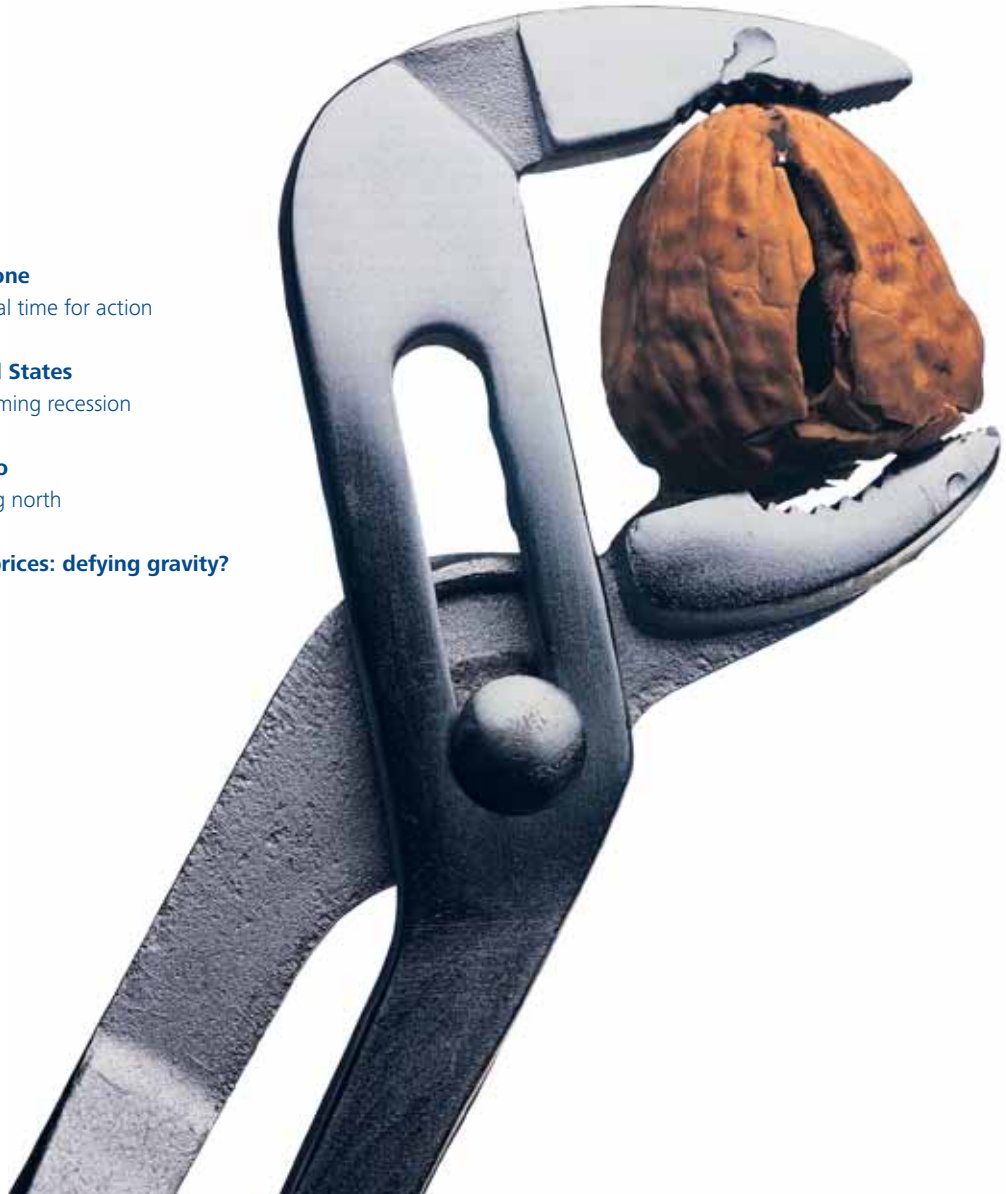
Global Economic Outlook

A Deloitte Research publication | 4th Quarter 2011

Stressful Times



Eurozone
A crucial time for action

United States
The coming recession

Mexico
Looking north

Gold prices: defying gravity?

Deloitte.

Global Economic Outlook Q4 2011

Last quarter, we began by stating that the biggest issues facing the global economy are the crisis in the Eurozone and uncertainty about the path of U.S. monetary and fiscal policy. Well, nothing seems to have changed. These remain the big issues. And yet, much has indeed changed. Since we published our last report at the end of July 2011, there has been one crisis after another.

In Europe, the members of the Eurozone agreed on a new package for assisting Greece, only to find that financial market stress kept getting worse as market participants doubted the package would be sufficient. Hence, as of this writing, discussions are under way to find a larger solution, and markets evidently have much lower expectations that the problem will actually be resolved.

In the United States, August witnessed a stressful round of negotiations on the budget, the results of which have been questioned by many. Then, U.S. government debt was downgraded for the first time in history, equity markets fell rapidly, the economy appeared to stall, and businesses were left wondering whether another recession was imminent. In emerging markets, concerns about rising inflation and rising currencies have been replaced by fear of a global slowdown and rapid currency depreciation.

In this issue of the Global Economic Outlook, we address all of these issues. First, Elisabeth Denison offers a cautiously hopeful assessment about the prospects for preserving the euro. She discusses what must happen in order for the Eurozone to have a chance of long-term success. On the other hand, she recognizes the considerable risk of failure and the high risk of recession if the Eurozone fails. For now, she sees recession taking hold principally in the peripheral nations of the EU rather than Germany and France.

Next, Carl Steidtmann offers a far more pessimistic view in his assessment of U.S. economic prospects. His argument is that the serious problems in Europe, which have a high probability of getting worse, are already having a negative impact on the U.S. economy and are likely to push the United States into another recession. He notes that, even absent the European crisis, the U.S. economy is already teetering on the edge with extremely slow growth and a dormant job market. Add to this the financial contagion from Europe, and the result is financial market stress causing a slowdown in credit creation.

In our next article, I provide some thoughts on the outlook for China. In particular, I note that China appears to be decelerating due to the negative impact of a global slowdown

and the lagged effect of tightening monetary policy. I also look ahead at potential troubles coming from the debts accumulated by local governments to fund investment in fixed assets. The end result could be a substantial slowdown in growth.

Following China, I look at the Japanese economy, which actually offers one of the few bright spots in the global landscape. Due to spending on reconstruction, the Japanese economy is likely to grow faster next year than this year. On the other hand, Japan still faces considerable obstacles to a return to sustained growth.

Ian Stewart then provides his prognostications for the UK. He says that the outlook for the UK economy is deteriorating, not only because of weaker domestic fundamentals, but more importantly, because of headwinds from the neighboring Eurozone. Ian also discusses how the uncertain business environment has moved corporate strategies toward a more defensive posture, as evidenced by Deloitte UK's CFO survey.

Next, Siddharth Ramalingam presents his outlook for India. Like Europe and the United States, India faces a slowdown in growth. But unlike those countries, the problem in India is that growth has been too rapid, thus leading to uncomfortably high inflation. The challenge for policymakers is to balance the fight against inflation with a desire to retain sufficient growth.

In my outlook for Russia, I discuss how recent political announcements offer clarity regarding Russia's political future but fail to provide clarity about the economic policy environment. I also discuss how a combination of monetary policy tightening and headwinds from Western Europe will likely lead to slower growth in Russia.

As for Brazil, I note the recent reversal in monetary policy as the central bank switches from fighting inflation to preventing a recession. I also discuss how the crisis in the West led to a dramatic shift in the direction of Brazil's currency, causing the authorities to change the direction of currency market intervention.

In our feature article on Mexico, Pralhad Burli discusses Mexico's considerable challenges as well as its great potential. He notes that Mexico has failed to grow at the rate of the BRICs and has thus been left behind. He also notes, however, that there are a number of factors that could boost future growth for Mexico.

Finally, Satish Raghavendran and Neha Jain provide some perspective on the factors that influence the price of gold. Given the roller coaster path that gold has lately experienced, this issue should be of considerable interest to our readers.

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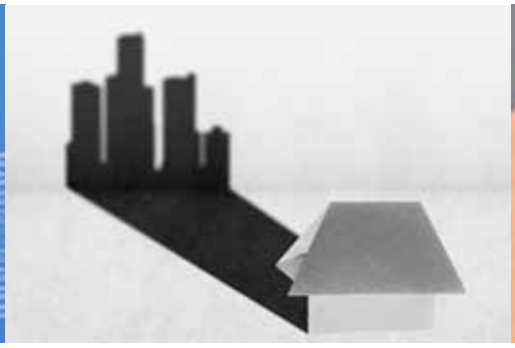

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EUROZONE

Eurozone: A crucial time for action

by Dr. Elisabeth Denison

Eurozone growth is slowing. Sentiment has deteriorated over the summer amid signs of weakening global demand and disappointed hopes of solving the sovereign debt crisis. This is a crucial time for Europe. If Eurozone leaders now act decisively to stabilize financial markets and turn their plans for closer cooperation into action, it could halt the downward spiral of deteriorating confidence and weakening activity. Real economic indicators are not yet indicating a recession, but markets remain unsettled by deteriorating sentiment and speculation about the future of the monetary union.

Ideology versus Execution

The fortune of the Eurozone depends crucially on whether — and how fast — a convincing solution to the debt crisis can be found and implemented. Fears of a Greek default and its contagion effect, including the possibility of an ensuing banking crisis, hang over the economy like the sword of Damocles. Leaders are currently trying to solve three key issues:

- dealing decisively with Greece while firewalling other, less-affected fringe nations
- establishing a mechanism for a functioning European bond market by giving the European Financial Stability Facility (EFSF) more money and more power
- putting the announced plans on fiscal and macroeconomic surveillance and enforcement into action

On July 21, European heads of state, together with EU institutions and the International Monetary Fund, reached an agreement on securing the future of the Eurozone with a 16-point action plan. It was a big achievement, but for it to be put into action, all 17 nations have to ratify the agreement, and the delay in getting this done has led to renewed turmoil in financial markets. Execution does not seem to be keeping up with ideology in Europe.

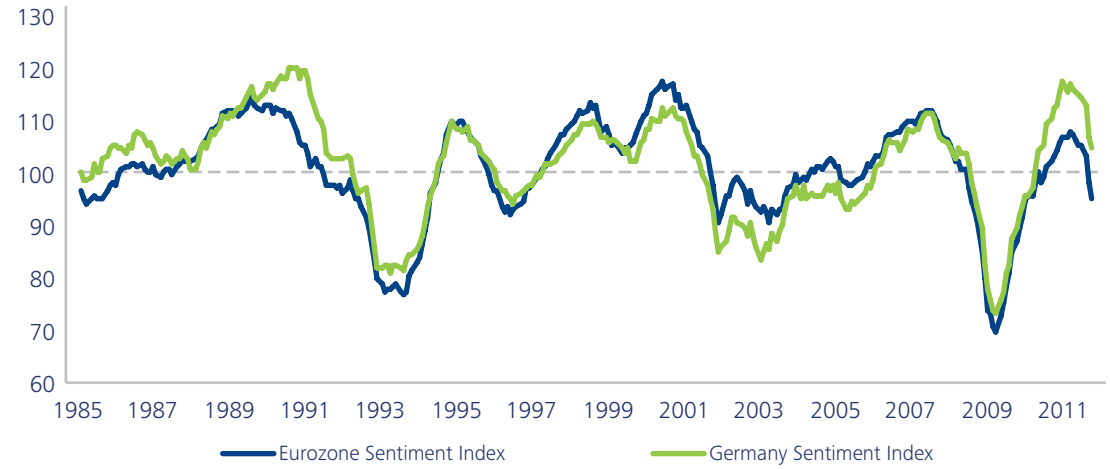
(1) Dealing with Greece

Opinions still vary widely on the necessity of restructuring Greek debt — not only between nations, but also between different groups of stakeholders. The main concern is the unpredictable effect a Greek default might have on European bond markets and, as a consequence, on the financial sector, which holds much of the Eurozone's sovereign debt. There is a stronger consensus on the obligation of firewalling other fringe nations with better fundamentals (especially Italy and Spain) from being sucked into a downward spiral of rising borrowing costs and increasing debt, but the mechanisms for doing so are far from being agreed upon.

(2) Giving the EFSF more power

Approving extra funding for the EFSF is a significant hurdle. Some crucial votes have taken place in recent weeks, clearing the way for implementation. However, disagreement about the mechanism of delivery abounds.

Figure 1: IFO survey Eurozone
(Index 100 = historic average)



Source: IFO Institute

The EFSF could finance itself through funding on capital markets by leveraging the guarantees of the Eurozone member states (seemingly the preferred option) or through refinancing at the ECB, which would, in fact, not be much different than if the ECB steps into markets and purchases bonds from member states.

Waiting for approval of the July 21 agreements, the ECB has already stepped in to buy Italian and Spanish government bonds to drive down borrowing costs and avoid these two economies from being forced to request bailouts like Greece, Ireland, and Portugal. Worried about its independence, the ECB stresses it does not plan to continue to intervene in bond markets. It expects the EFSF to be in a position to take over soon.

(3) Fiscal and macroeconomic coordination

With markets focused on the immediate concerns of solving the debt crisis and establishing a credible bailout fund, it has not been widely noted that the European Parliament has given its final agreement and voted to adopt a package known as "six-pack" in the last week of September. The six legislative proposals for enhanced surveillance of fiscal discipline and coordination of macroeconomic policies also include new enforcement mechanisms for non-compliant member states. The legislative package is expected to be in place by the beginning of 2012, in time for the next semester of Eurozone economic policy coordination.

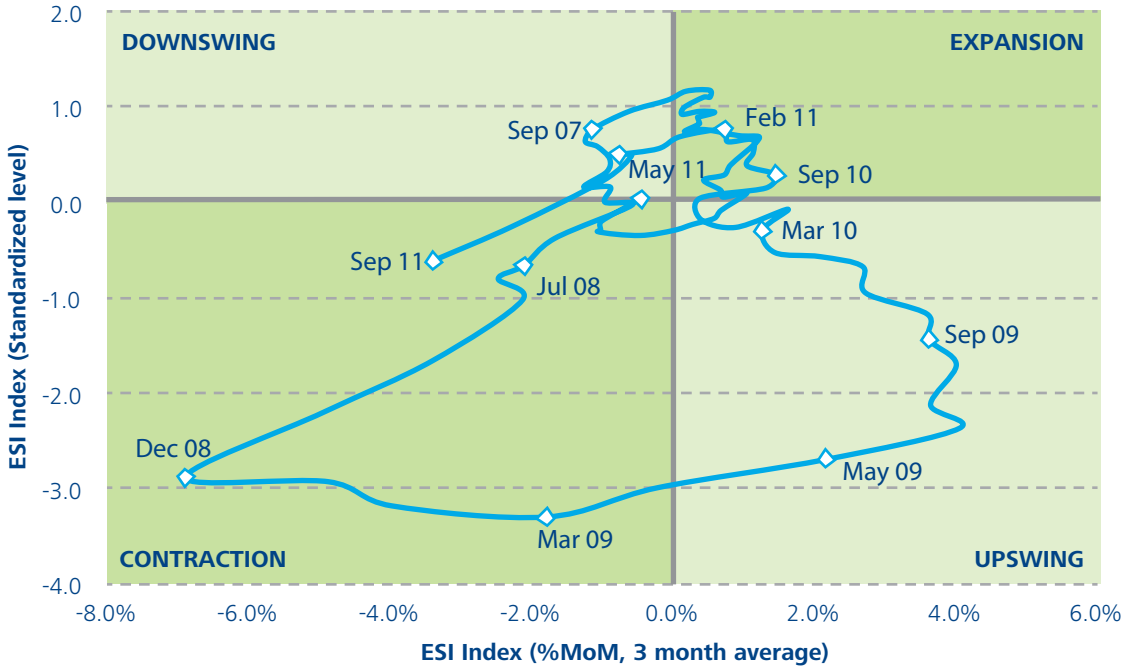
In his state of the union" address, EU President Barroso stressed the EU's commitment for action: "The time for piecemeal solutions is over. It is about political will. It is the test for our whole generation."

A recession in the cards?

Unfortunately, the process has been neither orderly nor decisive. Disappointed expectations have unsettled financial markets, and negative sentiment is now spreading to the business and private sector. The Ifo Survey's Eurozone sentiment index fell for the second quarter in a row in Q2 and is down 30 percent from its peak at the beginning of 2010, even if the measure of current activity is holding up for now (see figure 1).

The business-cycle tracer of the European Commission's Sentiment Index (ESI) confirms the threat of a recession in the Eurozone. This indicator graphs the level of economic sentiment (standardized index) on the vertical axis and its change (growth momentum) on the horizontal axis. Having held in expansionary territory for much of the past year, the indicator started to turn negative in spring

Figure 2: Business cycle tracer ESI



Source: European Commission

of 2011, entered the downswing quadrant in April, and moved into contractionary territory in August. The latest reading in September points to further deterioration (see figure 2).

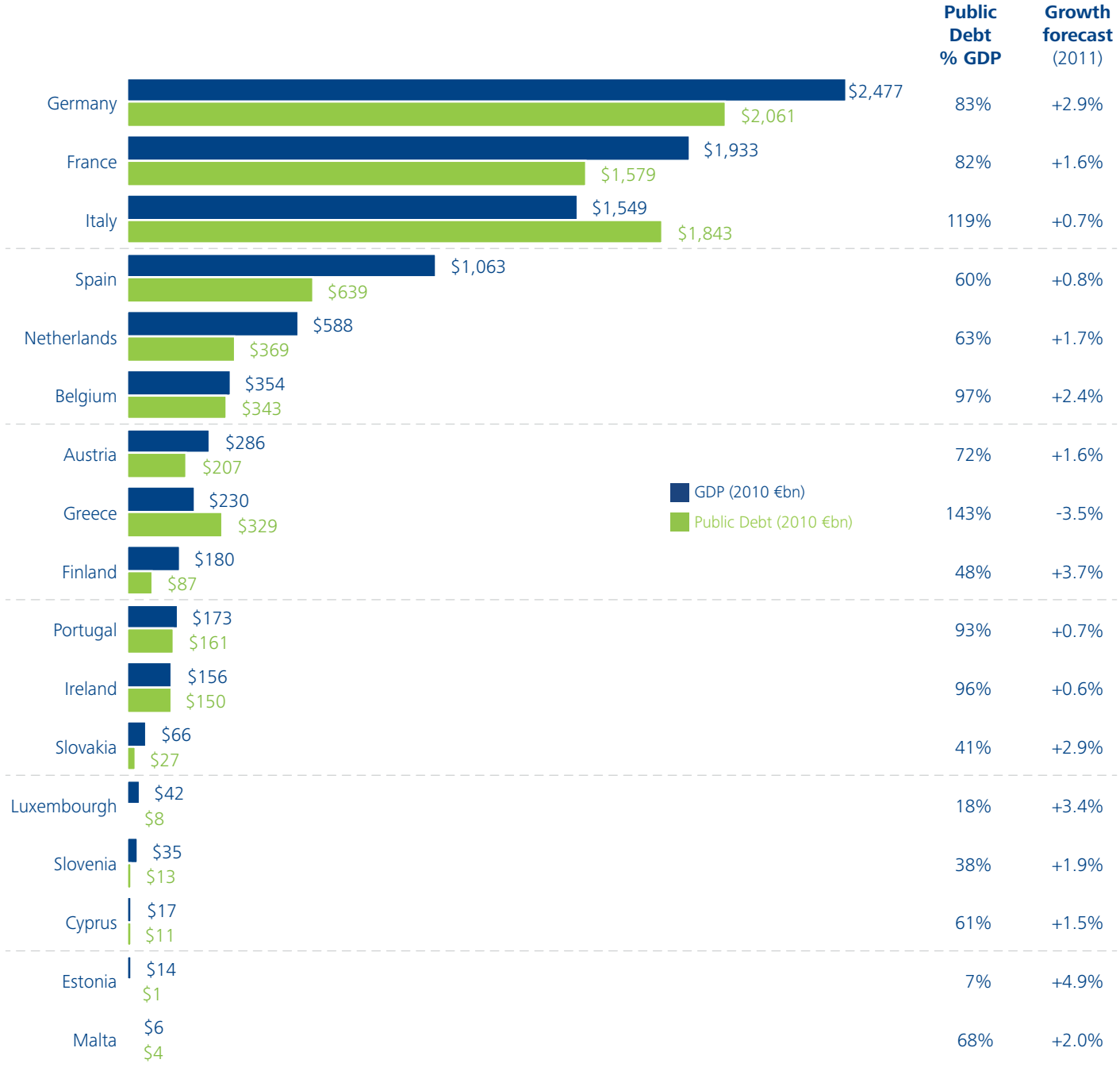
However, talk about a Eurozone recession should differentiate between countries. The danger of recession is particularly high in fringe nations where austerity packages are sapping growth and hurting confidence. Industrial nations like Germany and France are closely interconnected with their neighbors, but they are also depending on demand for their goods from emerging markets, especially the BRICs. As long as growth in emerging markets does not fall off a cliff, growth in these countries will likely decelerate without turning negative. Given their relative weight in the Eurozone, the possibility of a recession in the Euro area this winter will hinge on how deeply the fringe nations decline. Germany and France account for 48 percent of Eurozone GDP (see figure 3).

Growth estimates revised down

The latest official forecast from the European Commission still anticipates 1.6 percent GDP growth for the Euro area in 2011, with German growth revised from 2.6 percent to 2.9 percent for the year. Current economic indicators support this view, with the economy still benefitting from strong momentum in the first half of 2011. Industry orders for the Eurozone are still up 8 percent from a year ago and well above 2009 levels — despite declines in August and September (see figure 4).

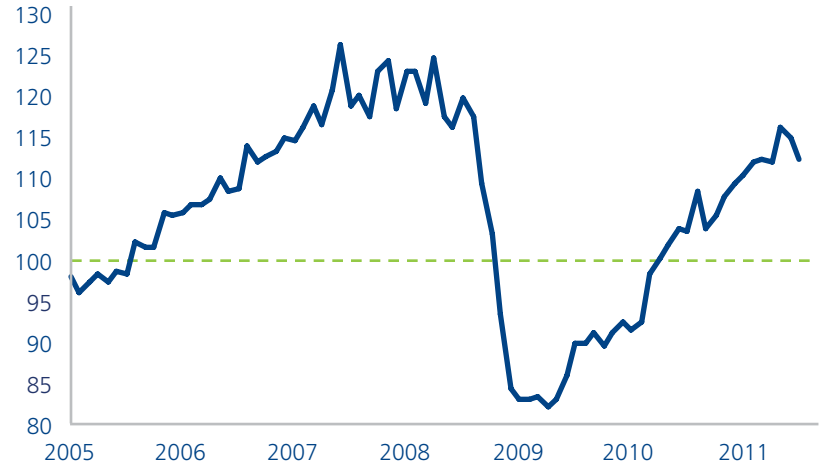
Judging by leading indicators, however, a deceleration is likely in the second half of the year. The negative momentum is expected to carry over into 2012 and weigh on growth prospects for next year. Forecasts for German growth have been revised to 1.0 percent or lower for 2012 based on recent data, and a recession for the Eurozone overall cannot be ruled out. This is due to a combination of several factors:

Figure 3: Eurozone country overview



Source: Eurostat

Figure 4: Eurozone new industry orders
(Index 2005 = 100)



Source: Eurostat

- **Decelerating export demand as global growth slows:** Emerging markets will provide less stimulus with growth slowing as a result of their countermeasures to overheating; in the United States, there is fear of a renewed recession amid attempted debt reduction and persistently high unemployment.
- **Weakening domestic demand due to deteriorating business and consumer sentiment:** Uncertainty about the future of the Eurozone is having a negative effect on confidence, which will impact the spending behavior of corporations and private households.
- **Investment costs are rising** amid financial market stress due to the sovereign debt crisis

The bigger picture

The current crisis is rooted in rising global imbalances. The United States and many nations of the European Union ran unsustainable deficits, which were financed by surpluses and emerging economies, particularly Asia. Along the way, these trade partners — first among them, China — accumulated huge financial interests in the West (currency reserves, sovereign debt, and other financial and direct investments). So an orderly, long-term solution to dealing with the debt overhang of Western nations is in everyone's interest (see China's offer to European leaders to buy Eurobonds if they are issued; however, the offer came attached to some unpopular conditions on easing trade barriers and tariffs).

To stabilize long-term world growth, Western industrialized nations will need to find a solution for a sustainable equilibrium in their relationship with the East. In a tri-polar world, Europe will have to find its place, and it will only be able to do that if it manages to speak with one voice.

President Barroso summed up the sentiment in his state of the union address: "Populist responses are putting into question the Union's greatest achievements, the euro, the single market and free movement of people. Yet there are solutions to the crisis. We can restore confidence and trust through united action. If we do not go for further integration, we risk fragmentation."

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USA

United States: The coming recession

by Dr. Carl Steidtmann

While the U.S. economy is not currently in a recession, the probability that it will slide into one before the end of the year is high and growing. The second-half uptick that so many, including ourselves, once expected was lost this spring in Europe as the first Greek bailout began to unravel. When the contagion spread to other fringe countries, the issue shifted from Greece to the over-leveraged European banks that hold 2 trillion euros in distressed sovereign debt, which is rapidly depreciating and cannot possibly be serviced, much less repaid. The endgame will play out shortly, but the results — a credit contraction and a severe recession for Europe — are the likely outcome.

In the United States, it is likely that job growth failed to materialize, in part, because the private sector faced increased costs associated with regulatory oversight in health care, financial services, and energy. Add to this the increase in government spending that was used to fund short-term consumption, shifting wealth from the future into the present. And finally, the Federal Reserve's high-risk but ultimately unsuccessful second round of quantitative easing increased oil and food prices but did little to stimulate real growth.

Q2 GDP points to recession

The first piece of hard data that argues in favor of a recession can be found in the most recent readings on U.S. Gross Domestic Product (GDP). While the 2007–2009 recession was more severe than previously advertised, the new data also showed that real GDP growth in the second quarter was up just 1.5 percent from a year ago. Since 1947, there have been 14 occasions when real GDP growth slowed below 2 percent. In 11 of those cases, the economy fell into a recession, which puts the historical probability at 78 percent.

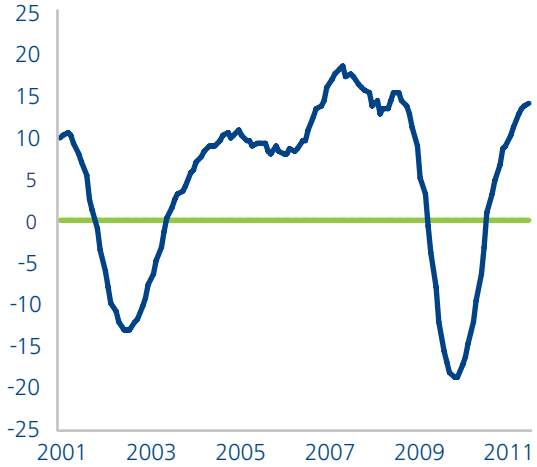
The European debt crisis

The second development that raises the risk of a recession in the United States is the European debt crisis and a corresponding recession that would follow it. A recession in Europe would wash back into the U.S. economy in several ways, including trade, industrial production, corporate profitability, and banking.

Trade: The European Union is a major trading partner for the United States, accounting for $259 billion in exports, which is roughly 12 percent of the $1.9 trillion in total U.S. exports. During the 2008–2009 recession, exports to the EU fell sharply from a peak of $272 billion to $220 billion, a peak-to-trough decline of 19.1 percent over a fifteen month period. Even with a recovery, U.S. exports to the EU are still 4.9 percent below their mid-2008 peak.

Another recession in Europe would have a comparable drag on U.S. exports. A comparable decline to what happened in 2008–2009 would bring U.S. exports down to $210 billion. Since Europe would not be the only place from which U.S. exports would decline, the trade sector would become a drag on growth.

Figure 1: U.S. exports to the European Union
(YoY % change)

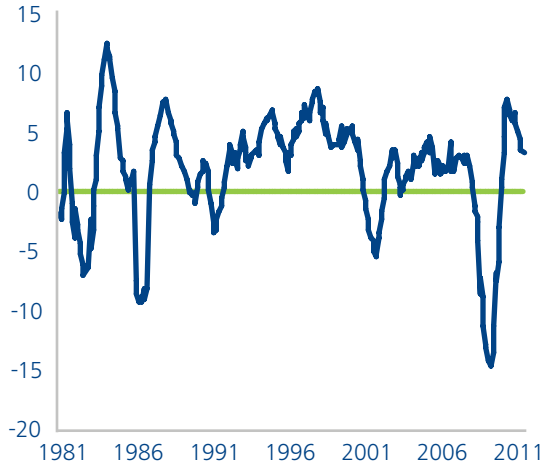


Source: U.S. Census Bureau

Industrial production: Manufacturing plummeted 15 percent during the 2008–2009 recession, its sharpest contraction since World War II. Beginning in the summer of 2009, industrial production posted a solid recovery, but it began to fade in the first quarter of 2011 due to problems in Japan and weaker growth in domestic demand. Production is up just 3.3 percent from a year ago while regional Federal Reserve indices point to future weakness.

While manufacturing as a share of GDP shrank over the years, it is still an important source of exports, profits, and

Figure 2: Industrial production
(YoY change)

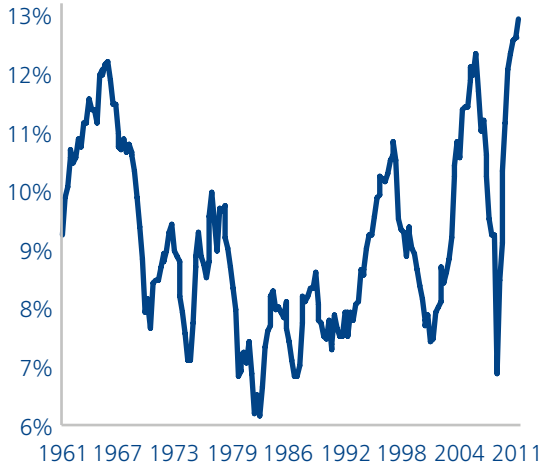


Source: Federal Reserve Board

employment. With new orders for factory goods on the decline, weakness in exports to Europe may push manufacturing back into a recession.

Corporate profits: After collapsing during the 2008–2009 recession, profits have posted their strongest and fastest recovery in more than 50 years. As a share of GDP, profits are at a level not seen since the early-1950s. Profits hit a low of 6.9 percent in Q4 2008 as a share of GDP only to rocket up to 12.9 percent in Q2 2011. U.S. businesses have been able to post record profits, in part, due to the strength of their overseas operations. A recession in Europe will undermine the performance of those operations and bring down corporate profitability in the United States.

Figure 3: Corporate profits as a share of GDP



Source: Bureau of Economic Analysis

Corporate profits are a key leading indicator for business investment. When profit growth is strong, businesses tend to invest in that growth. Therefore, a contraction in corporate profits will lead to weaker business investment.

Banking: In August 2007, commercial paper (CP) outstanding peaked at $2.2 trillion. As the credit crunch deepened, CP contracted by more than 50 percent over the following year. The Federal Reserve's purchases of commercial paper in the fall of 2008 may have staved off an even deeper contraction.

Figure 4: Commercial paper outstanding in the United States — foreign financial institutions
(In billions of $)

Source: Federal Reserve Board

Uncertainty over the degree of exposure on the part of U.S. banks to European debt and the counterparty risk exposure to European banks has led to a liquidity squeeze in the United States that can be seen in the commercial paper market. After peaking at $1.2 trillion in July 2011, commercial paper outstanding has contracted by $200

billion — an annualized rate of decline in excess of 50 percent.

U.S. banks are not the only financial institutions facing a liquidity crunch. Commercial paper issued by foreign financial institutions has also been on the decline. The contraction in dollar-denominated commercial paper is creating a liquidity crisis for some European banks that depend heavily on short-term financing. The Federal Reserve responded to this dollar liquidity squeeze by opening dollar swap lines with the European Central Bank, the Bank of England, and the Swiss National Bank.

Déjà vu and downturn signals

The current financial situation has an eerie déjà-vu sense to it. History never repeats itself perfectly, but there are enough parallels between the financial crisis of 2008 and the early developments in the current financial crisis in Europe to raise concern. While one or two of the events could be dismissed as a coincidence, they collectively make a strong case for a return to recession.

1. Federal tax collections fall: Tax collections began to sputter in the spring of 2008, posting small declines in the summer before plunging after the Lehman crisis in September. Tax collections peaked in late-July 2011. Through September, they have fallen 5.1 percent from that level, and they are flat from a year ago. Declining tax collections is a symptom of a declining economy.

2. M2 money supply growth: In the fall of 2008, M2 money supply growth exploded to the upside, rising nearly 25 percent quarter-to-quarter on an annualized basis. Rapid money supply growth, coupled with flagging real growth, is one of the characteristic signs of a liquidity trap where the demand for money rises sharply in the face of uncertainty. It is also a reflection of the rush to safety as some of the increase was driven by businesses shifting deposits from foreign to U.S. banks.

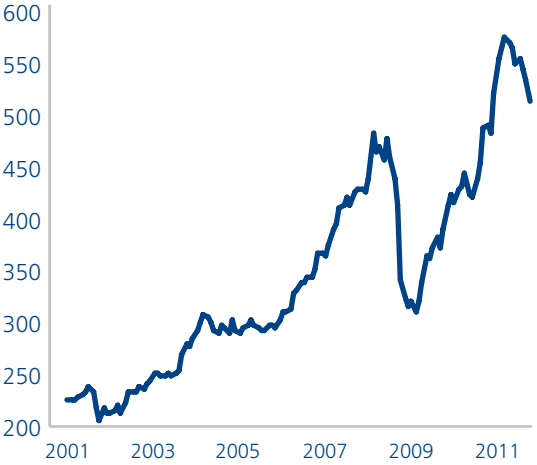
M2 money supply at the end of September was growing at a 26.4 percent clip. The growth in money supply represents a rush of European liquidity into the safety of U.S. banks.

3. Commodity prices: Prices for gold, oil, food, and feed all rose sharply from 2005 to early-2008. Prices then traded in a narrow range before plummeting in the summer of 2008, a decline that continued into early-2009. Gold prices fell 30 percent. Oil prices went from a peak of $147 a barrel down to $38. The peak-to-trough decline in all commodities was 34.7 percent.

Figure 5: M2 money supply
(YoY percentage change)

Source: Federal Reserve Board

Figure 6: Spot market price index
(1967 = 100)



Source: Commodity Research Bureau

Commodity prices peaked in March 2011 and have declined 10.6 percent. After peaking at $114 a barrel in late-April, oil prices are down more than 30 percent. Copper prices have fallen by roughly the same percentage. Wheat prices that reached $8.80 a bushel have fallen to $6.60. Declining commodity prices are generally associated with a decline in the global economy.

4. Credit spreads: Credit defaults rise during recessions. Fear of default drives increases in credit spreads. During the 2008 credit crisis, credit spreads hit levels we have not seen at any other time in the post-World-War-II economic era. While nowhere near those levels, credit spreads are again on the rise. The TED spread, the difference between interbank lending rates and U.S. Treasury bill rates, have more than doubled from a low of 16 in late-July to 36 more recently. Corporate risk spreads have risen from a low of 255 in April to 333 more recently.

In Europe, the expansion of risk spreads has been even more dramatic; spreads between Greek and German debt rose from a few hundred basis points to a few thousand. Italian and German spreads have gone from a low of 120 basis points to just under 400 basis points in late-September.

5. The dollar: After a decade of steady declines, the dollar was bid up on foreign exchange markets beginning in the summer of 2008. The rush into the dollar was a safe-haven move that showed up in an increase in U.S. money supply and price and a decline in the interest rates on U.S. Treasury bonds. From trough to peak, the dollar gained 20.4 percent over a nine month period in 2008–2009.

After peaking in March 2009, the dollar again moved lower as it did over the course of the previous decade. By in July 2011, it was back at its pre-crisis levels. The dollar is again on the rise. In the six weeks since recording its low in late-July, the dollar rose 3.4 percent as global investors sought the safety of dollar-denominated assets.

6. U.S. Treasuries: The global rush to safety that increased the value of the U.S. dollar also found its way into the price for U.S. Treasuries. During the fall of 2008, yields on 10 year U.S. Treasury bonds fell just over 200 basis points from 4.2 to 2.2 during the second half of 2008.

Figure 7: U.S. dollar, trade weighted
(1973 = 100)

Source: St. Louis Federal Reserve

Figure 8: 10 year U.S. Treasury bond yields
(Percentage)

Source: St. Louis Federal Reserve

Since March 2011, interest rates on U.S. Treasury bonds have followed a similar, downward path. Despite a downgrade in U.S. debt ratings, rates of the 10 year U.S. Treasury bond have fallen from a high of 3.7 to 1.9 and was as low as 1.7 — a drop of nearly 200 basis points over

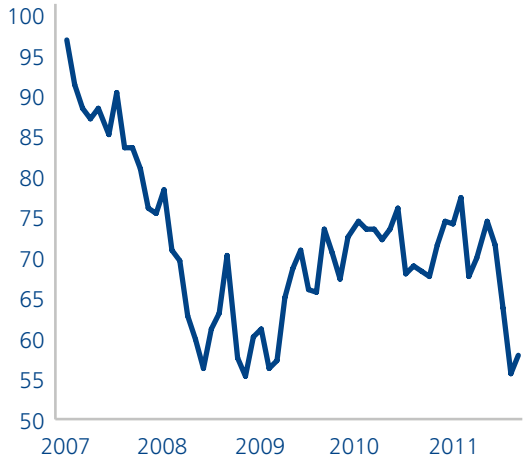
a period of seven months. The Federal Reserve's "Operation Twist" seeks to drive long-term rates even lower.

7. Collapsing consumer confidence: As the financial crisis began to build in 2007, consumer confidence began to slide. From a peak value of 96.9 in January 2007, confidence slipped steadily lower before hitting a low of 55.3 in November 2008 — a drop of more than 40 points.

After peaking in February 2011 at 77.5, consumer confidence, as measured by the University of Michigan survey, fell to a low of 55.7 in August 2011, a drop of nearly 22 points. In past business cycles, a decline in consumer confidence below 80 was a consistent sign of recession.

8. Short selling ban: In fall 2008, the Securities and Exchange Commission issued a ban on the short sale of bank stocks, but the ban failed to stem the decline in the share values of stocks. In August 2011, financial market regulators across Europe banned short selling of bank stocks, but the ban has failed to stop the decline in bank shares.

Figure 9: Univ. of Michigan consumer sentiment index
(1966 = 100)



Source: University of Michigan

What is different now?

U.S. businesses are going into this recession with much stronger balance sheets and much leaner operations than in 2008. Cash levels and productivity are substantially higher. With leaner operations, layoffs and inventory reduction will not create the kind of downdraft for the broader macro economy that they did in 2008.

On the downside, the policy options available to address the recession are much more limited today than they were in 2008. Back-to-back stimulus programs in 2009 and 2010 in excess of $800 billion are unthinkable today. A third round of quantitative easing is possible, but it will be controversial and given the effectiveness of the previous round, may be of limited value.

While a recession has probably already started in Europe, expect the U.S. recession to begin before the end of the year. Weaker exports, a decline in business investment, and contracting manufacturing will likely combine to push an economy that is operating at stall speed into a recession. The sharp cuts in inventories and employment that characterized the 2008–2009 recession should be limited in this downturn. Still, the United States starts this recession with an unemployment rate of 9.1 percent, a number that undoubtedly will go higher.

CHINA

China: Slower growth, longer-term risks

by Dr. Ira Kalish

China's economy is decelerating. In September, the purchasing managers indices for output and exports were below 50 for a third month in a row, which hasn't happened since 2009. Still, the indices barely slipped below 50, indicating that the decline in manufacturing is moderate. Moreover, China's central bank has stopped tightening policy given the latest global slowdown. Therefore, although China's economy will slow down, deceleration will likely be less-than-dramatic.

On the other hand, it is notable that a senior Chinese official recently predicted that growth in 2012 would be below 9 percent. If this prediction materializes, it would be the first year since 2001 that growth falls below 9 percent. These comments reflect a belief that a combination of monetary policy tightening and reduced global growth will cause the Chinese economy to grow more slowly.

Interestingly, there is evidence that the economic slowdown is being experienced principally by small- to medium-sized private businesses (especially those that export) and not by the large, state-run enterprises that retain favorable access to credit. After all, imports of oil and iron ore rose significantly in August. The biggest source of recent growth has been fixed asset investment, especially construction. The importation of iron ore, used to make steel, indicates ongoing strength in construction. Meanwhile, a deceleration in exports is the prime cause of the economic slowdown. While the strength of construction is good in the short term, it means that China continues to over-build.

Excessive debt poses risk for China

China's officials have complained about the rapid expansion of U.S. government debt. This reflects fear

that the massive stock of foreign currency reserves held by China's government could lose value. Less attention, however, has been paid to the big increase in overall debt in China itself. Yet, that is likely to change soon, given the fact that overall debt has nearly tripled in the past five years. Notably, a top Chinese official recently said that the debt of China's local governments is "our version of the U.S. subprime crisis." The $1.7 trillion in debts issued by local governments to fund infrastructure building has been a concern for some time, but officials have downplayed the danger until now. The fear is that multiple defaults could damage the health of China's banks without a bailout from the central government.

How did it come to this?

When the global economic crisis began in 2008 and China's exports suddenly dropped, the government implemented a vast stimulus program to boost domestic demand and offset the drop in exports. Part of this involved extending credit to provincial and local governments to engage in infrastructure development. In the short run, this policy was successful in boosting growth and preventing a general recession. The problem, however, is that many such investments have failed to generate adequate returns. The Chinese government estimates that little more than one quarter of local government investment has produced a return adequate to service the debts. Furthermore, local government borrowing is not the entire problem. During the global crisis, the government injected capital into state-run banks so that they could lend to state-run companies. The result was an investment boom. Yet this also involved many investments that are not producing an adequate return.

The result was that investment in fixed assets surged, reaching almost 50 percent of GDP last year. Meanwhile, consumer spending declined to about 35 percent of GDP. Now that the Chinese economy is slowing, the risk exists that China's debtors may soon face greater difficulties in servicing their debts.

What exactly is the risk?

Is China at risk of having a financial crisis? On one hand, there is a danger that a new round of defaults will damage the solvency of China's state-run banking system. Yet, it is likely that the government would bail out such banks and thereby prevent a larger financial crisis. Moreover, due to capital controls, China's financial system is not integrated into the global economy. Therefore, a problem in China's banks would not lead to problems outside of China.

On the other hand, China does face a risk. Specifically, if the government were compelled to bail out troubled financial institutions, it would probably not support continued lending for the purpose of poorly conceived investments. Consequently, investment would likely

It is safe to say that China is slowing down. In addition, it is probably safe to say that the excessive debt-financed investment of recent years will likely lead to challenges somewhere down the road.

fall considerably. Given that investment is now close to 50 percent of GDP, such a fall could have serious consequences for GDP without an offsetting increase in something else. What could that something else be?

Exports are not likely to take up the slack. With a rising currency, slower growth overseas, and rising wages at China's factories, it seems likely that export growth will be slow in the next few years. In this scenario, China will likely look toward a boost in consumer spending to offset a decline in investment, but it would have to grow rapidly to make a difference and avoid a significant slowdown, given that consumer spending is now only 35 percent of GDP.

What could go right?

There are some positive signs concerning the prospect for boosting consumer spending. First, wages have been rising, adding to real, disposable incomes. This reflects a shortage of labor as demographic trends limit the labor force's growth and as internal migration slows. In addition, provincial and local governments have been increasing their minimum wages. Second, the government intends to have state-run companies pay higher dividends to shareholders (mainly the government). In so doing, this will reduce retained earnings and therefore, the impetus to invest. Third, higher inflation will help to reduce some of the real value of the debts in question. On the other hand, high inflation means that real interest rates are largely negative, thereby fueling continued borrowing. Also, high inflation means that the real value of the currency is rising quickly, thereby hurting export competitiveness. So a slowdown in exports could become more pronounced.

What happens next?

It is safe to say that China is slowing down. In addition, it is probably safe to say that the excessive debt-financed investment of recent years will likely lead to challenges somewhere down the road. In that situation, economic growth will decelerate. How much it slows will depend on a variety of factors, including how the government responds to such an event.

In any event, an economic slowdown in China will have global ramifications. A Chinese slowdown will remove pressure on global commodity prices and reduce export growth for China's major trading partners. Domestically, slower growth could remove some of the upward pressure on wages and prices. It could also potentially lead to social unrest.

Japan: On the bright side…

by Dr. Ira Kalish

In a world of slowing economic growth, Japan is the exception. In fact, the country can reasonably expect that growth will soon accelerate — at least for awhile. The silver lining of a natural disaster is the extra spending that boosts economic growth, but the positive impact of reconstruction spending has not met expectations. Challenges remain for the Japanese economy.

In the second quarter of 2011, the economy contracted at a rate of 2 percent. This third consecutive quarter of declining GDP was, in part, due to the negative impact of the earthquake and tsunami. While many analysts anticipated a strong boost to economic growth in the second half of 2011, the latest numbers suggest slower growth than expected. The Tankan index of sentiment at large manufacturing companies rose from -9 in the second quarter to +2 in the third quarter. A positive reading means that there are more optimists than pessimists among the surveyed executives. The current reading is still lower than in March, just before the earthquake. Japan is recovering, but the pace is underwhelming. This is likely due to slower overseas growth, a high-valued yen, and slower-than-expected reconstruction spending.

The rising value of the yen is taking its toll on the industrial sector. While the automotive sector is recovering from damage to its supply chain, the major players are planning to shift production capacity offshore in order to avoid the impact of an overvalued currency. The strong yen reflects several factors, including the repatriation of overseas funds for the purpose of reconstruction. It is also due to the perception of Japan as a safe haven for financial assets in a time of global turmoil. Although the return on Japanese assets is very low, global investors do not perceive them to be at risk of outright failure.

Still, despite troubles in Japan's export sector, the country will probably grow faster in 2012 than either Europe or the United States. This would not be the case absent the earthquake and tsunami; reconstruction spending will make a significant difference.

In September, the Japanese government proposed its third reconstruction budget of 12 trillion yen — roughly $160 billion, which is about twice what has already been budgeted. This brings the total to about $240 billion. The big debate has been over how to finance this expenditure. The current government has indicated a preference for tax increases so as not to substantially increase the already-large debt. As such, it is likely that there will be an increase in the consumption tax. This will have some negative impact on consumer spending. In addition to increasing the consumption tax, the government plans to sell assets such as shares in Japan Tobacco to fund reconstruction. Interestingly, the government's deficit was already projected to be 8 percent of GDP even before the earthquake. Reconstruction costs, by adding an estimated 4 percent of GDP, will not have a big impact on overall debt, even if it is financed by borrowing.

Meanwhile, despite the government's plans for fiscal rectitude, Moody's has again downgraded Japan's sovereign debt. This action had little impact on the market for Japanese government bonds, which continue to offer among the lowest rates of return in the world. While Moody's was evidently concerned about the fact that government debt has reached 200 percent of GDP, there are other mitigating factors. For example, 95 percent of that debt is held domestically. In addition, Japan continues to have a very high rate of savings, so financing government deficits is not a problem.

Interestingly, Japanese monetary policy has been relatively aggressive this year; the Bank of Japan engaged in quantitative easing on a surprisingly large scale, but perhaps it has not been large enough. The currency continues to rise, and inflation continues to be very low. One of the purposes of a round of quantitative easing is to boost expectations of inflation. Higher inflation can have the effect of boosting spending, reducing real interest rates, and reducing the real value of debts. However, retail sales are declining, business investment fell in the second quarter, and inflation remains close to zero. Thus, the real level of debt has not improved.

Going forward, Japan continues to face several downside risks despite the anticipated boost from reconstruction spending. The global economic slowdown is first among these risks as it will have a negative impact on export growth. Domestically, major challenges include a slower-than-expected revival of electricity generating capacity, uncertainty about the future of Japan's nuclear program, political uncertainty, a continued high rate of savings, and long-term problems related to demographics.

Ian Stewart is Chief Economist at Deloitte Research in the United Kingdom

United Kingdom: Waiting for a Policy Response

by Ian Stewart

- The UK growth outlook has deteriorated
- CFOs are shifting to more defensive strategies
- The outlook hinges on the policy response from UK and international policymakers

What looked like a global soft patch in activity has turned into something much more serious. Consistent with the other large industrialized countries, UK growth slowed sharply in the second quarter (although, in the case of the UK, activity was somewhat depressed by timing effects and by the impact of Japan's tsunami and earthquake). UK domestic fundamentals have weakened, but the big change has been in the global environment. The Eurozone debt crisis created fears of a vicious spiral of sovereign and bank defaults. One consequence has been the virtual closure of corporate bond and bank term funding markets to new issuance. Our own measure of financial stress is now showing the highest readings in 2 years (see figure 1). Confidence about global growth has waned. Consensus forecasts for GDP growth have declined across the industrialized world (see figure 2).

The UK consumer sector remains weak with spending under pressure from a severe squeeze on real incomes. Over the last year, real personal disposable incomes have fallen by almost 3 percent, the fastest rate of decline in this indicator of consumer spending power since 1976. With consumer borrowing growing at single-digit rates,

Figure 1: Deloitte financial stress index

The Deloitte Financial Stress index is an arithmetic average of the ratio of 3 month LIBOR to base rates, the ratio of yield on high yield bonds to yield on government bonds, the VIX index, the ratio of total market return to banking stocks return and the ratio of yield on long term government bonds to yield on short term bonds.

Source: Economics & Markets, Deloitte Research, London


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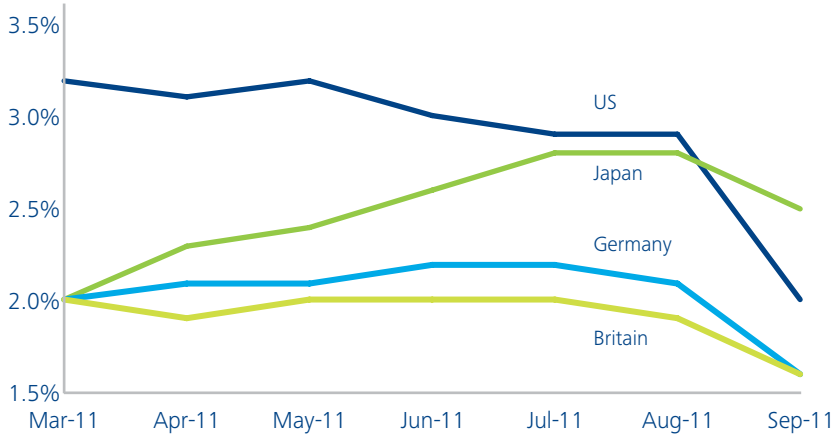
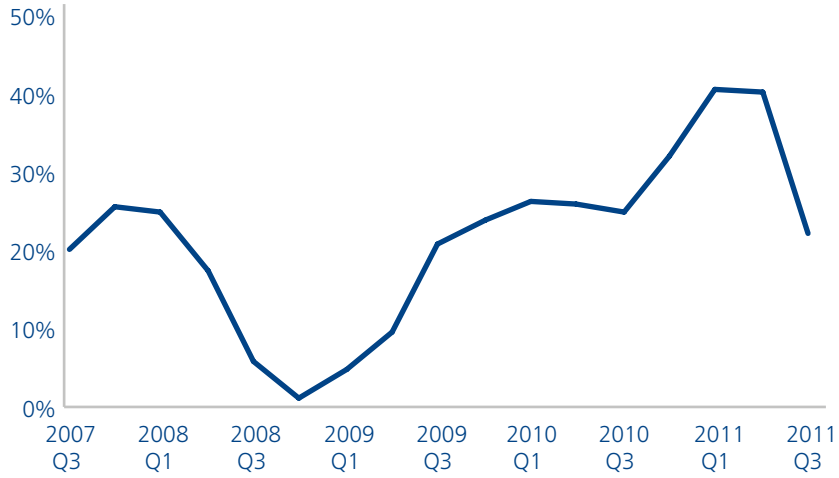
Figure 2: Consensus GDP growth forecasts for 2012



Source: *The Economist*

Figure 3: Deloitte CFO risk appetite survey
% of CFOs who think now is a good time to take greater risk onto their company's balance sheet



Source: Economics & Markets, Deloitte Research, London

credit has been unable to fill the gap. Over the last year, retail spending has hardly increased, and house prices have fallen. Mortgage approvals, a key leading indicator for housing activity, remain at historically low levels.

Deloitte UK's third quarter survey of chief financial officers testifies to the impact of recent macroeconomic and financial uncertainty on corporate sentiment and on business strategy. Optimism among UK CFOs has fallen for the third consecutive quarter and is now at levels last seen in early-2009 when the UK economy was in a recession. The world has become riskier and more uncertain for corporates. The proportion of CFOs who say external financial and macroeconomic uncertainty is "high" or "very high" has almost doubled to 46 percent, and on average, CFOs now see a 43 percent chance that the UK economy will fall back into recession.

A weaker and more uncertain economic backdrop has also dented CFOs' appetites for risk (see figure 3), and this, in turn, has expressed itself in a continuing tilt in the balance sheet strategies employed by CFOs. For the first time in a year, cost control is the top priority for CFOs. Capital expenditure and making acquisitions are tumbling down the list of priorities. Most think that a period of rapid margin expansion is drawing to an end. CFOs are responding with a renewed focus on cost control. Expectations of a revival in corporate capital spending and hiring are fading. For UK corporates, defensive strategies are, once again, to the fore.

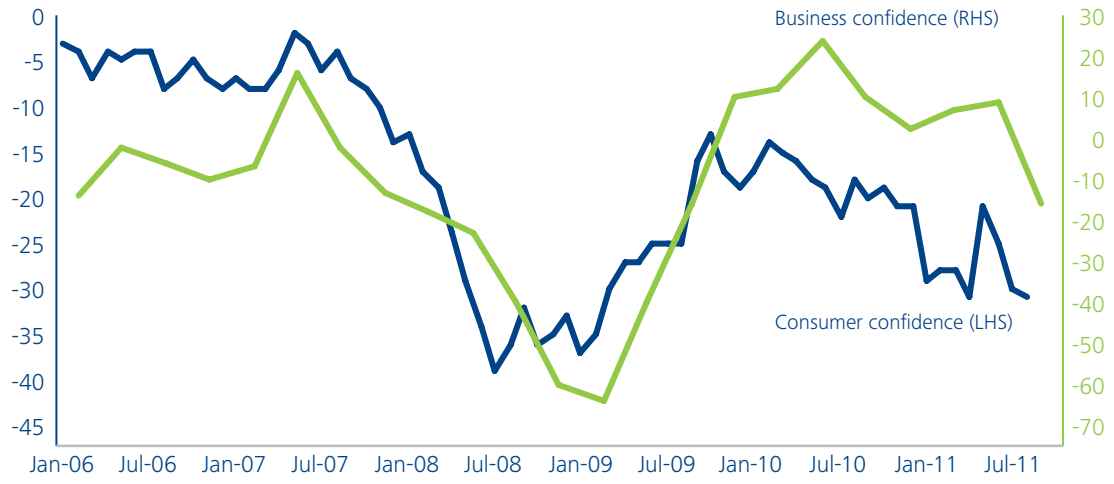
The findings from the CFO Survey suggest that, at least for now, corporate activity is likely to weaken. This represents a setback for a recovery that was always going to be heavily reliant on the private corporate sector to grow capital spending, exports, and hiring.

With sentiment sagging across the household and corporate sectors (see figure 4), policymakers have responded with further monetary ease. In October, the Bank of England announced a round of further quantitative easing worth £75bn, much higher than what the markets had expected. At the Conservative Party's conference on October 3rd, the chancellor surprised markets by announcing a program of "credit easing" designed to support the flow of finance to the corporate sector through government purchases of corporate bonds. The details have yet to be worked out, but the fact that the government has dusted off a policy response that was last employed in the first quarter of 2009 testifies to growing concerns about the outlook.

Much will hinge on the speed and effectiveness of the response from European policymakers to the crisis in the Euro area. The IMF summed up the problem neatly in its latest Financial Stability Report: "Until a sufficiently

A combination of monetary ease in the UK and abroad should help bolster growth next year. So, too, will sharply lower inflation; UK inflation is widely expected to almost halve over the next 12 months, and this will support consumer spending power.

Figure 4: Consumer and business confidence indices



Source: Confederation of British Industry and GfK NOP

comprehensive strategy is in place to address sovereign contagion, bolster the resilience of the financial system, and reassure market participants of policymakers' commitment to preserving stability in the Euro area, markets are likely to remain volatile."

A combination of monetary ease in the UK and abroad should help bolster growth next year. So, too, will sharply lower inflation; UK inflation is widely expected to almost halve over the next 12 months, and this will support consumer spending power. But the UK's fortunes are heavily dependent on events in the Euro area. Financial stress, as Lehman's failure demonstrated, can spread contagiously. Disruption to demand in the Euro area would hit the UK's largest export market. Introducing another round of quantitative easing in the UK is politically and technically straightforward, but finding a solution to the problems of the Euro area is precisely the opposite.

Siddharth Ramalingam is a Senior Analyst at Deloitte Research, India

India: Trudging along, for now

by Siddharth Ramalingam

Over the past two years, India has experienced one of the highest inflation rates in major emerging markets. High food inflation and fears of a lack of meaningful fiscal intervention have compelled the central bank to increase interest rates in order to pursue lower prices at the expense of growth. The central bank's latest tightening in September, the twelfth since March 2010, comes in the wake of fears of a global recession and the possibility of debt defaults in some Eurozone countries. While some critics of the central bank say that the bank has been too slow in reacting to inflation and has not been bold enough with its rate increases, several others lament the rising cost of capital and falling domestic demand. While the debate regarding India's monetary policy rages on, it is becoming increasingly likely that the Indian government will not meet its fiscal deficit target for the year. While policymakers tinker with policy tools, the Indian economy is on course to achieve over 7 percent growth this fiscal year.

Inflation stays high

Inflation continues to be the key issue for Indian policymakers. In a bold move to curb inflation, the central bank raised interest rates by 50 basis points in July and by another 25 basis points in September. Despite recent rate increases, inflation came in at over 9 percent in July and hit a 13-month high of 9.8 percent in August. Food inflation, despite hitting a 20-month low of 7.3 percent in July, settled at 9.1 percent in September. That food inflation continues to be an issue, despite a good harvest in the 2010–2011 season and normal rainfall this year, is a clear indication that structural issues and supply-side bottlenecks that plague the Indian agricultural sector will remain for some time to come.

Fuel inflation is beginning to exert upward pressure on headline inflation as well. In order to ease the burden of fuel subsidies on its purse, the central government decided to deregulate the price of petrol in 2010. Since this deregulation, prices have risen sharply, with two increases just in the last five months. This has pushed fuel inflation to about 15 percent for the year until September. While the inflationary impact of the rise in fuel prices is worrisome, what is interesting is the fact that the latest price increase was the result of the depreciating rupee against the dollar on imports of crude oil.

The external sector

With policymakers wrestling to control inflation and sustain growth in the context of a weak global economy, the rupee hit new lows as global funds chase better prospects for growth. The falling rupee is a serious cause of consternation for importers, oil companies included. At the same time, while one would normally expect a weaker rupee to benefit exporters, a shaky global recovery means exporters may not be able to take advantage of the opportunity for cost arbitrage in the coming months.

India's merchandise exports grew by 82 percent in July to $29 billion, while imports for the month climbed by 52 percent to $40 billion. India's exports maintained their growth momentum in August, rising 44 percent to $24 billion. Imports grew by 41 percent to $38 billion in August. Although exports seem to be doing well despite the economic woes in traditional Western markets, this is unlikely to be the case going forward. With the global economy in a sticky patch, exports could start to decelerate despite an increasing share of trade with emerging economies.

At 14 billion rupees, foreign direct investment (FDI) for the first quarter of the current fiscal year has almost tripled compared to last year. The commerce minister estimates that FDI will touch $30 billion during the current fiscal year. With much of the world still in recession, it is likely that global investors will invest in India. The government is exploring FDI in the retail and pharmaceutical sectors, and it has relaxed investment norms over the last few months. The government has also pledged to support the infrastructure sector and is setting up investment zones in order to attract investors. This is expected to pave the way for sustained growth over the next few years.

Consumption is bad, but industry is worse

Interest rate hikes have finally begun to put the brakes on GDP growth in India. GDP growth for the first three months of 2011 came in at 7.8 percent, compared to a growth of 9.4 percent in the corresponding quarter of 2010. Figures for the quarter that ended July further corroborate the slowdown in growth. GDP grew at 7.7 percent compared to 8.8 percent the previous year. What is surprising about data from the recent quarter is that investment increased almost 8 percent after floundering around zero percent during the previous quarter.

High interest rates, combined with a potential liquidity challenge in the second half of the year, could ensure that investment drops off once again as the year progresses. The central government recently announced that it will need to borrow 13 percent more than what it budgeted for the current fiscal year primarily due to a reduction in funds available through national savings accounts; there has been an exodus of funds from national saving accounts toward accounts in banks as they offer higher interest rates. This mopping up of funds from the market, although unlikely to add to the fiscal deficit, could crowd out investment from the private sector and increase the

cost of borrowing for both government and private sector borrowers. However, the central bank is likely to be called upon to buy government bonds from the market in order to infuse liquidity, and this could, in turn, add to inflation.

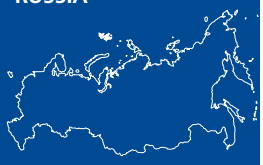
Consumer demand has taken a hit, and growth in rate-sensitive sectors has been weak in the last two quarters. Still, relatively speaking, domestic consumption is robust and is likely to act as a buffer for the economy in the event of further global economic turbulence. However, it is important to note that policymakers are currently grappling with high inflation. Both the finance minister and the head of the central bank believe that current levels of food inflation are a matter of grave concern, and another hike in interest rates is a possibility. That being said, we could also be very close to the end of the rate increases.

Until there is a clear indication that interest rates will stabilize, business confidence is likely to continue to drop. Private investment is expected to slow down in the coming months as well. India's manufacturing output slowed to its lowest pace in 30 months in September according to the HSBC purchasing managers index (PMI). The PMI slid to 50.4, which is just a touch above the level that divides contraction of manufacturing activity from expansion. Any reading above 50 indicates expansion. Also, the services sector grew at its slowest pace in two years in August, according to the HSBC Markit Business Activity Index.

A look ahead

The challenges that face Indian policymakers are, to a large extent, the same as they were a year ago. Inflation shows no signs of abating, and another interest rate hike is a possibility, but the end of the cycle of rate increases is probably very close. Consumer demand is likely to continue to slow down as monetary policy kicks in with some lag. Consequently, GDP growth may slow down further and may hover around 7.5 percent for the current fiscal year. The fiscal deficit is unlikely to meet the target level of 4.6 percent of GDP. Since a significant portion of the deficit is funded through funds from the central bank, money supply in the economy will continue to increase and exert upward pressure on inflation

RUSSIA



Russia: Political clarity, policy uncertainty

by Dr. Ira Kalish

At long last, the political situation in Russia has clarity. It was announced that Prime Minister Putin will return as president in March 2012, exchanging jobs with President Medvedev. This means that, in theory, Putin could be president for the next 12 years since the constitution would allow this. Yet, clarity about who occupies which chair does not imply clarity about the policy outlook, which remains uncertain. And it could be that uncertainty pertaining to policy has contributed to a declining value of the ruble. In the past few years, Russia has experienced almost $250 billion in capital flight, given the weak global economy and a perception of poor investment opportunities at home. Such flight puts downward pressure on the currency.

The recent political announcement was greeted by an acceleration of currency depreciation as it left many questions about the future unanswered. In the past year, President Medvedev spoke about creating a more diverse and transparent economy, promoting more foreign investment, privatizing state-run companies, and improving the finances of the state-run pension program. Meanwhile, Prime Minister Putin has evidently favored greater stability and predictability through state control of important sectors, particularly energy. Now that the two men are exchanging jobs, the conventional wisdom is that Putin is the more powerful figure. But does this exchange of jobs presage a shift in policy or more of the same? No one can say for sure. The country's finance minister, Alexei Kudrin, however, said he that couldn't work under the new regime and was promptly dismissed. Highly regarded for his fiscal management, Kudrin's exit added to the sense of uncertainty.

Clarity about who occupies which chair does not imply clarity about the policy outlook, which remains uncertain.

Modest growth ahead

Meanwhile, the Russian economy appears headed for growth in 2011 of about 4 percent. This is a disappointment, given the Russian economy grew far faster prior to the global crisis. Unfortunately, a slowing global economy and dampening oil prices will not be helpful. Instead, the economy will mostly have to rely on domestic demand. While consumer spending is doing well, fixed asset investment is not growing at a speed that would offset a slowdown in exports.

On the positive side, consumer spending continues to rise, given rising real wages and greater access to consumer credit. Also, it is widely expected that fiscal policy will be more expansive in the months leading up to the election in March. This expectation is based on the fact that similar policy shifts have taken place in the past. Fiscal expansion will likely have a positive impact on economic activity.

Also on the positive side is the fact that inflation is not accelerating. The central bank tightened monetary policy during the first half of 2011, but it left policy unchanged since May. This tightening, combined with declining global food and energy prices, has caused inflation to peak below 10 percent. In addition, it is expected that inflation will gradually decline in the coming year. However, a steep drop in the value of the ruble could have an inflationary impact.

As for monetary policy, the deceleration of inflation provides the central bank room for engaging in more aggressive policy, should the economic slowdown become onerous. On the other hand, while the central bank does not explicitly target the exchange rate, a declining ruble could restrain the bank from cutting interest rates.

Energy investment

One of Russia's problems in recent years was insufficient investment and declining production in the energy sector. This was partly due to poor relations between the government and foreign investors. Now, a state-controlled oil company has entered into a joint venture with an American company to develop energy under Russia's Artic coastline. This multi-billion dollar endeavor, in which Prime Minister Putin was present for the signing, suggests a new attitude toward foreign investment and a recognition that foreign technology will be needed to tap into oil in the most hostile conditions. It also suggests that several years down the line, energy output could start to grow again. The deal is big and is expected to involve tens of billions of dollars over time. The Arctic region is estimated to hold about one quarter of the world's recoverable oil and gas.

European troubles

Perhaps the biggest short-term risk to the Russian economy is the sovereign debt crisis in Western Europe. This has two potential implications for Russia. First, slower growth in Europe will hurt Russian exports of energy and manufactured goods. Indeed, this is already happening. Second, problems in Europe's credit markets could make it difficult for Russian debtors to roll over their external debts.

Brazil: Changing direction

by Dr. Ira Kalish

Brazil's central bank has chosen a new path. After a two year period of raising interest rates in order to fight rising inflation, the bank suddenly and unexpectedly cut the critical Selic rate in August. The changing fortunes of the global economy have caused the central bank to rethink its policy in light of a new outlook.

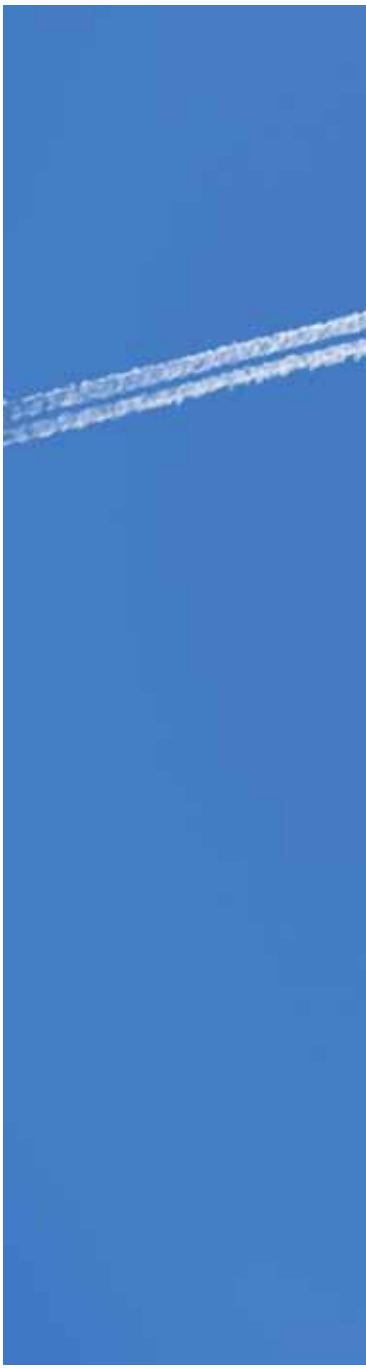
First, let's look at what has happened recently. When the United States implemented its QE2 policy of purchasing government bonds, which had the effect of keeping U.S. interest rates historically low, many investors sought higher returns in emerging markets such as Brazil. Not only did Brazil have relatively high interest rates, but investors also anticipated that the real would appreciate. Thus, the potential returns from putting money into Brazil were considerable. The problem was that the inward flow of portfolio investment had the effect of boosting the value of the currency. From December 2008 to August 2011, the currency rose 43 percent against the dollar. The result was damage to the competitiveness of Brazil's manufactured exports. The problem was exacerbated as Brazil raised interest rates during the past two years in order to fight rising inflation. Brazil's economy was on fire, and the government attempted to pour water on this overheated economy.

To deal with the problem of currency appreciation, the Brazilian government imposed taxes on inward investment in order to limit the flow of money. This did not work. Instead, the government finally decided that, given the choice of fighting inflation or fighting currency appreciation, it would focus on the former. It continued to raise interest rates in order to fight inflation. By the summer of 2011, the economy was showing signs of decelerating. In the period April through August, industrial production declined in three of the five months. By August, it was up only 1.8 percent from a year earlier. In September, the purchasing managers index (PMI) was down to its lowest level since April 2009. Moreover, as asset prices in Europe and the United States fell rapidly, investors shifted funds out of Brazil in order to cover their losses elsewhere. The result was that, from the end of August to late-September, the Brazilian real fell 16 percent against the dollar.

With this very new situation, the Brazilian central bank decided that it no longer needed to worry about inflation. Instead, it needed to worry about a significant economic slowdown. So in August, it cut the Selic rate by 50 basis points and is widely expected to cut the rate again in the near future. In addition, the central bank decided that too rapid a decline in the real could be disruptive and inflationary. In recent weeks, it has intervened in the currency markets by selling foreign currency reserves in order to stem the drop in the currency. The problem, however, is that propping up the currency has the effect of stemming money supply growth, which offsets the positive impact of cutting interest rates. Again, the government will have to make a choice. Does it want to stabilize the currency, or does it want to fight the effects of a global economic slowdown?

Going forward, it seems likely that interest rates will be cut further. After all, the inflation-adjusted interest rate remains fairly high by global standards. A lower rate will help maintain a satisfactory level of business investment. In addition, the rate of inflation is expected to decline as the economy slows and, especially, as commodity prices stabilize. Thus, a looser monetary policy is likely to be beneficial.

The Brazilian economy will probably grow more slowly in the coming year than it did recently. The lagged effect of tight monetary policy and a high valued currency will take its toll on growth. Yet the new policy of lower rates, combined with a declining currency, will help boost investment and exports. Foreign direct investment is likely to be strong given expectations about Brazil's long-term future. The big uncertainty concerns the impact of the global economy on Brazil. A severe recession in Europe emanating from a partial collapse of the Eurozone would certainly have a negative impact on Brazil. Moreover, a global slowdown could have a significantly negative impact on commodity prices, which in turn, would hurt Brazil's export revenue.



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Mexico: Looking north

by Pralhad Burli

At the turn of this century, Mexico was Latin America's largest economy. Its prospects were akin to those of the BRIC nations. However, as the BRICs' marched ahead, Mexico, it seems, lost its way. Despite being an upper-middle-income nation, Mexico continues to grapple with widespread income inequality and poverty. Between 2000 and 2010, Brazil's economy grew at an average rate of 3.7 percent compared to Mexico's 2 percent. Today, Brazil's economy is larger than Mexico and growing at a faster pace. While the outlook for China, India, and Russia is much more favorable, Mexico finds itself caught in the crossfire of violent drug cartels and the prospect of an economic slowdown for its major trading partner, the United States. Yet, Mexico has tremendous potential and if policymakers tackle the country's challenges effectively, the economy could blossom once again.

A bump in the road

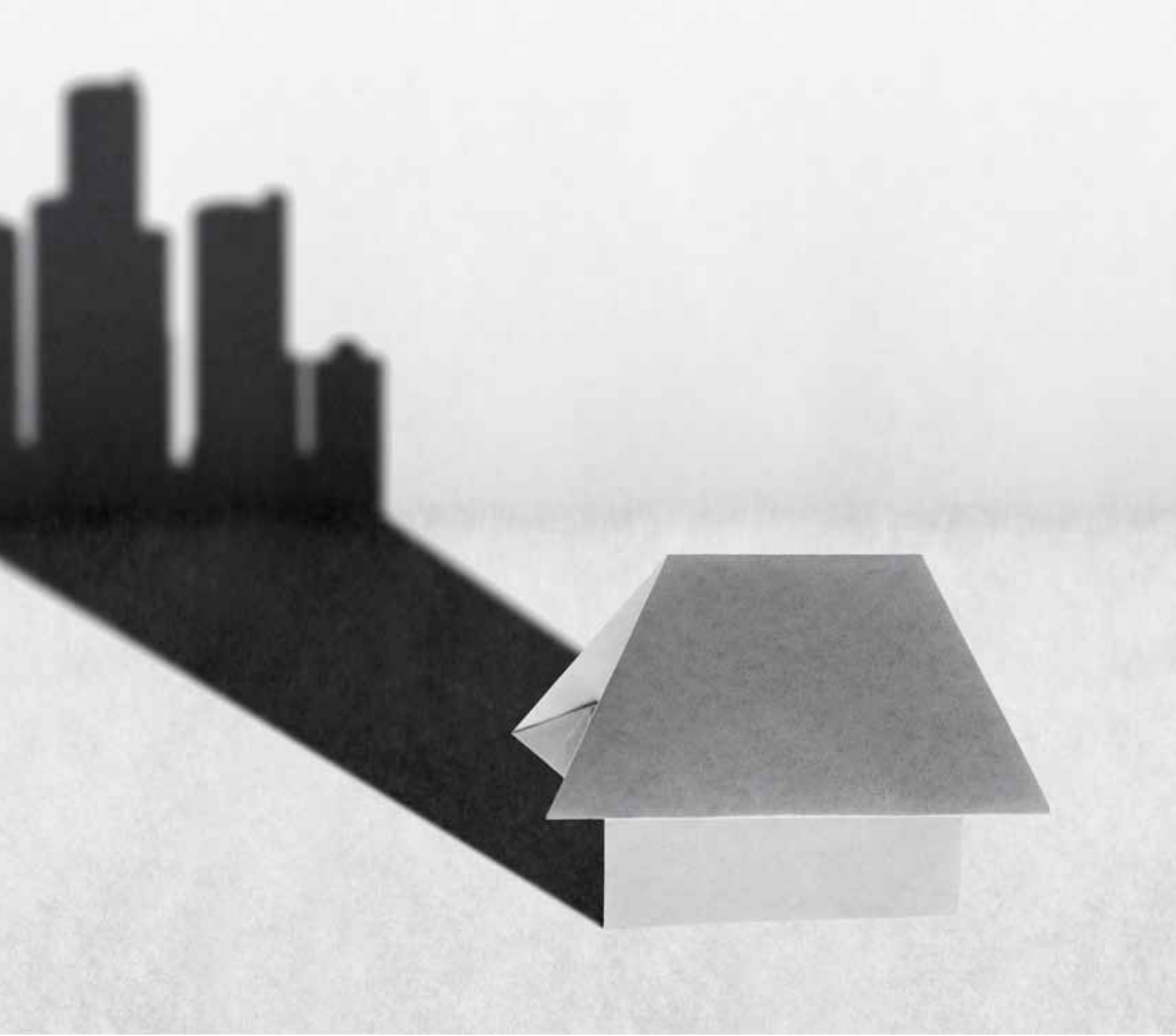
In Latin America, Mexico was among those hit hardest by the financial crisis. Job losses, factory shutdowns, closed shops, and demand slumps were the order of the day. As a result, the economy shrank by 6.1 percent in 2009. The economy bounced back rapidly thereafter. GDP growth was up at 5.4 percent in 2010. Industrial production grew 6 percent in 2010, reversing a majority of the decline seen during the previous year. The recovery was supported largely by consumer spending.

The first two quarters of 2011 have been favorable too. Economic activity picked up as domestic demand and exports experienced robust growth. Remittances, the second largest source of foreign currency, declined sharply since the onset of the recession, but they are once again on the rise. Despite a marked slowdown in the U.S. construction sector, an industry that employs many migrant workers, remittances between January and July 2011 grew 4.2 percent over the same period last year. Furthermore, manufacturing and industrial production have maintained an upward trajectory. As a result, Mexico has been able to close the output gap quite significantly.

Despite staging a strong recovery, the economy still faces some challenges. The gloomy economic outlook for the United States does not augur well. In fact, Mexico's growth forecasts have been lowered on dwindling growth prospects for the U.S. economy. Recent estimates peg Mexico's GDP growth rate between 3.5 and 4 percent in 2011, slightly lower than previous forecasts. Furthermore, unemployment continues to play catch-up and is well above the pre-crisis level of under 4 percent. Mexico's unemployment rate rose throughout the second quarter of 2011. In July, unemployment reached 5.6 percent after achieving a low of 4.6 percent earlier in March. Furthermore, in case the U.S. economy stalls, the grim unemployment situation in Mexico may worsen further. In that scenario, Mexico's growth forecasts may be revised downward.

Pushing for export diversification

Under the aegis of the North American Free Trade Agreement (NAFTA), the European Union Trade Agreement, and a slew of other bilateral arrangements, Mexico's nominal exports grew nearly 30 percent in 2010. The economy carried this momentum into 2011. During the first two quarters of this year, nominal exports grew 22.8 and 19.9 percent, respectively. Robust export sector growth will likely continue following an agreement to allow Mexican trucks to make deliveries in America. The



agreement will likely result in substantial cost savings for companies and give Mexico another opportunity to make the most of its proximity to the United States.

However, Mexico's dependence on demand from the United States makes it vulnerable to an external shock. For an economy that relies heavily on the export sector, Mexico is poorly diversified. The United States alone absorbs nearly 80 percent of Mexico's exports. Less than 5 percent of Mexico's exports go to the much-faster-growing BRIC nations. Of late, Mexico has taken significant strides to diversify its economy. Mexico, along with Peru, Chile, and Columbia signed a trade agreement toward creating one of the largest trading blocs in the region. As a result, exports to other countries within the region and to Asia are growing rapidly.

Meanwhile, higher wages in China, coupled with a rising yuan are favorable to Mexico's export sector. Moreover, the manufacturing sector contributes over 75 percent to Mexico's exports. Mexico's strong manufacturing base and rising wages in China may influence U.S. companies to source manufactured goods from Mexico. As a result, Mexico could potentially increase its market share in manufacturing exports both to the United States and globally. At the same time, stronger manufacturing exports will likely stabilize export revenues because the economy will be less dependent on volatile oil and commodity prices. Exports of fuel and mining products contribute around 16 percent to Mexico's total exports. However, a sharp decline in prices could potentially hurt Mexico's terms of trade.

Wait and watch

Unlike several countries in the region, inflation in Mexico is relatively benign. Moreover, going forward, Mexico's growth rate is expected to be lower than other Latin American countries. As a result, the inflation rate is likely to remain subdued. In 2011, inflation is forecasted to hover within the 3.4–3.6 percent range, close to the official target of 3 (+/- 1) percent. Moreover, the central bank may need to shelve any plans of monetary tightening due to uncertainty in the U.S. economy. Thus, it is likely that the policy rate will be maintained at 4.5 percent until the end of 2011.

An era of reforms

Mexican consumers reel under the weight of monopolies in several sectors of the economy. From telecom to aviation, Mexicans are forced to pay high premiums on services for lack of adequate competition. Only two banks control more than half of the market for deposit accounts. But all that is likely to change. Mexico seems to have begun what may become an era of anti-trust reforms. The government aspires to bring Mexico's anti-trust laws in line with best global practices. Furthermore, the political system is committed to ushering in reforms that allow firms a level playing field. The Mexican Senate approved an anti-trust law to establish greater penalties and fines for firms engaging in monopolistic practices. The legislature and the judiciary have also played a part in fostering competition and transitioning toward freer markets.

Such reforms could be potential game changers for Mexico's economy. One of the major beneficiaries could be the petroleum industry, which until now, has been closed to foreign investment. Oil revenues contribute in excess of 50 percent of all government revenues. However, despite soaring oil prices, revenues have not kept pace. Inadequate investments in the petroleum industry over the past decade will likely hurt this sector in the future. Output from the oil sector has been declining. As a consequence, Brazil may soon become the leading oil producer among the Latin American nations. On the other hand, structural reforms that facilitate more investment, both domestic and foreign, may prop up Mexico's oil economy. While President Calderon has laid out a plan to raise additional capital for the state-owned oil manufacturer, it is unclear whether the reforms will reach fruition or hit another political roadblock.

In April 2011, the Federal Competition Commission (CFC) issued a fine of $1 billion to a wireless telecom company for charging exorbitant interconnection fees. The government could also step in and break up existing monopolies. Furthermore, conglomerates engaging in monopolistic practices can now be fined up to 10 percent of their profits and in the most serious cases, face 10 years in jail. While these are promising signs, a lot more needs to be done across several sectors.

Public safety and the war against cartels

Meanwhile, Mexico's war against drug cartels continues. Violent confrontations between Mexican authorities and drug cartels have been a highlight of Felipe Calderon's administration. Until 2006, fighting drug crime was mainly the responsibility of the civilian police. Now, Mexico's military is on the offensive to restrain the cartels. At the same time, fights among the cartels are also on the rise.

So far, the death toll exceeds 34,000 and shows no signs of abating. Organized crime has crippled the overall security situation in Mexico, and cases of kidnapping and extortion have rocked public life. Recent polls in Mexico suggest that public security, rather than economic prosperity, is the top concern for its citizens.

Increasing violence poses a major risk to the socio-economic stability and the overall investment climate in the country. It is estimated that drug related violence knocks off nearly 1.2 percent of GDP growth each year. Small manufacturers, tourism operators, and companies face additional costs of doing business through massive extortion and demands for protection money to ensure business safety. The government aims to defeat the drug lords and thereby revive business activity by fostering a favorable economic environment. However, the prolonged state of conflict and the resulting collateral damage hints at a dead-lock that is unlikely to be resolved in the short term.

Conclusion

Mexico's growth rate will likely moderate in 2011. The economy will be constrained by declining oil output (due to underinvestment), poor business investment, and the likelihood of an unstable environment due to widespread violence. If remittances continue to increase, it could potentially boost domestic demand and positively impact the local economy. Higher consumer spending will likely benefit the retail industry as more people transition into the middle class. If demand from the United States strengthens, the export sector will be boosted. Yet, sooner or later, Mexico will have to diversify its export basket. Finally, Mexico's long drawn-out war against the drug cartels shows no signs of dying down anytime soon. The tourism industry may bear the brunt of the volatility resulting from the drug war. With elections next year, tackling security concerns and making Mexico's economic environment conducive for large-scale foreign and domestic investment will be high on the agenda.

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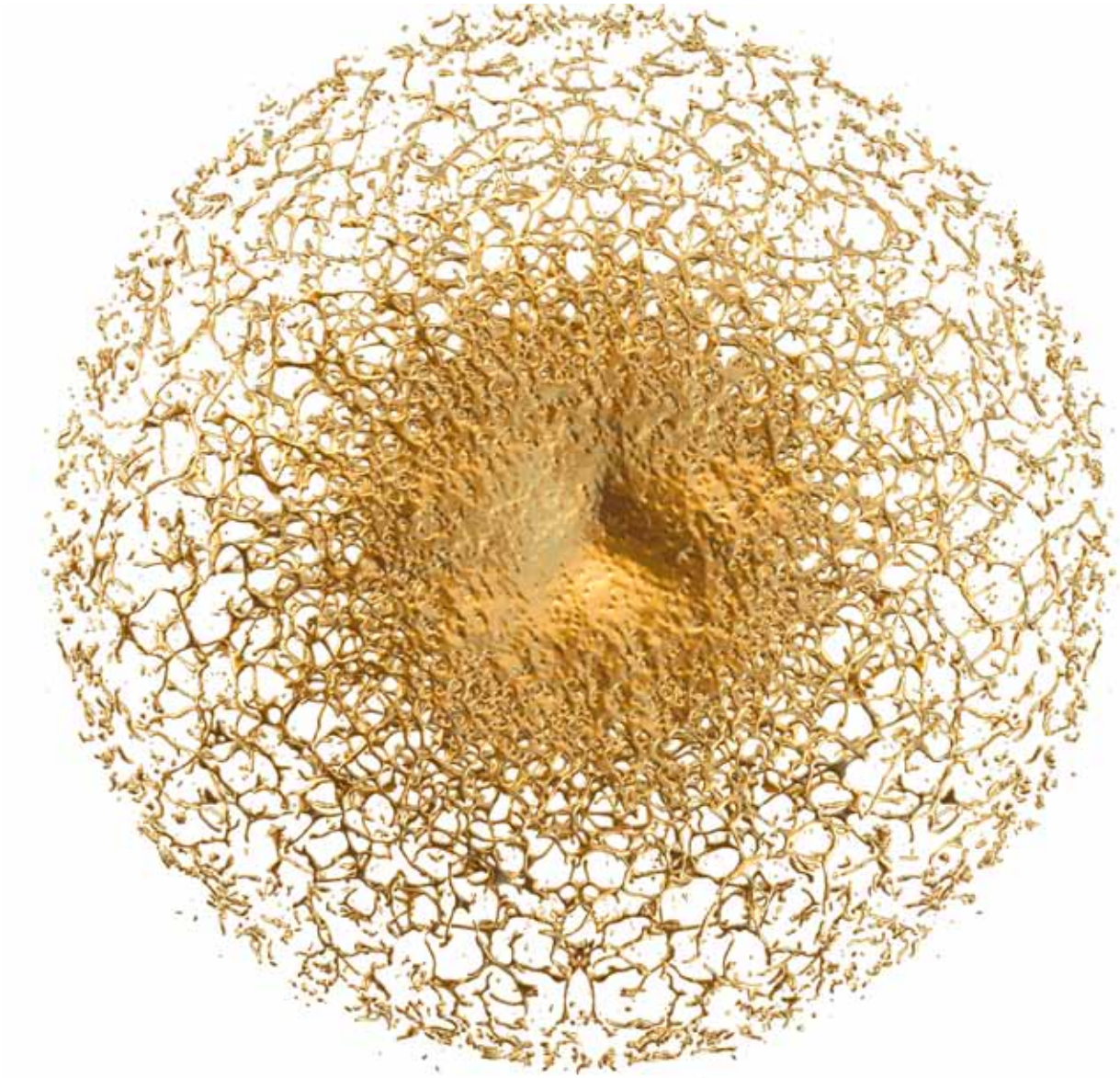
Gold prices: defying gravity?

by Dr. Satish Raghavendran and Neha Jain



World markets seem to be in a gold rush right now. Barring a few short-term corrections, gold prices have followed an unbroken ascent since the beginning of the decade. From $265 per troy ounce in 2001, gold soared through the decade, breaching the $1900 per troy ounce level in September 2011. The spot price of gold has already surged over 25 percent this year alone touching a peak of $1923.70 per ounce on September 6. European debt woes coupled with a sluggish American economy have sent gold prices on an exponential rise as investors rush to safeguard their portfolios against imminent economic and political stress. Statistics from the World Gold Council indicate that gold prices during the second quarter shot up by as much as 26 percent from the same period a year ago. On the contrary, demand for gold actually declined 17 percent year-over-year in volume terms and grew merely 5 percent in value terms during the quarter. Supply, on the other hand, remained more or less unchanged. This anomaly of decreasing demand and rising price has left many economists puzzled. Financialization of gold has appealed to the investors' risk appetite to hold gold in their portfolios. The recent bull rally has further intensified the belief that gold might be in a speculative bubble. The question is how long can gold continue to defy the laws of gravity and economics?

Understanding the idiosyncrasies of the yellow metal sheds light on the matter. Gold is not like other commodities. It has little use in industry and thereby moves more or less independent of business cycles. Unlike agricultural commodities, gold is not prone to weather-related supply disruptions either; in fact, the malleability and longevity of the yellow metal ensures that supply never drops – it is only re-circulated or supplemented by additional mining. Gold is especially favored for its storage properties, its longevity lending it a status almost equivalent to a financial asset. The only difference is that the yellow metal has no yield; it does not produce a regular cash flow and hence, is difficult to price accurately. This makes it a less favorable investment compared to equities and bonds. Its unique properties, however, make it a store of value and thus, a useful hedge against inflation and currency depreciation. Investors turn to gold in times of financial and political instability since it does not have any default risk.

Investment in gold has historically been associated with fears about rising inflation and during times of political turmoil. A recent study by Oxford Economics provides a meaningful perspective on this issue:

Over the very long-term gold tends to hold its value in real terms, but short-run factors can move gold away from its long run equilibrium for extended periods. These factors include financial stress, political turmoil, real interest rates, inflation, central bank activity and the U.S. dollar exchange rate.

Thus, gold acts a store of value during inflationary as well as deflationary scenarios, offering a hedge against extreme events.

Drivers of the decade-long rally

Gold as a monetary asset: Despite the dismantling of the gold standard in 1971 and the Bretton Woods system of fixed exchange rates, central banks across the globe have continued to hold large amounts of gold as a reserve asset. According to the World Gold Council's August 2011 report, central banks held almost 16 percent of the world's gold supply. Since central banks, governments, and international organizations are the largest individual holders of gold today, their activities have a significant impact on the price of gold. The past decade has seen a structural shift in the demand/supply dynamic as advanced countries have reduced sales while emerging economies have dramatically boosted reserves. In fact, for the first time since 1988, central banks became net buyers of gold in 2010. Their growing interest in gold has resulted in consistently increasing demand for the metal, thus pushing up prices throughout the decade. Of late, economic uncertainty has driven many central banks to behave like private investors in strengthening their gold reserves, further intensifying the bullish run.

Gold as a financial asset: Investors have been historically interested in the acquisition of physical gold, including coins and bars. However, the metal has also gained prominence in the commodities futures market as a tradable asset. More recently, several exchange traded funds (ETFs) and related products have made gold more accessible to a wider set of investors and added to short-run volatility. Since the introduction of the SPDR Gold Trust — the largest ETF backed by gold — in November 2004, prices have more than tripled. Moreover, as ETF's and related products gain popularity in next few years, investors,

particularly from India and China, will gain more access to the gold market, further influencing price variations.

Gold as jewelry: More than half of the world's gold reserves are in the form of jewelry. The World Gold Council estimates that India accounted for 33 percent of the world's jewelry demand followed by 23 percent from China during the year ending June 2011. Buying gold jewelry is an integral part of Indian culture, especially during weddings and festivals. India's upcoming festival and wedding season during October–December will likely boost demand for gold. Robust demand from emerging economies is also being driven by rising household incomes and inflation.

How long will this rally last?

Gold prices are already beginning to experience steep correction. On September 26, the price of gold dropped by more than $120 an ounce. The yellow metal lost almost 20 percent of its value between September 6 and September 26. This precipitous fall came as a market reaction to a number of developments across the globe. The drop was primarily triggered by a hike in margin requirements by the Chicago Mercantile Exchange (CME) on September 23. For the third time since August, the CME raised collateral requirements on gold, which effectively makes it more expensive for traders to open a position on gold. Similarly, the Shanghai Gold Exchange (SGE) had earlier announced an increase in trading margins on gold futures. The recent sell-off in gold can also be attributed to investors who needed to liquidate their gold positions in order to offset massive losses on other assets. However, it did not take much time for the dust to settle; gold prices have resumed their upward ascent as investors are taking advantage of subdued prices. In fact, such short-term swings are not new to gold. For instance, gold prices dropped 25 percent between May and June 2006 and almost 33 percent from March to November 2008 and recovered thereafter. Such oscillations are typical during times of extreme financial stress.

Recent weeks have seen gold traders in a frenzy. In these times of heightened uncertainty, financial markets are being driven primarily by human sentiment rather than rationality. Investors usually have two main investment criteria — yield and safety. At this point, safety has become a clear winner as investors across the globe are taking refuge in the precious metal. Gold is historically known to move inversely to the U.S. dollar and equity markets. Bad news for the economy is good news for gold. The extreme swings in gold prices that are occurring of late are a direct consequence of investors rushing to gold when all other avenues disappoint. Perhaps this is a case of Pavlovian conditioning at work.

In this ongoing crisis of confidence, the only asset that appears recession-proof is gold. For centuries, households and central banks have held onto gold to help them through difficult times. When people lose faith in the monetary system, they turn to gold. Today, the undecided fates of the euro and other world currencies have increased the importance of gold as an alternative means of payment.

What goes up must come down, eventually

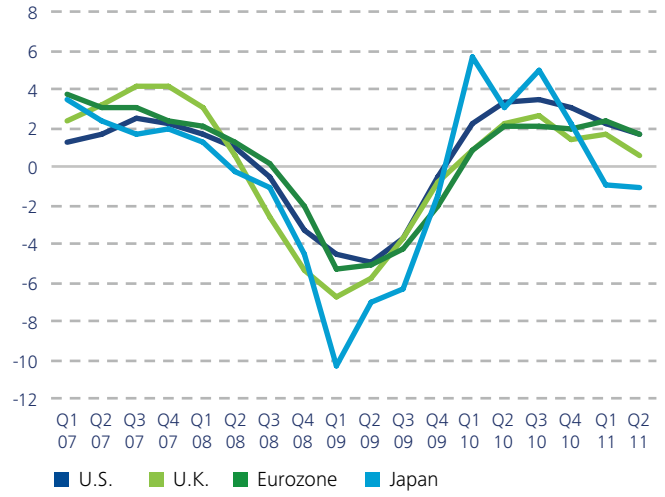
A historical perspective illustrates that gold follows a cycle inverse to economic stability. For example, the 2008 subprime crisis had a domino effect on the rest of the economy, slowing growth and prompting a gold rush. The gold rally, however, was kept in check as large institutions liquidated gold to pay off their debts. In comparison, the recent bullish run is steeper and likely to last longer because of increased complexity in the present situation. Contrary to the subprime crisis, the prolonged debt problems of the Eurozone have allowed markets an extended time to price future uncertainty, as reflected in the current rally. The severity of possible outcomes has further raised anxiety among investors and resulted in mixed reactions to macroeconomic data.

Despite the recent selling spree, the gloomy outlook of the world economy suggests that elevated gold prices are here to stay, at least for a while. In fact, many analysts believe that the sell-off has shaken the faith of short-term investors who have exited the market in the past few weeks. Going forward, gold prices are expected to be resurrected as the buying season of physical gold in India and China approaches. Moreover, the United States may provide stimulus to its sluggish economy in some form or another. Given the fear of stimulus-induced inflation, the gold market will likely remain tight in the near future.

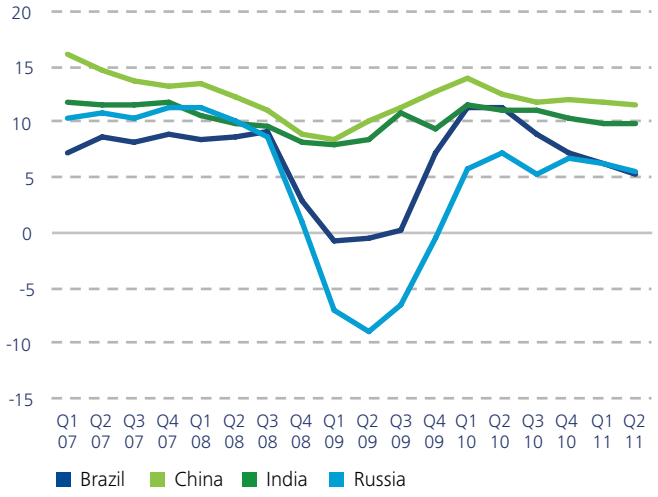
Gold's peculiar characteristics preclude it from fundamental analysis that can determine its rise and fall in a timely manner. The fact that the commodity's intrinsic value cannot be measured accurately makes it particularly challenging to determine when the bubble may burst, if it can be called a bubble at all. Even recent history does not provide an example of a world economy saddled with such complex economic problems. Gold prices are likely to weather the current storm and eventually return to their long-term average once the Eurozone crisis is resolved, the U.S. economy is revitalized, and inflation in the emerging markets is tamed. How long that will take, only time can tell.

Appendix

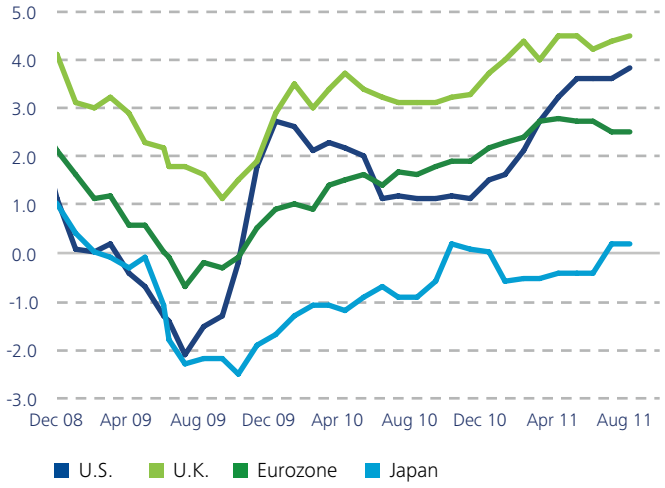
GDP growth rates (YoY %)*



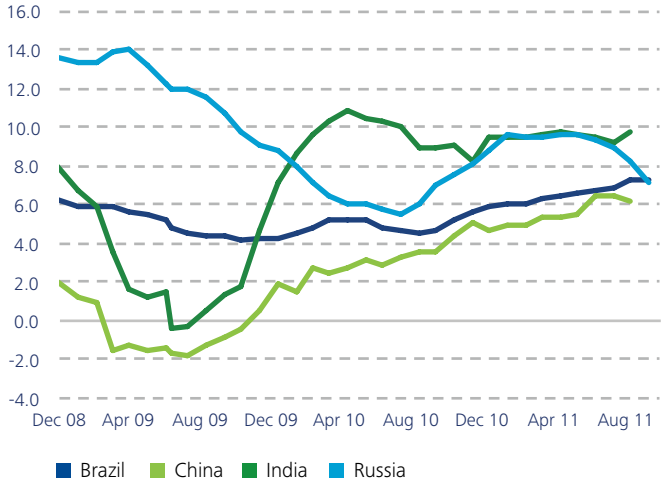
GDP growth rates (YoY %)*†



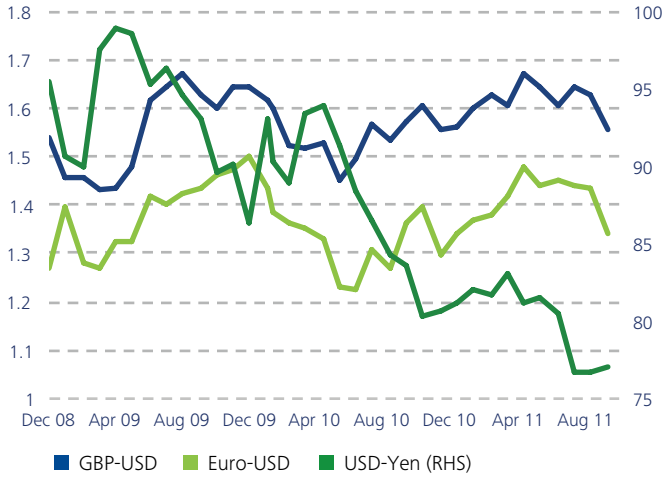
Inflation rates (YoY %)*



Inflation rates (YoY %)*‡



Major currencies vs. the US dollar*



Yield curves (as on July 11, 2011)*

	U.S. Treasury Bonds & Notes	UK Gilts	Eurozone Govt. Benchmark	Japan Sovereign	Brazil Govt. Benchmark	China Sovereign	India Govt. Actives	Russia‡
3 Months	0.05	0.53	0.48	0.10	11.20	3.44	8.40	5.81
1 Year	0.09	0.57	0.67	0.11	10.44	3.60	8.43	6.53
5 Years	1.08	1.37	1.25	0.34	11.49	3.80	8.52	8.41
10 Years	2.08	2.47	2.00	0.98	12.61	3.93	8.58	8.99

Composite median GDP forecasts (as on July 11, 2011)*†

	U.S.	UK	Eurozone	Japan	Brazil	China	India†	Russia
2011	1.6	1.1	1.7	-0.4	3.7	9.3	7.6	4.5
2012	2.2	1.7	1	2.5	3.8	8.7		4.5
2013	2.5	2	1.65		4.4			4.15

Composite median currency forecasts (as on July 11, 2011)*

	Q3 11	Q4 11	Q1 12	Q2 12	Q3 12	Q4 12	2011	2012	2013
GBP-USD	1.56	1.55	1.58	1.59	1.61	1.62	1.55	1.62	1.65
Euro-USD	1.34	1.35	1.37	1.4	1.4	1.4	1.35	1.4	1.37
USD-Yen	77.06	77	78	79	80.5	81	77	81	90
USD-Brazilian Real	1.88	1.74	1.7	1.7	1.7	1.6	1.74	1.6	1.65
USD-Chinese Yuan	6.38	6.31	6.25	6.18	6.11	6.06	6.31	6.06	5.79
USD-Indian Rupee*	48.97	47.35	46.75	46	46	45	47.35	45	43.5
USD-Russian Ruble	32.18	30.45	29.56	29.85	29.45	29	30.45	29	28.64

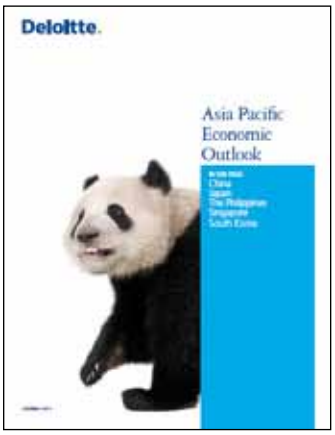
OECD Composite leading indicators (Amplitude adjusted)

	U.S.	UK	Eurozone	Japan	Brazil	China	India	Russia
Oct 09	102	99.8	96.4	103.3	101.4	100.2	103.3	100.6
Nov 09	102.9	100.4	97.4	103.9	101.8	101	103.5	100.6
Dec 09	103.4	100.9	98.4	104.2	102.1	101.6	103.4	100.6
Jan 10	103.8	101.3	99.2	104.3	102.2	102	103.2	100.5
Feb 10	104	101.6	99.8	104.3	102.2	102.3	102.8	100.4
Mar 10	103.9	101.9	100.3	104.2	102	102.5	102.5	100.4
Apr 10	103.7	102.1	100.5	104	101.8	102.5	102	100.3
May 10	103.4	102.2	100.5	103.8	101.6	102.3	101.6	100.3
Jun 10	103	102.4	100.4	103.8	101.4	102	101.2	100.2
Jul 10	102.6	102.6	100.3	103.7	101.2	101.7	101	100.2
Aug 10	102.4	102.8	100.3	103.6	101.2	101.6	101.1	100.2
Sep 10	102.3	102.8	100.6	103.5	101.3	101.6	101.3	100.3
Oct 10	102.3	102.6	100.9	103.5	101.5	101.8	101.6	100.5
Nov 10	102.3	102.3	101.5	103.5	101.7	101.9	101.8	100.6
Dec 10	102.3	102.1	102.1	103.5	101.8	101.9	101.9	100.6
Jan 11	102.3	101.9	102.6	103.4	101.8	101.6	101.9	100.7
Feb 11	102.2	101.7	103	103.1	101.7	101.1	101.6	100.7
Mar 11	102.1	101.5	103.2	102.6	101.3	100.4	101.3	100.7
Apr 11	101.8	101.3	103.2	102	100.9	99.5	100.9	100.7
May 11	101.4	101	103	101.1	100.5	98.5	100.5	100.6
Jun 11	101	100.8	102.6	100.1	100.1	97.2	100.3	100.5
Jul 11	100.4	100.7	102.1	99	99.8	95.9	100	100.3
Aug 11	99.7	100.8	101.5	97.9	99.4	94.8	99.8	100

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

Source: *Bloomberg ‡MICEX rates †JP Morgan

Additional resources



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