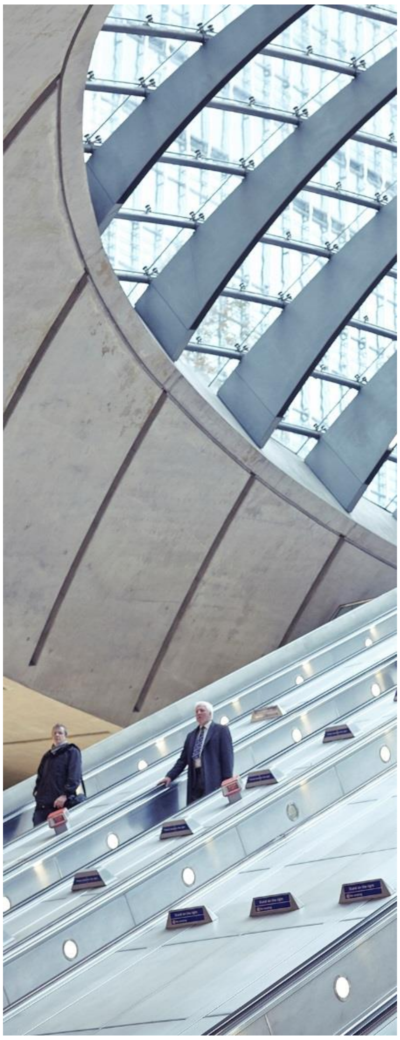
November 2015

Global Economy Watch

Public finance reform in oil exporters and structural changes in emerging markets



Dear readers,

More than a year has passed since the oil price collapsed, and we think that 'lower for longer' is the new reality. For net oil importers like the US, Japan, the UK and the Eurozone this is — on balance — good news. But in the Gulf, Nigeria and other major oil exporters, this low price environment is posing a significant challenge to public finances.

But with every challenge comes an opportunity. Policymakers should take this chance to tackle long overdue fiscal reforms to align spending to strategic priorities, stop wasteful spending and regain control of government finances.

To achieve these aims, the public finance management approach recommended by the IMF and the World Bank is a medium-term expenditure framework (MTEF) which has three key benefits as it:

1. Sets hard constraints on government spending;
2. Delinks government spending from the economic cycle; and
3. Aligns government spending plans to the nation's economic plan.

The wider challenge of structural reform

Structural reform is another area that policymakers should focus on. Oil exporters, for example, need to rebalance their economies and grow their non-oil sectors. But even non-oil exporters need to keep up reforms to grow the productive capacity of their economy.

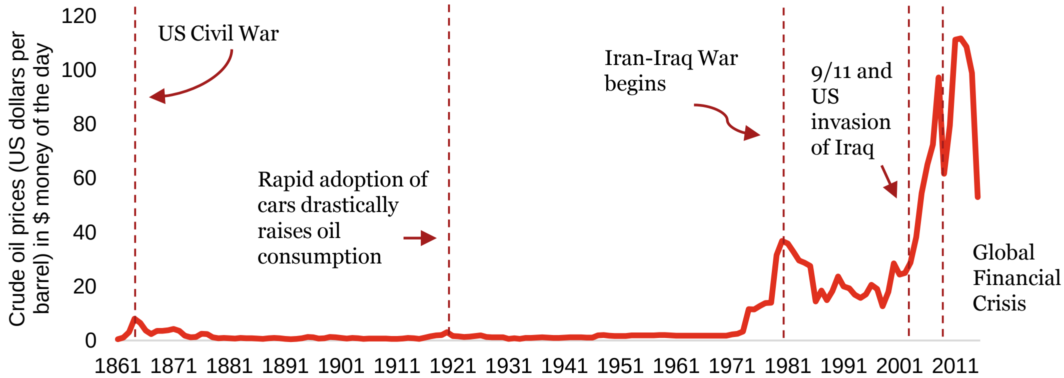
Based on the newly released World Bank's Ease of Doing Business Index, most large emerging economies (we have looked at Brazil, India, China, Malaysia, Mexico, Turkey) have seen improvements in their business environment over the last five years. China and Mexico have fallen but only very marginally.

Most have, for example, seen improvements in two areas that are clearly linked — resolving insolvency and getting credit. Such structural reforms should pay dividends in the longer term, though they do not alter the fact that some of the 'improvers' in the World Bank rankings – Russia and Brazil – face serious short-term problems as their economies have fallen into recession this year.

Kind regards

Richard Boxshall
PwC | Senior Economist

Fig 1: Oil prices – the long view



Source: BP

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Economic update: Will India be the world's next big services exporter?

India above China in GDP growth league table

For the first time since 1999, India's GDP growth is expected to overtake that of China in 2015 (see Figure 2). As we have mentioned in our 'World in 2050'[1] publication, long-term growth projections suggest that India will be growing faster than China for the foreseeable future as an ageing population and a gradual reduction of the "catch-up" effect weighs down on China's growth potential. But what does this mean for businesses?

India is gearing up to be a services powerhouse

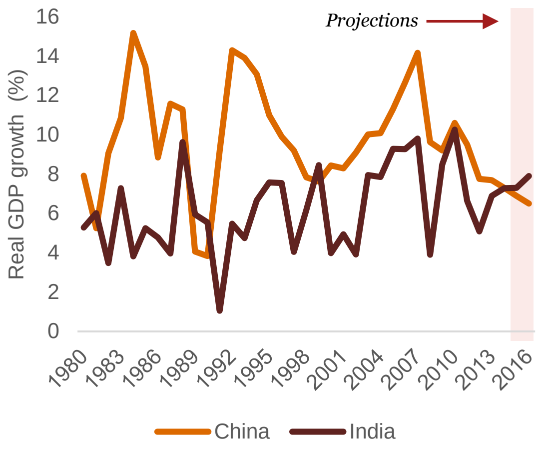
In the past decade, Chinese growth was focused around manufacturing. Trade figures and business experience suggest that China has a comparative advantage in the sector as it is a net exporter of goods. For Western businesses, most opportunities have historically focused on incorporating Chinese manufacturers into their supply chain.

Should we expect the same for India as it starts to grow faster? India is the reverse of China as it a net importer of goods and a net exporter of services. This suggests that its comparative advantage may lie in the services sector and that the short to medium-term business opportunities in India may focus more in services.

Manufacturing might still stage a turnaround in India. The current administration has promised a set of ambitious infrastructure reforms which could act as a growth impetus to the sector. But recent experience shows that it is difficult to push through regulatory reforms and raise finance for large-scale infrastructure projects, so it may be some time before any such manufacturing boost comes through in India.

[1] See report at: http://www.pwc.com/gx/en/issues/economy/the-world-in-2050.html

Fig 2: India's growth rate is expected to overtake China



Sources: PwC projections, IMF

How have business specific structural changes fared in emerging economies?

Growth rates in six large emerging economies (Brazil, India, China, Indonesia, Turkey and Mexico) have slowed down from an estimated GDP-weighted average rate of 7.5% in 2011 to a projected 5.4% this year. At times like this, attention is drawn to the structural factors (or factors that set the institutional and regulatory framework of how households and businesses behave in the market) that might be driving this trend. So how have these economies fared as far as business specific structural reforms are concerned?

To answer this question we have compared the rankings of the emerging economies in our sample over the past five years using the Ease of Doing Business Index (EODB) compiled by the World Bank. This index measures and ranks economies based on the regulations that enhance business activity and those that constrain it.

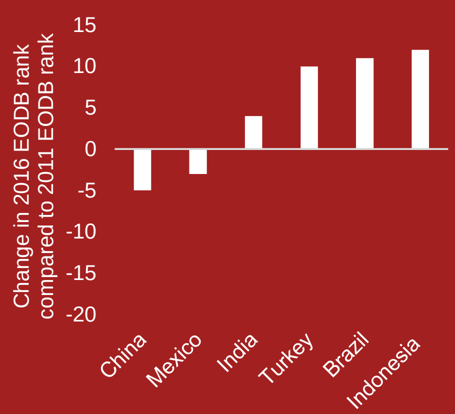
At a high level the results suggest that Mexico is the highest ranked economy (38th position) ranking higher than OECD economies like Greece, Italy and Belgium.

Conversely, India is the lowest ranked economy out of our sample (130th position).

Most of the large emerging economies have progressed with reforms

Figure 3 suggests that all but two of the emerging economies in our sample pressed ahead with reforms to enhance their business activity levels over the period. China and Mexico are the only two economies that recorded a slight decrease in their overall rankings over the period.

Fig 3: Four out of the six large emerging economies have improved their EODB ranking



Source: PwC analysis of World Bank data

The big picture message though is that the structural reform agenda with respect to businesses has been progressing in most of the E7 over the past five years.

But the devil lies in the details.

Insolvency frameworks have improved...

The biggest area of improvement recorded in the emerging economies in our sample is in the "resolving insolvency" category.

For example, Indonesia and Brazil improved their rankings in this area by around 40 positions over the period. To achieve this, insolvency frameworks were strengthened to make sure that secured creditors achieved the highest recovery rate possible in cases of corporate bankruptcies.

Countries which have improved their insolvency framework correlate positively well with those that improved their rank in the "getting credit" category.

This makes sense as a more robust insolvency framework reduces the risk and uncertainty taken on by lenders especially when loans go bad and collateral is called.

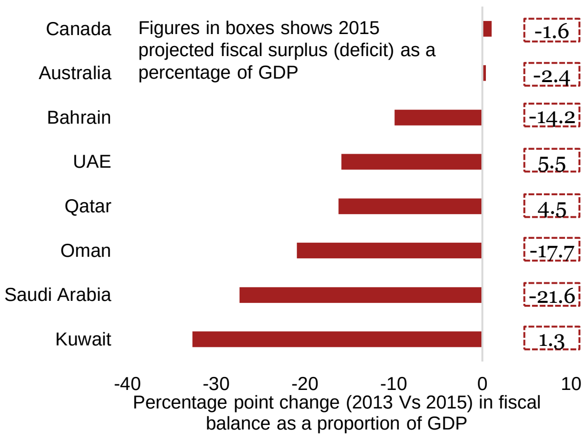
Brazil, for example, has climbed up the ranking in the "resolving insolvency" category by around 70 units since 2011 in which time the stock of credit to non-financial corporations grew from around 100% to 140% of GDP.

Structural changes necessary but not sufficient condition for growth

But even though structural changes help grow future potential output, they do not guarantee a short-term boost to economic growth. For example Brazil is one of the economies in our sample which is in recession in this year despite a significant increase in its EODB rank.

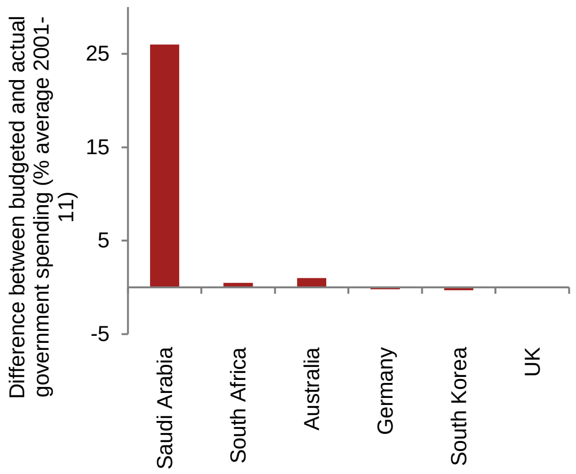
Public finance reform: It's time

Fig 4: *Public finances in all of the GCC economies have deteriorated significantly*



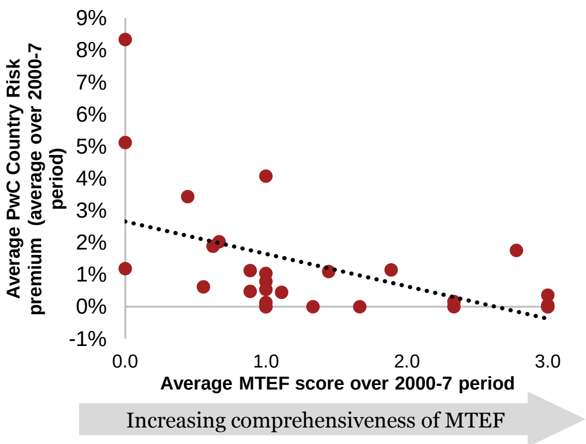
Source: PwC analysis, IMF

Fig 5: *Saudi Arabia experiences persistent and large budget over-runs*



Source: IMF

Fig 6: *Sophisticated MTEFs are associated with lower risk premiums on financial assets*



MTEF score describes highest MTEF stage attained: 0 = No MTFF and 3 = Full MTEF implementation

Sources: PwC Country Risk Premium, World Bank

Lower for longer oil prices good for most economies

Oil prices are expected to remain 'lower for longer'[1]. On balance, this is good news for net oil importing countries such as the US, Japan, UK and the Eurozone. But what about net oil exporters and especially the Gulf Cooperation Council (GCC) economies?

Typically, the effect of lower oil prices is felt through two main channels:

- **Public finances**: lower royalties and other oil related revenues via state-owned enterprises; and
- **External position:** Worsening current account positions which, when combined with fixed exchange rate regimes, have a knock on effect on foreign exchange reserves.

Back to the 1980s

The current oil price projections bear some resemblance to the decade-long oil price drop recorded from the mid-1980s onwards. One key difference, however, is the policy response. Whereas in the past low oil prices eventually led to deep government spending cuts, current fiscal adjustment plans in most GCC economies have been far too modest compared to what is required, which explains the large adverse swings seen in public finances as shown in Figure 4.

The situation though is manageable. One way to fund deficits would be to use up fiscal buffers sheltered in central banks and sovereign wealth funds (which were borne out of reforms implemented after the decade-long low oil prices after the mid-1980s).

This, however, is only a short-term fix. Fiscal buffers are finite, and some assets are ring-fenced. As the IMF has pointed out, fiscal buffers for some GCC economies are expected to run out in less than a decade.[2]

Public finance reform back on the agenda

Raising taxes could be one policy option. In practice, however, it would be difficult to set up complicated tax systems particularly in jurisdictions where households and corporations are used to a low-tax environment. So the alternative is to rein in government spending gradually by setting up or strengthening medium-term expenditure frameworks (MTEFs), as recommended by the World Bank and the International Monetary Fund (IMF).

Canada and Australia are examples of commodity-rich economies which have managed to get public finances under control in the past and reduce reliance on commodity sector revenues.

So what are the benefits of setting up a MTEF?

Medium-term planning could reduce budget over-runs…

First, it sets hard constraints on government spending. Doing so forces policymakers to plan spending using a multi-year rather than a single year time frame. Even though this comes with some short-term costs e.g. the government spending time and money to enhance its macro-forecasting capabilities, it helps to ensure that budget over-runs, which are a common problem in some net oil-exporters (see Figure 5), are reduced over time.

In fact, the World Bank estimates that fiscal balances improve on average by around 2.6 percentage points of GDP in the three years after implementing a MTEF.

…and reduce fluctuations in government spending

Second, MTEFs help delink government spending from the economic cycle. Canada, one of the world's largest oil producers, has managed to do this successfully. Setting fiscal rules and independent institutions to monitor and, where necessary, critique government spending plans is one aspect of a fiscal framework that would be welcome in some GCC economies.

If done properly this could make public finances more credible to international investors and rating agencies. Figure 6 shows that sophisticated MTEFs are associated with lower risk premiums on financial assets, which has positive knock-on impacts on both the public and private sectors.

But don't lose sight of the bigger challenge

Third, MTEFs link the government's budget to the country's long-term economic plan by targeting and prioritising spending on strategically important sectors. This goes to the heart of the even bigger policy challenge that some GCC economies face, which is to diversify their sources of economic growth by expanding their non-oil private sectors.

Two years ago we said that the Gulf region had to produce around 10 million jobs for its growing workforce by 2025[3]. An inevitable tightening of government spending in the future is likely to reduce public sector employment opportunities. This means that the private sector will need to take the lead in generating new jobs, making rebalancing more pressing.

In conclusion, we think 'lower for longer' oil prices present an opportunity for some GCC economies to pursue much needed reforms and to remove wasteful practices. In the process of pursuing these aims, however, these countries should not lose sight of the longer-term policy objective, which is to grow the non-oil economy so that it can become the biggest job creator.

[1] PwC *Opportunities in Adversity – strategies for a lower oil price,* October 2015
[2] IMF *Regional Economic Outlook, Middle East and Central Asia*, October 2015
[3] PwC Global Economy Watch, *The Gulf economies: young, big and growing fast,* December 2013

Projections: November 2015

	Share of 2014 world GDP		Real GDP growth				Inflation			
	PPP	MER	2014	2015p	2016p	2017-2021p	2014	2015p	2016p	2017-2021p
Global (Market Exchange Rates)		100%	2.9	2.7	3.0	3.1	2.3	1.7	2.4	2.5
Global (PPP rates)	100%		3.5	3.2	3.5	3.6				
United States	16.1%	22.5%	2.4	2.5	2.7	2.5	1.6	0.1	1.4	1.9
China	16.3%	13.4%	7.3	6.9	6.5	5.7	2.1	1.7	1.8	3.0
Japan	4.4%	6.0%	-0.1	0.7	1.2	1.3	2.7	0.9	1.0	1.9
United Kingdom	2.4%	3.8%	2.9	2.4	2.4	2.3	1.5	0.1	1.5	2.0
Eurozone	12.2%	17.4%	0.8	1.5	1.6	1.7	0.5	0.1	1.1	1.4
France	2.4%	3.7%	0.2	1.1	1.3	1.9	0.6	0.2	1.1	1.2
Germany	3.4%	5.0%	1.6	1.5	1.7	1.6	0.8	0.2	1.3	1.7
Greece	0.3%	0.3%	0.7	-2.2	-1.4	2.5	-1.4	-0.4	0.1	1.4
Ireland	0.2%	0.3%	5.2	5.6	4.5	2.5	0.3	0.2	1.3	1.5
Italy	2.0%	2.8%	-0.4	0.7	1.2	1.3	0.2	0.1	0.9	1.4
Netherlands	0.7%	1.1%	1.0	2.0	1.5	1.9	1.0	0.8	1.3	1.3
Portugal	0.3%	0.3%	0.9	1.7	1.8	1.8	-0.2	0.7	1.2	1.5
Spain	1.5%	1.8%	0.7	3.1	2.6	2.0	-0.2	-0.6	0.8	1.2
Poland	0.9%	0.7%	3.5	3.7	3.4	3.2	0.2	-0.8	1.1	2.5
Russia	3.3%	2.4%	0.6	-3.8	-0.5	1.9	7.8	15.6	8.9	4.3
Turkey	1.4%	1.0%	2.9	2.7	3.0	3.7	8.9	7.9	7.0	6.2
Australia	1.0%	1.9%	2.7	2.0	2.9	2.9	2.6	1.7	2.5	2.5
India	6.8%	2.7%	7.0	7.3	7.9	6.1	3.8	-2.5	3.0	6.0
Indonesia	2.5%	1.1%	5.0	4.0	4.1	5.4	6.4	6.8	5.6	5.1
South Korea	1.6%	1.8%	3.3	2.8	3.3	3.5	1.3	0.9	1.9	2.9
Argentina	0.9%	0.7%	0.5	2.1	1.7	2.1	-	20.0	25.0	-
Brazil	3.0%	3.0%	0.1	-2.4	-0.5	3.1	6.3	8.5	6.5	4.8
Canada	1.5%	2.3%	2.4	1.0	2.0	2.2	1.9	1.0	1.6	2.1
Mexico	2.0%	1.7%	2.1	2.3	3.0	3.9	4.0	2.8	3.2	3.1
South Africa	0.7%	0.5%	1.5	1.5	1.8	3.2	6.1	4.8	5.6	5.3
Nigeria	1.0%	0.7%	6.2	3.5	4.5	6.0	8.0	9.3	9.5	7.3
Saudi Arabia	1.5%	1.0%	3.5	2.8	2.3	4.4	2.7	2.1	2.5	3.4

Sources: *PwC analysis, National statistical authorities, Datastream and IMF. All inflation indicators relate to the Consumer Price Index (CPI), with the exception of the Indian indicator which refers to the Wholesale Price Index (WPI). Argentina's inflation projections use the IPCNu Index. We will provide a 2017-2021 inflation projection once a longer time series of data is available. There is not a complete series of year-on-year price growth data available for 2014 so we have not provided an estimate for annual inflation in this year. Also note that the tables above form our main scenario projections and are therefore subject to considerable uncertainties. We recommend that our clients look at a range of alternative scenarios.*

Interest rate outlook of major economies

	Current rate (Last change)	Expectation	Next meeting
Federal Reserve	0-0.25% (December 2008)	Rate to start to rise later in 2015	15-16 December
European Central Bank	0.05% (September 2014)	Rate on hold until at least late 2016	3 December
Bank of England	0.5% (March 2009)	First rise expected in early 2016	10 December

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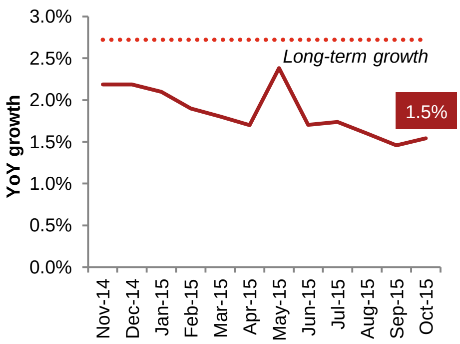
PwC's Global Consumer Index

Growth in consumer spending marginally improved in October, but remains below its long-term growth rate. Equity markets performance strengthened slightly. However, confidence has weakened due to uncertainty over the global macroeconomic outlook, particularly in emerging markets. Industrial production improved slightly. However, a slowdown in emerging markets could be a drag on consumer spending in coming months.



The GCI is a monthly updated index providing an early steer on consumer spending and growth prospects in the world's 20 largest economies. For more information, please visit ***www.pwc.co.uk/globalconsumerindex***

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