



Global Economy Watch

Risky business: how concerned do you need to be about emerging markets?



Dear readers,

Once again the global economy faces a dangerous cocktail of risks including slowing growth in China, a strong dollar, and low commodity prices. But this time, the emerging market economies look the most vulnerable, while advanced economies are still struggling to escape the low economic growth environment almost a decade on from the global financial crisis.

We expect:

- Chinese GDP growth to slow further to around 6.5% by 2016 – this is expected as the country manages a tricky rebalancing to a more sustainable growth model.
- Lower for longer oil prices – with the OPEC cartel refusing to cut production, demand will be insufficient to absorb the global supply glut.
- Sustained strength in the US dollar – less positive recent data may slow, but is unlikely to alter, the Fed’s monetary tightening cycle, maintaining upward pressure on the dollar.

To analyse the impact of these risks, we have updated our emerging market ‘risk matrix’ to

assess how vulnerable emerging markets are to a strong US currency. The analysis shows that Brazil has now joined Turkey as a ‘highly vulnerable’ economy as far as its foreign debt position is concerned. In fact, Brazil is one of the biggest underperformers among the emerging economies (see Figure 1) and is exposed to all three risks discussed above. We expect the Brazilian economy to shrink by around 3.6% this year as high inflation reduces the purchasing power of households domestically, and revenues fall for key commodity exports.

On a final note, advanced economies also have a lot to think about. The US scratched up a disappointing 1% growth during the fourth quarter of 2015, while the Eurozone economy increased by just 0.3% on the back of low growth in Germany and France, and Japan retracted by 0.4%. The response from a number of central banks has been to implement negative interest rates, the balancing act these central banks are performing is taking interest rates sufficiently negative to persuade banks to lend more but not so negative that they unsettle the financial system as a whole.

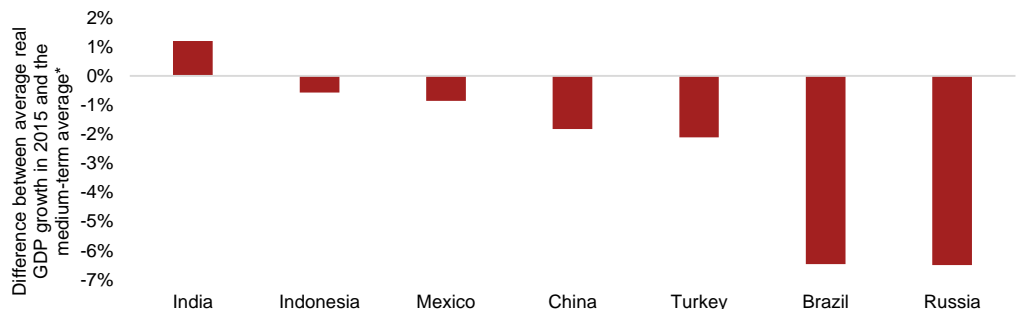


Kind regards

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Fig 1: Emerging economy growth is slowing down – of the E7, only India enjoyed faster growth in 2015 compared to its medium-term average



*Medium-term average defined as 2010-2014, growth measured on a quarterly basis in year-on-year terms
Note: Due to data availability, the growth data for India and Indonesia starts from 2012 Q2 and Q1 2011 respectively
Sources: PwC analysis, Datastream, National Statistical Agencies



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Economic update: Zero is no longer the lower bound

Japan follows Europe in setting negative interest rates

With growth sluggish and inflation well below target central banks in the Eurozone, Sweden, Switzerland, Denmark and Japan, around one quarter of the global economy in total, have now adopted a negative interest rate policy that is historically unprecedented.

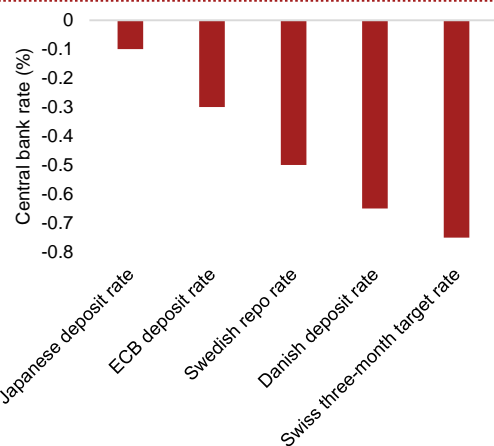
Since the crisis interest rates have been at or around zero, and so quantitative easing (QE) was used to inject new money into the system. The idea was to increase liquidity and, ultimately to raise credit growth rates, spur economic activity and so move inflation back up to target levels. If QE was the carrot approach, negative interest rates represent the stick. Policymakers hope to stimulate lending by imposing a charge on commercial banks' reserves.

Negative interest rates require careful management

But central bankers have to negotiate a delicate balancing act. So far it seems that banks have not passed negative rates to their customers. For consumers and businesses, this is good news. But if central bankers push interest rates to even more negative levels, then banks may have to start passing on these costs to their customers to protect their profitability.

The challenge for policymakers is to set rates negative enough to persuade banks to lend more, but not so negative that they risk unsettling the financial system as a whole.

Fig 2: Recent policy decisions shows that central banks are no longer constrained from the so-called zero bound



Sources: Datastream

Brazil's hangover: a slow recovery ahead for Latin America's former star

Carnival is over, and the hangover is here

Once a star of Latin America and the emerging markets, Brazil faces the prospect of a protracted recession.

The major driver of Brazil's economic growth in the last decade was household spending, which makes up around 60% of GDP. Specifically, the quarterly growth rate of household consumption was positive in every single quarter of the decade between 2004 and 2013. But now, Brazilian consumers are experiencing far tougher conditions.

Squeezed households

Brazil's consumers are under a lot of pressure. The inflation rate is running at close to 10% which is significantly above the central bank's target rate of 4.5%. Combined with lower revenues for key exports like energy-related commodities, and rising unemployment, this means that wages are struggling to keep pace with prices, so reducing the purchasing power of households and putting a drag on demand in the economy.

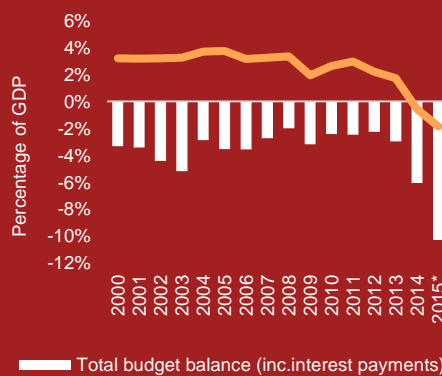
In manufacturing, for example, the latest data show that real wages fell by 1% in the final quarter of 2015 compared to the year before. Meanwhile retail sales in December 2015 fell by 7.1% compared to the same month a year ago, which suggests there may have been an overall GDP contraction in the last quarter of 2015.

Policymakers' hands are tied

The policy response of the government has been constrained by the economic realities it faces.

First, Brazil's government is facing challenges on the fiscal front. Its primary budget surplus has been on a downward trajectory since 2011, and is now running at a deficit of 2% of GDP

Fig 3: A weak fiscal position leaves little scope for government stimulus



Source: PwC analysis, Datastream

(see Figure 3). Higher public debt levels have led all three major rating agencies to cut the Brazilian government's credit rating to junk status. As a result, its debt servicing costs have shot up to over 8% of GDP, further worsening the public finances.

Second, the central bank has attempted to rein in inflation by increasing the headline policy rate to 14.25%, up from 10.5% at the beginning of 2014. This has placed further pressure on leveraged households and businesses which have cut back spending in response.

Can the pressure be alleviated?

Some of Brazil's problems are driven by global factors, such as low commodity prices, and the associated fall in the Real's exchange rate (though the latter should be good for manufacturing exporters). But the plight of the

Brazilian consumer is worsened by the necessary adjustment in the government's finances and the high inflation associated with this currency depreciation.

To combat these problems, deeper structural reforms are needed. Brazil's generous state pension is one area where changes could lead to tangible benefits for the public finances and encourage people to work for longer, but other painful reforms will also be required to cut the deficit, which could depress demand in the short-run.

Another source of relief to consumers could be changes to monetary policy. But the central bank seems reluctant to lower interest rates while inflation remains stubbornly above its target level and the currency remains weak. Rates are therefore unlikely to drop unless there are tangible signs that inflation is returning to its target range.

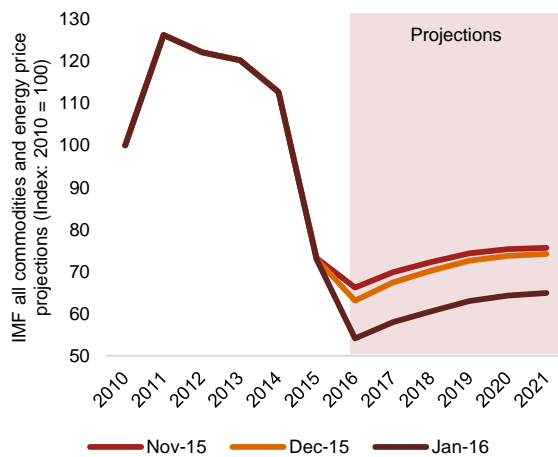
No quick bounce back in Brazil but longer term potential remains

Painful structural reforms are necessary if Brazil is to redress its fiscal imbalances and these will take time to bear fruit. Assuming commodity prices remain low, Brazilian GDP could contract by a further 3.6% in 2016, and by 2017 household consumption could be around 7% lower compared to 2014.

At the same time, Brazil retains longer term growth potential if it can address its problems with the deficit and high inflation. It has a young, fast growing labour force, a large domestic market and its manufacturing industry should be made more competitive by the weaker exchange rate. If its government can make some tough choices now, it could be a star performer again in 10 years time.

Is it time to worry about emerging markets?

Fig 4: Medium-term commodity price projections have been revised downwards in recent months



Sources: PwC analysis, IMF

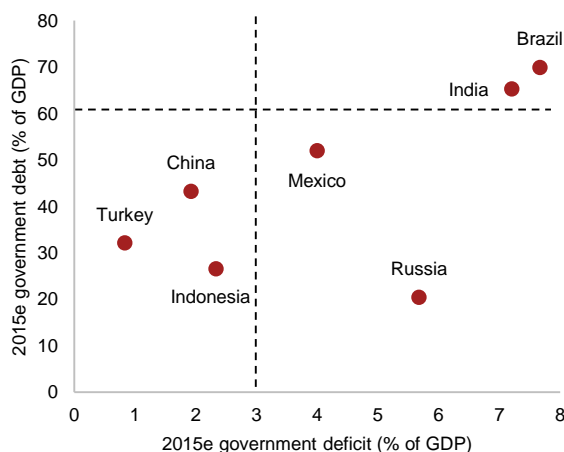
Fig 5: For most of the E7, the strong dollar still poses a significant risk

Countries	Vulnerability	Foreign currency external debt (% of GDP)	Jun 14 – Jan 16 currency movement (%)	Current account balance (% of GDP)
Turkey	High	53%	-29.5%	-4.5%
Malaysia	High	61%*	-25.9%	2.2%
Chile	High	59%	-23.4%	-0.7%
Colombia	High	38%	-42.5%	-6.2%
Brazil	High	37%*	-44.7%	-4.0%
South Africa	High	21%	-34.8%	-4.3%
Peru	Medium	36%	-18.7%	-3.7%
Indonesia	Medium	35%*	-14.4%	-2.2%
Argentina	Medium	25%	-40.2%	-1.8%
Mexico	Medium	25%	-28.1%	-2.4%
Russia	Medium	36%	-55.8%	5.0%
Thailand	Medium	27%	-10.1%	6.2%
India	Medium	16%	-11.2%	-1.4%
Philippines	Low	25%	-7.7%	5.0%
China	Low	13%*	-6.3%	3.1%

* Number shows total external debt as a % of GDP

Sources: PwC analysis, World Bank, IMF, Datastream

Fig 6: Most of the E7 have some space to provide fiscal support to boost growth



Note: The dashed lines represent the thresholds applied under the EU Treaty to assess whether the public debt and deficit are excessive.
Sources: PwC analysis, IMF WEO (Oct 2015)

Global risks have shifted towards the emerging economies

For much of the last decade advanced economies bore the brunt of the global economic crisis. From the sub-prime crisis and subsequent bank failures, to the Eurozone crisis and persistently high unemployment rates, most advanced economies have not had an easy time since 2008. But the tables have turned more recently.

The global economy is now facing a dangerous cocktail of risks including a strong dollar, low commodity prices and a slower growing China. All three of these pose threats to some of the large emerging markets.

Figure 1 supports this view as it shows that economic growth has slowed in six of the seven largest emerging markets (the 'E7') compared to previous trend growth rates. Only India grew faster in 2015 than its medium-term average rate. Brazil and Russia are contracting. So what has driven this deterioration in their economic outlook?

China's economy is slowing and commodity price projections are falling

After growing at above 8% per annum from 2000 to 2011, the Chinese economy slowed down to just under 7% growth last year and we expect this to decline further to around 6% in 2017. Even though some of this trend was expected (see for example, our [World in 2050](#) analysis), the slowdown has been faster than most commentators anticipated a couple of years ago and risks remain weighted to the downside despite the fact that, according to our latest CEO Survey, Chinese CEOs remain more confident than their US counterparts on their own companies' future revenue growth.

So, what are the main channels of transmission to other emerging economies? The main, direct effect is being felt through trade. Brazil and Indonesia remain the most exposed to China here. For example, the direct impact of a 10% decrease in Indonesia's goods exports to China would be to lower its GDP by around 0.2 percentage points.

The slowdown in China is also having an indirect impact on other emerging economies through lower commodity prices as Chinese demand falls. Russia, Indonesia, Brazil and, to a lesser extent, Mexico are all net primary commodity exporters and as such have suffered from this effect. Figure 4 shows that, over the last few months, medium-term commodity price expectations have been revised further downwards. Regarding oil specifically, between November and January the IMF reduced their 2021 oil price projections by 24% to around \$46/bbl. If this is correct it will put a persistent strain on the economies and public finances of major oil exporters.

Foreign currency debt is a source of weakness for some emerging economies

The strength of the US dollar coupled with the scale of dollar denominated debt continues to be an area of concern for some emerging market businesses, households (and to a lesser extent governments). We have updated our [May 2015](#) risk matrix to assess the vulnerability of a sample of emerging market countries to the dollar (see Figure 5). We conclude that:

- Brazil, an economy we said to keep an eye on last year, has joined Turkey in being classed as 'highly vulnerable' as far as its foreign debt position is concerned.
- China's external debt continues to remain relatively insulated from the effects of a strong dollar because foreign-currency denominated debt makes up a small proportion of its overall economy, although some individual Chinese enterprises are more exposed here.
- Indonesia, Mexico, Russia and India, which are four of the world's seven largest emerging economies, fall somewhere in the middle and so present a mixed picture in terms of their exposure to the dollar – though the first three of these have other exposures here relating to commodity prices and/or reliance on exports to China as noted above. India seems more secure and currently looks to be the strongest of the large emerging economies.

Policy makers do have some space to provide support to the economy

How much room for manoeuvre do policy makers have to support their economies? Our analysis shows that:

- Some of the E7 have fiscal space as they have relatively small budget deficits and a low level of relative debt (see Figure 6). Even in Mexico and Russia, where the deficit is over the 3% of GDP threshold, public debt is below 60% of GDP. Policy makers could use fiscal stimulus to boost demand if economic growth continues to slow.
- Things are less clear cut with monetary policy as inflation remains high in Brazil, Russia and Turkey for example, but is below target in China. However, with interest rates in the emerging economies not as low as in the advanced economies – the lowest policy rate in the E7 is in Mexico at 3.25% – policy makers do have the room to provide monetary stimulus to the economy if they so decide.

Overall though, the short term economic outlook for the emerging economies has deteriorated even though many retain considerable long-term potential. We therefore recommend that our clients stress test their business plans against a lower than baseline growth scenario for major emerging markets over the next few years.

Projections: March 2016

	Share of 2014 world GDP		Real GDP growth				Inflation			
	PPP	MER	2015e	2016p	2017p	2018-2022p	2015e	2016p	2017p	2018-2022p
Global (Market Exchange Rates)		100%	2.6	2.7	2.9	2.9	1.9	2.3	2.6	2.7
Global (PPP rates)	100%		3.2	3.2	3.5	3.4				
G7	32.0%	46.0%	1.8	1.9	1.9	1.9	0.2	1.0	1.7	1.8
E7	35.6%	25.4%	4.1	4.2	4.7	4.8	0.4	1.8	3.2	3.2
United States	15.9%	22.5%	2.4	2.3	2.3	2.3	0.1	1.3	2.1	2.0
China	16.6%	13.4%	6.9	6.5	6.0	5.7	1.5	1.8	1.8	2.8
Japan	4.4%	6.0%	0.7	1.3	1.3	1.0	0.8	0.9	1.1	1.4
United Kingdom	2.4%	3.8%	2.2	2.2	2.3	2.3	0.0	0.5	1.6	2.0
Eurozone	12.2%	17.4%	1.5	1.6	1.7	1.5	0.0	0.5	1.3	1.4
France	2.4%	3.7%	1.1	1.3	1.6	1.6	0.1	0.4	1.2	1.2
Germany	3.4%	5.0%	1.4	1.8	1.6	1.4	0.1	0.6	1.5	1.7
Greece	0.3%	0.3%	-0.3	-1.0	1.3	2.0	-1.1	0.1	1.4	1.4
Ireland	0.2%	0.3%	6.5	5.0	4.0	2.5	-0.0	1.0	1.5	1.7
Italy	2.0%	2.8%	0.6	1.0	1.2	1.2	0.1	0.2	1.0	1.4
Netherlands	0.7%	1.1%	1.9	1.7	1.8	1.8	0.2	1.0	1.5	1.3
Portugal	0.3%	0.3%	1.5	1.5	1.4	1.2	0.5	0.8	1.4	1.6
Spain	1.4%	1.8%	3.2	2.8	2.3	2.0	-0.6	0.2	1.3	1.2
Poland	0.9%	0.7%	3.5	3.5	3.6	3.6	-0.9	0.8	1.6	2.5
Russia	3.3%	2.4%	-3.8	-1.1	0.9	1.5	15.5	7.9	7.1	4.0
Turkey	1.4%	1.0%	3.4	3.3	3.4	3.5	7.7	8.5	7.5	7.0
Australia	1.0%	1.9%	2.2	2.4	2.5	2.7	1.5	2.3	2.5	2.5
India	6.8%	2.7%	7.1	7.7	7.7	6.5	4.9	4.1	4.3	5.0
Indonesia	2.5%	1.2%	5.2	4.8	4.8	5.4	6.8	6.1	6.1	5.1
South Korea	1.6%	1.8%	2.6	3.1	3.6	3.5	0.8	1.5	1.8	3.3
Argentina	0.9%	0.7%	2.0	1.7	2.3	2.5	17.0	25.0	25.0	20.0
Brazil	3.0%	3.0%	-3.8	-3.6	0.7	3.0	9.0	9.0	6.5	5.0
Canada	1.5%	2.3%	1.3	1.6	2.0	2.2	1.1	1.7	1.9	2.0
Mexico	2.0%	1.7%	2.5	2.7	3.0	3.3	2.7	3.2	3.1	3.0
South Africa	0.7%	0.5%	1.5	1.0	2.0	2.5	4.6	5.8	5.5	5.3
Nigeria	1.0%	0.7%	3.2	3.7	4.3	5.0	9.0	10.0	9.5	8.0
Saudi Arabia	1.5%	1.0%	3.2	1.3	2.1	3.0	2.2	2.7	3.2	3.2

Sources: PwC analysis, National statistical authorities, Datastream and IMF. All inflation indicators relate to the Consumer Price Index (CPI). Argentina's inflation projections use the IPCNu Index. 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	0.25-0.5% (December 2015)	Next rate rise may be delayed until later in 2016	15-16 March
European Central Bank	0.05% (September 2014)	More loosening expected in 2016	10 March
Bank of England	0.5% (March 2009)	No immediate rate rise likely	17 March



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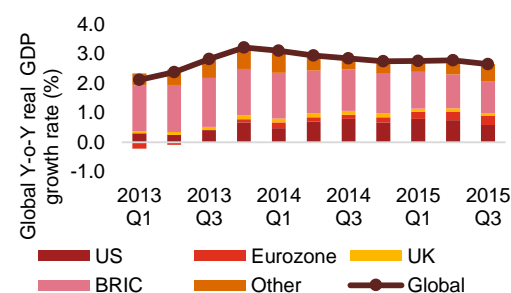
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Chart of the month

Global year-on-year (Y-o-Y) GDP growth in the third quarter of 2015 fell to 2.6%, its lowest rate since the second quarter of 2013.

The contribution of the US fell in Q3 while the contribution made by the BRICs was lower than at any time since the first quarter of 2013.

Chart of the month: US contribution to global growth falls to lowest level since early 2014



Note: Based on 2014 market exchange rate (MER) GDP weights
Sources: PwC analysis, Datastream, National Statistical Agencies

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