February 2017

Global Economy Watch

Where do the pockets of opportunities lie beyond the BRIC economies?

Dear readers,

When businesses think about which emerging economies to expand their activities into, the natural conclusion is to focus on the large emerging economies of the world. Indeed, our recently launched World in 2050 report shows that in the long-term the seven largest emerging economies, the E7, could grow twice as fast as the G7 on average.

However, we think that there are other smaller but equally appealing economies—what we call the 'pockets of opportunity'—businesses should consider when thinking of expanding their international footprints.

Vietnam, for example, has negotiated a trade deal with the European Union and so could develop into a manufacturing hub in the future. Poland, with its access to the Single Market, has one of the most liberal Foreign Direct Investment (FDI) regimes of rich economies. And Colombia, has embarked on a radical $70 billion infrastructure programme—a boon to businesses that specialise in design and construction.

In this issue, we also discuss the prospects of a further rise in US interest rates on emerging economies. Even though we think that some markets may be overly exposed to dollar-denominated debt, we think most are in a better position to deal with tighter US monetary policy for three reasons.

First, the Fed has signalled a slow and measured rate rise, giving businesses in emerging markets more time to plan their foreign-debt management strategy.

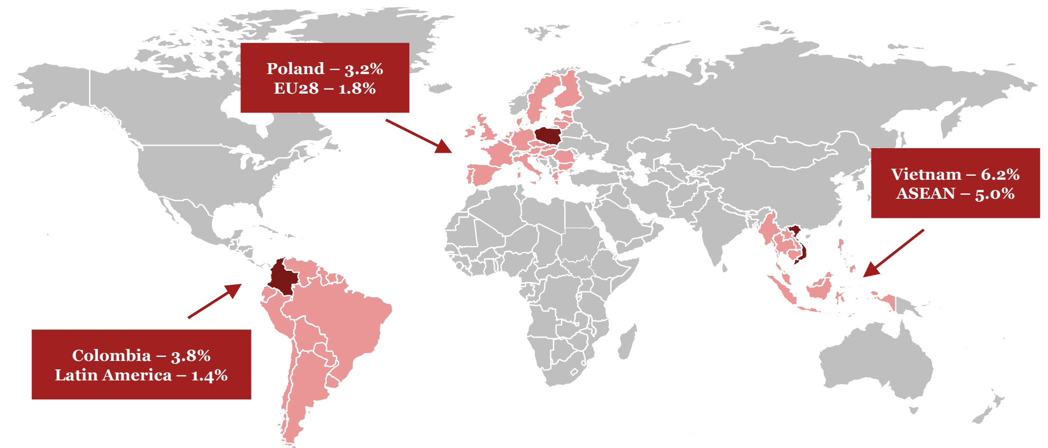
Second, most emerging markets have flexible exchange rate regimes allowing them to moderate the impact of negative capital flows through the nominal adjustment of their exchange rate.

Third, most commodity prices on which some emerging economies are reliant (e.g. Nigeria, Brazil) are back on the rise and likely to remain relatively stable, improving external balances.

Kind regards

Barret Kupelian
PwC | Senior Economist

Fig 1: Our pockets of opportunity are projected to outperform their neighbours over the next 5 years



Sources: PwC analysis, IMF

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Economic update: Spain first peripheral economy expected to grow bigger than its pre-crisis level

In the last three months of 2016, Eurozone GDP grew by 0.4% quarter-on-quarter, growing for the 15th quarter in a row. As mentioned in our previous edition of the Global Economy Watch there has been a synchronised uptick in activity across the G7 since the second quarter of last year (we will be analysing this in further detail in our next edition) which partly explains the Eurozone's stronger than expected GDP growth rate.

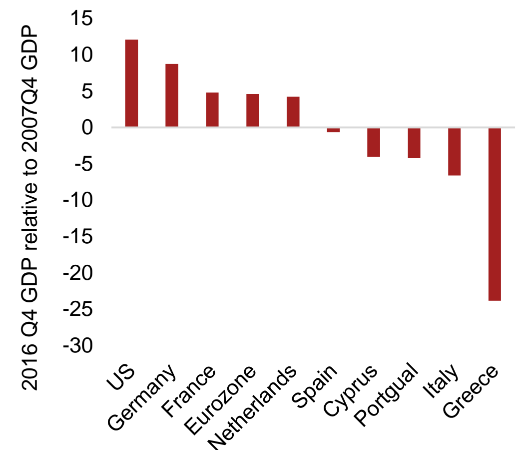
Looking at the picture for the whole of last year, the latest set of national accounts show that the Eurozone grew faster than the US in 2016. However, a closer look at the numbers reveals a more telling story.

First, the US economy is around 12% bigger now compared to the beginning of the financial crisis which we have defined as the last quarter of 2007. Set against this context, the performance of the Eurozone is more disappointing as it is just 4.6% bigger. This suggests that the pace of the recovery over this period in the Eurozone has been three times slower compared to the US.

Second, even though GDP in the Eurozone periphery is growing faster than the core, the picture in GDP level terms is different. For example, Figure 2 shows that core economies like Germany, France and the Netherlands are now bigger compared to when the global financial crisis started. Italy, however, is the only core economy in our sample which remains smaller compared to its pre-crisis size.

At the opposite end of the spectrum, looking at the bailout economies, the picture is mixed. At one end Greece's economy is around 25% smaller. Portugal and Cyprus continue to be smaller compared to their pre-crisis size but the latter has managed to recover ground faster post-bailout than the former. Finally, Spain is the star student in the periphery as its economy is just 0.7% smaller compared to its pre-crisis level. Bar an accident we expect Spain to be the first peripheral economy to grow bigger than its pre-crisis size.

Fig 2: Current size of economy compared to pre-crisis level



Sources: PwC analysis, Eurostat, BEA

The impact of Federal Reserve actions on emerging markets

Prospect of Fed rate rise is exposing high US-denominated debt levels

Strong job creation to the tune of around 180,000 per month, coupled with low unemployment and the prospect of a fiscal stimulus in the world's largest advanced economy, have helped push forecasts of US inflation close to its 2% target. In line with the consensus view, we expect the Fed to tighten its monetary policy in a cautious and measured manner this year in response to these trends. But some emerging markets are feeling the strain of a higher interest rate and stronger US dollar. For example, in the past 18 months, net portfolio inflows to emerging countries have slowed down from the average $20 billion a month recorded in the 2009-15 period.

Haven't we seen this before?

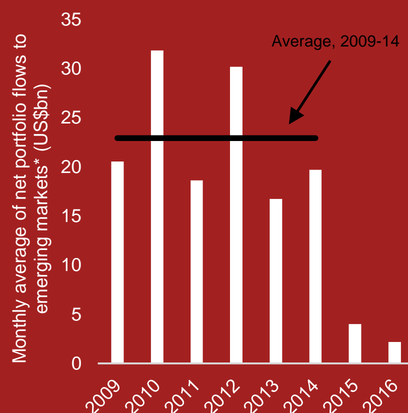
The 1997 Asian financial crisis was triggered in large part by rising US interest rates—which led to capital outflows—and high levels of foreign currency debt, encouraged by the apparent (but ultimately illusionary) stability provided by fixed exchange rates. However, we think that there are a few reasons why emerging economies are in a better position now to cope with tighter dollar liquidity than in 1997.

1. The Fed has signalled a slow rise in rates

First, the Fed has made its broad intentions about the future path of interest rates clear. The median expectation of the Fed monetary policy board of governors is for rates to rise by 0.75 pp by the end of 2017. This 24-month tightening cycle starting in December 2015 is expected to be much smaller compared to the average 2.3 percentage point rise historically. A relatively slow and gradual increase in the policy rate this time means businesses in emerging markets will have more time to plan their foreign-currency debt management strategy.

However, there are two main factors we are monitoring which could push inflation higher and

Fig 3: Portfolio flows to emerging markets have been falling for the past 2 years



Sources: PwC analysis, IIF

so affect the pace of monetary tightening:

- the size, timing and form of the infrastructure stimulus, which could boost aggregate demand and inflation in the short-term; and
- the rate of growth of labour productivity, which could affect how far and fast inflation picks up over the next year or two.

2. Flexible exchange rates smooth out business cycles

Second, one of the legacies of the Asian financial crisis is that many emerging economies moved towards more flexible exchange rate regimes. For example, Thailand, Indonesia and South Korea all now operate some form of floating arrangement. Others, including Malaysia and Singapore, abandoned their fixed rates but still have a more managed regime. Doing so comes with some benefits. First, flexible exchange rates help to dampen the impact of external shocks on the real economy through trade. Second, central banks are less vulnerable to reserve depletion. In fact, we have seen that some of the emerging economies with managed exchange rates, like Nigeria in June 2016, were pushed to adopt flexible exchange rate regimes to stem falling foreign exchange reserves.

3. Rising commodity prices should improve emerging market prospects

After falling to below $30 a barrel[1] – lows not seen for over a decade – in January last year, oil prices have been back on the rise, almost doubling to around $55 a barrel in early February 2017. Commodity prices in general are expected to continue gradually rising over the coming year, but will still remain around 50-60% of their mid-2014 peaks based on consensus projections (though, as always, these are subject to large margins of error).

Rising – or at least broadly stable – commodity prices will improve the prospects for the many emerging markets that rely heavily on commodity exports. Firstly, for those economies operating a managed exchange rate regime, it will mitigate some of the pressure of falling foreign exchange reserves. Secondly, it will improve the external balance by boosting export revenues. And by improving international investor confidence, it could also stem significant capital outflows.

Conclusions on emerging market prospects

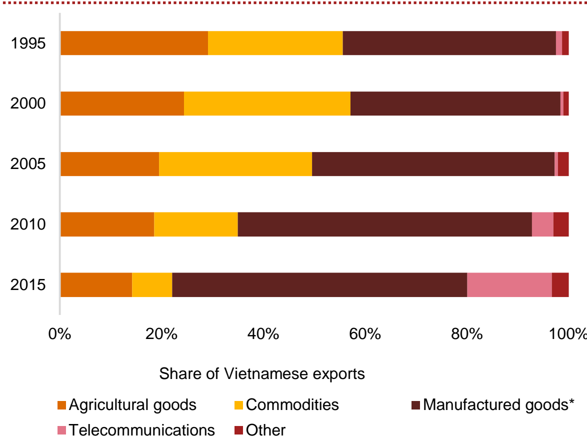
After years of capital inflows to emerging markets, the monetary policy actions of the Fed will have international consequences. Businesses and investors should remain aware of the impact of a stronger dollar on emerging markets and continue to stress test their business plans accordingly. But they should also not forget the long-term growth potential of emerging markets, which remains considerable despite the volatility of some of these economies in recent years.

[1]Average of three spot prices; Dated Brent, West Texas Intermediate, and the Dubai Fateh

* Average includes: China, India, Indonesia, South Korea, Malaysia, Philippines, Taiwan, Thailand, Brazil, Chile, Mexico, Bulgaria, Czech Republic, Hungary, Poland, Turkey, Ukraine and South Africa.

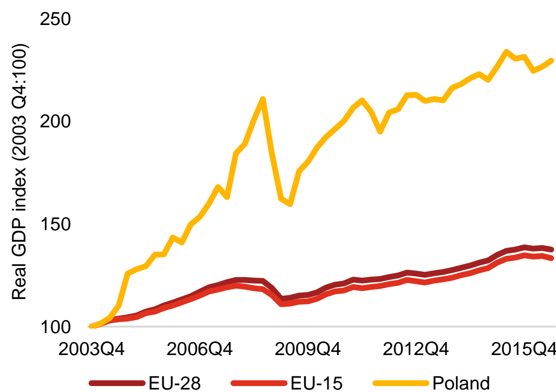
Beyond the BRICs: Where are the pockets of opportunity for your business?

Fig 4: Vietnam's exports are moving away from commodities towards high value added manufactures



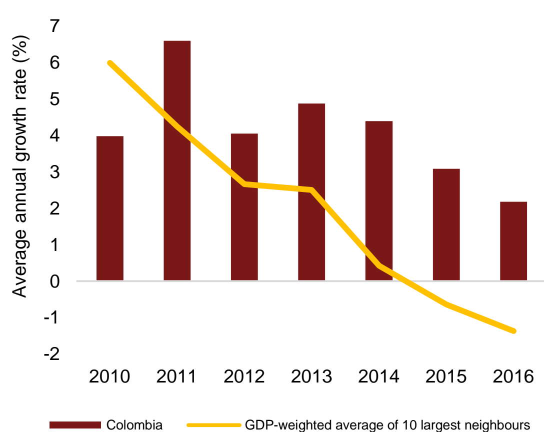
Sources: PwC analysis, UNCTAD
* Manufactured goods excluding telecommunications

Fig 5: Poland has significantly outperformed the rest of the EU over the past decade



Sources: PwC analysis, Eurostat

Fig 6: While multiple Latin American countries have entered recession recently, Colombia has outperformed



Sources: PwC analysis, IMF

Mid-sized economies should be on businesses' radar

Businesses typically focus on large emerging economies when looking to grow their revenue base. In the long-run, this makes sense. As we argued in our recent World in 2050 report, the largest seven emerging markets (the 'E7') are expected to grow around twice as fast as the largest seven advanced economies (the 'G7') on average until 2050.

Practically, however, converting trust and reputation into revenue in a new market takes time, especially in larger economies. That is why we think mid-sized economies shouldn't fall off the radar of businesses seeking to grow their international footprint. With this in mind, we've focused here on the 'pockets of opportunity' in the mid-sized economies of the world that we think offer the best short-to-medium term prospects for businesses looking to grow.

Vietnam: Asia's gem

In Asia, we think that Vietnam's strong macroeconomic fundamentals and outward-looking approach will support growth. Currently economic growth is fuelled by domestic and foreign investment in labour-intensive industries, partly because of its relatively low labour costs—wages are only around one third those in China. However, there is tangible evidence that Vietnam is using Foreign Direct Investment ("FDI") to move its economy away from a high volume, low cost base to a more high value-added focus. For example, mobile phones and computers are now its biggest export, as compared to commodities ten years ago.

Free trade deals are a key tool used by policymakers to modernise the Vietnamese economy. Vietnam is the second ASEAN economy after Singapore that has negotiated and agreed a free trade agreement with the EU. Crucially, the deal covers both the manufacturing and services sectors, indicating the authorities' willingness to prepare the economy for its eventual long-term transition from manufacturing to services, once demographic and economic conditions start to change (mirroring what is happening now in China).

For the moment, though, Vietnam is seeking to replicate the investment- and export-led growth model that led to the rise of successful Asian Tigers like South Korea and more recently China. Our World in 2050 report shows that, in the long run, Vietnam, along with India and Bangladesh, have the potential to be the fastest growing economies of the 32 we focused on in the report. While such long-term projections are inevitably uncertain, Vietnam's short-to-medium term prospects also look very positive.

Poland should remain a relatively strong performer within Europe

Poland was the largest economy of those in the 2004 wave of expansion of the European Union (EU) to the East. Unlike most advanced economies, it managed to escape relatively unscathed from the 2008 global financial crisis. Poland has made the most of its membership of the EU. The OECD estimates that Poland has a more liberal FDI regime compared to other large economies like South Korea, Australia, Canada and the US. It also has relatively low labour costs — for example the hourly cost of labour in Poland was €8.60 in 2015 which was significantly below the EU average of €25 per hour. These two factors, along with its central location within the broader European continent, have helped Poland attract FDI with the total stock now around $200 billion or around 50% of its GDP.

Looking forward, we expect the Polish economy to grow by around 16% in volume terms in the next five years. However, Poland's main challenge is the fast pace at which its population is expected to age. Even though this is a medium to long-term issue, policymakers have already started to take notice. For example, last year the government announced a new economic roadmap for the next quarter of a century. This focuses, among other things, on boosting R&D spending to the EU average rate. Doing so will help grow labour productivity and so offset some of the effects of an ageing workforce. Supporting people to work for longer is also part of this government strategy.

Colombia: Latin America's new growth star?

Colombia is a mid-sized economy that we think is well poised to grow in the short to medium term (as well as potentially the longer run). The stabilisation or, in some cases, increases in commodity prices over the past year and the depreciation of the Colombian peso mean that its external adjustment is largely complete, boosting revenues from exports of commodities, which comprise almost 10% of GDP.

One big opportunity for the country is related to the government's ambition to spend $70 billion on infrastructure to 2035. Specifically the focus is on building more than 11,500 kilometres of roads and highways to improve connectivity. This should support demand in the medium-term and help the country deal with its competitiveness issues. For example, Colombia was ranked 103 out of 140 in the latest Business Environment and Infrastructure Index[1] suggesting there is ample scope to improve its physical infrastructure.

Also, the latest government tax reforms, which have been in force from the beginning of the year, are expected to reduce the tax burden on business in Colombia. To do this, the authorities have increased VAT to 19%, thereby broadening the tax base rather than just focusing it on the corporate sector.

Finally, in the long run, our World in 2050 analysis suggests that Colombia has the potential to be the fastest growing of the Latin American countries included in our study, just ahead of Mexico and clearly ahead of Brazil and Argentina. This does depend, however, on sustained progress of the Colombian government's economic reform agenda in the longer term.

[1] World Economic Forum

Projections: February 2017

	Share of 2016 world GDP		Real GDP growth				Inflation			
	PPP	MER	2016e	2017p	2018p	2019-2023p	2016e	2017p	2018p	2019-2023p
Global (Market Exchange Rates)		100%	2.5	2.9	3.0	3.0	1.9	2.7	2.6	2.5
Global (PPP rates)	100%		2.9	3.4	3.5	3.5	2.5	3.1	3.0	2.9
G7	31.5%	46.4%	1.4	1.7	1.9	1.9	0.9	1.9	2.1	1.8
E7	36.2%	25.9%	4.6	5.2	5.1	5.0	1.6	3.5	3.8	3.3
United States	15.8%	24.5%	1.6	2.2	2.4	2.3	1.3	2.3	2.5	2.0
China	17.3%	15.2%	6.5	6.5	6.1	5.7	2.0	1.8	2.5	2.8
Japan	4.2%	5.6%	0.6	0.5	0.7	0.8	0.1	1.3	1.5	1.5
United Kingdom	2.4%	3.9%	2.0	1.5	1.5	2.1	0.7	2.3	2.8	2.3
Eurozone	12.0%	15.8%	1.6	1.5	1.6	1.5	0.2	1.4	1.3	1.4
France	2.3%	3.3%	1.4	1.5	1.6	1.6	0.3	1.2	1.1	1.2
Germany	3.4%	4.6%	1.7	1.4	1.5	1.4	0.4	1.8	1.9	1.7
Greece	0.3%	0.3%	-1.0	0.5	1.3	1.6	-0.3	0.5	0.8	1.1
Ireland	0.3%	0.4%	4.0	3.3	3.0	2.6	-0.1	0.8	1.3	1.5
Italy	1.9%	2.5%	0.9	1.0	1.1	1.2	0.2	1.1	0.8	1.4
Netherlands	0.7%	1.0%	1.6	1.6	1.8	1.8	0.8	1.5	1.1	1.3
Portugal	0.3%	0.3%	1.2	1.2	1.1	1.1	0.6	1.0	1.0	1.4
Spain	1.4%	1.6%	2.6	2.3	1.9	2.0	-0.4	1.3	1.1	1.2
Poland	0.9%	0.6%	3.6	3.4	3.2	3.5	-0.3	1.2	1.7	2.4
Russia	3.3%	1.8%	-1.6	1.0	1.1	1.5	7.3	5.6	4.8	4.0
Turkey	1.4%	1.0%	3.1	2.9	3.2	3.4	7.7	8.1	8.4	7.0
Australia	1.0%	1.7%	3.1	2.7	2.9	2.7	1.5	2.5	2.4	2.5
India	7.0%	2.8%	7.3	7.3	7.7	6.5	5.1	5.0	5.3	5.0
Indonesia	2.5%	1.2%	5.0	5.1	5.5	5.4	3.6	4.5	4.4	5.1
South Korea	1.6%	1.9%	2.7	2.6	2.8	3.3	1.0	1.6	2.8	3.3
Argentina	0.8%	0.9%	-2.2	1.9	2.4	2.5	-	25.0	-	-
Brazil	2.8%	2.4%	-3.6	0.4	1.5	3.0	8.8	5.0	4.5	4.5
Canada	1.4%	2.1%	1.3	1.9	2.1	2.2	1.5	1.9	2.0	2.0
Mexico	2.0%	1.6%	2.0	1.8	2.1	3.0	2.8	3.4	3.0	3.0
South Africa	0.6%	0.4%	0.5	1.0	1.7	3.0	6.3	6.0	5.7	5.5
Nigeria	1.0%	0.7%	-1.0	0.9	2.4	4.2	15.6	14.2	12.0	12.0
Saudi Arabia	1.5%	0.9%	1.0	1.2	2.0	3.5	4.0	3.2	3.0	2.5

Sources: *PwC analysis, National statistical authorities, Datastream and IMF. All inflation indicators relate to the Consumer Price Index (CPI). Argentina has recently launched a new CPI measure, which only contains data from April 2016. Therefore we only project inflation for 2017, and will provide 2018 and 2019-2023 projections once a longer series is available. 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	0.5-0.75% (December 2016)	Further gradual tightening over the next year	14 – 15 March
European Central Bank	0.0% (March 2016)	No rate rise for the foreseeable future	9 March
Bank of England	0.25% (August 2016)	No change in rates expected in the short-term	16 March

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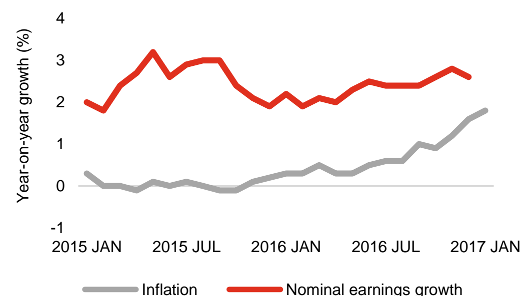
Chart of the month

Q4 data for 2016 revealed UK employment hit an all-time high of 74.6%, driven by record numbers of working women at 70%, as well as a fall in part-time work.

But we are not seeing these improvements in the job market feed through to earnings growth. Last month, UK inflation rose to 1.8% - the highest rate for two-and-a-half years, while nominal earnings growth slowed at the end of 2016.

UK inflation is picking up pace and may soon start to erode earnings growth



Sources: PwC analysis, OECD, ONS

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