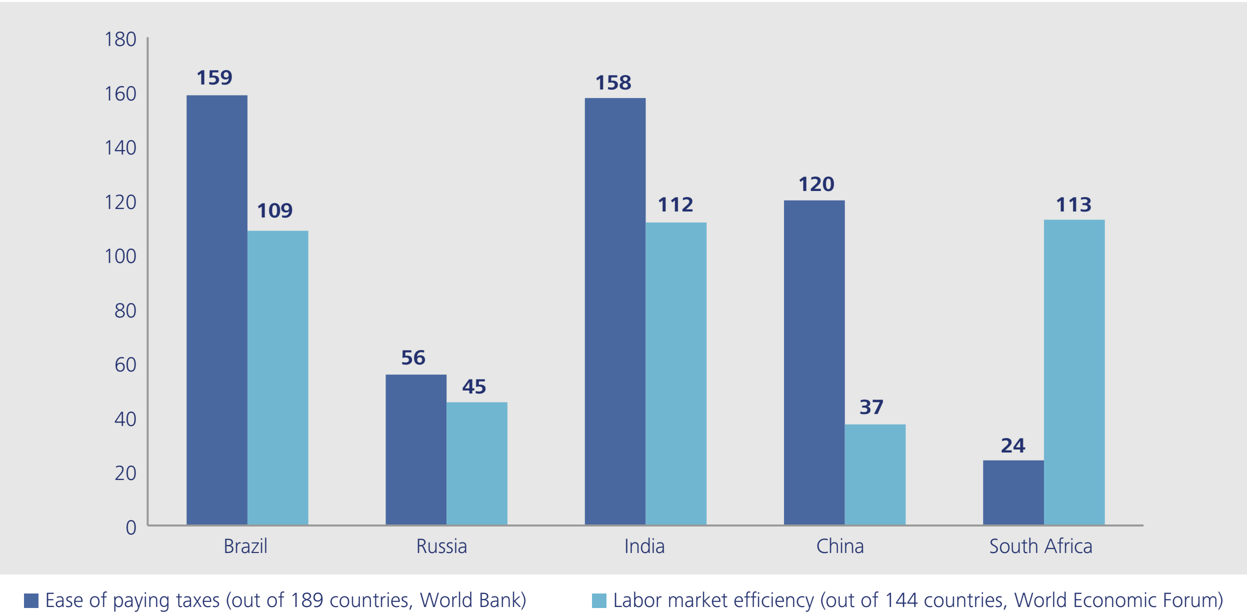
Don't forget the rigidities that stifle investment

Ironically, what currently keeps consumers' income high is also one among many factors that keeps the economy's potential GDP in check: a rigid labor market. Labor market reforms are essential to induce businesses to invest in Brazil, especially in high-end manufacturing and services. Businesses often complain of highly unfavorable labor laws as a key deterrent to investing in the country. For example, in the World Economic Forum's global competitiveness rankings, Brazil ranks 109th out 144 countries in labor market efficiency.[14] A complicated tax regime also adds to the misery of businesses in the country. According to the World Bank's "Doing Business" rankings, Brazil ranks a dismal 159th among 189 countries in the ease of paying taxes.[15] It takes an absurd 2,600 hours for an average company in Brazil to pay its taxes, much more than the average 369 hours for Latin America and the Caribbean, and the 175 hours for Organization for Economic Cooperation and Development (OECD) countries.[16]

Lack of skills adds to labor market woes

What certainly does not aid the labor market is the relatively low skill level of many workers. For years, firms have complained of a dearth of skills that keeps the employable labor force in high-end jobs low, with a consequent impact on wages and salaries. For example, ManpowerGroup's 2014 global talent shortage survey revealed that 63 percent of Brazilian employers reported difficulty filling jobs, much worse than the global average of 36 percent.[17] On an encouraging note, the government appears to have recognized the severity of the problem. It has channeled large investments in technical and vocational education through its flagship National Program for Technical Courses (PRONATEC) program. A report by the US government also highlights these efforts; it states that short-duration vocational courses will be a key driver of the education sector in Brazil in the next decade.[18] The Brazilian government, however, will need to work closely with the private sector to ensure that the right skills are being taught to the right people.

Figure 6. Global rank for ease of paying taxes and labor market efficiency



Source: World Bank, September 2014; World Economic Forum, September 2014.

Graphic: Deloitte University Press | DUPress.com

Too much government is bad for the economy

The overarching presence of the state has not helped the Brazilian economy. It has dented market efficiency and raised concerns regarding the management of public finances. For example, the government's total debt burden is often underreported, as disbursement of funds to public sector banks (mainly BNDES) does not figure in net debt calculations. Consequently, many analysts consider it prudent to consider the gross public debt figure when calculating Brazil's creditworthiness.[19] Arguably, the best example of the negative impact of excessive government intervention is Petrobras, the state oil company. It has severely underperformed over the years; it is one of the world's most indebted oil companies; and it has steadily seen its share price drop over the last few years. The most recent scandal regarding alleged kickbacks by Petrobras to politicians will certainly not help.[20]

The government's repeated intervention in the economy has also impacted an area where it had built a certain amount of credibility after the hyper-inflation years: central banking. With the government's willingness to tolerate fiscal laxity and higher inflation, the government prevented the central bank from reacting to rising price pressures sooner. This has led to arguably the biggest erosion of confidence in the central bank. Moreover, the central bank has shifted its focus to defending the exchange rate to keep inflation in check. That has kept the exchange rate relatively overvalued, thereby denting export competitiveness. For example, according to the Economist's Big Mac Index, the real is overvalued by about 22.1 percent relative to the US dollar.[21]

A few steps, but too little too late

Structural impediments, if not addressed soon, will no doubt weigh down on potential GDP growth. According to Oxford Economics, potential GDP growth in Brazil will likely fall to 2.8 percent a year on average in 2014–23, lower than the 3.3 percent expansion recorded in 2004–13.[22] To be fair to the government, external conditions have been a large factor contributing to the country's slowing growth. For example, China's slowing growth has meant subdued demand and prices in global commodity markets. For Brazil, this has meant large dents in revenues from exports of iron ore, soybeans, and corn. At the same time, economic troubles in Argentina have meant a slowdown in exports to the country; Argentina accounts for about 90 percent of all car exports from Brazil.[23] Moreover, quantitative easing by the Fed and subsequent tapering has meant volatility in short-term capital inflows and a consequent impact on the currency.

However, all these factors do not mask the fact that the country's policymakers failed to leverage the good times to implement core reforms. For the poor and the middle class, the next step on the economic ladder seems a bit more remote. And they seem more wary about the current government than they used to be. Businesses seem excited with the prospect of a Neves win, especially given his proposals for free trade, fiscal prudence, and central bank autonomy.[24] Post backing from Silva, Neves has also promised to tackle environmental concerns, promote land reforms, and support indigenous and rural communities; this is likely to attract many of Silva's supporters.[25] Clearly, the results are showing in opinion polls. In Vox Populi's most recent pre-poll survey (October 11–12), Neves was in a statistical tie with Rousseff for the October 26 second round polls.[26] For Rousseff, this might seem a bit unfair, given her party's role in economic progress since 2003. But, these days, politics in emerging economies is increasingly tied to economic fortunes. India found that out in May. The verdict for Brazil will be out in October.

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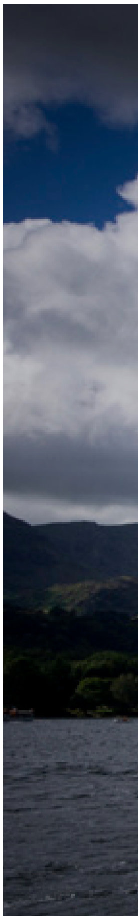
The United Kingdom

Decent growth in an uncertain world

By Ian Stewart



THE standout feature for the United Kingdom in the last year has been the pace of activity. GDP has increased by 3.0 percent over the last year, making the United Kingdom one of the world's fastest-growing developed economies.

Activity is rebalancing away from finance and government. Output from the financial and insurance services sector, one of the super-growth sectors of the boom years, is in its sixth year of decline. Government spending is growing more slowly than GDP as the drive to reduce the public sector deficit continues.

> Corporates are prioritizing expansion over strengthened balance sheets. A recovery in investment offers the prospect of more balanced and sustainable growth.

Over the course of the year, manufacturing output growth has outstripped activity in the wider economy. The construction sector, which suffered two deep recessions in the last six years, is expanding strongly, helped by a surge in house building. Employment has reached a record high, with unemployment back to levels last seen in 2008.

The United Kingdom's fastest-growing sector is professional and business services. This sector accounts for 11 percent of GDP (now more than manufacturing) and covers services provided to the other businesses, including law, accountancy, architecture, consulting, scientific research, and business support services. Output growth here has risen by a heady 9.1 percent in the last year.

During the recession, companies hunkered down, saving rather than investing or expanding, and became major providers of capital to the rest of the economy. Investment plummeted, and the corporate sector financial surplus—a rough proxy for corporate saving—rose.

This is changing. In the last year, business investment rose by 10.6 percent. In a sign of growing confidence, the corporate sector financial surplus is shrinking. Corporates are prioritizing expansion over strengthened balance sheets. A recovery in investment offers the prospect of more balanced and sustainable growth.

Summer jitters over Scotland's independence referendum and geopolitical worries from Ukraine and the Middle East did not arrest the uptrend in corporate risk appetite. In September, a record 72 percent of CFOs in the Deloitte CFO Survey said that now was a good time to take greater risk—a seven-year high. For CFOs, the external negatives seem to have been offset by good news on the US and UK economies, plentiful liquidity, and a feeling that the policy environment in the United Kingdom is pretty benign.

With inflation likely to run below its target over the next 18 months, the Bank of England seems likely to aim for gradual increases in interest rates, probably from early 2015.

After a grim few years, the United Kingdom is outperforming expectations as well as its peers. Yet it is not all easy sailing, and the United

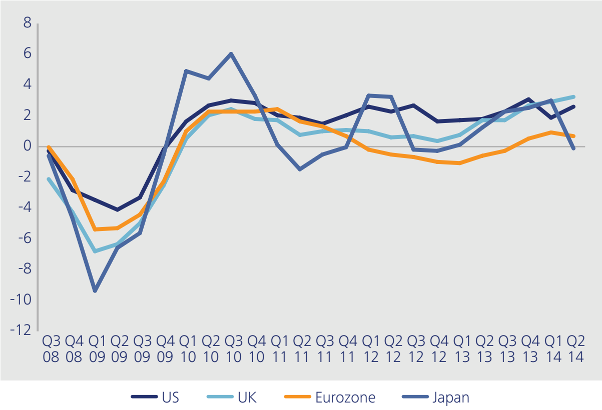
Kingdom is not immune to renewed fears that the global economy is running out of steam. The International Monetary Fund now sees a 40 percent chance that the euro area—the United Kingdom's largest trading partner—will relapse into recession. This appears to be affecting sentiment already, with the British Chambers of Commerce ringing the "alarm bell" for the UK recovery, after manufacturing firms reported the weakest export growth in almost two years in its quarterly economic survey.

A slowdown in two of the world's major emerging economies, Brazil and Russia, have further dampened spirits, while non-economic events such as the spread of Ebola, conflict in the Middle East, and continued fighting in Ukraine have added to the external uncertainties. These concerns led to a global sell-off in equity markets, with the FTSE 100 falling to its lowest levels of the year in October. Moreover, some of the United Kingdom's familiar problems have resurfaced. The housing market has shown signs of excess. Productivity, or output per person, remains weak, as does the United Kingdom's trade perfor-mance. Investment is way below its long-term levels, and consumer incomes are still falling. The government has been successful in cutting public spending, but tax receipts remain disappointingly weak—as a result of weak incomes growth—and the deficit remains stubbornly wide.

This recovery is strong, but its sustainability will depend on how the United Kingdom deals with these challenges. Our expectation is that after a strong bounce in 2014 with the economy growing at around 3.0 percent, UK activity will decelerate modestly in 2015 to post growth of around 2.7 percent. Ultimately, however, much depends on how persistent and severe the slowdown in Europe is.

Economic indices

GDP growth rates (percentage, year over year)



Source: Bloomberg.
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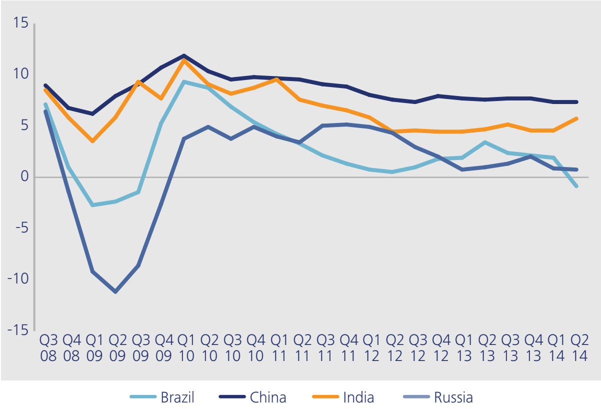
GDP growth rates (percentage, year over year)



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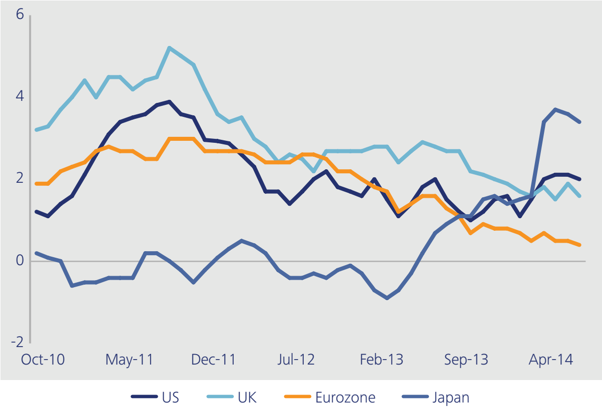
Inflation rates (percentage, year over year)



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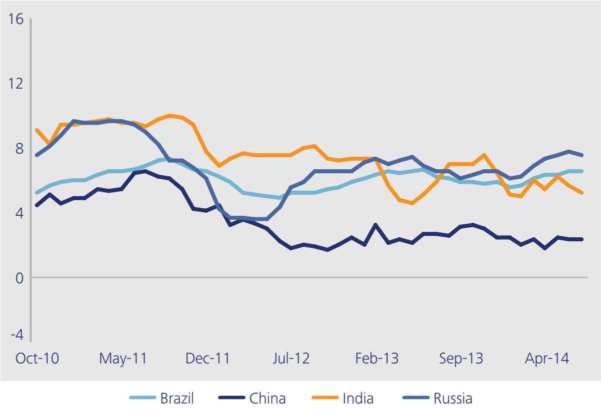

Source: Bloomberg.
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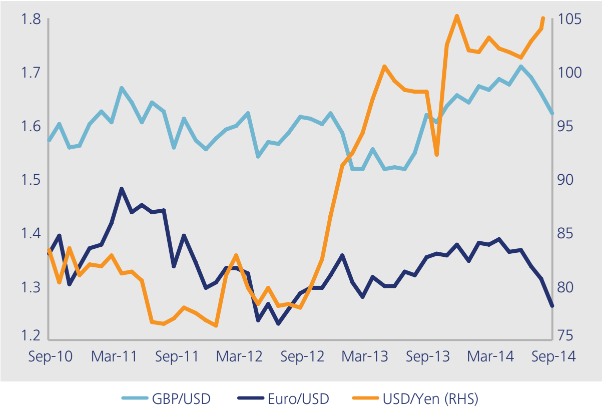
Major currencies vs. the US dollar



Source: Bloomberg.
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Yield curves (as of Oct 07, 2014)*

	US Treasury bonds & notes	UK gilts	Eurozone govt. benchmark	Japan sovereign	Brazil govt. benchmark	China sovereign	India govt. actives	Russia‡
3 months	0.01	0.48	-0.01	-0.02	11.02	3.68	8.48	8.37
1 year	0.09	0.52	-0.03	0.04	11.78	3.77	8.62	8.90
5 years	1.68	1.67	0.16	0.15	11.73	3.96	8.52	9.59
10 years	2.41	2.34	0.92	0.51	11.78	4.07	8.45	9.56

Composite median GDP forecasts (as of Oct 07, 2014)*

	US	UK	Eurozone	Japan	Brazil	China	Russia
2014	2.2	3	1.1	1.5	1.4	7.4	0.5
2015	3	2.5	1.5	1.2	1.8	7.2	1.75
2016	3	2.4	1.5	1.2	2.6	7.2	2.3

Composite median currency forecasts (as of Oct 07, 2014)*

	Q4 14	Q1 15	Q2 15	2015	2016	2017	2018
GBP-USD	1.64	1.63	1.62	1.62	1.6	1.59	1.59
Euro-USD	1.27	1.26	1.25	1.24	1.24	1.25	1.26
USD-Yen	109	110	111	113	112	108	102
USD-Brazilian real	2.35	2.38	2.41	2.39	2.46	2.29	2.12
USD-Chinese yuan	6.12	6.11	6.08	6.01	5.9	5.69	5.71
USD-Indian rupee	60.91	61.08	61.29	61.05	59.64	61.06	57.91
USD-Russian ruble	38.38	38.53	38.71	39.04	39.44	41.19	40.53

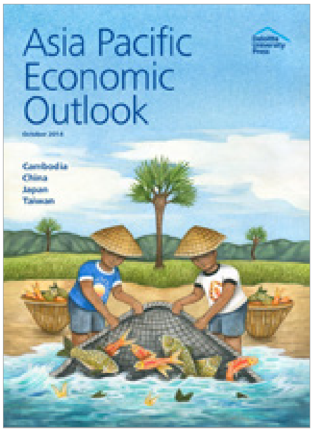
OECD composite leading indicators (amplitude adjusted)†

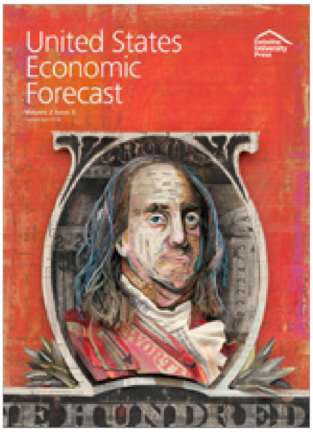
	US	UK	Eurozone	Japan	Brazil	China	India	Russia Federation
Jun 12	99.7	99.0	99.1	99.7	100.3	99.9	99.9	100.4
Jul 12	99.6	99.1	99.0	99.6	100.4	99.9	99.8	100.0
Aug 12	99.6	99.3	98.9	99.5	100.5	99.9	99.7	99.7
Sep 12	99.7	99.5	98.8	99.4	100.6	100.0	99.6	99.6
Oct 12	99.8	99.7	98.8	99.4	100.6	100.0	99.5	99.5
Nov 12	99.9	99.8	98.8	99.4	100.7	100.1	99.4	99.5
Dec 12	100.0	99.8	98.9	99.5	100.6	100.2	99.3	99.4
Jan 13	100.1	99.9	99.0	99.7	100.5	100.3	99.2	99.4
Feb 13	100.2	99.9	99.2	99.9	100.3	100.3	99.0	99.4
Mar 13	100.3	99.9	99.3	100.1	100.1	100.1	98.9	99.4
Apr 13	100.4	100.0	99.4	100.3	99.9	100.0	98.8	99.4
May 13	100.4	100.0	99.6	100.5	99.6	99.9	98.7	99.5
Jun 13	100.5	100.2	99.7	100.7	99.4	99.7	98.5	99.5
Jul 13	100.6	100.4	99.9	100.8	99.2	99.7	98.4	99.6
Aug 13	100.6	100.6	100.1	100.9	99.1	99.6	98.3	99.7
Sep 13	100.6	100.8	100.3	101.1	99.1	99.6	98.2	99.8
Oct 13	100.6	101.0	100.5	101.2	99.1	99.5	98.1	99.8
Nov 13	100.6	101.0	100.7	101.2	99.1	99.4	98.0	99.8
Dec 13	100.5	101.1	100.8	101.2	99.0	99.2	98.0	99.7
Jan 14	100.5	101.1	100.9	101.1	98.9	99.0	97.9	99.6
Feb 14	100.5	101.1	101.0	100.9	98.8	98.8	97.9	99.4
Mar 14	100.5	101.1	101.1	100.7	98.6	98.6	97.9	99.3
Apr 14	100.5	101.1	101.1	100.6	98.5	98.6	97.9	99.2
May 14	100.5	101.0	101.0	100.4	98.9	99.0	98.7	100.1
Jun 14	100.6	101.0	100.9	100.1	99.1	99.0	98.9	100.2
Jul 14	100.6	100.8	100.8	99.9	99.4	99.1	99.0	100.3

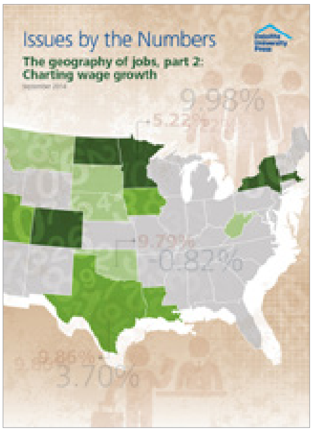
*Source: Bloomberg ‡MICEX rates †Source: OCED

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

Additional resources







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For more information about Deloitte Research, please contact
John Shumadine, Director, Deloitte Research, part of Deloitte Services LP,
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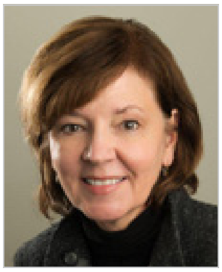
About the authors

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



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

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

Ian Stewart is chief economist, Deloitte UK.

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

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

Contact information

Global Economics Team

Ryan Alvanos
Deloitte Research
Deloitte Services LP
USA
Tel: +1.617.437.3009
E-mail: ralvanos@deloitte.com

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

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

Dr. Alexander Börsch
Deloitte Research
Germany
Tel: +49 (0)89 29036 8689
E-mail: aboersch@deloitte.de

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

Dr. Rumki Majumdar
Deloitte Research
Deloitte Services LP
India
Tel: +1 615 209 4090
E-mail: rmajumdar@deloitte.com

Akrur Barua
Deloitte Research
Deloitte Services LP
India
Tel: +1 678 299 9766
E-mail: abarua@deloitte.com

Sunandan Bandyopadhyay
Deloitte Research
Deloitte Services LP
India
Tel: +1 678 299 9130
E-mail: subandyopadhyay@deloitte.com

Global Industry Leaders

Consumer Business

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

Energy & Resources

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

Financial Services

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

Life Sciences & Health Care

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

Manufacturing

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

Public Sector

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

Telecommunications, Media & Technology

Jolyon Barker
Deloitte & Touche LLP
UK
Tel: +44 20 7007 1818
E-mail: jrbarker@deloitte.co.uk
Tel: +
E-mail: xx@deloitte.com

US Industry Leaders

Banking & Securities and Financial Services

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

Consumer & Industrial Products

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

Life Sciences & Health Care

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

Power & Utilities and Energy & Resources

John McCue
Deloitte LLP
Tel: +216 830 6606
E-mail: jmccue@deloitte.com

Public Sector (Federal)

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

Public Sector (State)

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

Telecommunications, Media & Technology

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

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