

# Global Economic Outlook

1st Quarter 2017





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By Ira Kalish

In the Q1 edition of the *Global Economic Outlook*, our economists across the globe examine the unfolding environment in the United States, Eurozone, China, Japan, India, Mexico, Turkey, and South Africa, as well as the impact on the global shipping industry.

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Illustrations by Stephanie Dalton Cowan



# Introduction

By Ira Kalish

AS 2017 begins, the global economic environment is characterized by new political realities. In the United States, there is a new president with ideas and goals different from those of his predecessor. The US election has led to higher bond yields and a higher-valued US dollar based on expectations of faster growth and more inflation. In Europe, growth and inflation have begun to accelerate, yet unemployment remains stubbornly high in much of the continent. Meanwhile, important elections are on the horizon for both Germany and France, setting the stage for the policy environment in the coming year. In Asia, growth is stabilizing, but risks are piling up in the form of higher debts and rising trade tensions. In this edition of Deloitte's *Global Economic Outlook*, our economists across the globe examine the unfolding environment and offer their thoughts on how things might evolve.

First, Patricia Buckley discusses the US economy in light of the election. She notes that the economy is in "fairly good shape," but that the incoming administration has fiscal plans designed to boost growth and trade as well as immigration plans meant to shield the US economy from the vicissitudes of the global economy. She discusses the details of the policy proposals but acknowledges a considerable degree of uncertainty around the likely outcome, given that the new president must find common ground with the US Congress.

In our second article, Alexander Börsch looks back at 2016 and how it was not a bad year for the Eurozone from an economic perspective. He discusses how the current environment sets the stage for continued moderate growth with rising inflation. On the other hand, he notes the political earthquakes that struck Europe in the past year, such as Brexit and the Italian referendum, as well as the various downside risks to Europe's economy.

In our third article, I look at the Chinese economy. I discuss how two issues in particular are likely to determine the path of the Chinese economy. First, trade is top of mind, with exports declining due to a high-valued currency, rising wages, and weak external demand. Moreover, the threat of protectionist action by the United States makes the trade outlook uncertain. Second, efforts to cool down an overheated property market are bearing fruit but threaten to undermine growth. Finally, I look at China's efforts to stabilize its currency.

Japan is the topic of our fourth article. I examine how stronger exports have led to an acceleration in economic growth. Moreover, the weakness of the yen bodes well for continued export growth. Given the rising strength of the economy, it is expected that monetary policy will remain unchanged. On the other hand, I discuss how wages have failed to respond to the tightening labor market, boding

poorly for consumer spending. Finally, I look at how the failure of the Trans-Pacific Partnership might hurt the government's efforts to engage in structural reform.

In her article on India, Rumki Majumdar offers a detailed examination of the government's recent and controversial demonetization. She notes the potentially disruptive effect of this policy. However, she also discusses the possible longer-term benefits of this currency reform. Finally, Rumki discusses various external factors that might influence the Indian economy, including the US election, the slowdown in China, and the rebound in oil prices.

Mexico is the subject of our next article by Jesus Leal Trujillo and Daniel Bachman. The country has attracted quite a bit of attention given President Donald Trump's talk about renegotiating NAFTA. Jesus and Danny examine the history of Mexico's shift toward freer trade in the past two decades and the economic impact. They also examine how, in the process, Mexico's manufacturing industry became a key component of the North American supply chain. Thus a significant change to NAFTA could be quite disruptive. The possibility of such a change has already caused a sharp drop in the value of the peso, potentially creating much higher inflation. Jesus and Danny discuss the policy options for Mexico in light of a possible external disruption.

# Global Economic Outlook

Published quarterly by  
Deloitte Research

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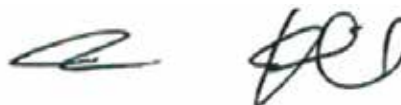
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In our next article, Akrur Barua examines Turkey, an economy with many positive attributes. However, currently Turkey faces some significant challenges, including terrorism, an influx of refugees, slow growth in export markets, and political uncertainty. The currency has fallen, restricting policy options. The result has been a decline in economic activity. Given that government finances are in relatively benign shape, a planned fiscal stimulus makes sense. Yet Akrur suggests that the economy also requires structural reforms.

Lester Gunnion examines the South African economy in our next article. He points to relatively slow growth and the necessity of tight monetary and fiscal policies, which don't much help persistently high unemployment. Lester notes that the country suffers from a shortage of skilled workers, a troubled education system, poor infrastructure, and a very

high level of income inequality. He discusses how boosting investment could be the key to bringing the country out of its doldrums.

In our final article, Akrur Barua and Anshu Mittal take a look at the global shipping industry. They discuss the upheavals facing the industry as a result of excess capacity and a slowdown in global trade. They look at commodity prices, shipping costs, and capital expenditure. They conclude with some thoughts on the likely direction and structure of the industry.



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A blue header banner featuring a collage of US symbols including the Great Seal, the Statue of Liberty, and a 'WALL ST' sign. The text 'UNITED STATES' is prominently displayed in white, bold, sans-serif capital letters.

# UNITED STATES

## An economy in transition

By Patricia Buckley

**T**HE election of a new US president, particularly one of a different political party than the predecessor, comes with the expectation of a shift in policies. Among the changes that President Donald Trump is advocating are lower corporate and personal taxes, increased federal infrastructure spending, a change in existing trade deals, increased immigration enforcement (including a wall on the southern border), the repeal or replacement of Obamacare, and a reduction in regulation. The fact that the president's party controls both houses of Congress increases the odds that many of these proposals will indeed become reality in some form, although the details and timing are unclear at this point. Also unknown is how these changes will be paid for.

### The current state of the economy

The incoming president is inheriting an economy that is in fairly good shape, with moderate growth and a labor market that continues to show strength. Last year got off to a slow start, with just 1.1 percent growth (annualized rate) in the first half. In the third quarter, growth picked up, with GDP growing 3.5 percent (annualized), the fastest pace of growth in two years. Over the first three quarters of the year, real consumer spending was strong, supported by low gasoline prices, cheaper imports due to the strong US dollar, and increasing employment. Business investment remained muted, as increased investment in intellectual property (primarily invest-





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The incoming president is inheriting an economy that is in fairly good shape, with moderate growth and a labor market that continues to show strength.

ment in research and development and software) was offset by declines in equipment investment over all three quarters. Exports grew at their fastest rate in nearly three years in the third quarter, driven by large increases in soybean and corn exports, as bad weather in Brazil and Argentina caused widespread crop damage. Otherwise, the contribution from exports was low but sufficient to offset the subtraction from imports. Residential investment contracted in both the second and third quarters, which was surprising given the rising home prices and low levels of inventories. Government spending (at all levels) made a very small but positive contribution over the three quarters in total.<sup>1</sup>

During 2016, the US economy generated 2.2 million net new jobs (figure 1). Although the pace of job creation was slower than in 2014 (3.0 million) and 2015 (2.7 million), it was still a healthy rate of growth. While job creation was slow to gain steam early in the expansion (it took until 2014 for the level of employment to surpass its prior peak of 2007), the growth has now been sufficient to reduce the unemployment rate to 4.9 percent for 2016 as a whole, just above the 4.6 percent rate experienced before the recession (figure 2).

With the economy and, particularly, the labor market continuing to exhibit strength, the Federal Open Market Committee (FOMC) of the Federal Reserve Board raised the target for the federal funds rate a quarter of a point in December, one year after the last increase. The current target range is 0.50–0.75 percent.

## Looking forward

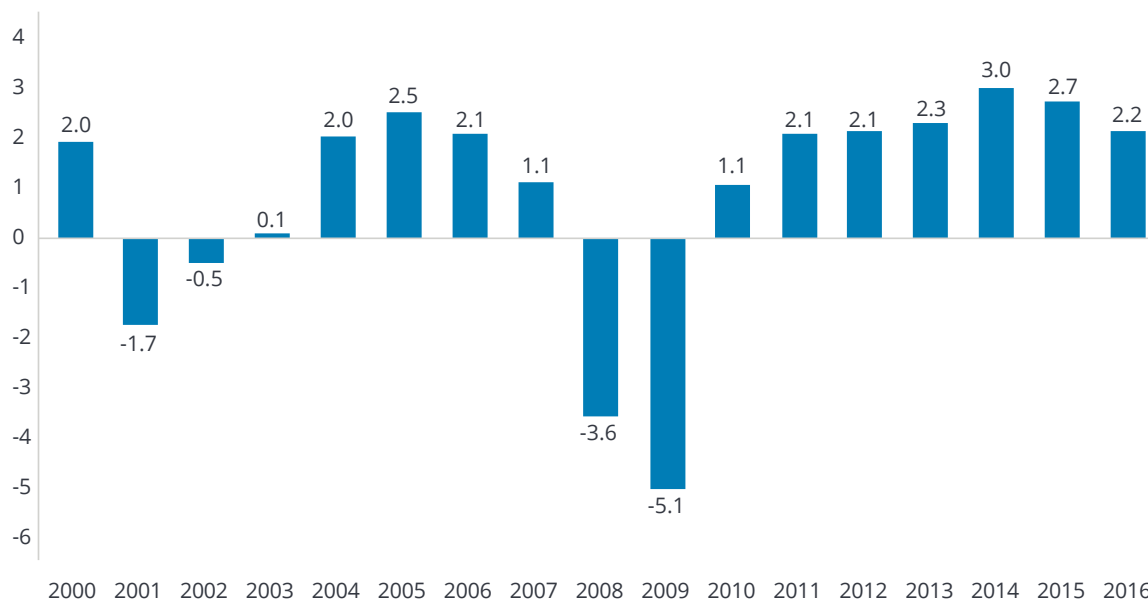
While the formulation and timing remain uncertain, as noted above, some version of the following changes are likely to be debated this year and possibly enacted:

- **Corporate and personal income tax reform**—While the top rates for both types of taxes will likely be lowered, the details will determine what the final impact on individual tax bills will be. The details will also ultimately

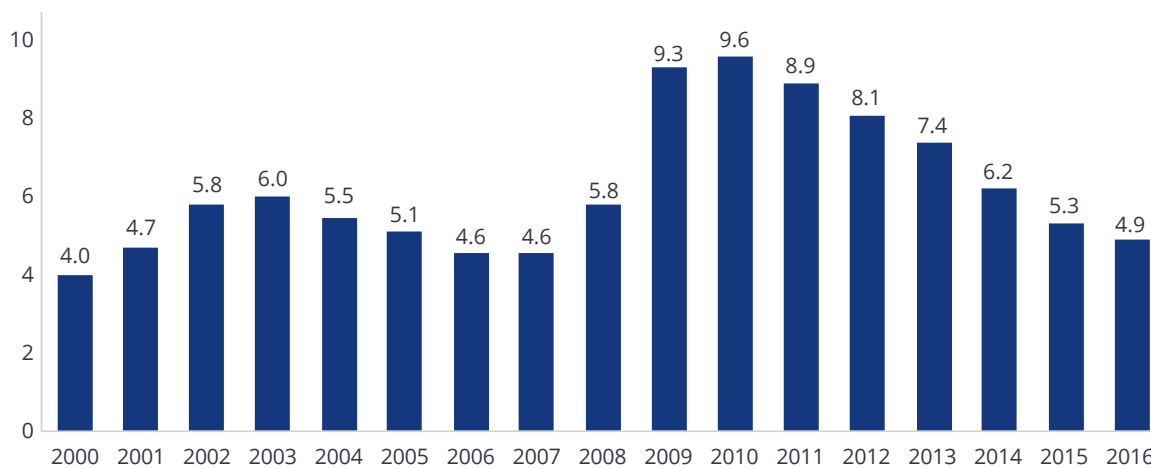
determine how stimulative to the economy and costly to the Treasury the actual plan will be.

- **A federal infrastructure spending program**—An increase in federal spending should spur economic growth over what it otherwise would have been.
- **Review of existing trade deals and a move toward bilateral enforcement**—The United States currently has free-trade agreements (FTAs) with 20 countries, the first of which was with Israel (in 1985) and the most recent with Colombia and Korea (both in 2012). The North American Free Trade Agreement (NAFTA), with the United States' largest trading partners, Canada and Mexico, was signed into law in 1994.<sup>2</sup> In 2015 (the last full year available), the United States had a trade deficit of \$500 billion, comprising a \$763 billion deficit in goods trade partially offset by a \$262 billion surplus in services trade. Any action by the United States to withdraw from or fail to abide by the terms of an existing FTA could invite counter-measures, putting at risk some portion of the over \$2 trillion in goods and services that the United States exports annually.<sup>3</sup>
- **Increased immigration enforcement and stronger border controls**—Any policies that ex-President Barack Obama put in place, such as the 2012 directive that the US Citizenship and Immigration Services accept and process “requests for consideration of deferred action, which could enable people who arrived in this country as children to receive employment authorization for two years,” can—and most likely will—be rescinded.<sup>4</sup> It is unclear what other steps to increase enforcement Trump plans to take, but he remains committed to building a wall on the US-Mexican border, with the Mexican government eventually covering the cost. According to the Pew Research Center, the number of unauthorized immigrants in the workforce has been stable at around 8 million since 2009.<sup>5</sup>
- **Repeal and replacement of Obamacare**—Popular provisions of the 2010 Affordable Care Act (Obamacare), such as the ability to keep



**Figure 1. Change in employment (in millions)**

Source: Bureau of Labor Statistics.

Deloitte University Press | [dupress.deloitte.com](http://dupress.deloitte.com)**Figure 2. Unemployment rate**

Source: Bureau of Labor Statistics.

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**Figure 3. Five-year forward inflation expectation rate**



Source: Federal Reserve Board.

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Any action by the United States to withdraw from or fail to abide by the terms of an existing FTA could invite counter-measures, putting at risk some portion of the over \$2 trillion in goods and services that the United States exports annually.



young adults on a parent's health insurance plan until age 26 and guarantee of coverage for pre-existing conditions, will most likely remain in whatever new health insurance law is enacted.

- **Regulatory reform across agencies**—One of the first actions in this area will likely involve substantial changes to the 2010 Dodd-Frank Wall Street Reform and the Consumer Protection Act.

Following the election, the major US stock indices reached new heights on expectations of at least some of these actions actually being taken. But with the economy nearing full employment, there is also an increasing awareness that some of these actions, particularly the stimulating impact of tax decreases and infrastructure spending, along with new trade restrictions, may drive up prices. Indeed, in the three weeks following the election, the five-year inflation expectation rate rose sharply, reaching 2.0 percent for the first time since August 2015 (figure 3). Should actual inflation start accelerating

at a rate that alarms the FOMC, interest rates would increase faster and possibly in larger increments than would otherwise be the case. This would negate some of the stimulus impact of lower taxes and increased government spending.

One of the biggest unknowns is how the new administration and Congress will choose to pay for the tax cuts and infrastructure spending. Federal deficits will be significantly larger if Congress passes large tax cuts and infrastructure spending bills without taking steps to curtail spending. Even without these changes, the budget deficit was on track to rise because of projected rises in Social Security and Medicare spending, reflecting an aging population. Trump suggested during the campaign that he would not change Social Security and Medicare, although some of his advisors as well as the speaker of the house, Paul Ryan, are advocates of privatization. Although the new administration may cut other entitlement programs such as medical care for the poor (Medicaid), changing the long-run path of the budget without reforming Social Security and Medicare will be difficult.

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## Endnotes

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## Political risks will test a resilient recovery

By Alexander Börsch

### Introduction

Politically, 2016 was a bumpy year for the Eurozone. New political risks materialized, ranging from the unexpected decision of the United Kingdom to leave the European Union to the defeat of the Italian government in a constitutional referendum. Nevertheless and quite surprisingly, the Eurozone economy showed remarkable resilience and continued its recovery, relatively unaffected by political turbulence within and outside the European Union. Although growth rates are still moderate, the recovery has been solid and is about to enter its fourth year.

### 2016: Not a bad year in economic terms

Unlike within the political sphere, the last year brought some good economic news for the Eurozone:

- Real GDP finally surpassed its precrisis level, and all Eurozone countries, except Greece, grew in 2016.

- The output gap—the difference between potential and actual GDP—is narrowing, even if the speed is slow.
- Labor markets are recovering, and job creation is progressing at a solid pace.

Last year saw two developments on the labor market that are shaping the recovery. First, the unemployment rate dropped from 10.5 percent (November 2015) to 9.8 percent (November 2016). This is the lowest value since mid-2009. To be sure, there are huge differences between member states—unemployment in the Czech Republic stands at 3.7 percent, while it is 23.0 percent in Greece—but the general trend is clearly positive.<sup>1</sup>

Second, employment and employment rates are increasing. Employment has grown without interruption since mid-2013, and employment growth in 2016 was, at 1.4 percent, the highest since 2008.<sup>2</sup> The employment rate in the Eurozone is now close to 66 percent, almost reaching its all-time high from 2008. Coupled with increases in real disposable income, this has led to purchasing power gains.





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Quite surprisingly, the Eurozone economy showed remarkable resilience and continued its recovery, relatively unaffected by political turbulence within and outside the European Union.

As a consequence, private consumption has been the main driver of the recovery in 2016. While the contribution of net exports (exports minus imports) was moderate, investments contributed in a minor way. As in the last four years, corporate investments developed more weakly than forecasted in the beginning of the year, hindering higher growth rates.

Nevertheless, the Eurozone's economy grew at 1.7 percent in 2017, slightly more than the rate in the United States and higher than its (long-term) potential growth rate of 1.1 percent.<sup>3</sup> What is remarkable is that the Eurozone economy stayed on track despite the Brexit shock, the political crisis in Italy, and concerns about the stability of the European banking system.

## The baseline for 2017

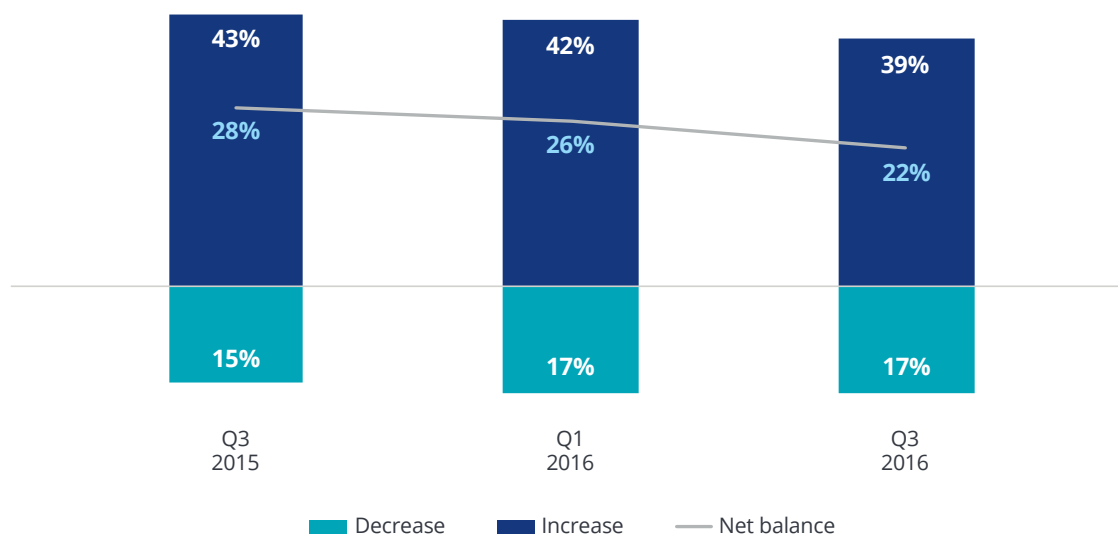
Looking at the economic fundamentals, the Eurozone economy is likely to keep its current momentum. The positive development in the labor market

is likely to continue, with private consumption likely to remain the key growth driver. Even if higher inflation is to be expected, mainly due to rises in energy prices, the labor market dynamics should compensate for that. Higher consumption will lead to higher imports, so the net effect of foreign trade is not likely to contribute much to growth.

Monetary policy, given its current highly expansive character, is unlikely to be eased further; there are concerns that it has reached its limits. Fiscal policy, on the other hand, will be only moderately expansive, given the still-high debt levels in the Eurozone.

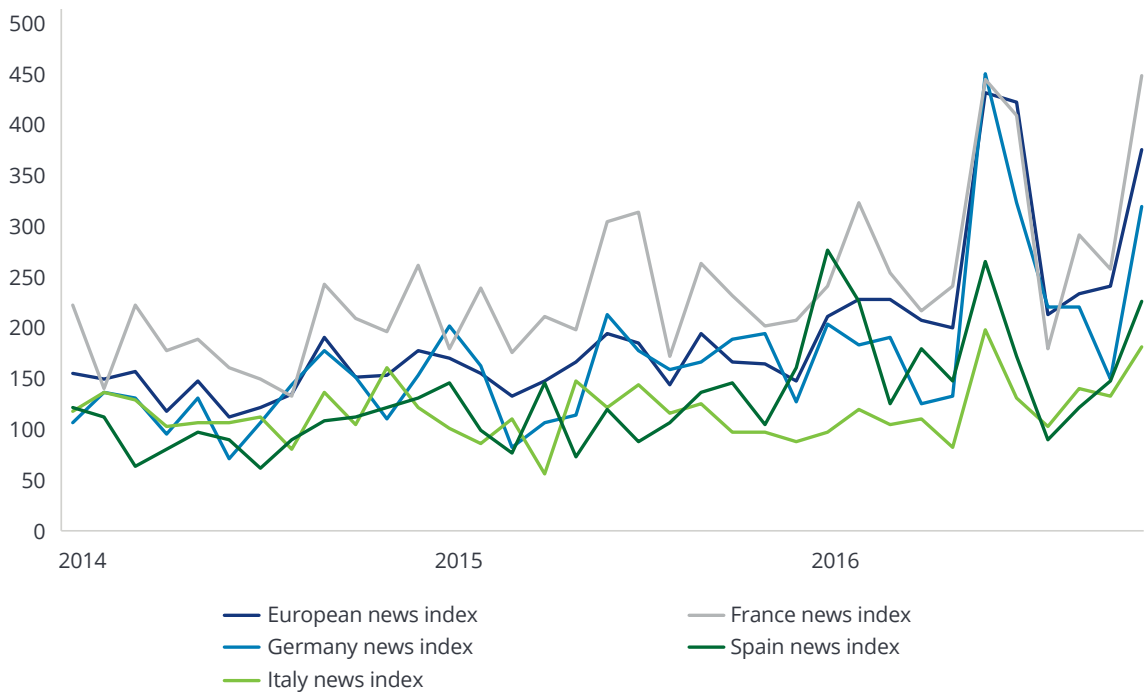
For years, the Eurozone has been waiting for corporate investment to accelerate. Hopes at the beginning of each year have been disappointed year after year. Despite extremely favorable financing conditions, the highest capacity utilization since 2008, and strong corporate sentiment, investments underperformed expectations in 2016 as well. According to the investment intentions of European CFOs, acceleration is not expected in 2017 either (figure 1).

**Figure 1. Investment propensity of European corporates over the next 12 months**



Source: Deloitte European CFO Survey, November 2016.

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**Figure 2. Economic Policy Uncertainty Index**

Source: Scott R. Baker, Nicholas Bloom, and Steven J. Davis, "Measuring economic policy uncertainty," [www.policyuncertainty.com](http://www.policyuncertainty.com), accessed January 16, 2017.

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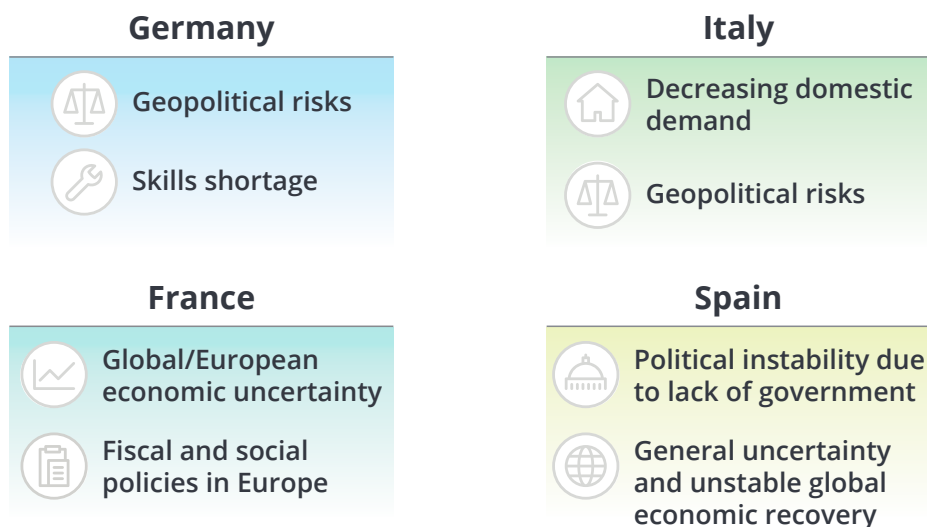
One of the key reasons for the continuing investment restraint is political risks and uncertainties. The economic resilience in 2016 does not mean that the political shocks had no effect at all. Uncertainty in the Eurozone reached new heights. The Economic Policy Uncertainty Index, a news-based measure of uncertainty, exploded after the Brexit and Italian constitutional referenda (figure 2), and climbed to a much higher level in 2016 than in previous years, which saw events such as the Greek debt crisis, the

Ukraine crisis, and concerns about a hard landing of the Chinese economy.

Uncertainty will continue to shape the cyclical outlook for 2017, as political events and associated risks could easily interfere with economic fundamentals. This is visible in the risk agenda of European corporates (figure 3). European CFOs worry mostly about current political trends and the implications for their business. Geopolitical risks top the risk agenda of CFOs in many European countries.

For years, the Eurozone has been waiting for corporate investment to accelerate. Hopes at the beginning of each year have been disappointed year after year.

Figure 3. Key business risks over the next 12 months



Source: Deloitte European CFO Survey, November 2016.

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## Downside risks

Political risks dominate the risk agenda for three reasons. First, there are elections in the Netherlands, France, and Germany: countries that represent close to 60 percent of the Eurozone economy. After the demise of the Italian government, snap elections in Italy are also possible. The recent strength of anti-EU parties in many parts of Europe will turn these elections into a crucial test for the future course of the Eurozone. The risk of fragmentation of the Eurozone and the European Union would rise substantially with successes of anti-EU parties.

Another major political risk is Brexit. While the immediate economic and financial market reactions were milder than anticipated, Brexit is a process and not a one-time event. In the last few months, hopes for a soft Brexit—that is, a continuing close relationship between the United Kingdom and the

European Union along the lines of the EU-Norway relationship—have largely disappeared. A hard Brexit seems now much more likely; even an uncontrolled Brexit, if there is no agreement, is conceivable. Once the negotiations start, the Brexit scenarios and the disruptive potential of the more extreme options will add to uncertainty on political, economic, and financial market levels.

A third uncertainty is closely related to the rise of anti-globalization and anti-EU parties in Europe and movements in Europe itself and elsewhere. As a highly export-oriented economy, the Eurozone benefitted substantially from the liberalization of world trade in the post-war era as well as from the removal of trade restrictions within the European Union through the internal market. The rhetoric of deglobalization and higher protectionism within Europe and outside of it therefore directly challenges the Eurozone's growth prospects and is a fundamental risk to its future.



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## Geopolitical risks top the risk agenda of CFOs in many European countries.

### Upside risks

While the downside risks to the economic outlook seem to be numerous and are firmly in the center of public attention, there is also a flip side. If the downside political risks fail to materialize, there is likely to be strong impetus to the ongoing recovery. For example, if European populist parties lose momentum in the upcoming elections and have no or minimal electoral successes, political uncertainty for business would be significantly reduced. Given the current high capacity utilization in combination

with favorable financing conditions, this could be a signal for an acceleration of corporate investments, stabilizing and strengthening the recovery.

In this way, politics will drive economics and financial markets to an unusually high degree in 2017, and key political events will likely result in considerable volatility of economic and financial market expectations. Whether the recovery can keep its resilience and continue to develop irrespective of political uncertainties is therefore the crucial question in 2017.

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### Endnotes

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## New US policies could hurt exports

By Ira Kalish

### The state of the economy

In December, China's exports, measured in US dollars, declined 6.1 percent from a year earlier. For all of 2016, exports were down 7.7 percent, the second consecutive year of decline and the steepest decline since the global financial crisis of 2009. Exports to the United States and South Korea were strong, up 5.5 and 8.3 percent respectively, but exports to other locations fared poorly. Exports to the European Union were down 4.7 percent, and those to Japan were down 5.5 percent. The overall weakness in exports reflected several factors: the negative impact of an overvalued currency, the negative impact of rising Chinese labor costs relative to other countries, and relatively weak global demand.

Going forward, many observers are pessimistic about the prospects for Chinese exports. This partly

reflects concerns that the new US administration will implement protectionist policies that could hurt Chinese exports. It is notable that Chinese exports to the United States continue to grow, yet possible policy shifts in the United States put such growth at risk. Meanwhile Chinese imports, measured in US dollars, were up only 3.1 percent in December versus a year earlier. This was a slower rate of growth than many analysts anticipated, and reflected weak domestic demand. In addition, much of what China imports involves inputs that are used to produce exportable goods. Thus export weakness fuels import weakness.

### Avoiding a bubble

It appears that China's effort to stem the rise in house prices is working. In November, house prices

Indeed, much of the frothy behavior of house prices in recent years has been due to excessive speculative activity on the part of Chinese investors.



es in the country's four big coastal cities (Beijing, Shanghai, Guangzhou, and Shenzhen) increased only 0.1 percent from the previous month. This follows many months when prices rose 3.0–4.0 percent per month. In addition, in the first half of December, the volume of residential floor space sold fell 17.0 percent from a year earlier.

Among the measures implemented by many local governments are restrictions on purchases of second homes, requirements for larger down payments, and restrictions on borrowing for the purpose of purchasing land. The government in Beijing recently defended these actions, saying, “Houses are for living in, not for speculating with.”<sup>1</sup>

Indeed, much of the frothy behavior of house prices in recent years has been due to excessive speculative activity on the part of Chinese investors. In the past several years, the government has gone back and forth on this issue, stimulating housing when the economy weakened, and restricting housing when prices threatened a speculative bubble and when debt appeared to grow too fast. We are now in the former phase, and many analysts expect housing market activity to decline in the coming months. Yet, if this leads to a slowdown in the economy, the government could reverse course. On the other hand, some analysts expect that the government will accelerate the pace of infrastructure investment in order to offset a deceleration in housing.

## Currency concerns

The Chinese authorities are concerned about the outflow of capital from China, which is putting downward pressure on the value of the currency. As such, they have instituted some capital controls meant to discourage Chinese companies from acquiring overseas assets. Yet the reality is that bank lending accounts for a much larger share of capital outflows than direct investment. In fact, in the first nine months of 2016, outbound direct foreign investment was \$78 billion, while the outflow from bank lending and securities investment was \$301 billion. A leading economist, Brad Setser, says that “several hundred billion in outflows are simply associated with repayment of existing loans.”<sup>2</sup> Inter-

estingly, foreign bank lending to Chinese nationals has actually decreased in the past two years. Yet the repayment of the massive loans taken prior to that continues to generate substantial outflows of capital. Also, there is no method of capital control that the government could use to stem that outflow. Thus downward pressure on the currency is likely to continue.

This means that the central bank will either continue selling foreign currency reserves in order to stabilize the currency, or it will simply allow the currency to fall in value—something many analysts now expect. Yet there will clearly be a political cost to allowing depreciation. The incoming Donald Trump administration in the United States is already complaining about the value of the renminbi. A cheaper renminbi could lead to further calls for trade restrictions. Moreover, a cheaper renminbi will mean that Chinese companies with dollar-denominated debts will have greater difficulty servicing them.

For many years, when capital inflows into China put upward pressure on the renminbi, the Chinese central bank fought currency appreciation by furiously purchasing foreign currency reserves, many of which were held in the form of US Treasury securities. The question has often arisen as to whether there is a risk that China might wreak havoc with US financial markets by dumping large amounts of US Treasury bonds. The answer is that the Chinese are unlikely to do this, as they would then suffer a capital loss.

Moreover, Chinese holdings, large as they are, do not represent a systemic risk. Even a large sale by the Chinese would not be sufficient to move the market substantially. Indeed, it turns out that China has actually been selling US Treasuries in large amounts. Although it may be wrong to say that they would never do this, it is correct to say that the impact would be muted. For the past three years, capital outflows from China have put downward pressure on the currency. In order to prevent the currency from dropping sharply in value, the central bank has been furiously selling reserves, including its stash of Treasuries. The result is that, today, China is no longer the largest non-US holder of US Treasuries. That status now belongs to Japan,



Market economy status would imply that the prices of Chinese goods are determined by market forces rather than by government fiat. As such, it would make it more difficult for China's trading partners to impose anti-dumping duties on Chinese imports.

which had held that status prior to 2008. Although US bond yields have risen since the election, they were historically low for most of 2016, a period during which China sold Treasuries at a rapid pace. Thus Chinese sales do not appear to have made any difference. For China, the necessity of avoiding a sharp depreciation of the renminbi suggests that such sales are likely to continue. And now that the US Federal Reserve has begun interest rate normalization, the downward pressure on the renminbi is likely to increase.

## Market status

When China joined the World Trade Organization (WTO) 15 years ago, it was not given market economy status because of the heavy involvement of the Chinese government in the economy. However, the United States and the European Union had made a commitment that, eventually, China would be given such status. Market economy status would imply that the prices of Chinese goods are determined by market forces rather than by government fiat. As such, it would make it more difficult for China's trading partners to impose anti-dumping duties

on Chinese imports. Not having achieved this status, China is launching a case at the WTO that such status should now be granted. China's case rests on a clause in its accession agreement with the WTO indicating that there would be an automatic shift to market status no later than 15 years after accession. If the WTO rules in China's favor, the United States and the European Union will have no choice but to comply. So far, however, both have resisted China's demands for market economy status. They have pointed to China's alleged dumping of cheap steel on the global market, fueled by excessive and unprofitable production by state-run companies in China. They claim that a large part of China's economy is not yet characterized by market status.

The incoming Trump administration is expected to take a relatively protectionist stand on trade with China. It is not yet clear, however, what this will mean in terms of official US resistance to China's desire for market economy status. It is possible that the United States and the European Union will seek concessions from China in exchange for granting such status. If, instead, the WTO must rule on China's claim, the process could take up to two years.

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# Continued weakness in yen may boost growth

By Ira Kalish

## Good news on growth

The Japanese economy grew at an annualized rate of 2.2 percent in the third quarter.<sup>1</sup> This was far better than many analysts had expected. The strength of GDP growth was largely due to trade. The growth of exports combined with shrinking imports contributed 1.8 percentage points of the 2.2 percent growth. Export strength is attributed to the revival of the US economy and the stabilization of the Chinese economy. Business investment did not grow at all. It should be noted, however, that the first estimate of Japanese GDP in each quarter is often significantly revised in later months. Thus the latest report ought to be taken with a pinch of salt.

Going forward, the weakness in the value of the Japanese yen should enable further export growth. This will be helped by an acceleration in global economic growth. Stronger export growth might lead businesses to accelerate

the growth of investment. Also, the expected government fiscal stimulus is likely to provide a boost to growth. On the other hand, consumer spending could remain weak, given low wage gains. The lagged effect of a strong yen could also boost imports, thus subtracting from economic growth. Therefore, a reasonable scenario is that economic growth remains modest at best in the coming year.

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## Monetary policy remains hopeful

The Bank of Japan (BOJ) left monetary policy unchanged at its latest meeting, with the benchmark interest rate at -0.1 percent, the 10-year bond yield capped at 0 percent, and the pace of asset purchases (known as quantitative easing) unchanged. Investors expect the BOJ to leave policy unchanged in the months ahead.

Meanwhile, the value of the yen has fallen sharply since the US presidential election. BOJ Governor Haruhiko Kuroda said that the drop in the yen was “not yen weakness, but dollar strength. I don’t think



the level it's at is surprising.”<sup>2</sup> Indeed, the US dollar has strengthened against most major currencies due to market expectations that the new US administration will pursue an expansionary fiscal policy. Whatever the reason, the drop in the yen should help boost Japanese inflation, which remains dormant. The BOJ is optimistic that this will change. It said that “the year-on-year rate of change in the consumer price index is likely to be slightly negative or about 0 percent for the time being. As the output gap improves and medium- to long-term inflation expectations rise, it is expected to increase towards 2 percent.”<sup>3</sup>

The BOJ has been expecting a reversion to higher inflation for the past several years, so its latest expectations might not appear credible to investors. Indeed, during the period when the BOJ kept expecting price rises to accelerate, inflation remained close to zero. Part of the problem is simple demographics. A declining population is exacerbating the problem of excess capacity. On the other hand, the recent rebound in oil prices might raise Japanese inflation, at least temporarily. As for the yen, if the new US administration follows through with fiscal stimulus, it is possible that the dollar will rise more, thus pushing the yen down further. This would help boost Japanese inflation as well as improve the competitiveness of Japan's exports. On the other hand, a more protectionist US policy could damage Japan's massive trade sector and lead to slower growth of exports. That, in turn, could further damage business investment.

One interesting aspect of Japan's monetary policy is that the BOJ is accumulating a very large share

of the government's debt. Currently, the BOJ holds about 37 percent of government debt, a figure that will continue growing as the BOJ purchases debt faster than it is issued by the government. As intended, this will keep bond yields very low. Meanwhile, as bond yields in the United States rise, the gap between the two should contribute to further downward pressure on the value of the yen, which is the BOJ's intention.

## Wages disappoint

One of Prime Minister Shinzo Abe's biggest frustrations is that, despite low unemployment and rising inflation, wages have barely budged. This means that real incomes are actually declining, leading to very weak growth of consumer spending. Abe has been encouraging businesses to accelerate wage gains. In a meeting with business leaders, he said that he expects them to boost wages in 2017 by at least the same rate as in 2016.<sup>4</sup> In the Japanese system, there is a national negotiation each year in which management and unions set wage goals. Businesses are not required to follow suit, but many of the big ones do so. Abe has attempted to influence these negotiations and is doing so again. In the past year, the yen has appreciated, and deflation reared its ugly head. Abe evidently fears that market conditions will hurt prospects for significant wage gains. Yet now that the US dollar is once again rising, and, given the tightening of Japan's job market, he hopes to push wages higher, thus boosting prospects for consumer spending growth.

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Following the US election, it is clear that the TPP is dead. Thus Abe, who had expended some political capital in order to obtain parliamentary approval of the TPP, will now face a substantially changed and more challenging political environment.



## External risks

As discussed in the last edition of this report, the Japanese government implementing structural reforms would offer the best hope for a sustained improvement in the rate of economic growth.<sup>5</sup> This last “arrow” of Abenomics is the most difficult because it is the most politically controversial. Yet Abe had hoped that implementation of the Trans-Pacific Partnership (TPP), a free-trade agreement between Japan, the United States, and 10 other Pacific Rim nations, would provide him with the political cover necessary to obtain structural reforms.<sup>6</sup> The TPP would have required Japan to do many of the tough things that would open markets and encourage greater productivity. However, following the US election, it is clear that the TPP is

dead. Thus Abe, who had expended some political capital in order to obtain parliamentary approval of the TPP, will now face a substantially changed and more challenging political environment. Moreover, with an increasing likelihood of a trade conflict between the United States and China, Japan stands to suffer collateral damage. Japan’s manufacturers play a critical role in China’s manufacturing supply chain, contributing high-tech inputs to products that are assembled in China for export to the United States and elsewhere. A decline in Chinese trade with the United States would, therefore, be detrimental for Japan. Thus it is no surprise that Abe was the first foreign leader to meet in person with Donald Trump following the election. He likely made the case that changes in the trading regime should be undertaken with care.

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## The pains and gains of demonetization

By Rumki Majumdar

### Introduction

It might sound deceptive if one were to begin a report on India's outlook by quoting the latest quarterly GDP growth. India grew at 7.3 percent year over year in Q2 FY 2016–17 and is among the fastest-growing economies of the world,<sup>1</sup> and economic fundamentals are still very strong. However, recent events, specifically in the last quarter, have reshaped expectations and raised concerns about India's future growth. International organizations such as Asian Development Bank as well as a few credit rating agencies and broking houses now expect growth to be slower than previously estimated by 30–350 basis points.<sup>2</sup>

Very rarely is an economy that grew at 7.2 percent in the first half of the fiscal year, and that still maintains strong economic fundamentals, expected to retreat from a robust growth path.<sup>3</sup> The reason behind this setback in growth expectations is the government's decision to demonetize over 85 percent of the currency in circulation overnight in order to curb the flow of unaccounted income, stop the flow of counterfeit currency (which is understood to fund illegal activities), push the economy toward a cashless digital system, and bring the unorganized and unbanked sector under the ambit of the formal economy. This government's program is, in all like-

lihood, going to create a big ripple in the economy, where a significant proportion of transactions is conducted in cash, and over half of the population didn't even have bank accounts before the demonetization move.<sup>4</sup> The question that worries investors is how deep and long will this ripple be.

In addition, global uncertainties have increased with Donald Trump's win in the US election; the continued slowdown of the Chinese economy and the resulting financial turmoil; the steady rise in oil prices due to the Organization of Petroleum Exporting Countries' (OPEC's) decision to cut oil production volumes; and the fallout of Italy's referendum to amend constitutional reforms (within a few months after Brexit), followed by the Italian government's decision to recapitalize its oldest and most troubled bank. These events are likely to have significant long-term implications for India's economic activity, trade, and its relations—affecting its overall path to prosperity.

At the time of writing this article, very few data were available to objectively assess the impact of demonetization on businesses and growth. The limited available data suggest that there are significant downside risks to economic activity in the second half of this fiscal year (FY 2016–17). However, the disruption to economic activity is expected to be



Very rarely is an economy that grew at 7.2 percent in the first half of the fiscal year, and that still maintains strong economic fundamentals, expected to retreat from a robust growth path.

temporary, as this demonetization initiative is not expected to destroy demand permanently but merely postpone it by a few months. As this article shows, economic activity is likely to bounce back, and growth may accelerate in FY 2017–18 on the back of strong fundamentals still in place, implementation of reforms, easing monetary policy and credit conditions, and infrastructure spending. More importantly, in the long run, India may benefit immensely from the increased digitalization of the economy and expansion of the formal banking sector.

## Demonetization might disrupt economy in the short term

The unfolding effects of the withdrawal of the two highest-denomination bank notes (500 and 1,000 Indian rupees) since November 8, 2016, are not yet clear. However, there are two immediate channels through which demonetization may impact economic activity: the negative wealth effect shock and the liquidity squeeze. The negative wealth effect shock could happen if not all the old demonetized currency gets back to the system, affecting purchasing power in the long run and destroying demand permanently. The liquidity squeeze will likely be the result of a fall in the currency in circulation and the limited credit availability because of withdrawal limits, again restricting purchasing ability temporarily, which will be the case until credit constraints are removed.

The most obvious impact of these two would likely be on consumption, which has been the strongest pillar of growth, as households feel the cash crunch. At the same time, the possibility of any revival in long-term investment also plummets in the near

term as businesses grapple with managing their supply chains while the economy remonetizes. This does not bode well for an economy whose growth has continued to remain lopsided, with consumption (both private and government) doing most of the heavy lifting. As per the latest data, investment growth continued to contract for the third quarter in a row.<sup>5</sup>

Contrary to expectations, the potential impact of the wealth effect shock has progressively declined, as 93 percent of the old notes have been deposited by the end of December 2016. (It is worth noting that, due to lack of data, it might be difficult to assess how much of the cash returned to the banks can be spent without scrutiny.) In other words, concerns over the negative effect of the unreturned money on demand in the long run have been mitigated. Consumers will likely come back with pent-up demand once currency circulation normalizes.

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Nevertheless, the impact of a liquidity squeeze has been widespread. To add perspective, the effective currency in circulation in the economy fell to 5.2 percent of GDP (as on December 23, 2016) from 11.3 percent of GDP before the demonetization (November 8, 2016).<sup>6</sup> This squeeze in liquidity has left businesses, especially small and medium-scale enterprises, scrambling for cash to run their day-to-day operations, while lower workplace activity has impacted jobs. Unskilled and daily wage laborers have been

the most affected as their employers fail to make payments on a daily basis.

According to a primary survey conducted by the State Bank of India (SBI) between December 30, 2016, and January 3, 2017, 69 percent of the respondents affirmed that their business was impact-



ed because of the limited availability of cash; the construction sector and informal roadside vendors were among the worst affected.<sup>7</sup> The performance management index (PMI) data released early in January reaffirmed that the cash crunch took a toll on the manufacturing sector, as it contracted sharply in the months post demonetization.<sup>8</sup> Output and new orders fell in December for the first time in 2016, and companies reduced their purchases and payroll numbers substantially. At the same time, rising input costs (owing to supply chain disruptions and increasing oil prices) reduced profit margins for producers, as they failed to pass on the cost inflation to output charges, which rose at the slowest pace since August 2016.

Demonetization has also impacted consumer demand, as demonstrated by falling sales in the auto industry post demonetization. Both passenger car as well as two-wheeler segment sales reported the highest year-over-year decline since the Society of Indian Automobile Manufacturers (SIAM) started recording the data in 1997.<sup>9</sup> As expected, house sales and new home launches took a substantial hit in the October–December quarter in eight major cities.

On the positive side, falling demand has resulted in declining prices across the board, indicating that the consumer price index may fall short of the Reserve Bank of India's (RBI's) 5.0 percent inflation target in March 2017. In addition, it is expected that some of the deposits in the form of old currency might attract tax and penalties and increase government revenues, thereby improving the fiscal balance.

## An opportunity to transform India in the medium to long term

Undoubtedly, demonetization is likely to impact economic activity adversely, at least in the short term (two or three quarters), assuming the economy quickly remonetizes within the next couple of months.<sup>10</sup> However, India can benefit substantially in the medium to long term if it optimally uses the opportunities this initiative may provide. At present, it might be hard to assess the implications, given the difficulty in evaluating costs and benefits associ-

ated with this move. However, expanding the formal economic grid and building a digital and cashless economy can go a long way in redefining India's path to prosperity.

It is expected that rising deposits will increase liquidity in the banking system in the near term. This will likely help banks correct their balance sheets and increase their willingness to pass on the benefits of policy rate cuts to consumers by lowering lending rates. Again, suppressed demand and the liquidity squeeze might bring down inflation expectations, giving the RBI further room to cut policy rates. With concerns over the negative wealth effect shock waning and the increasing possibility of further monetary policy easing, demonetization may not destroy demand permanently but merely postpone it for a few months. In other words, once the liquidity issue is resolved, demand and production will surge back, compensating for the lost momentum.

In the long term, demonetization may encourage the economy to gradually move away from cash-based transactions to an electronic payment-based system. According to the SBI survey mentioned earlier, 15 percent of cash-based transactions (worth 250 billion rupees) have moved to digital transactions in the past two months.<sup>11</sup> This may also accelerate the government's initiative of financial inclusion by bringing more of the population into the formal financial net. With proper policies and a targeted approach, several small and marginal traders, merchants, and grocery shops could be brought into the formal economy through digital platforms.

The corporate sector may benefit in the long run as well. The financial (especially banks) and telecom sectors have immense potential to grow and innovate as more people (especially from rural India) come into the formal financial system. Rising digitalization may provide the information technology (IT) and IT enabling services (ITES) industries greater opportunity to develop software that enables digital transactions and to expand services for the masses.

Sectors that are highly dependent on cash transactions, such as manufacturing and construction, will likely be hit. The manufacturing sector has been

## SECTORS THAT WILL BE AFFECTED BY MONETIZATION

### Positively

- E-commerce
- Banking industries
- Financial technology
- ITES

### Negatively

- Agriculture
- Luxury goods (SUVs, gems, jewelry, etc.)
- Real estate
- Commodities
- Traditional retail (roadside vendors, cab drivers, etc.)

struggling to grow at a steady pace on and off since 2011. With demonetization and the ensuing cash crunch, this sector's revival might be pushed further away. However, manufacturing and mining are also the sectors where the majority of businesses do not fall under the formal economic grid. Forcing these businesses to operate in the formal economy is surely desirable, even though it might imply that these sectors may have to go through a prolonged and painful transition, as unviable units close and low-skilled and daily wage jobs are lost.

There might be some corrections in real estate prices, too, which is already evident in some of the big cities. However, real estate prices were due for correction for some time now, particularly in the repurchase market; a correction in prices will likely have a disinflationary impact and make homes affordable for taxpayers.

## Global uncertainties pose risks

Beyond demonetization, a few global events are likely to have a significant impact on India's economy in the coming quarters: the outcome of the US

election, rising global oil prices, and the heightened global uncertainty resulting from China's slowdown and geopolitical and financial tensions in Europe.

Donald Trump's win in the US presidential elections is of great significance due to possible policy changes on a number of fronts, and it has the potential to impact the global economy considerably. Expectations that the new administration might increase government spending (through infrastructure outlay) have resulted in considerable optimism in the US equity and bond markets. However, the US president has also hinted at the possibility of stricter US trade policies, where he has the authority to act independently. A stricter trade regime may impact India's exports to the United States, as well as cross-border capital movement. That said, these are all speculations, and it will take a few months to get clarity about Trump's policy direction.

In November, OPEC struck a long-sought agreement to reduce production by 1.2 million barrels a day.<sup>12</sup> If the member countries stick to this agreement, which they have been doing so far, a cap on production will likely reduce the supply glut that has depressed oil prices for over two years. Gradually rising oil prices are likely to impact the trade deficit of India, which is a net importer of crude oil.

The impact of the Brexit issue has been muted so far, as expected. However, Euroscepticism is on the rise, which is evident from the fallout of Italy's referendum and the increasing criticism of strict austerity policies imposed by the European Union throughout large parts of the continent. Many European nations are witnessing the rising influence of nationalist and far-right parties as well as anti-globalization sentiments. In addition, the Italian government's bailout of the country's banks and the financial trouble within China have unnerved global investors. Consequently, emerging economies are witnessing strong capital outflows, while the US dollar has appreciated substantially in the past few months.

India, too, has witnessed a strong portfolio investment outflow since October, while foreign direct investment inflows have softened. That said, India's good relations with Trump in the past, a stronger

dollar, and strong demand for software developers and professional services in the United States will likely help India's IT and ITES industries grow at a sustainable pace.

Overall, as events unfold, several forces will continue to reshape growth expectations in the coming months. The impact of demonetization is likely to be more transient than what the market anticipates, with substantial potential benefits in the long run. However, these depend on the government's next

attempts to contain the pain and tap into potential gains. Global uncertainties may accelerate capital outflows. However, strong fundamentals and reform implementations, together with easing inflation and monetary policy, will likely keep inflows of direct investments and business sentiments steady. The likelihood of continued appreciation of the US dollar against the Indian rupee will help increase revenues and the competitiveness of India's export-oriented businesses.

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# MEXICO

## Embracing trade as a source of economic growth

By Jesus Leal Trujillo and Daniel Bachman

### Introduction

The Mexican economy has left behind its days of protectionism and industrial substitution to fully embrace trade as a strategy for sustained economic growth. While 2016 was a particularly volatile year for international financial markets and trade, Mexico will continue to bet on commerce as a major driver of economic growth.

Mexico was not always a beacon of free trade. For many years of the past century, Mexico's economic development strategy followed a model that shielded national industries from foreign competition through hefty tariffs on imports. This protectionist strategy coupled with a monopoly on oil production, refinement, and distribution resulted in an economy that was vulnerable to fluctuations in international

commodity prices and overly reliant on a single export good. After several economic crises and repeated currency devaluations, Mexican authorities fundamentally changed their approach to trade.

The signing of the North American Free Trade Agreement (NAFTA) between the United States, Canada, and Mexico in 1994 marked a pivotal moment for the Mexican economy. Since then, Mexico has ratified 11 more free-trade agreements (FTAs) with 46 countries, and it is among the countries with the most FTAs in the world.<sup>1</sup> As a result, exports of goods and services contribute to more than one-third of the GDP, up from just 11.0 percent in 1980 (figure 1).

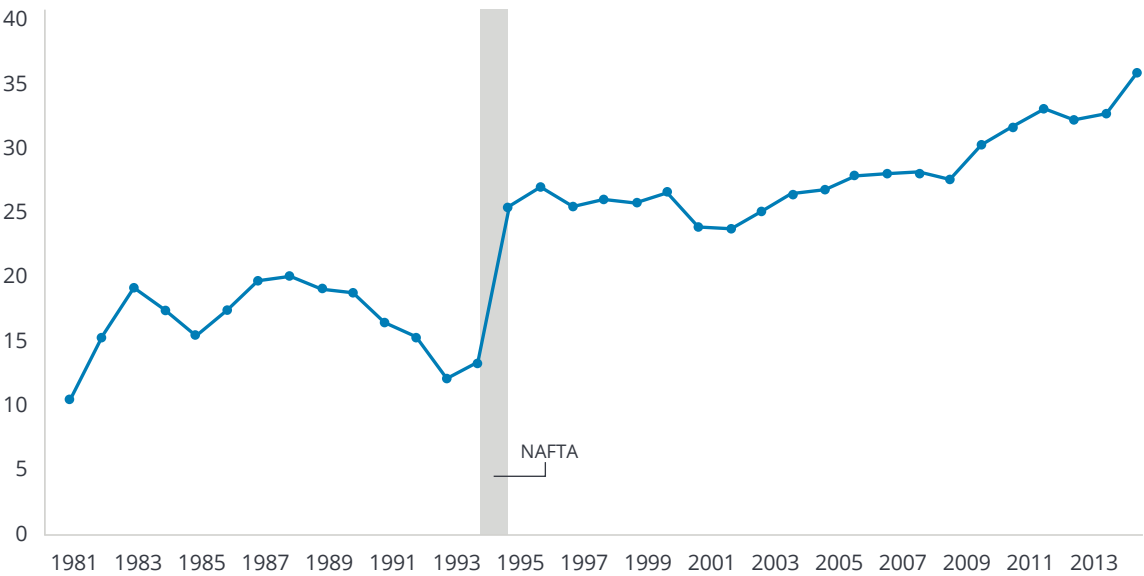
Over the last 20 years, trade has become a critical part of Mexico's growth strategy. It is therefore not surprising that authorities and economic stakehold-

After several economic crises and repeated currency devaluations, Mexican authorities fundamentally changed their approach to trade.



**Figure 1. Exports of goods and services as share of GDP**

Year-over-year total, 1980–2015 (percentage)



Source: World Bank development indicators.

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ers have shown concern over the campaign promise of President Donald Trump to renegotiate NAFTA. Although concrete actions have yet to be announced, press reports suggest that some of the largest automotive manufacturers in the country have already halted or canceled investment projects.<sup>2</sup> However, a drastic alteration in the trade terms of NAFTA can also create major disruptions in the United States, since Mexico is the largest export market for Texas, California, and Arizona, and the second-most important market for another 20 states.<sup>3</sup>

## A healthier approach to trade

The 1970s saw an economic boom in Mexico. This was a consequence of high international oil prices and newly discovered oil production sites, which resulted in unprecedented growth for Mexican exports. Between 1970 and 1985, exports of oil and other petrochemical products registered double-digit compound growth rates.<sup>4</sup> However, the large profits from the export frenzy did not translate into higher productivity in these sectors. By the time oil prices started to fall in the 1980s, the Mexican government was facing enormous pressure due to a rising public deficit, financed largely by international debt, and a falling currency. The drop in oil prices and the poor management of public finances—which from 1973 to 1981 led to the external debt of Mexico's public sector growing at an average annual rate of more than 30 percent—resulted in a

crisis that rocked the foundations of the Mexican economy.<sup>5</sup> Between September 1981 and December 1982, the Mexican peso depreciated 222.0 percent against the US dollar, while the economy contracted 0.5 percent in 1982 and 3.5 percent in 1983.

In response, Mexican policymakers started a series of reforms aimed at liberalizing the economy and opening it up to international trade. In 1986, Mexico joined the General Agreement on Tariffs and Trade, the precursor to the World Trade Organization, and, in 1994, it signed NAFTA. FTAs with Colombia, Nicaragua, the European Union, Japan, and other countries followed. Today, Mexico's FTAs touch over a billion consumers, and Mexican companies have access to a market that makes up about 60 percent of the world's GDP.

The new-found openness of the Mexican economy has resulted in a more diversified basket of goods exported and has contributed to the generation of clusters of industrial activity in higher-value-added industries. For example, in 1989, mineral products and fuel (oil) accounted for 33.8 percent of exports; by 2015, the category accounted for less than 10.0 percent of exports, while machinery and transport equipment represented more than 60.0 percent of exports (figure 2). The diversification of the Mexican economy was positively impacted by trade agreements, particularly NAFTA.<sup>6</sup>

## Mexican and US global value chains

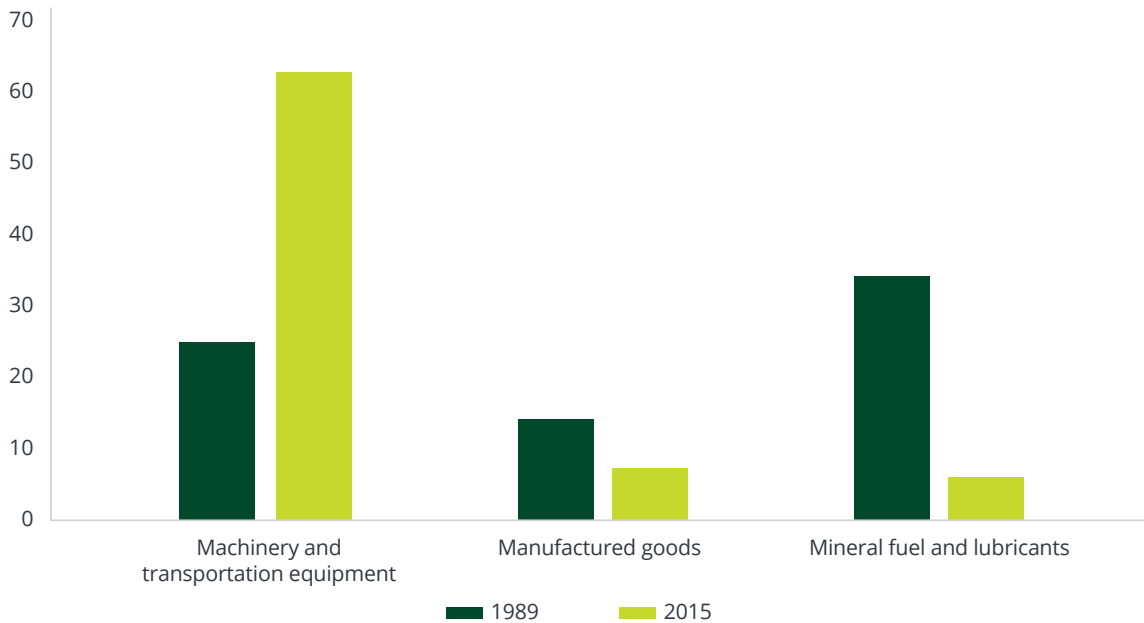
The diversification of Mexican exports was in part driven by an increase in intra-industry trade, where similar firms specialize in different segments of a supply chain and trade inputs used in the creation of a final product. Contemporary trade is no longer a mercantilist zero-sum game but rather a complex set of economic relationships where many of the imports into a country have a significant amount of domestic value added.<sup>7</sup> For example, a car manufactured in North America crosses the border eight times before being shipped as a final product.<sup>8</sup> While trade between Mexico and the United States increased 128.0 percent between 1995 and 2000, trade in shared industries such as miscellaneous manufactured articles grew 145.5 percent, and ma-

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Today, Mexico's FTAs touch over a billion consumers, and Mexican companies have access to a market that makes up about 60 percent of the world's GDP.

**Figure 2. Selected Mexican exports**

Share of total exports for 1989 and 2015 (percentage)



*Note: Products correspond to the Standard International Trade Classification, Rev. 3. For manufactured goods, the category encompasses goods classified chiefly by material. For more information, see United Nations, "SITC Rev.3 detailed structure and explanatory notes," <http://unstats.un.org/unsd/cr/registry/regcst.asp?Cl=14>, accessed January 11, 2017.*

Source: Deloitte analysis of UN COMTRADE data.

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achinery and transport equipment expanded 158.7 percent in the same period. There is strong evidence that NAFTA caused the fast intra-industry trade growth.<sup>9</sup>

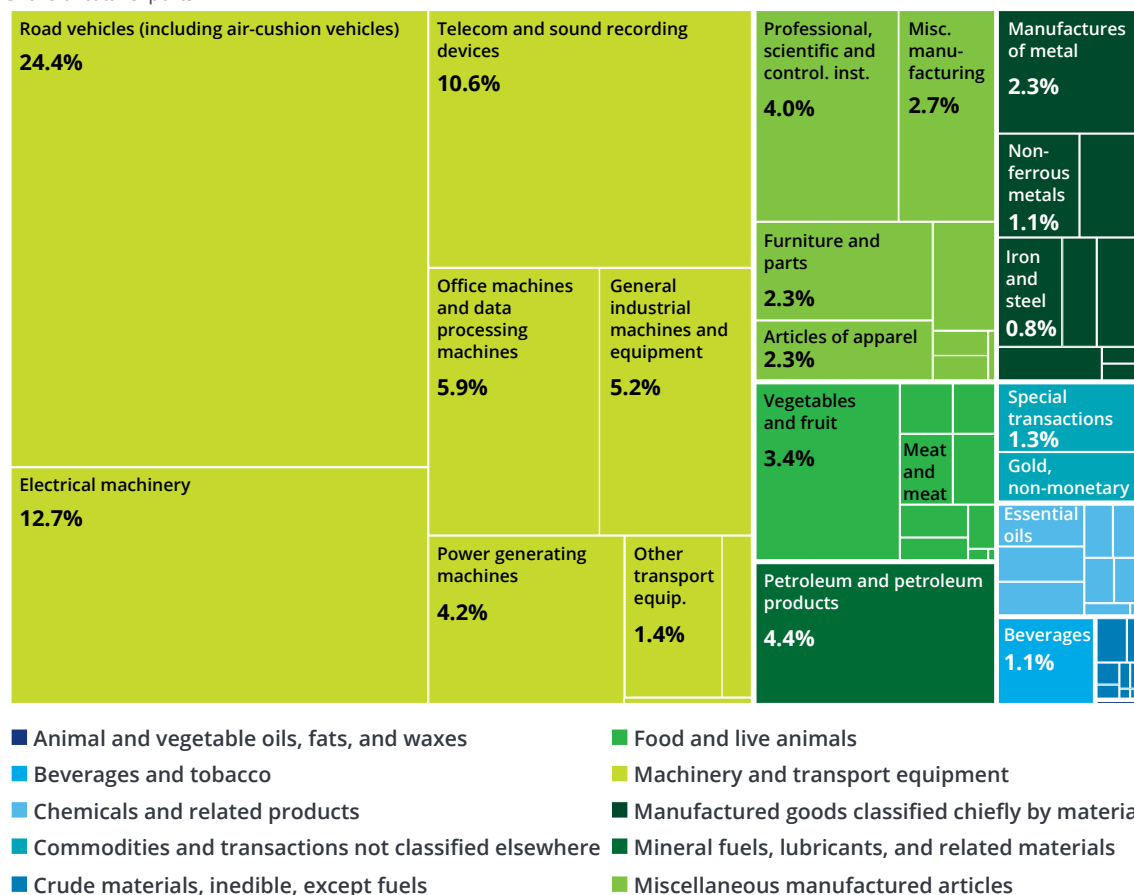
This close economic relationship has resulted in a trade relationship that focuses on similar types of products and industries. For example, machinery and transport equipment is the single largest type of commodity traded between Mexico and the United States, accounting for more than half of Mexican

exports to the United States (figure 3) and 45.8 percent of the exports from the United States to Mexico (figure 4). It is therefore not surprising that out of every 100 dollars that Mexico trades with the United States, 40 dollars are actually American value added.<sup>10</sup> While the automotive industry epitomizes the impressive network of trade between Mexico and the United States, other clusters of industries have also emerged as sources of growth for both nations.

A car manufactured in North America crosses the border eight times before being shipped as a final product.

**Figure 3. Mexican exports to the United States in 2015**

Share of total exports



Source: Center for International Development, Harvard University, "What did Mexico export to the United States in 2014?," *Atlas of Economic Complexity*, [http://atlas.cid.harvard.edu/explore/tree\\_map/export/mex/usa/show/2014/?prod\\_class=sitc4&details\\_treemap=2&disable\\_widgets=false&disable\\_search=false&node\\_size=none&queryActivated=true&highlight=&cat\\_id=&cont\\_id](http://atlas.cid.harvard.edu/explore/tree_map/export/mex/usa/show/2014/?prod_class=sitc4&details_treemap=2&disable_widgets=false&disable_search=false&node_size=none&queryActivated=true&highlight=&cat_id=&cont_id;); UN Comtrade 2015 data; Deloitte analysis.

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While Mexico has done a good job of diversifying the variety of goods it sells abroad, when it comes to services, it is still heavily reliant on tourism as its single largest service export. In 2015, tourism accounted for 77.0 percent of all exports, a higher share than in 2000. In this particular industry, the United States accounts for more than three-quarters of Mexico's travel and tourism exports.

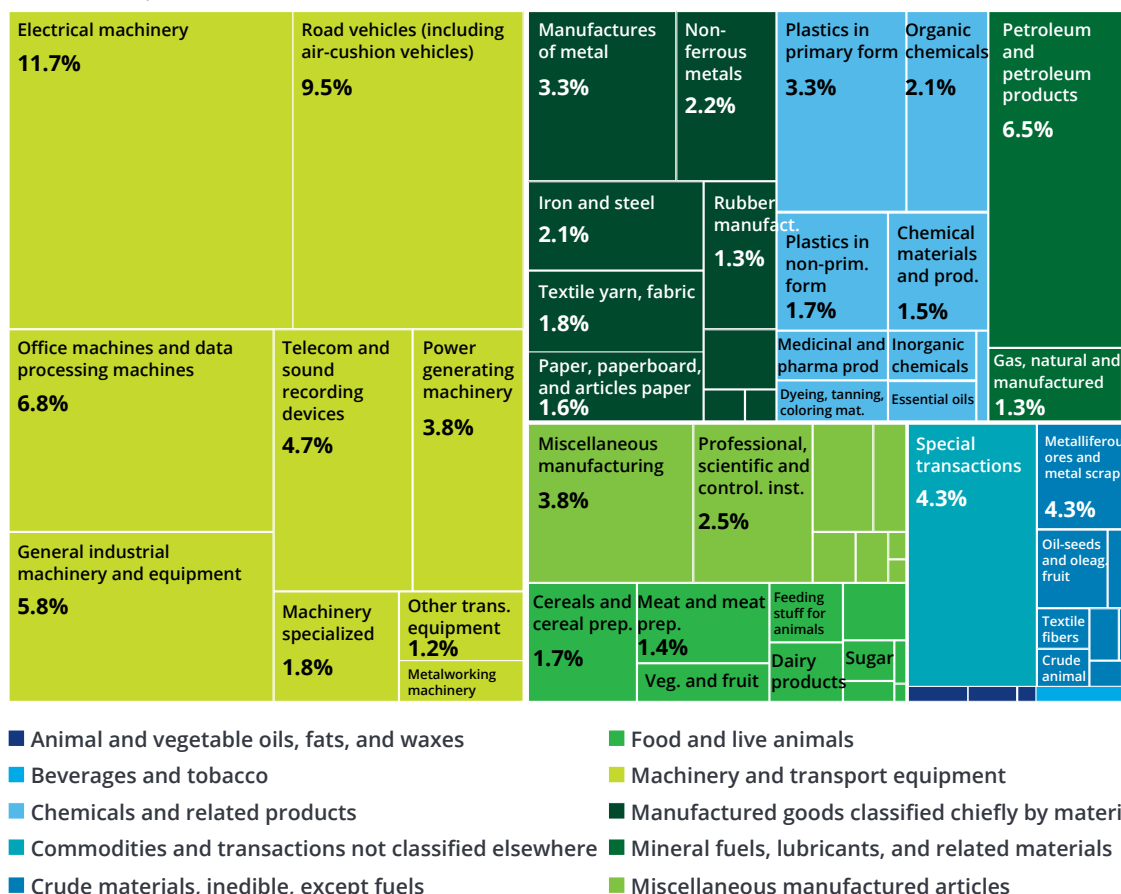
## A bumpy Q1 2017

While trade continues to be one of the brightest spots of the Mexican economy, the weakness of the peso, rising energy prices, and high levels of public expenditure create risks for economic prospects in coming months. The background of low growth—the economy has not grown above 2.5 percent since 2012—makes these risks more problematic.



**Figure 4. US exports to Mexico in 2015**

Share of total exports



Source: Center for International Development, Harvard University, "What did Mexico export to the United States in 2014?," *Atlas of Economic Complexity*, [http://atlas.cid.harvard.edu/explore/tree\\_map/export/mex/usa/show/2014/?prod\\_class=sitc4&details\\_treemap=2&disable\\_widgets=false&disable\\_search=false&node\\_size=none&queryActivated=true&highlight=&cat\\_id=&cont\\_id](http://atlas.cid.harvard.edu/explore/tree_map/export/mex/usa/show/2014/?prod_class=sitc4&details_treemap=2&disable_widgets=false&disable_search=false&node_size=none&queryActivated=true&highlight=&cat_id=&cont_id;); UN Comtrade 2015 data; Deloitte analysis.

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The exchange rate of the peso versus the US dollar reached a new low in December 2016, when the dollar cost \$20.5 pesos, a 20.7 percent depreciation compared with December of the previous year (figure 5). The depreciation of the exchange rate is already producing some inflationary pressure. In November 2016, core inflation reached a two-year high at 3.3 percent, slightly above the 3.0 percent target established by Banxico. The weaker peso has

also affected energy prices, particularly the price of gasoline. During the first weeks of 2017, the government increased gasoline prices between 14.0 and 20.0 percent. The increment was driven by lower oil production and the need to cover a deficit in tax revenue. The rise in prices was accompanied by multiple demonstrations across multiple cities in the country.<sup>11</sup>

**Figure 5. Exchange rate of Mexican peso to US dollar**

Monthly exchange rate (USD)



Source: Banxico/Haver Analytics.

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The protests were in part fueled by major corruption scandals involving the party of the president, the most salient being the fleeing of the former governor of Veracruz, Javier Duarte, under investigation for the embezzlement and mismanagement of dozens of millions of dollars destined for social programs.<sup>12</sup> The former governors of Chihuahua and Quintana Roo are also under investigation for systematic corruption under their administration. It is not surprising that, as result of corruption scandals, the approval rate of President Peña Nieto is below 30.0 percent.

Given the limited tools available to control international economic shocks and the uncertainty regarding the future of NAFTA, the Mexican government will need to concentrate on policies that address the sluggish economic growth, among them ensuring the rule of law and fostering productivity. While fighting corruption may not address long-term economic maladies, it is a necessary step to calming social unrest and restoring a favorable business environment.

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## Trudging on in troubled times

By Akrur Barua

### Introduction

You may be forgiven for envying the Turkish economy. Nestled strategically between the East and the West, between commodity consumers and producers, and armed with rich heritage and natural beauty, Turkey has often drawn upon these benefits to advance steadily in economic stature. However, things did not go well for the country last year. As if strife across its borders and an influx of about 3 million refugees were not enough, a failed coup with its consequent uncertainty, a spat with Russia, and a host of terrorist attacks have weighed further on confidence among businesses, consumers, and tourists.<sup>1</sup> Add to this slow growth in Turkey's key export market, Europe, and a deteriorating current account funded by short-term capital inflows, and one may just believe that the economy is headed for a perfect storm. But are things really so bad for the Turkish economy? While there are dark clouds still hovering above, some of the political uncertainty will likely ease in the coming quarters. Also, with government finances in good shape, the economy will gain in the short to medium term from any fiscal stimulus. However, for long-term gains, policymakers have their task cut out in reforming the economy and injecting greater credibility in institutions, especially the central bank.

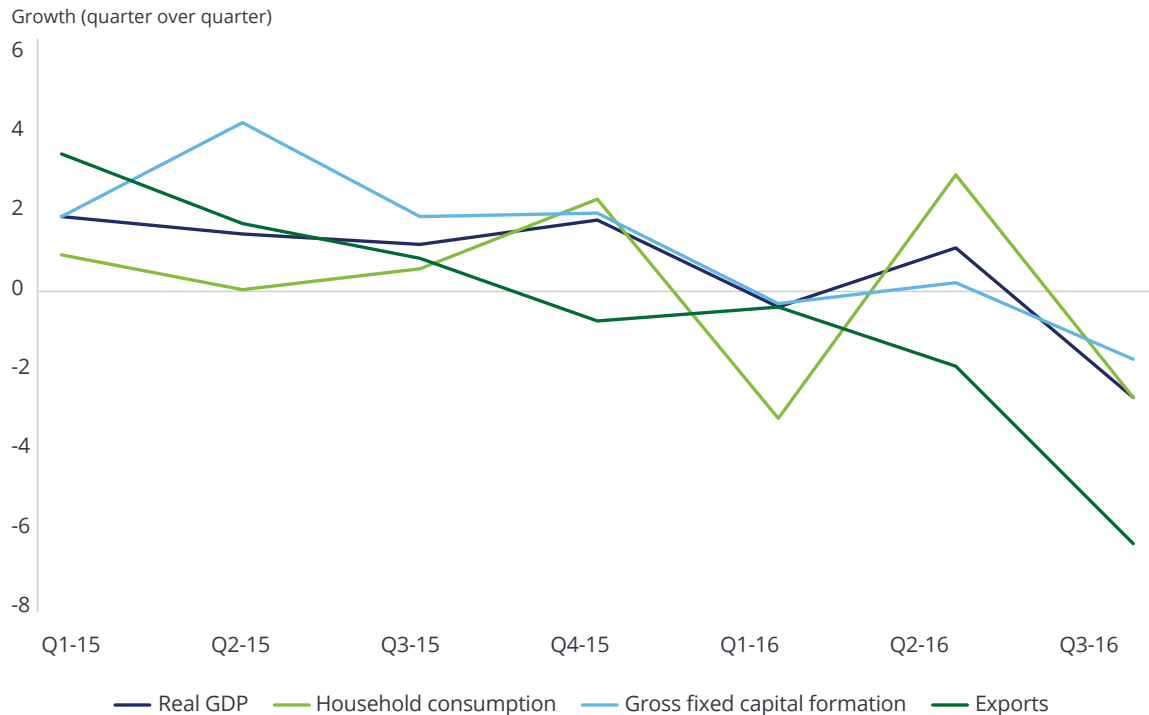
### The economy contracted sharply in Q3 2016

Weighed down by a failed coup in July 2016 and its aftermath, the economy contracted 2.7 percent quarter over quarter in Q3 2016, the sharpest decline since Q1 2009 when the global economy went into a tailspin. Household consumption—a major source of growth for the Turkish economy in recent times—led the decline, contracting 2.6 percent. Ironically, this was the second quarterly contraction in 2016 (figure 1). While the failed coup dented consumer sentiment, a string of job suspensions in the public sector and other services by the authorities investigating complicity in the attempted coup likely impacted household spending in the quarter. Businesses were also affected by the sudden jolt in July, with gross fixed capital formation declining 1.7 percent in Q3 2016, the sharpest decline in about two years. And as Europe continued to lumber along and sanctions by Russia dented food exports, total exports fell 6.3 percent, the most in more than six years. Although the government did its part to counter the slowdown by pushing up spending, it was not enough to prevent a contraction.





**Figure 1. Fall in household spending, investments, and exports dragged down GDP in Q3 2016**



Source: Haver Analytics, Deloitte Services LP economic analysis.

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Although the government did its part to counter the slow-down by pushing up spending, it was not enough to prevent a contraction.

## For consumers, the short-term scenario appears moribund

The fortunes of consumers haven't improved since Q3 2016. Consumer pessimism, in fact, has increased, with the consumer sentiment index measured by the Central Bank of Turkey (CBT) continuing to slip further below 100, the level that separates optimism from pessimism; the number for December was the lowest in more than a year (figure 2).<sup>2</sup> It's no wonder then that retail sales volumes barely increased in November after declining for the previous two months. Households are also dealing with high inflation, which went up in December and has remained above the CBT's target of 5.0 percent for quite some time now.<sup>3</sup> High inflation, in turn, has dented real earnings, despite a sharp rise in minimum wages in early 2016.



Unfortunately, rising inflation and consumer pessimism have come at a time of growing joblessness: Between January and September last year, the unemployment rate went up to 11.3 percent from 10.1 percent. While slowing investment has dented employment, a drop in tourist numbers, owing to Russian sanctions, the failed coup, and rising terror attacks, has added to the misery, especially in the travel and hospitality industry. With total foreign tourist arrivals for 2016 barring December falling 30.9 percent year over year, it was no surprise that employment in accommodation and food services fell in Q2 (-12.7 percent) and Q3 (-11.5 percent) of last year.

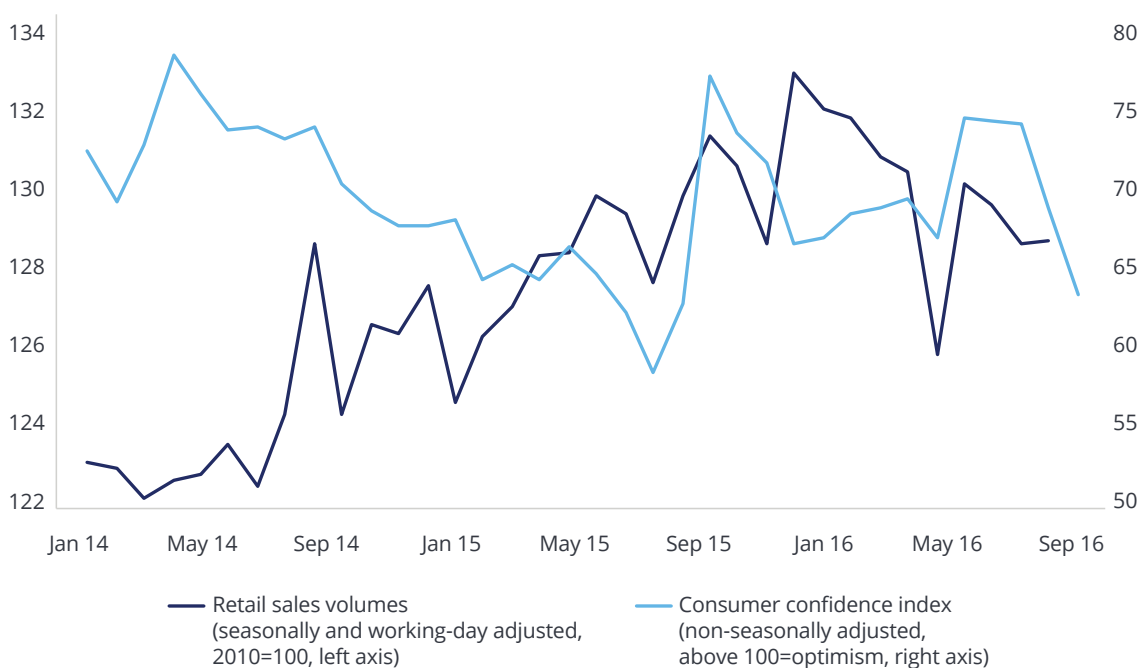
## Businesses have too much to deal with

The scenario for businesses is not pleasant either. Business confidence, for example, is subdued, with sentiment particularly down in retail and construction sectors, according to the components data of the Turkish Statistical Institute's economic con-

fidence index.<sup>4</sup> This is also borne out in data for industrial production, which has been volatile for most of 2016. After contracting in Q2 and Q3 of last year, industrial output revived in October, only to falter again in November. Trends in manufacturing follow a similar trend as wider industrial output. In fact, real gross value added in manufacturing contracted for the first three quarters of 2016, with manufacturing output data until November hinting at a weak Q4 as well (figure 3).

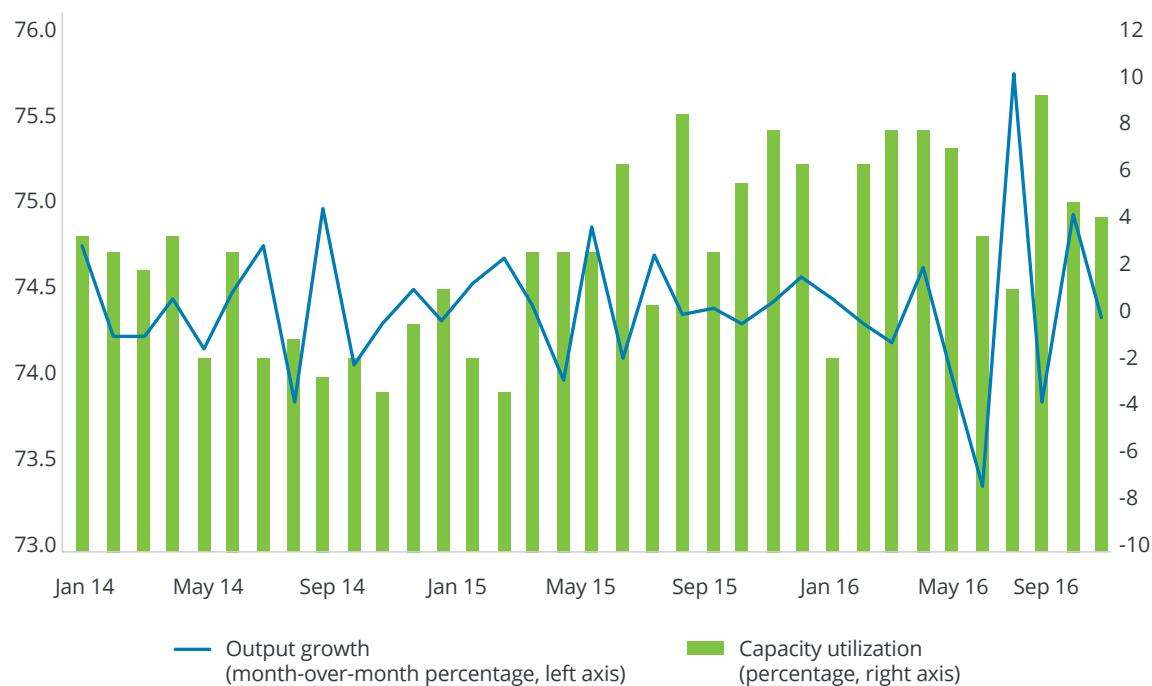
Within key industrial groupings, the only positive is the rise in output of capital goods and durable consumer goods in the first two months of Q4 2016, although, even here, there is an evident decline in pace in November. While businesses have had to deal with slowing domestic household consumption and weak exports, they are also slowly contending with rising prices of inputs, given the global recovery in oil and metal prices last year. From a low of 1.6 percent in September, producer price inflation shot up to 9.9 percent in December of last year, thereby raising the cost of production for businesses in the country.

**Figure 2. Consumer confidence has slipped, as have retail sales volumes**



Source: Haver Analytics, Deloitte Services LP economic analysis.

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**Figure 3. Manufacturing output was weak in 2016**

Source: Haver Analytics, Deloitte Services LP economic analysis.

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## CBT stuck between a rock and a hard place

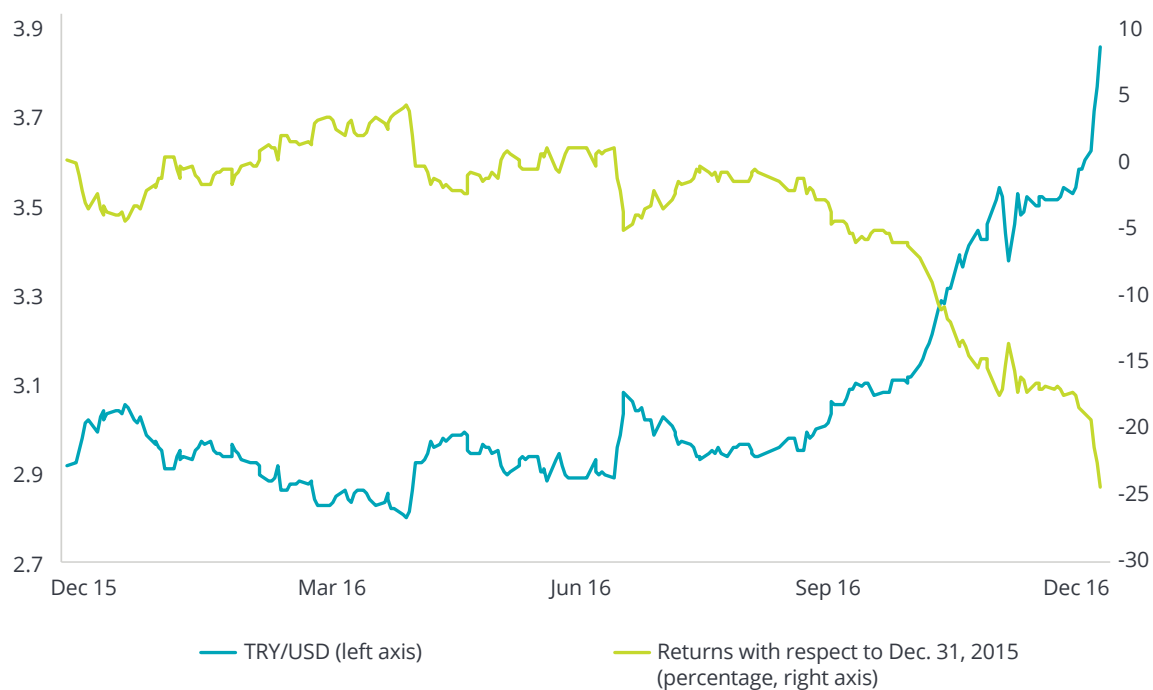
The rise in producer and consumer prices in 2016 will be a worry for the CBT, which has often been under pressure from the government to ease monetary policy irrespective of economic conditions.<sup>5</sup> For the CBT, apart from government pressure, there are opposing forces at work. While slowing economic growth ideally warrants a dose of monetary easing, the CBT's hands appear tied by multiple factors. First, both headline and core inflation have been moving up. While headline inflation shot up to 8.6 percent in December from 7.0 percent in November—much above the CBT's 5.0 percent target and its year-end forecast of 7.5—inflation for all items except energy and unprocessed food went up to 9.1 percent from 8.1 percent during this period.<sup>6</sup> The

surge in energy prices, in particular, is not surprising given the strong increase in global crude prices from the lows of January 2016—the price of Brent, for example, has gone up more than 100 percent since then.

Second, inflation is also facing pressure from a weak Turkish lira. Since December 31, 2015, the lira has lost about 25.0 percent against the US dollar (figure 4), with the dip accelerating since November 2016 as expectations of a faster interest rate hike by the US Federal Reserve in 2017 become stronger and short-term capital makes its way out of emerging markets. The lira's decline is also a result of a deterioration in Turkey's external balances: The current account deficit has been widening, reaching 6.2 percent of GDP in Q2 2016, with estimates by Oxford Economics putting the annual figure at 4.8 percent in 2016, up from 4.5 percent the year before.<sup>7</sup>



**Figure 4. The lira has weakened about 25 percent against the US dollar since the end of 2015**



Source: Haver Analytics, Deloitte Services LP economic analysis.

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After an initial gain following the rate hike, the lira has continued its free fall, including a decline of more than 8 percent in the first two weeks of 2017.



Indeed, the CBT appears to be attempting to dent lira vulnerability and rising inflation by raising interest rates for the first time in three years in November 2016. But given the pressure the government has put on it, it is unlikely that the central bank is going to raise rates by more than 50 basis points this year; in its December 2016 meet, the CBT kept rates on hold. Not surprisingly, the slow progress of expected rate hikes due to pressure from the government, and hence weakening CBT credibility in financial markets, is putting further pressure on the lira. After an initial gain following the rate hike, the lira has continued its free fall, including a decline of more than 8 percent in the first two weeks of 2017.

### The way forward is reforms, not just fiscal stimulus

It is likely that, given subdued consumer and business spending, the government will take over the task of stimulating the economy. Already, the economic plan for 2017–19 includes a swathe of infrastructure-related investments, and the government has announced credit lines to small and medium

enterprises.<sup>8</sup> Encouragingly, the government has a healthy balance sheet to back its stimulus objectives. Central government debt as a share of GDP is low (28.8 percent in Q3 2016), while the average government budget deficit for the first three quarters of 2016 was below 1.0 percent of GDP.<sup>9</sup>

While the push to stimulate the economy is credible, what is lacking is a long-term reform plan to strengthen the country's institutions and increase productivity. For example, the CBT's independence has been much eroded in recent years by the government's pressure to cut interest rates.<sup>10</sup> That does not augur well for healthy macroeconomic policy. Productivity—both labor and total factor—on the other hand, is not likely to rise without investments and innovation. Output per person or labor productivity has actually fallen this year, while potential GDP growth, according to Oxford Economics, is likely to decline between 2015 and 2024 compared with the previous 10-year period.<sup>11</sup> Without tackling productivity, growth will continue to be lower than what an economy with a strategic location and demographic gains would otherwise have achieved.

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# SOUTH AFRICA

## In a tight spot

By Lester Gunion

### Introduction

South Africa's economy continues to be stifled by weak growth on one side and the need for fiscal consolidation on the other. Weak growth links back to tepid external demand, subdued private investment, low business confidence, labor market challenges such as high unemployment and skills shortages, and political uncertainty. While spending on infrastructure and skill development is necessary for long-term economic growth, South Africa needs to exercise fiscal prudence to retain its investment-grade sovereign credit rating. South Africa's monetary policy might also tighten in 2017 in response to US monetary tightening. A rating downgrade of South Africa's sovereign debt, though not that likely in the

coming quarters due to a commitment to fiscal consolidation, will imply higher borrowing costs that will put upward pressure on domestic interest rates. Weak growth and tight economic policy make for a difficult economic scenario.

A major reason behind the region's decelerating growth is the slowdown in its two largest economies: Nigeria and South Africa.

### A slowdown in 2016

The International Monetary Fund (IMF), in its October 2016 outlook, projected a global growth rate of 3.1 percent, slightly slower than 3.2 percent in 2015 and 3.4 percent in 2014.<sup>1</sup> IMF estimates show that the economy of sub-Saharan Africa, one of the fastest-growing economic regions of the

world since 2000, is likely to grow just 1.4 percent in 2016, down sharply from 3.4 percent in the previous year.<sup>2</sup> A major reason behind the region's decelerating growth is the slowdown in its two largest



economies: Nigeria and South Africa. Both Nigeria and South Africa have come under pressure from slowing global demand and weak commodity prices. According to the IMF, South Africa's economy is projected to record growth of just 0.1 percent in 2016.<sup>3</sup> In 2016 until the end of Q3, the South African economy grew 0.3 percent: The primary sector (agriculture and mining) shrank 4.8 percent; the secondary sector (manufacturing, construction, and utilities) expanded 0.3 percent; the tertiary sector (wholesale, retail, transport, finance, and government services) expanded 1.2 percent; and taxes (less subsidies) contracted 0.8 percent.<sup>4</sup> South Africa's Ministry of Finance projects that economic growth for 2016 will be 0.5 percent.<sup>5</sup>

Latest data indicate that on a quarter-over-quarter seasonally adjusted annualized basis, economic growth (measured by production) slowed to 0.2 percent in Q3 from 3.5 percent in the previous quarter (figure 1).<sup>6</sup> Mining was a major contributor to overall growth due to an increase in iron ore production in response to the rising iron ore prices. A recovery in mineral prices could boost future mining activity in the country. General government, finance, real estate, and business services also contributed to overall GDP growth in Q3. However, agriculture, manufacturing, utilities (electricity, gas, and water), and trade subtracted from overall growth. Agriculture contracted for the seventh straight quarter, as a direct consequence of drought conditions across the



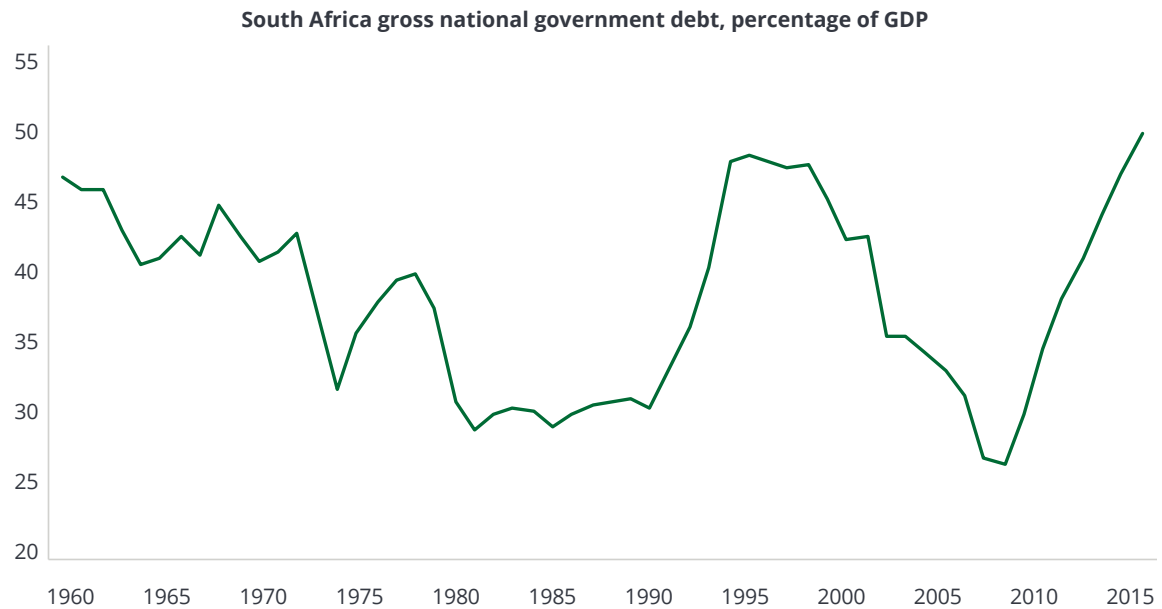
Figure 1. Growth slowed to 0.2 percent in Q3 2016



Source: Statistics South Africa, Deloitte Services LP economic analysis.

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Figure 2. Rising government debt in South Africa has attracted the scrutiny of ratings agencies



Source: Statistics South Africa, Deloitte Services LP economic analysis.

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country. Manufacturing contracted after a strong showing in the previous quarters, due to slowing domestic demand and weak trade. A contraction in manufacturing and weak domestic demand is reflected in declining utilities production. Measured by expenditure on GDP, growth in Q3 was 0.5 percent, down from 3.7 percent in the previous quarter. Gross fixed capital formation subtracted 0.2 percent from overall growth in Q3, while exports subtracted 9.0 percent.<sup>7</sup>

## Fiscal policy is likely to remain tight in 2017

The most prominent threat to the South African economy in 2016 was a sovereign credit rating downgrade to below investment grade, primarily due to fiscal imbalance (figure 2). Though this threat did not materialize in 2016, it has not gone away. All three major ratings agencies have pegged South Africa's sovereign credit rating at the lowest investment grade (or just above) with a negative outlook, due to structural imbalances, political instability, and weak business confidence. South Africa is likely to come under the scrutiny of the ratings agencies once again in mid-2017.

The ruling administration has made a commitment to fiscal consolidation. The medium-term budget policy statement (MTBPS), delivered in October 2016, indicates that South Africa's Ministry of Finance expects the budget deficit for the fiscal year 2016–17 to be 3.4 percent of GDP, slightly lower

than 4.2 percent in the previous year.<sup>8</sup> The budget for the next fiscal year (2017–18), due to be presented in February 2017, will likely reinforce a commitment to fiscal discipline in order to negate the threat of a ratings downgrade. However, political instability and weak economic growth continue to pose risks.

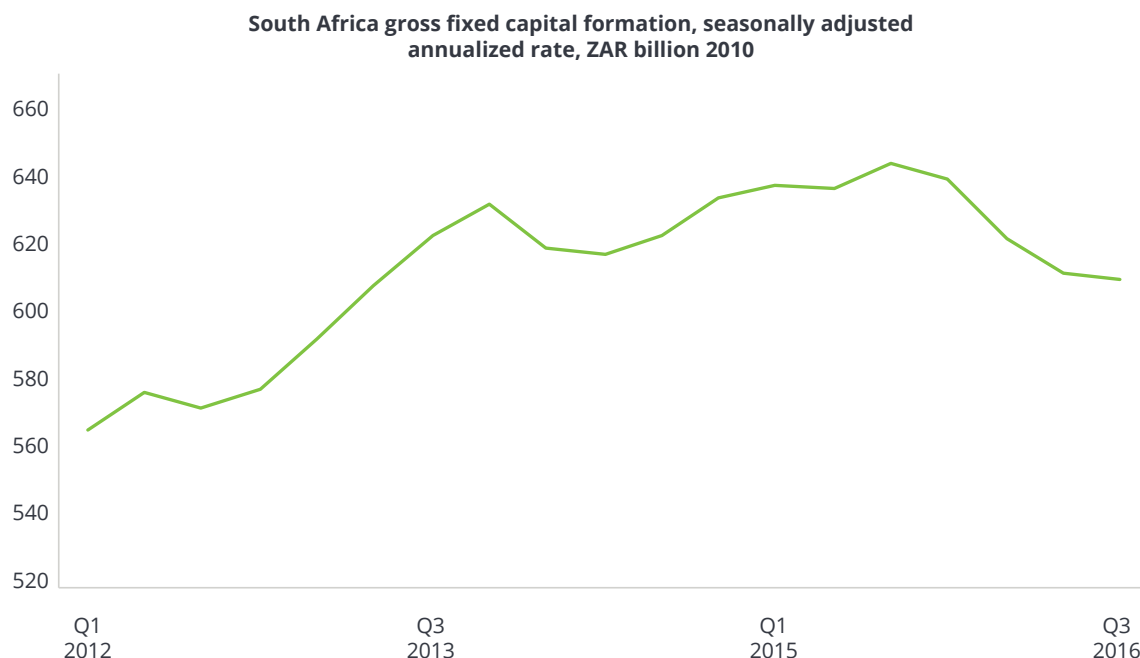
On the external front, what might work to South Africa's advantage (and to the advantage of sub-Saharan Africa) is an uptick in global commodity prices, strengthening economic growth in the United States and Europe and allaying fears of a China hard landing. Internally, boosting domestic investment remains critical to overall growth: Gross fixed capital formation declined 5.2 percent in Q3 on a year-over-year basis, the third straight quarter of decline (figure 3). Investment in machinery also declined in Q3 for the fourth straight quarter.<sup>9</sup> Business confidence remains low and is likely to weigh on investment decisions. According to the South African Chamber of Commerce and Industry, the average of the business confidence index in 2016 was 93.5, far lower than 100 in 2015 (the base year for the index).<sup>10</sup> Furthermore, monetary policy might also tighten in the near term.

## Interest rates could edge up in 2017

The South African Reserve Bank (SARB) might come under pressure to raise the policy interest rate in 2017 in response to the domestic price rise and US Federal Reserve's tightening monetary policy. The policy repo rate has been held steady at 7.0 per-

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All three major ratings agencies have pegged South Africa's sovereign credit rating at the lowest investment grade (or just above) with a negative outlook, due to structural imbalances, political instability, and weak business confidence.

**Figure 3. South Africa needs to boost falling domestic investment**

Source: South African Reserve Bank/Haver Analytics, Deloitte Services LP economic analysis.

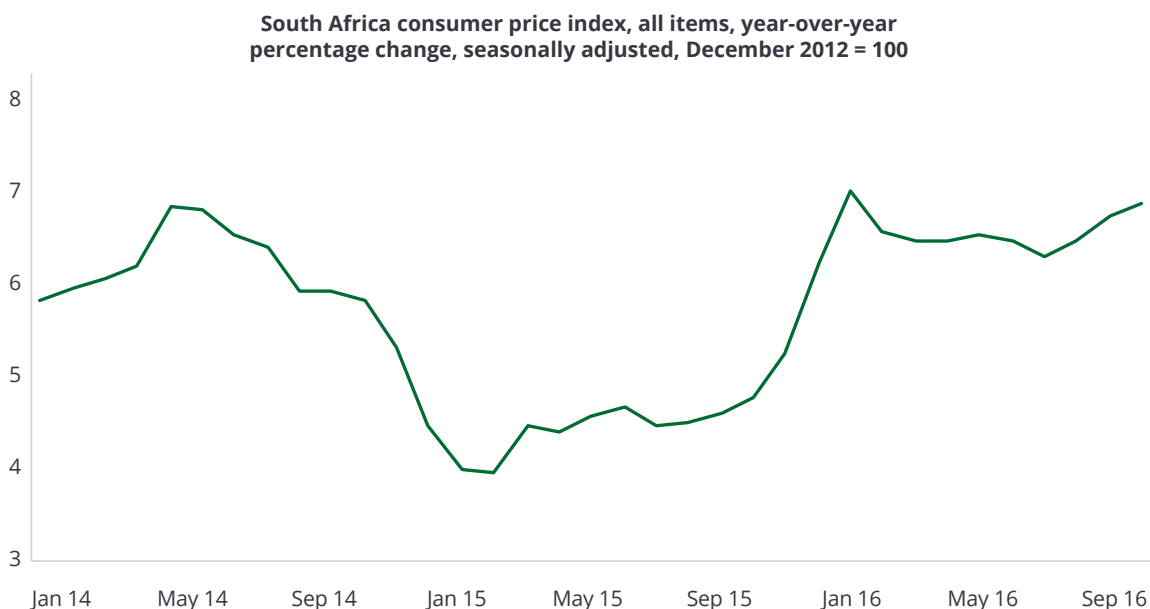
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cent since a hike in April 2016. Even though the real effective exchange rate of the South African rand has been on an upward trend since the beginning of 2016, higher interest rates and improved economic performance in the United States are likely to keep the US dollar strong and exert downward pressure on the rand's recovery. Other factors likely to contribute to a weaker rand are a widening current account deficit in South Africa and a high inflation differential between the two countries (United States and South Africa). A weaker rand will likely add to inflationary pressure. Another factor likely to contribute to inflation is the higher price of crude oil. Inflation data in each month of 2016 (November 2016 being the latest available data point) was above the SARB's target inflation range of 3–6 percent (figure 4).<sup>11</sup> Drought fueled inflation, resulting

in a sharp rise in food prices. If drought conditions abate, resulting in lower overall prices, and if the rand does not weaken considerably, then the SARB might hold the policy repo rate steady in the short term.

However, if interest rates are hiked, they are likely to weigh heavily on already-weak business investment and indebted consumers. Household debt in South Africa is roughly 75 percent of disposable income.<sup>12</sup> Despite a decline from the highs of 2008, the level of household debt coupled with tighter monetary policy will likely keep consumer expenditure under pressure. If South Africa stumbles in its fiscal consolidation plan or falls far short of its GDP growth potential (as it has in 2016), then a ratings downgrade in mid-2017 could result in a steep increase in interest rates and borrowing costs.

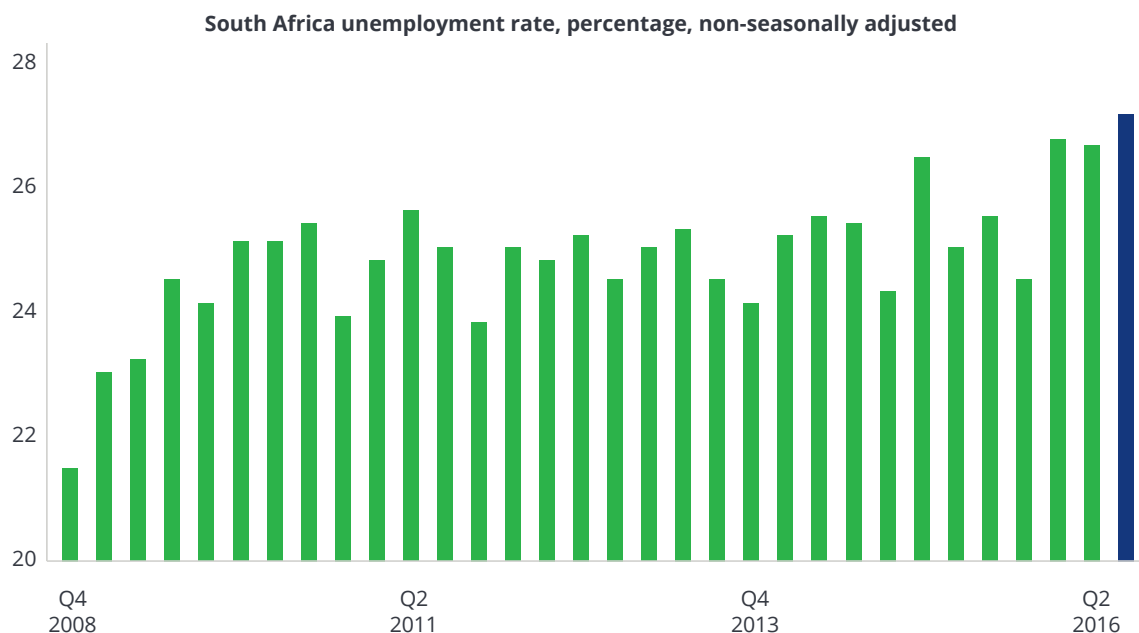
**Figure 4. Inflation exceeded the SARB's target range (3–6 percent) in 2016**



Source: Statistics South Africa/Haver Analytics, Deloitte Services LP economic analysis.

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Apart from trying to maneuver between weak growth and tight fiscal (and monetary) policy, South Africa's economy will have to continue to address certain persistent problems in 2017.

**Figure 5. Unemployment has risen to a multiyear high**

Source: Statistics South Africa/Haver Analytics, Deloitte Services LP economic analysis.

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## South Africa's woes: More of the same

Apart from trying to maneuver between weak growth and tight fiscal (and monetary) policy, South Africa's economy will have to continue to address certain persistent problems in 2017. Unemployment is likely to remain high: The official unemployment rate rose to 27.1 percent in Q3 2016, the highest level since early 2004 (figure 5).<sup>13</sup> High unemployment means that South Africa's tax-paying population will remain relatively low, making balancing the fiscal budget difficult. Another problem is a shortage of skilled labor. This problem is rooted in a weak education system. According to the Organization for Economic Cooperation and Development's 2015

ranking of education systems, South Africa ranks 75 out of a list of 76.<sup>14</sup> Furthermore, inequality in South Africa continues to remain stark, as indicated by the country's Gini coefficient score of 0.66–0.69, one of the highest readings in the world.<sup>15</sup> Infrastructure shortcomings also continue to plague the country. The South African minister of finance, in his October MTBPS, committed to adding revenue through tax measures; allocating additional government expenditure to post-school education, health services, and social protection; and continuing investment in infrastructure. He also forecasts weak but improved growth of 1.3 percent in 2017.<sup>16</sup> Though this is encouraging, South Africa will have to do a lot more if it is to meet its National Development Plan goals by 2030.



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## Shipping: Sailing in troubled waters

By Akrur Barua and Anshu Mittal

### Introduction

The shipping industry is no stranger to economic fluctuations, given its deep links to global demand dynamics, commodity prices, and rules of international trade. However, the current tides appear more ominous given the supposed bright future promised by strong trade and investment flows prior to the Great Recession. Since 2008–09, international trade has faced headwinds from slowing global economic growth (figure 1), especially in key markets for both finished products and commodities. According to the International Monetary Fund (IMF), global exports volumes grew at an average annual rate of just 2.9 percent in 2008–15, less than half the corresponding figure for 2001–08.<sup>1</sup> The value of trade flows hasn't fared any better.<sup>2</sup>

The slowdown in both value and volume of international trade has, in turn, impacted the price paid for shipping goods across continents. In February 2016, the Baltic Exchange Dry Index—an indicator of freight rates for dry goods and commodities—fell to its lowest level ever.<sup>3</sup> And despite a recovery in the past few months, the index is still about 90 percent below the peak of May 2008 (figure 2). Respective indices for tankers used for shipping crude oil and refined products show similar, albeit more moderate, trends.

### The dark clouds hovering over revenues

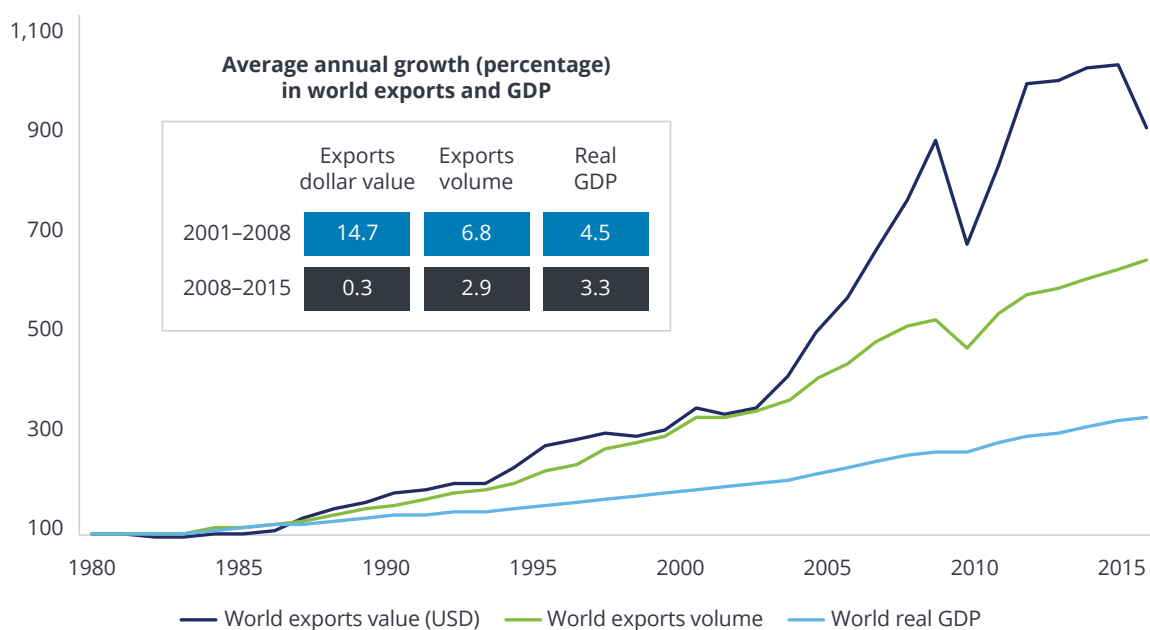
As international trade slows and freight rates for transporting goods across the world's seas and oceans decline, shipping revenues have been hit. Figure 3 reveals how revenues have been either stagnant or falling for key shipping companies for quite some time now. For example, AP Moller Maersk, the largest company in terms of capacity, has been witnessing weak revenue growth since 2010.<sup>4</sup> In 2015, the company's revenues fell by 15.3 percent to \$40.3 billion, the lowest level since 2005.<sup>5</sup> That slide continued into 2016 as well, with revenues declining 17.3 percent year over year in the first nine months of the year.<sup>6</sup> The slowdown in revenues, coupled with elevated levels of debt for many companies, has also raised questions of sustainability for a few shipping companies.

A good way to analyze the revenue upheaval shipping companies are facing, especially the container and bulk business that transports products and dry commodities, is to look at demand from key markets and supply from major producers. Arguably, there is no better way to do that than sift through international trade data for China—a manufacturing exports powerhouse and a big consumer of metals and



**Figure 1. Growth in world exports has slowed since 2008 due to declining economic growth**

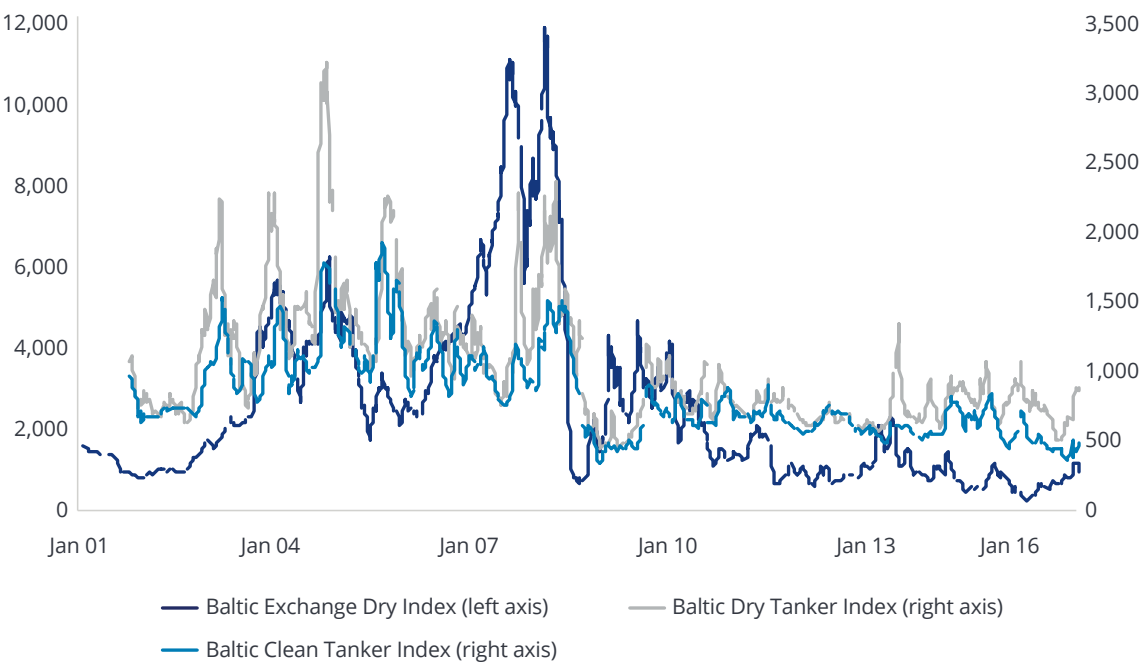
Rebased 1980=100



Source: Haver Analytics, Deloitte Services LP economic analysis.

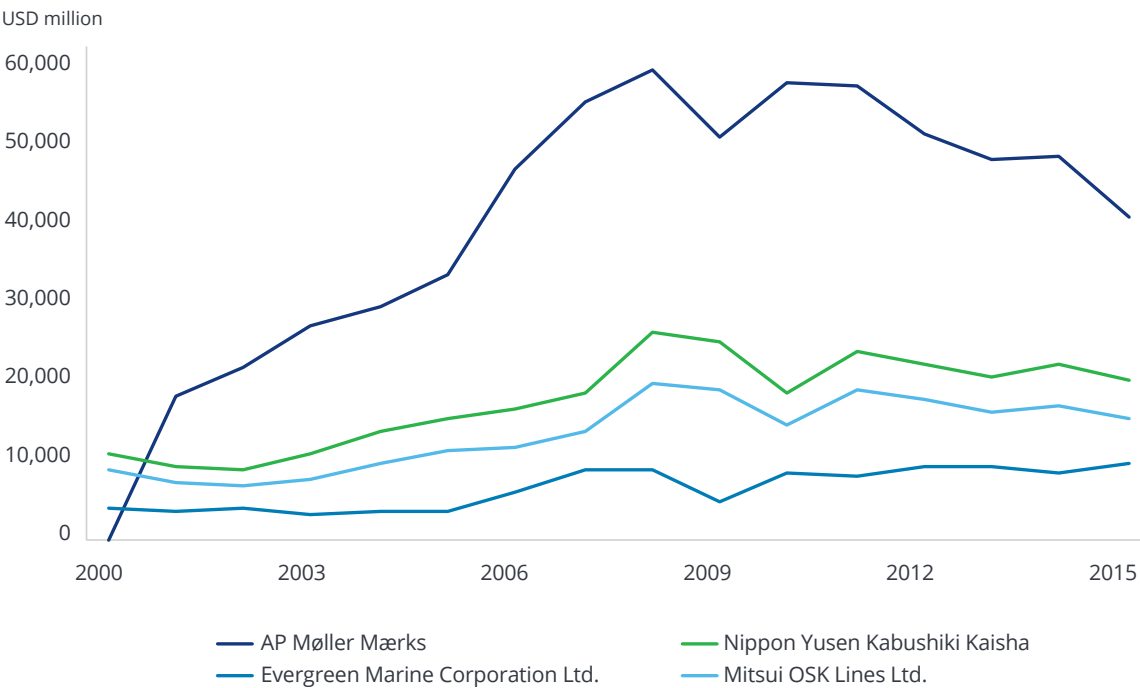
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Figure 2. The Baltic Exchange Dry Index is far from its peak of May 2008



Source: Haver Analytics, Deloitte Services LP economic analysis.

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Figure 3. Key shipping companies have faced stagnant or declining revenues in recent years



Source: S&P Capital IQ, Deloitte Services LP economic analysis.

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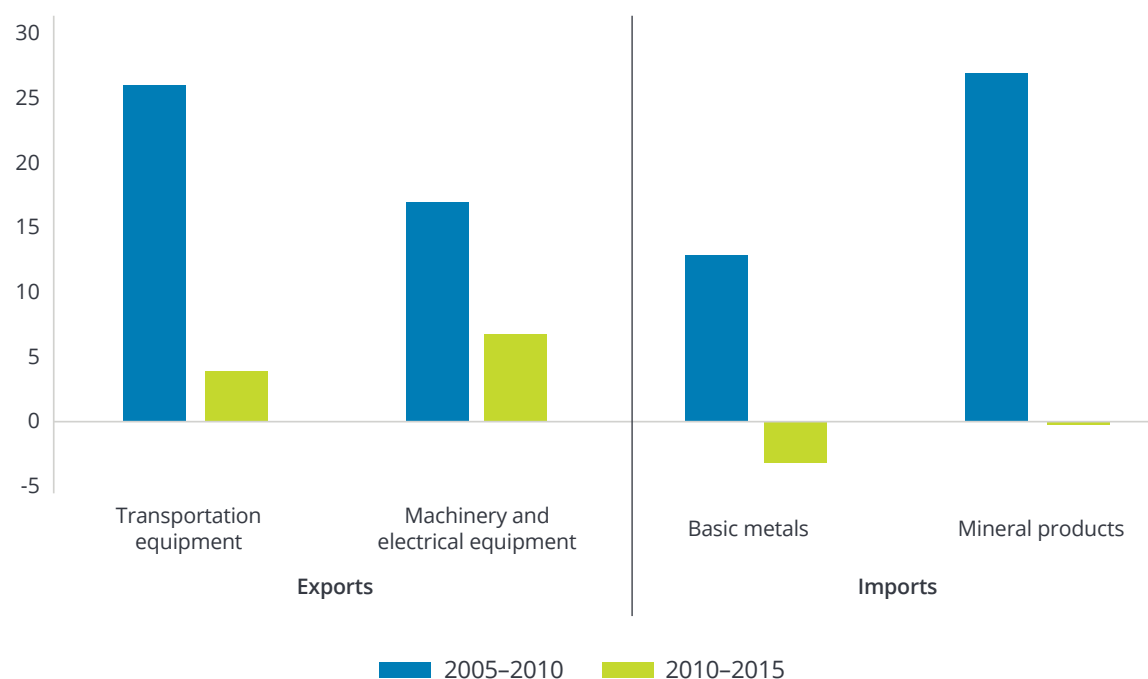
minerals. A quick look at the data on China's key trade items between 2005 and 2015 lays bare the problem of volumes and value facing container and bulk shipping. For example, the value of exports of transportation equipment as well as machinery and electrical equipment from China slowed significantly during 2010–15 compared with the previous five-year period (figure 4). This is most likely a result of slower economic growth in major markets such as Europe and the United States.

The story is similar for two of China's major imports: basic metals and mineral products (figure 4). China and other fast-growing emerging markets such as India had played a key role in the sharp surge in

commodity prices prior to the Great Recession and the relatively modest recovery during 2010–11. But, with China's growth slowing from the double-digit figures witnessed in the previous decade, global metal and mineral demand has been hit, which, in turn, has impacted prices. For example, copper, zinc, and aluminum are trading much below their respective peaks of the last decade (figure 5). Also, it is likely that shipping companies and the world's major commodity producers may not experience the sharp price growth witnessed in the previous decade, as policymakers in China attempt to shift to a more sustainable, consumption-led growth model from an investment-driven one.

**Figure 4. Container and bulk shipping are facing slowing trade growth in key markets such as China**

Average annual growth (percentage)



Source: Haver Analytics, Deloitte Services LP economic analysis.

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## Rising capacity: The micro-issue within a macro-problem

A slowdown in international trade growth couldn't have come at a worse time—a period where capacity has been expanding faster than global demand—for the shipping industry. According to data from the United Nations Conference on Trade and Development and the IMF, growth in capacity (in dead weight tons) of the world's merchant shipping fleet

has outpaced growth in global export volumes every year since 2007, except one (figure 6).<sup>7</sup> Figures 1, 2, and 6 also give us an insight as to why shipping companies went on a capacity expansion binge: sharp growth in international trade and a corresponding rise in freight rates.

Moreover, despite a decline in commodity prices and freight rates in recent years, capacity expansion has continued, albeit at a slower pace. This is because capacity expansion is a medium- to long-

**Figure 5. As global growth and specifically China's growth slow, prices of metals fall**



Source: Haver Analytics, Deloitte Services LP economic analysis.

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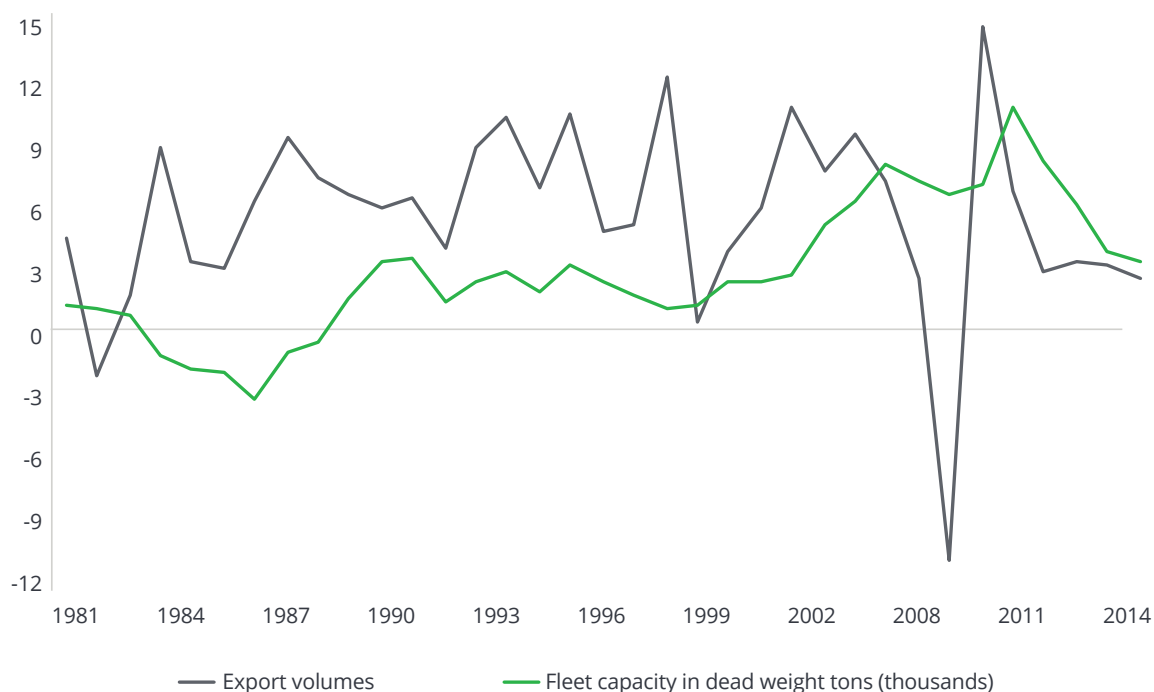
term process involving years of funding that companies often are not able to reverse (see the sidebar “Commodity and freight cycles and its impact on capital expenditure”). So even as freight rates have fallen since 2008, shipping capacity has kept growing, although the pace has slowed after 2011, when capacity increased 10.9 percent. Also, the 2010–11 recovery could have soothed nerves in the shipping business, prompting it to expect a return to a pre-2009 growth trajectory. Unfortunately, that has not happened, given the debt crisis in Europe, slowing

growth in China, and moderate economic expansion in the United States.

Not surprisingly, capacity expansion—a lot of which is often fueled by borrowing—has increased the debt burden for some shipping companies, especially since 2009–10.<sup>8</sup> Given that the rise in debt has come at a time of slow revenue growth—the period after 2010—it has put further pressure on shipping companies’ balance sheets. Rising debt in recent years comes after a period of steady debt reduc-

**Figure 6. Shipping capacity growth has outpaced global exports volumes growth for most of 2007–15**

Annual growth (percentage)



Source: Haver Analytics, Deloitte Services LP economic analysis.

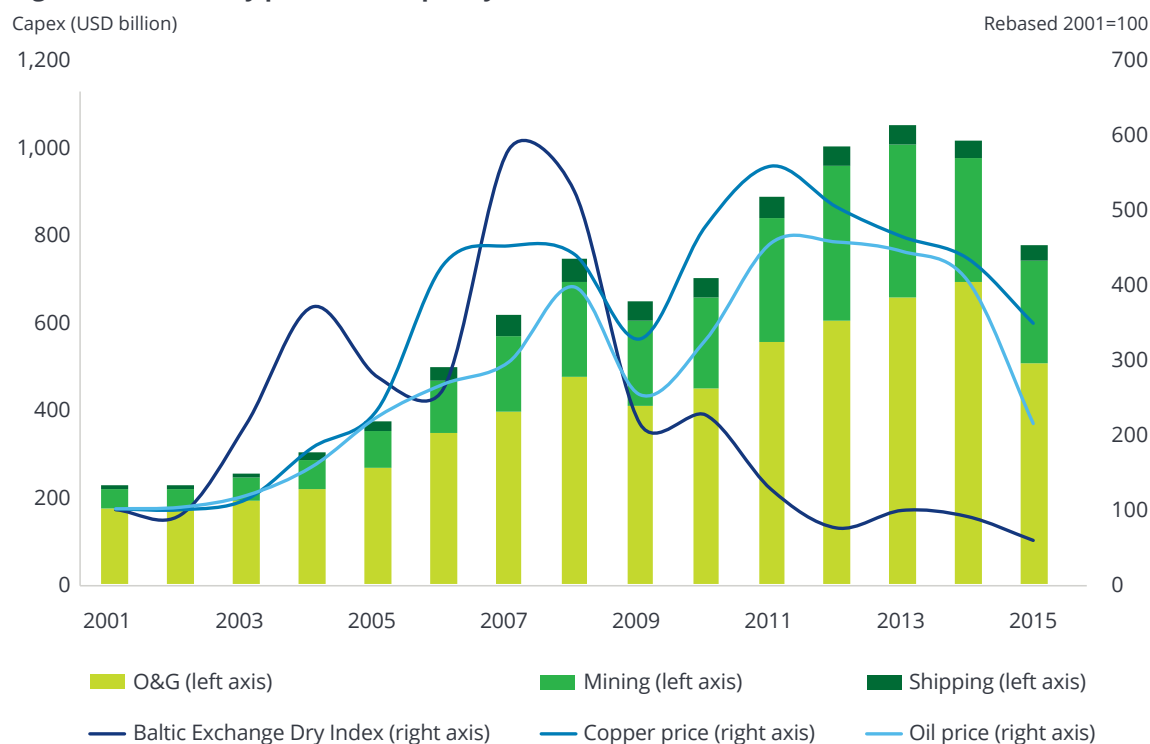
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## Commodity and freight cycles, and their impact on capital expenditure

The problem of surplus is not limited to the shipping industry, and it is not just because of a year or two of excess investments. The genesis of the recent surge goes back to 2003–08. Record prices in anticipation of strong demand from fast-growing Asian economies led to record capital raising and, thus, a fourfold increase in capital investments across commodities during this period (figure 7). Seeing significant capacity expansion upstream, it was natural for shippers to follow suit and invest heavily in adding capacity.

However, the 2008–09 financial crisis and a lower-than-expected recovery post the recession left the significant capacity buildup underutilized. Further, the buildup was largely of mega fields, mines, and ships, which have a longer capital gestation period and, thus, require continuous investments across the price and freight cycles. This is reflected in strong capital expenditure (capex) during 2010–13 despite moderation in prices. Although there has been a significant fall in capex and, hence, in over-supply over the past two years, a majority of commodities and the shipping industry remain in a lower-for-longer downturn and will likely witness a slow road back to recovery.

**Figure 7. Commodity prices and capex cycles**



*Note: OG& capex is for the upstream industry.*

Source: Haver Analytics, US Energy Information Administration, S&P Capital IQ, and Deloitte Services LP economic analysis.

tion by shipping companies leading up to the Great Recession; ironically, that period was also one of steady growth in freight rates and revenues.

## Fortune favors the tankers

On a brighter note, the tanker business has been doing better than its container and bulk counterparts. Maersk Tankers, for example, witnessed a 22.9 percent rise in operating profit before tax in 2015 despite a sharp drop in crude prices; the average Brent price fell by half that year relative to 2014.<sup>9</sup> In contrast, Maersk Line's operating profit before tax—the container side of the business—fell during the above period.<sup>10</sup> So within such a scenario of low oil prices, how did tankers fare better? There are several reasons:

- Hydrocarbon demand from key emerging markets such as India and China has been strong, as car sales and power generation continue to expand in these economies. For example, in 2010, China replaced the United States as the world's largest automobile market.<sup>11</sup> Between 2010 and 2015, crude import volumes went up 40.2 percent for China and 20.3 percent for India.<sup>12</sup> Also, countries such as China and the United States

took advantage of the sharp decline in oil prices in 2015 to increase their strategic reserves.<sup>13</sup>

- As demand from Asia rises and a glut of shale oil in the United States emerges, routes for tankers have turned longer. Crude from Latin America, for example, was earlier mostly destined for the United States.<sup>14</sup> Not anymore: As Asian hunger for energy rises and the United States turns self-sufficient in oil, crude from Latin America and Africa is increasingly finding its way to Asia.<sup>15</sup> Also, as the United States starts exporting oil, Asia is likely to be a key market, ensuring a long route for tankers.<sup>16</sup>
- Finally, as oil prices started declining from mid-2014 and producers kept pumping crude, companies started following a new strategy: keeping oil in tankers offshore at sea to be sold when prices go up.<sup>17</sup> By the end of May 2016, the International Energy Agency suggested that about 94 million barrels of crude were kept offshore.<sup>18</sup>

It is no wonder, then, that tanker demand has gone up, with companies also ramping up capacity. In the last five years, for example, oil tanker capacity has gone up 14.4 percent.<sup>19</sup>



## All's well that ends well?

As 2017 dawns, it is apparent that the shipping industry will continue to face headwinds. The global economy is in uncertain territory, with a new administration taking over in the United States, Europe still mired in weak growth, and economic activity in China not showing signs of picking up sharply. To top it all, international trade faces a rise in protectionist rhetoric, with events such as Brexit shaking the foundation of free movement of goods, services, and capital. Also, with Asian growth outpacing other regions, trade growth within Asia will rise, thereby impacting shipping distances. For example, in 2015, exports from developing countries in Asia were 18.2 percent of the region's total exports, up from 6.6 percent in 1980, with much of the surge happening in the new millennium.<sup>20</sup> This trend is likely to continue.

In the tanker business, companies are wary of a dent to oil demand as crude prices rise. Brent prices have more than doubled since the low of January 2016, with a proposed cut in supplies by the Organization of Petroleum Exporting Countries (OPEC) and non-OPEC countries likely to keep prices elevated in the near term. Also, as prices rise, demand for offshore tankers will decline, as will the drive to increase strategic reserves.<sup>21</sup>

Nevertheless, it would be wrong to expect only dark clouds on the horizon for the shipping industry. There appears to be a rise in tailwinds of late. Metal prices are firming up: Copper is up more than 23 percent since the end of 2015. Fiscal stimulus focusing on infrastructure and investment in China and Japan is likely to aid demand for metals.<sup>22</sup> This augurs well for freight rates, which have also been moving up in recent months, as is evident from the



Baltic indices (figure 2). Most importantly, the shipping industry can draw comfort from an expected rise in international trade growth in the near term. For example, the IMF expects growth in global exports volumes to rise to 3.5 percent in 2017 from an estimated 2.2 percent last year.<sup>23</sup>

For tankers, the advent of the United States as an energy exporter with products destined for Asia—a longer route—will aid sentiment. Also, the flow of US oil into the global market will likely keep a

lid on prices, thereby ensuring a ceiling. This will ensure that demand does not falter much despite a recent rise in crude oil prices. Also, with Iran entering the fray after years of sanctions, supply is likely to increase. The country's shipments of crude has already crossed pre-sanction highs.<sup>24</sup> Finally, with key emerging markets and Japan searching for fuels cleaner than coal, natural gas has seen an upsurge in demand. This is likely to continue, aiding demand for liquefied natural gas tankers.

## Acknowledgements

The authors would like to thank Vivek Bansal, senior analyst, and Deepak Vasantlal Shah, assistant manager, from the Deloitte Center for Energy Solutions for their contributions to the report.

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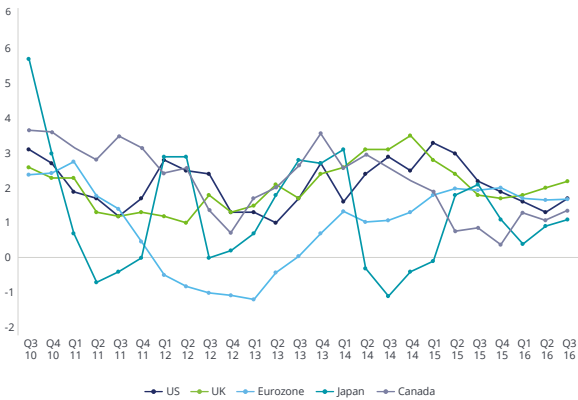
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# Economic indices

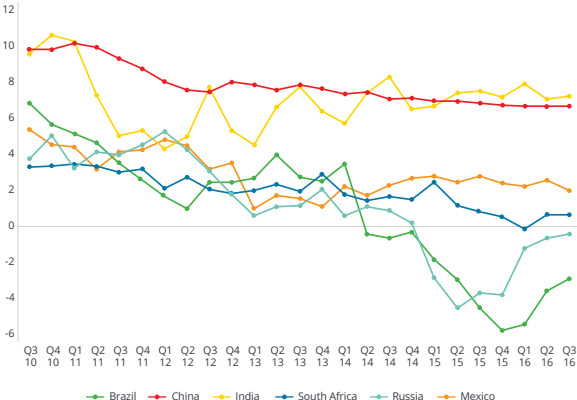
Figure 1. GDP growth rates (percentage, year over year)



Source: Bloomberg, Haver Analytics.

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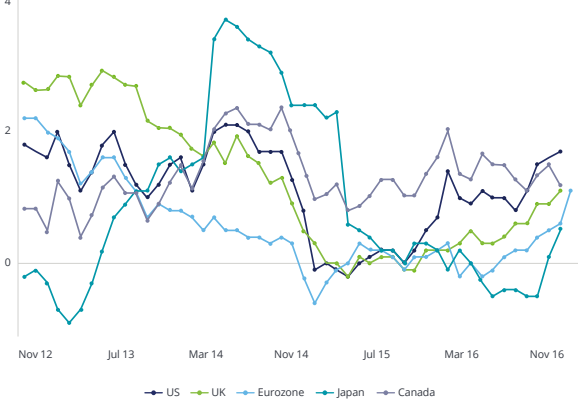
Figure 2. GDP growth rates (percentage, year over year)



Source: Bloomberg, Haver Analytics.

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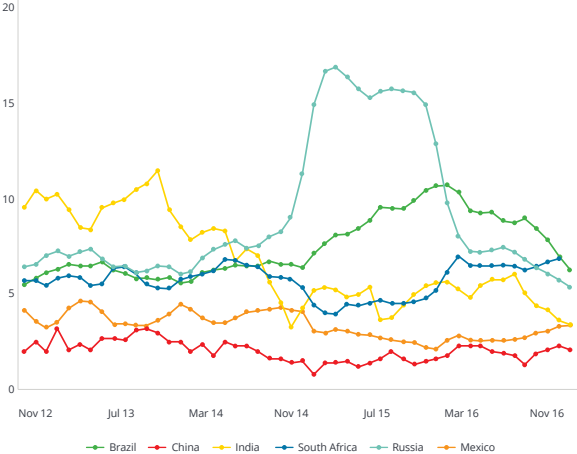
Figure 3. Inflation rates (percentage, year over year)



Source: Bloomberg, Haver Analytics.

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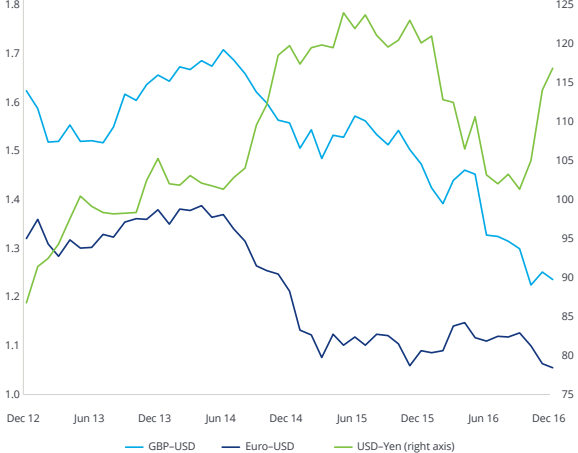
Figure 4. Inflation rates (percentage, year over year)



Source: Bloomberg, Haver Analytics.

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Figure 5. Major currencies vs. the US dollar (percentage, year over year)



Source: Bloomberg, Haver Analytics.

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**Yield curves (as of January 16, 2017)\***

	US Treasury Bonds & Notes	UK Gilts	Eurozone Govt. Benchmark	Japan Sovereign	Canada Sovereign	Brazil Govt. Benchmark
3 Months	0.52	0.23	-0.65	-0.27	0.46	12.51
1 Year	0.80	0.11	-0.57	-0.31	0.62	10.99
5 Years	1.90	0.58	-0.48	-0.12	1.13	11.01
10 Years	2.40	1.36	0.34	0.05	1.72	11.06

	China Sovereign	India Govt. Bonds	South Africa Sovereign	Russia	Mexico
3 Months	2.66	6.23	7.25	8.69	6.22
1 Year	2.70	6.28	-	8.46	6.83
5 Years	2.94	6.46	8.05	7.92	7.27
10 Years	3.24	6.44	8.66	8.16	7.57

**Composite median GDP forecasts (as of January 16, 2017)\***

	US	UK	Eurozone	Japan	Canada	Brazil	China	India	South Africa	Russia	Mexico
2016	1.6	2	1.6	1	1.3	-3.5	6.7	-	0.4	-0.6	2.1
2017	2.3	1.2	1.5	1	1.9	0.8	6.4	6.9	1.1	1.1	1.7
2018	2.3	1.3	1.5	0.9	1.9	2.2	6.1	7.6	1.7	1.5	2.2

**Composite median currency forecasts (as of January 16, 2017)\***

	Q1 16	Q2 17	Q3 17	Q4 17	2016	2017	2018
GBP-USD	1.21	1.21	1.23	1.25	1.23	1.25	1.28
Euro-USD	1.04	1.03	1.05	1.05	1.05	1.05	1.1
USD-Yen	115	118	116.5	115.75	116.96	115.75	112.5
USD-Canadian Dollar	1.35	1.35	1.36	1.36	1.34	1.36	1.32
USD-Brazilian Real	3.4	3.45	3.47	3.45	3.26	3.45	3.59
USD-Chinese Yuan	7	7.1	7.13	7.15	6.95	7.15	7.4
USD-Indian Rupee	68.78	69.03	69.5	69.2	67.92	69.2	71.75
USD-SA Rand	14.42	14.5	14.7	14.6	13.74	14.6	15.25
USD-Russian Ruble	61.68	62	62	61.33	61.54	61.33	60.5
USD-Mexican Peso	21.13	21.35	21.5	21.3	20.73	21.3	21.25

\*Source: Bloomberg    ‡MICEX rates    †Source: OECD

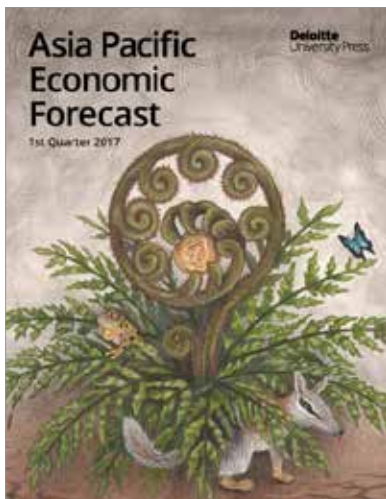
OECD composite leading indicators (Amplitude adjusted)<sup>†</sup>

	United States	United Kingdom	Euro area	Japan	Canada	Brazil	China	India	South Africa	Russian Federation	Mexico
Aug 13	100.6	101.4	99.7	101.1	99.9	99.1	101.0	98.6	100.7	99.7	98.7
Sep 13	100.6	101.6	99.9	101.2	100.0	99.0	101.0	98.5	100.6	99.9	98.7
Oct 13	100.6	101.8	100.1	101.4	100.1	98.8	101.0	98.5	100.6	100.0	98.8
Nov 13	100.6	101.9	100.2	101.5	100.1	98.6	101.0	98.4	100.5	100.2	98.9
Dec 13	100.6	102.0	100.3	101.5	100.1	98.5	100.9	98.4	100.5	100.4	98.9
Jan 14	100.6	102.0	100.4	101.4	100.1	98.4	100.8	98.4	100.4	100.5	98.9
Feb 14	100.7	102.0	100.5	101.3	100.2	98.3	100.8	98.4	100.3	100.7	98.8
Mar 14	100.7	102.1	100.4	101.1	100.2	98.3	100.7	98.5	100.2	100.9	98.8
Apr 14	100.8	102.1	100.4	100.9	100.2	98.3	100.7	98.5	100.2	101.1	98.8
May 14	100.8	102.0	100.3	100.6	100.3	98.4	100.6	98.6	100.1	101.3	98.8
Jun 14	100.9	102.0	100.3	100.4	100.3	98.5	100.5	98.7	100.2	101.4	98.9
Jul 14	100.9	101.9	100.2	100.3	100.4	98.6	100.5	98.7	100.3	101.4	99.1
Aug 14	100.9	101.7	100.1	100.2	100.4	98.6	100.4	98.8	100.5	101.3	99.4
Sep 14	100.9	101.6	100.0	100.1	100.3	98.5	100.3	98.9	100.6	101.1	99.7
Oct 14	100.9	101.4	100.0	100.1	100.3	98.3	100.1	99.0	100.6	100.7	100.1
Nov 14	100.8	101.3	100.1	100.1	100.2	98.1	100.0	99.0	100.6	100.3	100.3
Dec 14	100.8	101.2	100.1	100.1	100.1	97.9	99.9	99.1	100.6	99.9	100.6
Jan 15	100.7	101.1	100.2	100.2	100.0	97.7	99.8	99.2	100.5	99.6	100.8
Feb 15	100.6	101.0	100.3	100.3	99.9	97.5	99.7	99.2	100.5	99.5	101.0
Mar 15	100.5	100.9	100.4	100.3	99.8	97.4	99.7	99.3	100.5	99.5	101.0
Apr 15	100.4	100.8	100.4	100.4	99.8	97.3	99.7	99.4	100.5	99.5	100.7
May 15	100.3	100.7	100.4	100.4	99.7	97.3	99.6	99.4	100.5	99.5	100.4
Jun 15	100.2	100.6	100.4	100.4	99.7	97.2	99.5	99.5	100.4	99.4	100.1
Jul 15	100.1	100.5	100.4	100.4	99.6	97.2	99.4	99.6	100.3	99.2	99.7
Aug 15	99.9	100.4	100.4	100.3	99.5	97.2	99.2	99.7	100.2	99.0	99.4
Sep 15	99.7	100.2	100.4	100.2	99.4	97.2	99.1	99.7	100.1	98.7	99.4
Oct 15	99.5	100.1	100.4	100.1	99.3	97.2	98.9	99.8	100.1	98.5	99.4
Nov 15	99.4	100.0	100.4	100.0	99.2	97.2	98.8	99.8	100.0	98.2	99.5
Dec 15	99.3	99.8	100.4	99.9	99.2	97.2	98.6	99.9	100.0	98.0	99.7
Jan 16	99.2	99.7	100.4	99.8	99.1	97.4	98.5	99.9	99.9	98.0	100.0
Feb 16	99.1	99.5	100.3	99.8	99.2	97.6	98.4	100.0	99.7	98.1	100.3
Mar 16	99.1	99.3	100.3	99.7	99.2	98.0	98.3	100.0	99.6	98.4	100.4
Apr 16	99.1	99.1	100.2	99.7	99.4	98.5	98.3	100.1	99.5	98.7	100.5
May 16	99.1	99.0	100.2	99.6	99.5	99.1	98.4	100.1	99.4	99.1	100.6
Jun 16	99.1	98.9	100.1	99.6	99.6	99.7	98.5	100.1	99.3	99.5	100.7
Jul 16	99.0	98.8	100.1	99.6	99.7	100.2	98.6	100.1	99.2	99.8	100.6
Aug 16	99.1	98.9	100.2	99.6	99.8	100.7	98.7	100.1	99.2	100.0	100.5
Sep 16	99.1	99.1	100.2	99.7	99.9	101.0	99.0	100.1	99.2	100.2	100.2
Oct 16	99.2	99.2	100.3	99.8	100.0	101.3	99.3	100.0	99.3	100.4	99.9
Nov 16	99.3	99.4	100.4	99.9	100.1	101.5	99.6	99.9	99.3	100.6	99.4

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

Source: OECD.

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