Global Economic Outlook

A Deloitte Research publication | 4th Quarter 2010

Multi-speed recovery

United States:
A liquidity trap forces the Fed's hand

China:
Soft landing in sight

Brazil:
Too much of a good thing

Deloitte.

Global Economic Outlook Q4 2010

The global economy continues to grow, but ongoing imbalances haunt policymakers. Interest rates in developed countries are unusually low, reflecting aggressive monetary policy and weak demand for credit. Hence, money is flowing out of these countries into higher interest rate emerging markets. Yet in those countries where growth is strong, the inflow of capital is putting upward pressure on currency values, thereby hurting export competitiveness. At the same time, rapid growth in emerging markets is creating new inflationary pressures which have led some central banks to tighten monetary policy – thereby putting upward pressure on currencies yet again. Now, many governments are intervening in currency markets to hold down their currencies in order to improve export competitiveness. Yet this risks exacerbating inflation. Moreover, if every country tries to devalue their currency, no currency will decline in value, but everyone will increase their money supplies – thus generating inflation.

Hence, the global economy is imbalanced. Countries that have traditionally relied on exports (such as China, Japan and Germany), and need to move toward domestic-led growth, continue to depend heavily on exports. Countries that relied too heavily on their consumers (such as the United States and United Kingdom), and need to export more, now face competitive devaluations in their target export markets. Failure to adjust to new realities will only delay the day of reckoning. Yet, making the necessary adjustments involves short-term pain.

Affluent countries that nearly experienced financial meltdown now face tattered financial markets. Credit fails to grow as consumers and businesses hoard cash and continue to deleverage. Debate rages over whether central banks and governments should respond by becoming more aggressive. Yet an aggressive stance risks the continuation of global imbalances.

The good news is that growth in many parts of the world is strong and that inflation is low by historic standards. What happens next is uncertain, but our team of economists remains determined to offer their points of view.

In this issue of Deloitte's quarterly *Global Economic Outlook*, we begin with Carl Steidtmann's view on the US outlook. Carl highlights the continuing liquidity trap that results from private sector deleveraging. He notes that this is the prime reason for weak growth and discusses the Federal Reserve's response in moving toward a more aggressive policy aimed at creating inflation.

Next, Elisabeth Denison discusses the strong, export-driven growth in the Eurozone's core countries of Germany and France. This contrasts with the weak growth in the zone's periphery, the result of fiscal contraction and financial market stress. Elisabeth suggests that the adjustment under way in the fringe countries, while painful in the short-run, will set the stage for a more stable Eurozone in the future.

Next, I discuss the outlook for China. My view is that Chinese authorities have successfully engineered a soft landing for China's economy. This ensures continued growth but also helps to deal with troubles such as rising inflation and a property price bubble. I also examine how changing demographics in China threaten long-term growth and create a need for structural change.

Siddharth Ramalingam provides his outlook for India. Siddharth describes an economy that is growing rapidly but faces some challenges. First, the surprisingly strong manufacturing sector is starting to show signs of slowing, especially given waning demand overseas. Second, inflation remains too high despite monetary tightening. These factors threaten to slow the growth of GDP. Along with other emerging countries, India now faces the dilemma of reigning in inflation without creating an uncompetitive currency.

Next, I pose some questions about Japan's economic outlook. The answers suggest that Japan faces a weakening economy. This is due to the strength of its currency and the unaggressive nature of its fiscal and monetary policies. Moreover, Japan's current deflation poses challenges of its own. It tends to discourage consumer and business spending. Finally, recent political turmoil makes it less likely that radical policy options will be undertaken.

Ian Stewart then examines the outlook for the United Kingdom. Ian notes that the recovery so far has been stronger than many had expected. However, the United Kingdom faces troublesome headwinds owing to balance sheet rebuilding on the part of both consumers and the government. The fiscal tightening is a well known story, but the degree of retrenchment on the part of consumers may surprise some. That is because consumer debt as a share of GDP in the United Kingdom is more than twice the level in the United States. Hence, far more deleveraging will be undertaken before a full consumer recovery can take place.

Next, I tackle the outlook for Russia. The economy is growing at a moderate pace with moderate inflation, a nice outcome following an unusually deep recession. Yet, as with other emerging countries, Russia's policymakers face a balancing act. The currency is rising and inflation is likely to get worse. Hence, monetary policy must deal with both issues. Longer term, while Russia faces many serious challenges, the recent news that Russia is getting closer to joining the WTO bodes well for economic restructuring.

I also examine the outlook for Brazil, a country much in the news recently after a closely followed election. As of this writing, the outcome remains uncertain. However, Brazil's economy is on fire. The next president will have to find a way to restrain growth in order to suppress inflation. Yet this must be done without causing the currency to rise too high.

Finally, Pralhad Burli offers a point of view on Australia, the first major industrial economy to recover from the global recession. Its commodity base has served it well, but now controversy has erupted over how to tax mining company profits. This controversy played a role in changing the Prime Minister and in the outcome of the recent hotly-contested election. Despite this controversy, Pralhad offers an optimistic take on Australia's economic outlook.

Dr. Ira Kalish
Director of Global Economics
Deloitte Research
Deloitte Services LP

***Global Economic Outlook*
Published quarterly by
Deloitte Research**

Editor-in-chief
Ira Kalish

Contributors
Pralhad Burli
Elisabeth Denison
Siddharth Ramalingam
Carl Steidtmann
Ian Stewart

Editorial address
350 South Grand Street
Los Angeles, CA 90013
Tel: +1 213 688 4765
ikalish@deloitte.com

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6 **United States: A liquidity trap forces the Fed's hand** The US economy is caught up in a liquidity trap. Banks, non-financial corporations and households are holding on to excessive amounts of cash while cutting debt. Collectively, this cash hoarding is a drag on the US economy and requires changing consumer and business expectations to improve. Thus, another round of quantitative easing is in the offing, this time with the hope of expanding the money supply and sparking inflation. While embracing higher inflation is a high risk strategy, it's also the path of least resistance out of the post-credit crisis liquidity trap that is currently inhibiting growth.

12 **Eurozone: Rising to new standards** The Eurozone's core nations are progressing on a path to sustainable recovery, where strong export demand and rising industrial production have started to spill over to the domestic economy, spurring consumption and investment spending. However, all is not well at the fringe. Peripheral nations in the Euro area continue to struggle with necessary reforms to lift competitiveness against the background of a strong common currency. Above all looms the prospect of tighter controls and increasing regulation as Brussels proposes sweeping changes in the aftermath of the crisis.

16 **China: Soft landing in sight** There is global anxiety about the rate of deceleration in China but the good news is that Chinese authorities have orchestrated a soft landing for the country's economy. Stimulating consumer spending, dealing with the economic consequence of a deflated property bubble and allowing the currency to rise in value are key concerns for policymakers. In addition, changing demographics could affect the country's productivity growth moving ahead.

20 **India: Wait and watch** Bumper harvests from India's successful monsoon season will likely infuse the country's economy with liquidity and in turn feed the substantial appetite for consumption in the domestic sector. Furthermore, foreign institutional investors have been pouring funds into the economy, foreshadowing sustained growth in the near term. Challenges that lie ahead for Indian policymakers include dealing with an appreciating rupee and ballooning inflation.

24 **Japan: The lost decade revisited** Decoding Japan's economic future depends on how well the country can detangle its political conundrums, overcome chronic deflation and successfully implement quantitative easing. Japan also relies heavily on exports for growth, so the country's near term outlook depends heavily on how the global economy recovers. If China's growth slows down drastically and austerity in Europe intensifies, Japan may experience a negative shock to its export revenues. Reviving consumer and business confidence are the keys to Japan's success.

28 **United Kingdom: Slower growth to come** So far the United Kingdom has experienced an unexpectedly firm recovery, but several factors will likely weigh on growth in the near term. With consumers still clutching tightly onto their purses, the scope for a strong recovery in domestic demand is limited. Furthermore, as the government rebuilds its balance sheet, imminent spending cuts will ripple through the economy. Continued growth in the UK economy depends on successfully rebalancing the economy away from public to private sector demand by focusing on industrial production, exports and capital spending.

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Geographies (continued)

32 **Russia: Turning point for policymakers** With most sectors of the Russian economy recording some growth in the past year, the country's economy is recovering at a modest pace relative to other big emerging markets. However, policymakers face some tough decisions ahead. They must balance concerns about growth and the impact of currency values on the trade balance with worries about potential inflation. They must also weigh the desire to invest in new infrastructure with a desire to limit the growth of government debt. Recent moves to join the World Trade Organization bode well; it will help the country diversify away from excessive dependence on commodities.

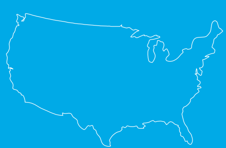
36 **Brazil: Too much of a good thing** The challenge for Brazil's new president is an enviable one: cool down the economy. Policymakers will have to deal with the appreciating currency, which has hurt the competitiveness of Brazil's non-commodity exports. However, a significant loosening of monetary policy will also risk spurring higher inflation. Increased spending on infrastructure and education, labor market reform, pension reform, and restraints on public spending are some of the structural changes that could help the country grow in the right direction.

38 **Australia: Navigating political crossroads** While Australia's growth in the last cycle was punted by government funding and healthy global demand, the country's momentum will likely moderate as stimulus packages are rolled back and China's economy cools off. Furthermore, Australia's mining industry – a star performer during the recession – is at the heart of a new controversy on how to tax mining company profits. The country's new government may face the challenges of coalition politics and the economic reform process may be relatively sluggish.

40 **Appendix**

Charts for developed countries GDP growth rates; inflation rates; major currencies vs. the U.S. dollar; yield curves; composite median GDP forecasts; composite median currency forecasts; OECD composite leading indicators.

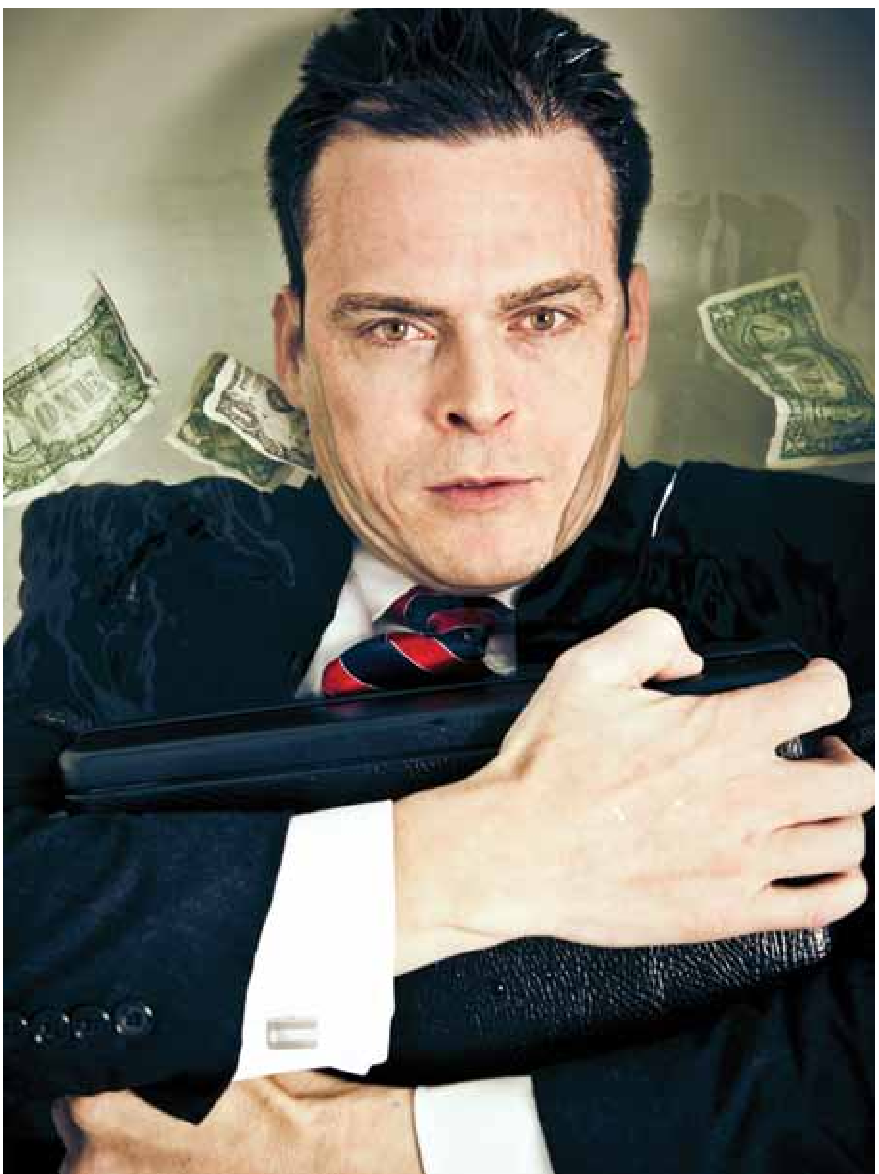
Dr. Carl Steidtmann is
Chief Economist at
Deloitte Research



USA

United States: A liquidity trap forces the Fed's hand

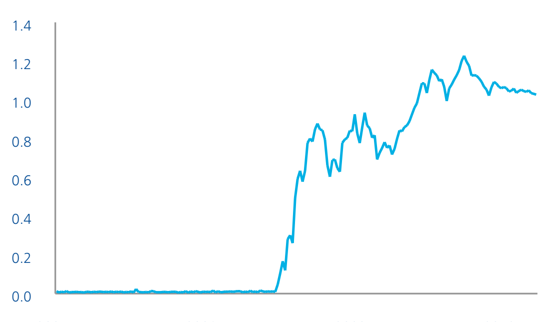
by Dr. Carl Steidtmann



Coined by John Maynard Keynes, a liquidity trap occurs when short-term interest rates fall to zero, as the demand for money goes parabolic, leaving a central bank with few if any means for stimulating the economy. During the 1930s, consumer and most commodity prices fell, interest rates went to rock bottom levels and the price of gold soared. Businesses, banks and households hoarded cash. The term "liquidity trap" fell into general disuse in the 1960s as economists came to believe that a second great depression was highly unlikely given the extensive intervention of the state in the economy. However, by the late 1990s, the idea of a liquidity trap occurring in a large developed economy came back into use with the Japanese experience of zero interest rates, large fiscal deficits, mild deflation and little real growth. As Japan's "lost decade" of the 1990s is now two decades long, both the reality and the negative effects of a liquidity trap have been brought home to policymakers in the rest of the world.

What makes traditional monetary policy less than effective in a liquidity trap is the explosive demand for money. The existence of a liquidity trap in the US economy can be seen in the growth of demand or money by banks, non-financial corporations and households over the past year. All three are aggressively accumulating liquidity while cutting debt. In doing so, they have dramatically increased the demand for money. While each of these actions makes rational individual sense, collectively they are putting a damper on real growth.

Figure 1: Reserve Balances with Federal Reserve Banks
Trillions of dollars, weekly averages



Source: US Federal Reserve Board

The US Federal Reserve has responded to this liquidity trap by aggressively expanding bank reserves through quantitative easing. The Fed hopes that by increasing liquidity in the banking system, the banks in turn will be more willing to lend. So far, that has not been the case. The banking system is collectively holding in excess of $1 trillion in reserves.

Banks are reluctant to lend in the face of increased regulatory oversight and an absence of what they deem to be qualified borrowers. While the Fed is hoping they will lend more, regulators are demanding that they reduce the leverage on their balance sheets and raise more capital. To date, the regulators have won the argument as bank lending to consumers and business has contracted sharply. Higher bank capital requirements that are part of the Basel III Agreement will keep the pressure on.

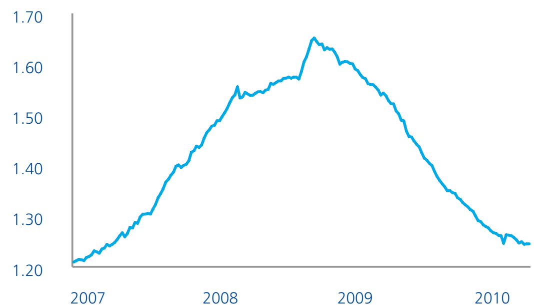
Since late 2008, bank lending for commercial and industrial loans has fallen by $450 billion. In the credit crunch that followed the 2008 collapse of Lehman Brothers, businesses fearing a loss of access to credit markets raised cash by cutting inventories, delaying capital investment and reducing headcounts. Even with a recovery in place, businesses have not come back to banks looking for credit.

While the contraction in real estate loans has not been as severe, real estate lending dropped by $250 billion since mid-2009. The overbuilding of commercial real estate coupled with a decline in demand for commercial space will keep downward pressure on real estate lending.

Consumers have also cut back on their use of credit. At the same time, bank standards for credit cards have been raised, reducing consumer's access to credit. Open balances for consumer credit have declined by $160 billion since mid-2008, the largest contraction of consumer credit in more than 60 years. Taken together, bank lending has contracted by over $850 billion. Total private sector debt has contracted by roughly $3 trillion since its peak in the third quarter of 2008. While this process of deleveraging is a healthy development in the long run, as long as it continues, the US economy will likely remain stuck in a liquidity trap.

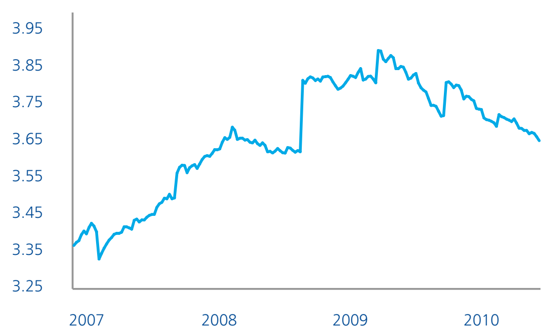
Banks are not alone in holding excessive amounts of cash. Non-financial corporations are also cash hoarders. Liquid assets

Figure 2.1: Commercial and Industrial Loans
Trillions of dollars



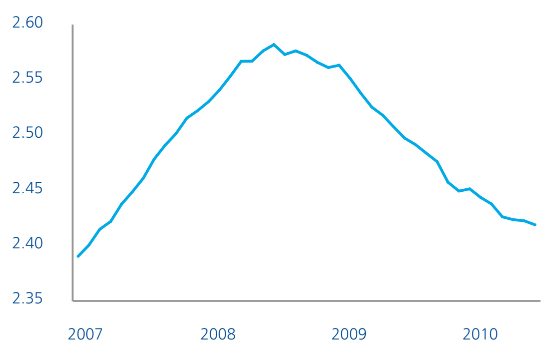
Source: St. Louis Federal Reserve

Figure 2.2: Real Estate Loans
Trillions of dollars



Source: St. Louis Federal Reserve

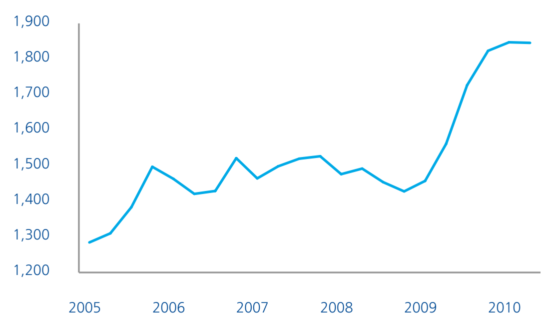
Figure 2.3: Consumer Credit
Trillions of dollars



Source: St. Louis Federal Reserve

at non-financial, non-farm corporations in the United States have soared over the past year and a half. Since early 2009, liquid assets at these institutions have risen by over $400 billion to $1.8 trillion. The rise in cash holdings can be attributed, in large part, to a strong rebound in corporate profitability coupled with high levels of uncertainty over the impact of recently passed healthcare and financial services regulation. Potential changes in the rate of future taxation of corporate income have also added to the uncertainty.

Figure 3: Non-Financial Non-Farm Corporations
Liquid Assets, in billions of dollars



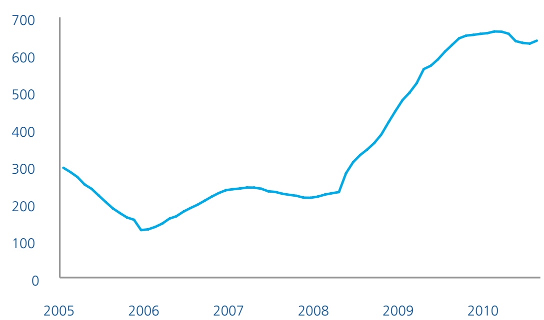
Source: U.S. Federal Reserve Board

Households have also increased their cash holdings while reducing their debt. Household saving began to rise in mid-2008 as the recession deepened. While consumer savings can be volatile month to month, smoothed out over the previous year, household savings is up just over $450 billion dollars over the past two years. This is the sharpest increase in savings in the post-World War II era. By increasing their rate of savings, consumers have reduced their pace of spending, putting yet another damper on economic growth.

The Fed responds

Breaking out of the liquidity trap involves changing consumer and business expectations. If businesses and consumers can be induced to fear inflation more than they fear recession, they will be more inclined to spend their cash hoards before rising prices reduce their value. For the first time in the history of the US Federal Reserve, it is now on record as favoring a higher rate of inflation. The Fed is

Figure 4: Household Savings
Billions of dollars, 12 month moving average



Source: US Bureau of Economic Analysis

essentially saying that in order to maintain price stability we have to create price instability, at least for a little while.

The Fed is making this move out of a fear that a liquidity trap in the credit markets, left unattended, is likely to deepen. With banks, corporations and households hoarding trillions of dollars in cash and continuing to deleverage, the Fed needs to break the current deflationary expectations. When faced with businesses engaged in very rational decision making that is not to the Fed's liking, the Fed is going unconventional. In its press release following the September 21 meeting, the Fed opined:

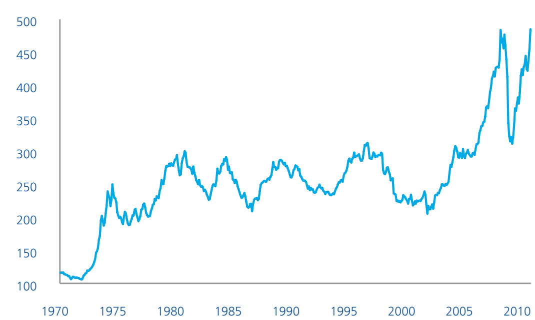
The Committee will continue to monitor the economic outlook and financial developments and is ***prepared to provide additional accommodation if needed to support the economic recovery and to return inflation****, over time, to levels consistent with its mandate.*

The phrase "additional accommodation" is Fed speak for more quantitative easing, which is expected to take the form of the Fed buying more US government debt in the hopes that the expansion of the money supply will spark inflation, increase credit creation and spending. While there is some disagreement on the Fed's policymaking board, it is likely that we will see another round of quantitative easing before the end of the year. The only question is whether it will be larger than the last round of quantitative easing that boosted the Fed balance sheet by roughly $1.7 trillion in the fall of 2008.

The transmission effect of quantitative easing

The path for successful quantitative easing runs through the currency and commodity markets. In the 1930s, the US government sought to raise the price of gold as a means of breaking the liquidity trap that was holding down prices. In the fall of 1933, the US Treasury raised the official price of gold from $20.67 to the market price of $29.82 and began to buy gold at slightly above market prices. The result was a sharp drop in the value of the US dollar, particularly relative to the British pound and a general rise in the price of commodities. In early 1934, the price of gold was fixed at $35 an ounce by the Gold Reserve Act. A rising price of gold and other commodities reversed the deflationary spiral of the previous eight years and gave a sharp boost to the economy that lasted until the recession of 1937-8.

Figure 5: Commodity Research Bureau
Spot Market Price Index: all commodities; 1967=100



Source: Commodity Research Bureau

Despite a weak economy, gold and other commodity prices have been rising. Copper, industrial commodities and grains have all performed well. The rise in commodity prices gives a lift to commodity-related businesses. It also gives a boost to inflation which is critical to breaking out of a liquidity trap. The Commodity Research Bureau's Spot Market Price Index is at an all-time record high, fully recovering from the losses posted during the recession.

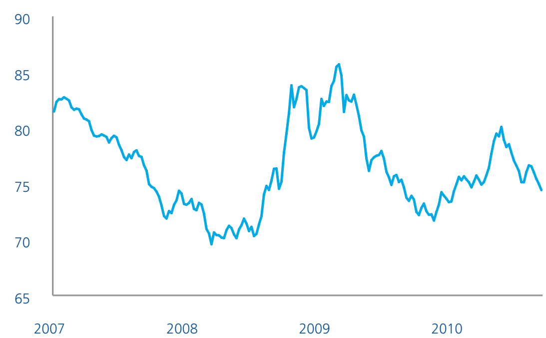
Currency and Protectionism: The race to the bottom

The other place where quantitative easing has a material impact is on the value of the dollar. During the 1930s, nations sought to escape the grips of depression by

A weaker dollar coupled with a rebound in the global economy has produced a strong recovery in US exports. While not back to its peak levels of mid-2008, the rebound in global trade has been one of the pillars of growth in an otherwise weak recovery.

exporting their way out of their problems. One way to do this was by depreciating the value of their currency. This became a bit of a self defeating effort when everyone sought to follow the same policy. The United States has succeeded in bringing down the value of its currency over the past year. After rallying during the credit crisis through much of 2008, the dollar was brought down by the first round of quantitative easing. The dollar rallied again from late 2009 through mid-2010 on the heels of the European debt crisis. Weaker US growth and expectations of another round of quantitative easing have started to push the dollar lower again.

Figure 6: US Dollar Trade Weighted Value
1973=100

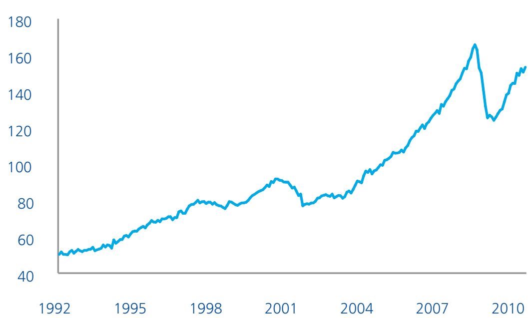


Source: NY Federal Reserve

A weaker dollar coupled with a rebound in the global economy has produced a strong recovery in US exports. While not back to its peak levels of mid-2008, the rebound in global trade has been one of the pillars of growth in an otherwise weak recovery.

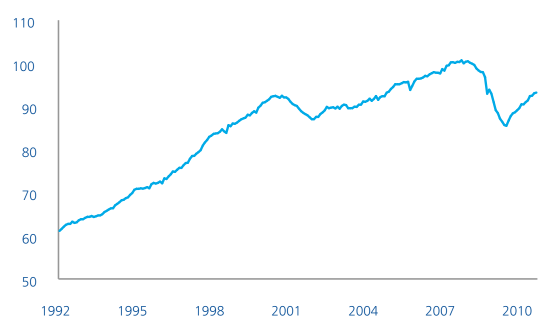
The rebound in US and global trade stands in sharp contrast to the contraction in trade that coincided with the Great Depression. The rebound in trade has had an equally positive impact on industrial production. Like trade, manufacturing has been a source of growth in an otherwise sluggish economy. And like trade, it has not returned to its previous peak reached in late-2007.

Figure 7.1: Exports of Goods and Services
Billion of dollars, monthly



Source: Bureau of Economic Analysis and Federal Reserve Board

Figure 7.2: Industrial Production
2007 = 100



Source: Bureau of Economic Analysis and Federal Reserve Board

The risk to exports, manufacturing and the broader economy is that US trading partners retaliate against the devaluation of the dollar by devaluing their own currencies. An even greater risk is that competitive devaluation escalates into a trade war. Much of the tension between the United States and China revolves around China's own aggressive valuation of its currency. Both Europe and the United States have lodged complaints against the Chinese and have encouraged Chinese policymakers to allow their currency to rise in value. While the US complaints have not risen much above the level of political rhetoric, the concern is that rising populist sentiments in the United States will force more drastic actions.

Conclusions and Observations

The US economy is mired in a liquidity trap. Over the past two years households, business and banks have increased their cash holdings by nearly $2 trillion. At the same time, deleveraging has cut total private sector debt by $3 trillion. This $5 trillion balance sheet shift has created a major drag on the US economy and partially accounts for both the severity of the downturn and the lackluster nature of the recovery. US policymakers have been very aggressive in trying to reverse the deflationary psychology that makes a liquidity trap self-reinforcing and difficult to break.

With another round of quantitative easing in the offing, the Federal Reserve is publicly embracing a path towards higher inflation for the first time in its history. This is a very high risk strategy and one that is fraught with many potential unintended and still unknowable consequences. However, with still high levels of debt and falling real estate prices, this is the path of least resistance out of the post-credit crisis liquidity trap that is currently inhibiting growth and risking a second downturn in the US economy in as many years.

Dr. Elisabeth Denison is Senior Economist and Director of Corporate Development & Strategy, Deloitte Germany

EUROZONE

Eurozone: Rising to new standards

by Dr. Elisabeth Denison

With the global recovery losing momentum, Eurozone growth is moderating too. Surprisingly, it is not export-driven economies inducing the slowdown. In countries like Germany and France, strong industrial production of recent quarters has started to spill over to the rest of the economy, laying the foundation for a sustainable recovery. It is the fringe nations of the Euro area which look worrying. Spain remains mired in recession with a fifth of its workforce unemployed, Portugal is slow to commit to long overdue structural reforms and Greece waits for its economy to start growing now that severe austerity measures have been implemented. Meanwhile, Ireland's banking sector continues to cause some concern in financial markets. Above all looms the prospect of tighter controls and increasing regulation as Brussels flexes its muscles in the aftermath of the crisis.

Europe's two-tier recovery

After a strong start to the year, the Eurozone will likely average better than expected growth of about 1.7 percent in 2010, with strength in the industrial sector now also spurring domestic demand. The degree of capacity utilization is approaching levels of around 80 percent, traditionally linked to increased spending on equipment investments, which is further supported by the improving profit situation of firms. As a reflection of trade and general economic activity, the health of companies in the transport sector is a particularly good leading indicator. Revenue of logistics firms in the Netherlands – whose ports and airports count among the biggest in Europe and handle much of the continent's cargo – clearly reflect the rebound and point to continuing stabilization in trade flows in coming quarters (see figure 1).

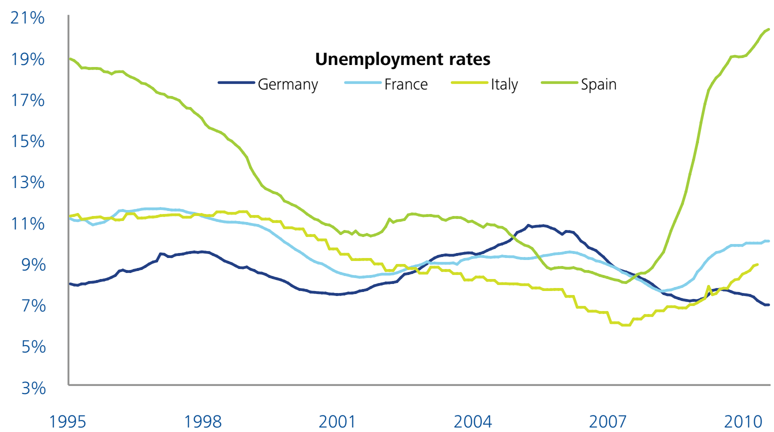
Figure 1: Transport Sector Revenues as a Leading Indicator of Economic Activity (QoQ%)

Source: Eurostat and Statistic Netherlands, Deloitte Research NL Analysis

Meanwhile, improving labor-market conditions, subdued inflation and a decline in the household savings rate from its crisis peak bode well for consumer spending in the near term. The French statistical office (INSEE) estimates that household spending will rise 1.4 percent in France in 2010, more than double the 0.6 percent pace of 2009.

In Germany, consumer confidence during September hit the highest levels in more than two years, with the recovery broadening beyond the export-led industrial sector and the unemployment rate continuing its steady fall. Germany's labor market flexibility has enabled companies to respond to the upturn in global demand since mid-2009 without delay, unlike firms in countries where staff had to be hired anew. Recent months' figures have shown that the German labor market remains resilient

Figure 2: Diverging Labor Market Trends in Europe



Source: ECB Statistical Warehouse, Bureau of Labour Statistics Current Population Survey

even as the short-work program's importance fades. Twenty years after the reunification of East and West Germany, unemployment is once again approaching the psychological threshold of 3 million. The German unemployment rate has fallen to under 7 percent in recent months, a stark contrast to the rising unemployment rates of its European neighbors (see figure 2).

While the Eurozone's core nations seem to be progressing on a path to sustainable recovery, all is not well at the fringe. Spain is struggling to emerge from a two-year recession after its construction and real estate sectors collapsed. Unemployment continues to edge higher and has now surpassed 20 percent. In late September, Spain's ailing economy was hit with yet another downgrade of its government debt by a major ratings agency, which will raise its borrowing costs just as it struggles to cut its deficit amid gloomy economic recovery prospects. Like other southern European nations, Spain faces key challenges in trying to boost low productivity and international competitiveness. In contrast to expected growth of over 3.5 percent in Germany and close to 2.0 percent in France, Spain will likely see no growth at all in 2010 (see figure 3).

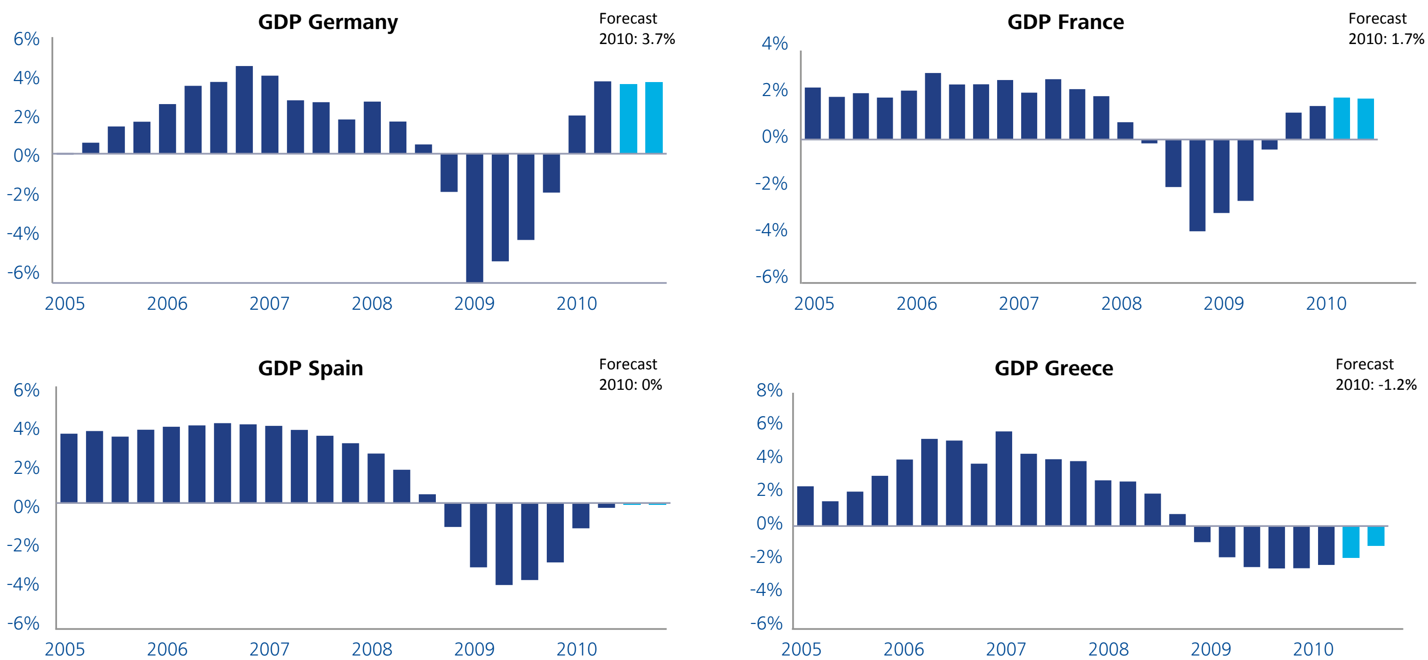
Greece, too, struggles to regain its footing. Despite some progress on reforms, the government is behind on its program to shrink the budget deficit from more than 13 percent to 8 percent and the economy is slipping back into a deep recession. Tax revenues are modest, even though tax rates have been raised. Faced with a weak economy, rising unemployment and social unrest, the Greek government recently announced a corporate tax cut from 24 percent to 20 percent. Whether this will help the economy turn the corner remains to be seen.

Tighter controls and increasing regulation

While many countries are still struggling to get back on their feet, Brussels is proposing sweeping changes to the EU's governance structure with punitive fines of up to 0.2 percent of GDP for countries which do not keep their public finances under control. Increases in annual spending would be monitored to stay in line with GDP growth and countries over the 60 percent debt limit must show they are moving towards the threshold by reducing the gap by one-twentieth every year over a three-year period. In addition, a new scoreboard to track countries' economic competitiveness would be established. All these reforms are geared towards one overriding goal: To encourage structural reforms and push underperformers to increase productivity in order to ease the strain on the single currency caused by internal imbalances in the Eurozone.

The astonishing pace of reform in Europe is also reflected in financial markets; within a few months of tying the

Figure 3: Eurozone Growth (YoY%) - Uneven Developments Across Member States



Source: Eurostat and European Commission

€110bn bailout package for Greece, EU country leaders agreed on the structure for a European Financial Stability Facility (EFSF), which has funds up to €440bn to distribute as a backstop for countries being shut out of bond markets. On September 20, the EFSF received a triple-A rating from the three big rating agencies.

Conclusion

The solid pace of recovery of the Eurozone in 2010 has surprised observers. The rebound is driven largely by industrial nations at the core, where strong export demand and rising industrial production have started to spill over to the domestic economy spurring consumption and investment spending. This will help offset some of the drag of declining export growth as world demand slows. At the same time, however, fringe nations continue to struggle with necessary reforms to lift competitiveness against the background of a strong common currency and Brussels pushing for tighter regulation and stricter controls. The process will likely be a painful one, but there is hope that when all is said and done, Europe will have emerged from the crisis with better and stronger fundamentals and moved a step closer to being a truly integrated economic region.

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CHINA

China: Soft landing in sight

by Dr. Ira Kalish

There have been signs of a soft landing in China, with the economy actually accelerating a bit in August. This was evidenced by a small increase in the purchasing managers index (PMI), the first rise since April. On the other hand, inflation rose in August to 3.5 percent year over year, but this performance was not unexpected.

The government had, earlier in the year, started the process of tightening monetary policy in order to slow growth and defuse inflationary pressures. In response, global financial market participants, by pushing down equity prices, had demonstrated concern that China might be headed for a hard landing. That is, they were worried that government policy would be too blunt and that the economy would slow down excessively. Thus, the recent numbers suggest that, rather than a hard landing, the economy is slowing gradually. The rise in inflation is not surprising as the impact of monetary tightening on inflation will likely take time. Thus, a reasonable expectation is that inflation will continue to rise before starting to decline sometime in 2011.

One reason for global anxiety about the rate of deceleration in China is that the country has become an engine of growth for the world. Rising domestic demand in China leads to increased imports, thereby stimulating exports in other parts of the world including the United States, Germany and many commodity-exporting emerging countries. As domestic demand decelerates, there could be a negative impact on global output.

Still, the global economy will probably be better off if China undergoes a soft landing rather than a future crisis. And China may be better off as well. History shows that China tends to face increased social unrest and wrenching economic change during periods of inflation. Clearly the Chinese authorities want to avoid such an occurrence.

Property market

One side effect of the monetary policy tightening has been the end of the worst aspects of the property price bubble. Although the government has successfully attempted to slow the rise in property values, it has not had the effect of slowing investment in residential property, especially low-income housing. Luxury residential investment has, however, declined. Also, it is interesting that property values have stopped growing in the coastal cities but continue to rise in the interior and northern parts of China. Thus, a rising housing market endures in those regions of the country where authorities want strong growth. The government is intent on fueling growth in these regions given their relatively low level of per capita income.

What is the economic consequence of a deflated property bubble in China's coastal cities?

First, individuals who own relatively high-valued properties will experience a loss of wealth. For some, this will cause a cutback in spending. For others, the consequence could be bankruptcy. Second, Chinese banks will accumulate larger portfolios of non-performing assets. There will be write-downs and a potential contraction in credit. This could be offset if the government takes steps to re-capitalize the banks – perhaps through the use of foreign currency reserves as has been done in the past.

Yet the economic consequences might not be too onerous as there will likely be some positive factors in the economy to balance things out. First, export growth has clearly revived. Second, government investment in infrastructure, especially in the poorer parts of China, continues to expand. Third, most consumers in China were not property speculators and, therefore, will not themselves experience a negative wealth effect. Thus, the overall impact on consumer spending may be muted.

Dispute with the United States

There seems to be a dissonance between political concerns about US-China economic relations and the actual facts on the ground. For example, American politicians threaten to impose restrictions on Chinese imports to the United States. Their reasoning is that an excessively under-valued Chinese currency is hurting the competitiveness of US exports to China and causing imports from China to harm US producers. Yet US exports to China grew at a rate of 35 percent in the first eight months of 2010. In addition, while US imports from China are up 31 percent from a year earlier, that is off a low base given the severe drop in imports during 2009. Imports from China are actually only marginally higher than in 2008.

Thus, it is not clear what all the fuss is about. What is clear, however, is that this political issue could have economic ramifications. There are several possible scenarios. One is that China will choose to significantly re-value its currency in order to stem the political pressure coming from the US Congress. Rather than having a big impact on trade flows, a more likely effect would be to reduce Chinese inflation. That is because allowing the currency to rise would entail less foreign currency purchases by China's central banks which are funded, in part, by printing money. Thus, money supply growth would slow. In addition, a higher valued currency would lower import prices, thus putting downward pressure on inflation. This would actually be a good thing for China at a time when the leadership is trying to slow down an overheated economy.

Demographics and the cost of labor

In the past two decades, China has benefited from a declining dependency ratio. That is, the ratio of dependents (children and retirees) to workers has been declining. This means that the share of the population composed of workers has increased. That, in turn, helped fuel strong economic growth, especially as the number of young workers continually rose.

Now, things are about to change. Starting in 2011, the number of dependents (mainly retirees) will rise faster than the number of workers. This will be true, in part, due to a decline in the number of young workers. Thus, a long period will commence during which the dependency ratio will rise. This means the share of the population in work will decline. Absent an offsetting increase in productivity, that suggests slower economic growth. It also implies the need for increased transfers from workers to retirees unless the retirement age is increased. Moreover, unless there is an increase in rural-urban migration, a shortage of labor will likely lead to higher labor costs. Indeed this is already happening. Witness the recent labor unrest in some of China's coastal industrial cities and the recent sharp increases in wages for such workers.

One positive impact of rising wages and the increased numbers of retirees could be that the personal savings rate declines, leading to stronger growth of consumer spending. On the other hand, that was the expectation in Japan when its dependency ratio started to rise. Instead, Japan's savings rate has held high due to poor returns on savings and due to a cultural proclivity toward frugality. China, too, has a cultural inclination toward high savings. In China, the prospect of more expensive labor could have important implications. First, it will encourage companies to invest in labor saving technology, thereby potentially increasing labor productivity. Second, it is likely to accelerate the ongoing movement of manufacturing capacity toward lower-wage locations such as China's interior or lower-wage countries such as India. Third, higher wages will help to develop a larger middle class. The latter effect would be consistent with China's need to spur domestic demand.

Yet, in the absence of improvements in productivity growth, the demographics described here will necessarily lead to slower economic growth. What would lead to faster productivity growth? Normally, more investment does the trick. Yet China's investment is already an abnormally high share of GDP. The problem is that much of that investment has not been spent in areas that yielded a positive return. The increased output relative to the investment input is low compared to other fast-growing emerging nations. Rather, China needs to find a way to improve the efficiency of its investment. This will probably entail more privatization of banks and state-run enterprises as well as more market pricing of credit, energy and other important inputs.

Now, things are about to change. Starting in 2011, the number of dependents (mainly retirees) will rise faster than the number of workers.

Siddharth Ramalingam is a Senior Analyst at Deloitte Research, India

INDIA

India: Wait and watch

by Siddharth Ramalingam

The monsoons have been a resounding success. The imminent bumper harvests bode well for India as it will infuse the economy with much needed liquidity. Foreign institutional investors have been pouring funds into the economy over the last few months, portending sustained growth in the near term. However, recent economic data juxtaposed with developments in India's external sector are a cause for some concern.

GDP data for the first quarter of the current fiscal is a strong indication that India is indeed on course to achieving over 8 percent growth for the year. At 8.8 percent, growth is largely broad-based, with increases in almost all major sectors. The manufacturing industry grew 12.4 percent compared to 3.8 percent during the same period last year. Growth seen in the agriculture sector is a welcome sign as much of India's long-term success is likely to depend on a buoyant agriculture sector. However, sluggish performances in financial, insurance and real estate services during the fiscal year signals that the services sector is far from a full recovery.

Despite the abundant rainfall, food prices are yet to trend consistently downward. Food price inflation hovered around the 15 percent mark in September. Although wholesale price inflation came in at 8.5 percent in August, it is well above the central bank's target level of around 6 percent. The central bank, which has raised its interest rate five times this year, could very well increase the interest rate even further to stem inflation. However, any increase could adversely affect the manufacturing sector that is touted to be India's growth engine.

The imminent bumper harvests bode well for India as it will infuse the economy with much needed liquidity.

Manufacturing – a slippery slope

While there is much anticipation that a bumper harvest will release liquidity into the Indian economy and fuel domestic demand-led growth, recent manufacturing data seems to paint a mixed picture. India's manufacturing sector grew at the slowest pace in 10 months during September and the purchasing managers index (PMI) fell to 55.1 from 57.2 in August. The decline in the index is surprising given strong domestic demand, especially for luxury goods. Merchandise exports rose 22.5 percent in August from a year earlier, after a 13.2 percent gain was reported in July. Imports gained 32.2 percent as well, lending credence to the view that there is a substantial appetite for consumption in the domestic sector.

It is likely that manufacturers' sentiments about demand in the coming months are negatively affected by the appreciating rupee, fears of another interest rate hike, and economic and political instability on the global front. Indian exports are closely correlated with economic conditions in developed countries. The possibility of a slower growth in the developed world is real and Indian exporters will have to plan for such a possibility. Although Indian exports have recovered from the lows reached during the peak of the financial crisis, growth in this sector will likely remain sluggish until the geographic mix of export destinations begins to skew towards Africa, Latin America and Asia. To compound matters for Indian exporters, the Indian rupee has been appreciating against the dollar in recent weeks, making Indian products less attractive in the global marketplace. It is unlikely that the central bank will come to the aid of exporters as any intervention would almost certainly increase money supply and exacerbate inflationary conditions. Notwithstanding real economic pressures, political fallouts from the global recession – like protectionism and government intervention in controlling exchange rates – could come to haunt the Indian export sector as well. Despite all this, there seems to be a consensus amongst domestic observers that India's exporters are on course to meet, if not surpass, the year's target of $210 billion.

The PMI sub-indexes for September bring to light another worrying trend - new domestic orders continue to ease, leading to a slowdown in production. The deceleration, if reflective of short-term expectations, is not counterintuitive as the increase in liquidity from the monsoon and the upcoming festival season will likely take effect only by the end of this year. However, September's PMI could indicate a lack of belief in a long-term growth trajectory for Indian manufacturing as well. Last quarter, preferential lending rates were abolished for businesses, ending access to cheap credit. As the central bank continues to increase its lending rate, the cost of credit has increased substantially for firms. Indian banks have reported that disbursements of loans came in below the target range from the beginning of this fiscal year till September.

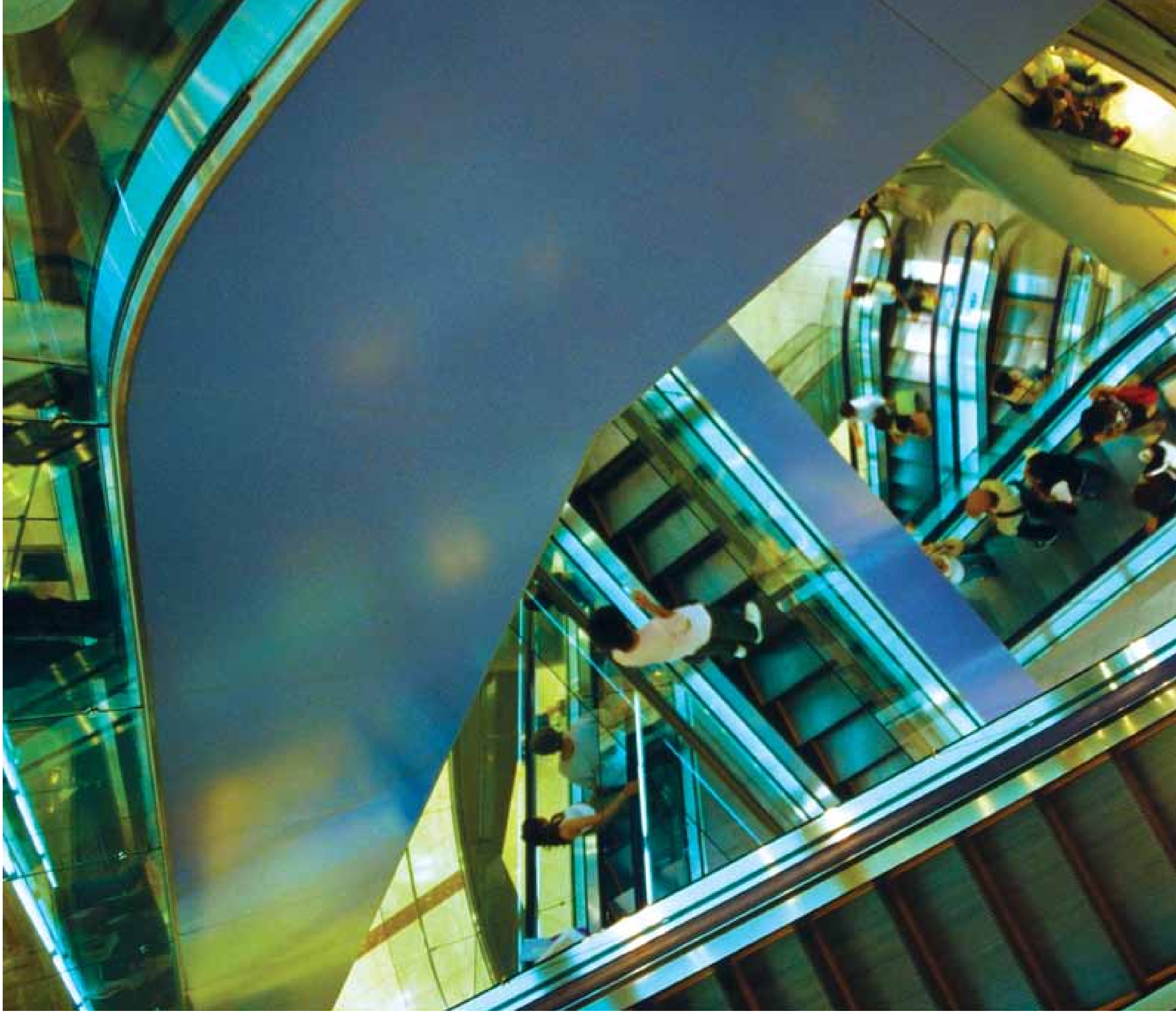
Uncertainty about the external and domestic environment could force businesses to postpone capital expenditure. Rising commodity prices will lead to increased costs for businesses as well. What will likely follow are price markups by manufacturers as they struggle to absorb rising costs and demand side inflation. A recent study by researchers at the Institute of Economic Growth shows that Indian industry has largely failed to produce mass consumption goods at reasonably low prices.

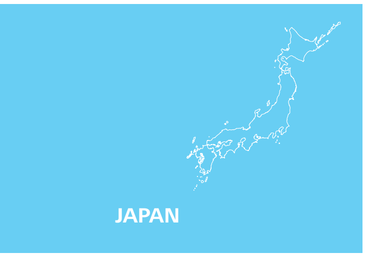
Foreign investors flock to India

Foreign direct investment (FDI) is crucial for building capacity in manufacturing and developing infrastructure, both of which are crucial for driving growth. Flows into India have been lackluster this fiscal; FDI declined by 27 percent to $7.6 billion for the period from April to July. However, foreign institutional investments (FII) into the country surged in September. About $20 billion has been pumped into India to date during this fiscal year. Although important to offset the burgeoning trade deficit, capital inflows are exerting an upward pressure on the Indian rupee. Although the government is showing no signs of stepping in to regulate the spurt in the flow of funds, it is likely that gradual interventions will follow in the coming months if funds continue to flow in at the current pace.

A tough task ahead

Indian policymakers are faced with an onerous talk in the coming months. While the export sector needs support, inflation is the biggest concern for the central bank. India can ill-afford a "my currency, your problem" approach to exchange rate management. It is likely that the central bank will further increase its interest rate, but unlike in earlier months, the timing is less easy to predict.





Japan: The lost decade revisited

by Dr. Ira Kalish

Japan could face a situation similar to what happened in the country during the 1990s. That "lost decade" is certainly not a model for what Japan needs at this point in time.

Japan faces several important questions.

First, was the slowdown in the second quarter an anomaly or a sign of things to come? Unfortunately it was probably the latter. Japan experienced strong growth in the fourth quarter of 2009 (3.4 percent at an annual rate) and the first quarter of 2010 (5.0 percent). Then in the second quarter, growth dropped to 1.5 percent. What went wrong? Consumer spending stopped growing completely. Business investment decelerated, exports slowed and imports accelerated slightly.

As for exports, there had been a substantial revival following the collapse that took place during the global crisis. But once exports recovered to their previous level, they essentially stopped growing. This is likely due to the strength of the yen, fierce competition from other Asian producers and waning consumer demand in the United States. As long as these factors remain and as long as the domestic side of the Japanese economy remains weak, the country's economic engine has little fuel to run on.. Hence, the slowdown in growth in the second quarter will likely be the start of a period of weakening. Still, the very strong growth of the first quarter nearly guarantees that full year growth for 2010 will be strong – probably around three percent.

Second, will the current political turmoil hurt economic growth or will it have little impact? Or conversely, despite political turmoil, will the government enact reforms necessary to propel future growth? The answer to both questions remains uncertain. What is almost certain is that the current economic path is not conducive to success. Japan relies heavily on exports for growth and yet two factors have slowed the growth of exports. These are the continuing rise in the yen and the slow growth of consumer spending in the United States – a key market for Japan. One potential long-term solution for Japan is to stimulate domestic demand. What would the government have to do to make that happen? Among the possibilities are increased spending directed at job creation, deregulation aimed at reducing the cost of doing business, financial market reform targeted at reducing consumer saving, and tax incentives for business investment and consumer spending.

Liberal Democratic Party (LDP), the rise to power of the Democratic Party of Japan (DPJ) was expected to result in substantial changes in policy. Instead, the DPJ faced an early resignation of Prime Minister Yuko Hatoyama amidst corruption charges. The new Prime Minister, Naoto Kan, faces problems in corralling coalition partners as well as members of his own party. Thus, the prospects for reform are not considered good. Moreover, the uncertainty regarding the policy regime could have the effect of dampening business and consumer confidence.

Recently, the new Prime Minister proposed a stimulus of 920 billion yen, roughly 0.2 percent of GDP. Such a small expenditure is not likely to have a significant impact on economic activity. Unfortunately, the political situation is not auspicious for more radical reform. After an election in 2009 that ended nearly 60 years of rule by the

Third, will the central bank engage in a more aggressive policy thereby removing the risk of further deflation? Given that prices are falling, it would make sense to try and boost the money supply in order to create a little inflation. Deflation can be hugely damaging as it results in a real increase in the value of debts, boosts real interest rates even when nominal rates are close to zero and discourages consumers from spending lest they miss out on a future bargain. The latter, in turn, discourages businesses from investing. Hence, economic recovery requires an end to deflation. A little inflation would probably boost consumer spending, reduce the real value of debts and encourage businesses to invest.

The latest news is that, on October 5, the government announced a new policy of quantitative easing. Specifically, the Bank of Japan (BOJ) will set aside roughly 5 trillion yen (US$60 billion) to purchase government bonds and other assets. The goal is to increase the supply of money, put downward pressure on long-term interest rates, encourage business investment and create a bit of inflation. In addition, the BOJ indicated that it would keep short-term rates close to zero until deflation has ended.

The important question is whether this will be sufficient. While the central bank's target interest rate has already been less than 0.1 percent, the broad money supply has been growing at a very modest rate of about 2 percent. Lowering it to zero will probably not make much difference. An injection of 5 trillion yen is not that large relative to the size of the money supply or the Japanese economy. It is certainly a modest plan compared to the quantitative easing plans that the US and UK central banks have done in the recent past. And although the government is now intervening in currency markets to drive down the value of the yen, it has so far offset this action by selling government debt in order to prevent a rise in the money supply. This "sterilization" of foreign currency intervention almost ensures that any drop in the yen will be short-lived. The quantitative easing, however, may allow for a meaningful drop in the yen. While the goal of the new policy is to end deflation, its modest size makes it unclear as to whether it will be successful. If not, Japan could face a situation similar to what happened in the country during the 1990s. That "lost decade" is certainly not a model for what Japan needs at this point in time.

Finally, what will it take to revive consumer and business confidence in Japan? For consumers, a rise in wages would be helpful. For businesses, a rise in profitability might do the trick. Interestingly, both things are happening to a modest degree, with an emphasis on the word "modest." Compensation in Japan has been rising for several months owing to increased payments for overtime and increased bonuses. Yet wages have been falling. This is unfortunate as, historically, Japanese tend to save bonuses and spend wages. Thus, although compensation is rising, it is rising in a way that does not encourage increased spending.

As for businesses, their profits are up considerably following a period of cost-cutting. In addition, the Tankan Survey of manufacturing companies indicates rising business confidence after a long period of decline. This is good news and bodes well for increased investment. On the other hand, the strong yen does not bode well for the success of export-oriented manufacturers. Failure to shift the focus of growth toward domestic demand suggests that improved performance of manufacturers could be short-lived.

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

United Kingdom: Slower growth to come

by Ian Stewart

- So far the United Kingdom has seen a strong recovery, with growth exceeding the rates seen in the last recovery of the early 1990s
- Balance sheet rebuilding in the government and consumer sectors will likely weigh down growth
- The long awaited consolidation in the public sector has started and will intensify over the next year

The UK economy expanded by a stronger than expected 1.2 percent in the second quarter of 2010, with this performance buoyed in part by a sharp rise in construction output. So far, at least, this has been an unexpectedly firm recovery. Even excluding construction, the UK's recovery in this cycle has been stronger than after the last recession during the early 1990s.

Nonetheless, the pace of growth is widely expected to ease in coming quarters as cuts in government spending ripple through the economy and consumers rebuild their balance sheets. On average, UK economists expect modest growth of 1.9 percent in 2011. UK corporates view the outlook as being uncertain and see substantial risks ahead. In fact, UK CFOs see a 38 percent probability that the UK economy returns to recession. We attach a far lower probability but nonetheless acknowledge that uncertainties lie ahead.

Recent data suggest that the UK economy may, gradually, be starting to rebalance away from public to private sector demand. Manufacturing output grew 3.6 percent year on year in the second quarter, the fastest pace recorded in over 15 years. Private sector services output has rebounded while on the other hand, after strong growth during the downturn, output from public sector services is slowing.

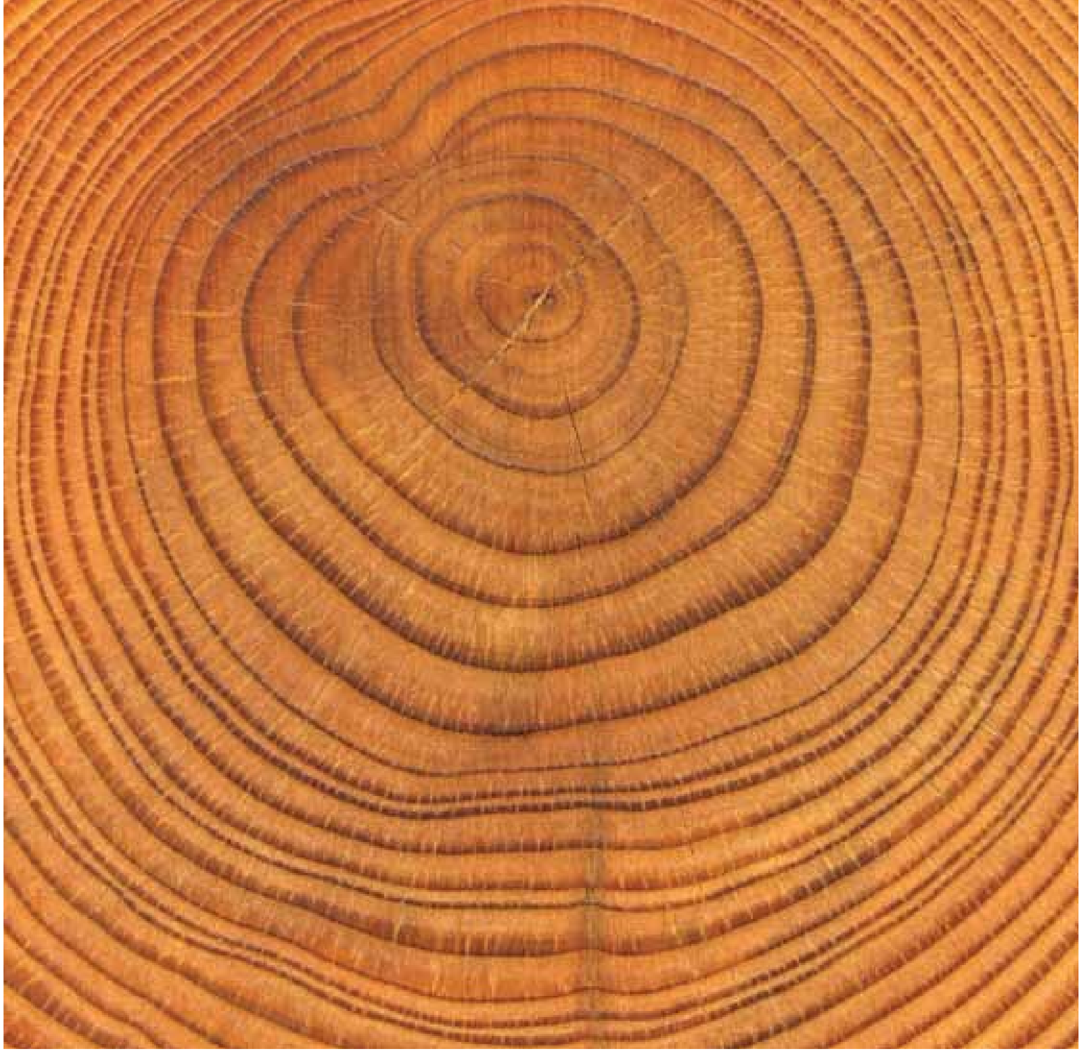
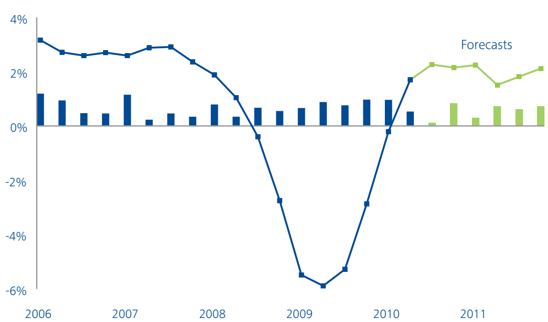


Figure 1: UK GDP Growth Forecasts (YoY%)



Source: Datastream

Meanwhile, private sector employment has recovered in tandem with rising GDP growth. After shedding around 850,000 jobs during the recession, the private sector created 344,000 new jobs so far this year, about one-third of which are full-time jobs. By contrast, public sector employment is contracting after a period of rapid growth. The public sector shed 47,000 jobs this year. Overall, UK employment is now only 1.2 percent below its pre-recession peak.

The corporate sector proved resilient through this downturn and, in contrast to the consumer sector, company balance sheets look fairly strong. During the recession, corporate liquidations rose less than they did in the last, much milder, economic downturn. The number of liquidations in the first half of this year has fallen 18 percent over the first half of the previous year. Corporate profitability has recovered and many United Kingdom companies are cash rich.

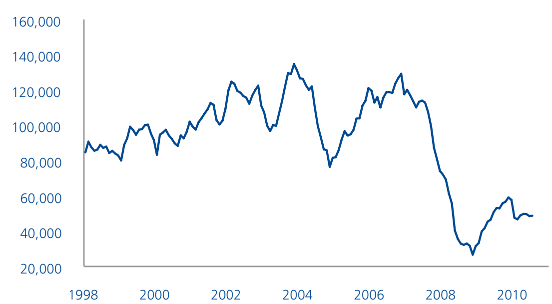
The battered UK consumer staged a recovery in the second quarter with spending up 1.3 percent year on the year and the household savings ratio down sharply, to just 3.2 percent. By contrast, housing market activity is subdued. Home prices are at broadly the same level they were at during the end of last year and turnover is running at low levels. The average number of mortgage loans approved so far this year is at half the rate seen between 1998 and 2007.

Low interest rates have mitigated the worst effects of the recession on the consumer sector. As a result, the degree of distress in this cycle, measured in terms of unemployment and housing repossessions, has been less than in the last recession.

Yet the scope for a strong recovery in consumer spending seems limited. The resilience of the UK employment sector has come at a price. In this cycle,

much of the pain for employees has taken the form of a reduction in overtime, hours worked and a squeeze on pay. Part-time and temporary work has soared during the downturn as companies have changed working practices in order to control costs. Wages have come under pressure and the strain on consumer incomes has intensified even as the economy emerged from recession. Over the last year, private sector earnings have risen by 1.2 percent. With RPI inflation running at 4.7 percent, real earnings have fallen by 3.5 percent over the last year, the sharpest decline since the deep recession of the early 1980s.

Figure 2: Growth in UK Employment
Net jobs created each quarter in the public and private sector (in thousands)

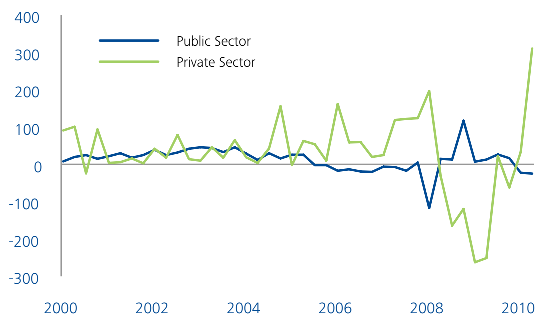


Source: Datastream

Consumer balance sheets are stretched and the deflating of UK home prices – as well as those in much of mainland Europe – appears to be in its early stages. Compared to rents and incomes, home prices look expensive in the United Kingdom, and, indeed, also in Spain, Ireland, the Netherlands, Italy and France. UK consumers are carrying particularly high levels of debt. According to the IMF, UK consumers with a debt to GDP ratio of 221 percent are the world's most indebted. The next most indebted consumers are in Denmark, with a debt to GDP ratio of 145 percent. Elsewhere, consumers look like paragons of thrift compared to the United Kingdom, with debt to GDP ratios of 97 percent in the United States, 91 percent in Spain and 61 percent in Germany.

While credit conditions have improved in the United Kingdom over the last year, the mortgage lending policies of the banks and building societies have become much more selective. This is reflected in the much lower volumes of high loan to value mortgage products offered by the banks and building societies. In an environment of sluggish income growth and constrained credit supply, and with households focussed on repairing their balance sheets, consumer spending is unlikely to return quickly to the heady growth rates seen before the recession.

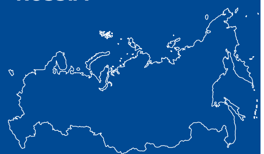
Figure 3: UK Mortgage Approvals



Interest rate expectations have fallen sharply in recent months, reflecting growing uncertainties about the global and UK economic outlook and a new, more accommodating, tone from the Bank of England. Markets now assume that UK rates will stay on hold at 0.5 percent for nearly a year, rising only slowly thereafter. With growing speculation about the risk of a renewed slowdown, the debate on the Bank's Monetary Policy Committee has shifted increasingly from the timing of interest rate rises to whether the committee should undertake renewed quantitative easing – so-called QE2. In September, the recently appointed US member of the Committee, Adam Posen, argued for just such a policy. At the time of writing he appears to be in a minority but any sharp deterioration in the growth outlook will likely prompt such a response.

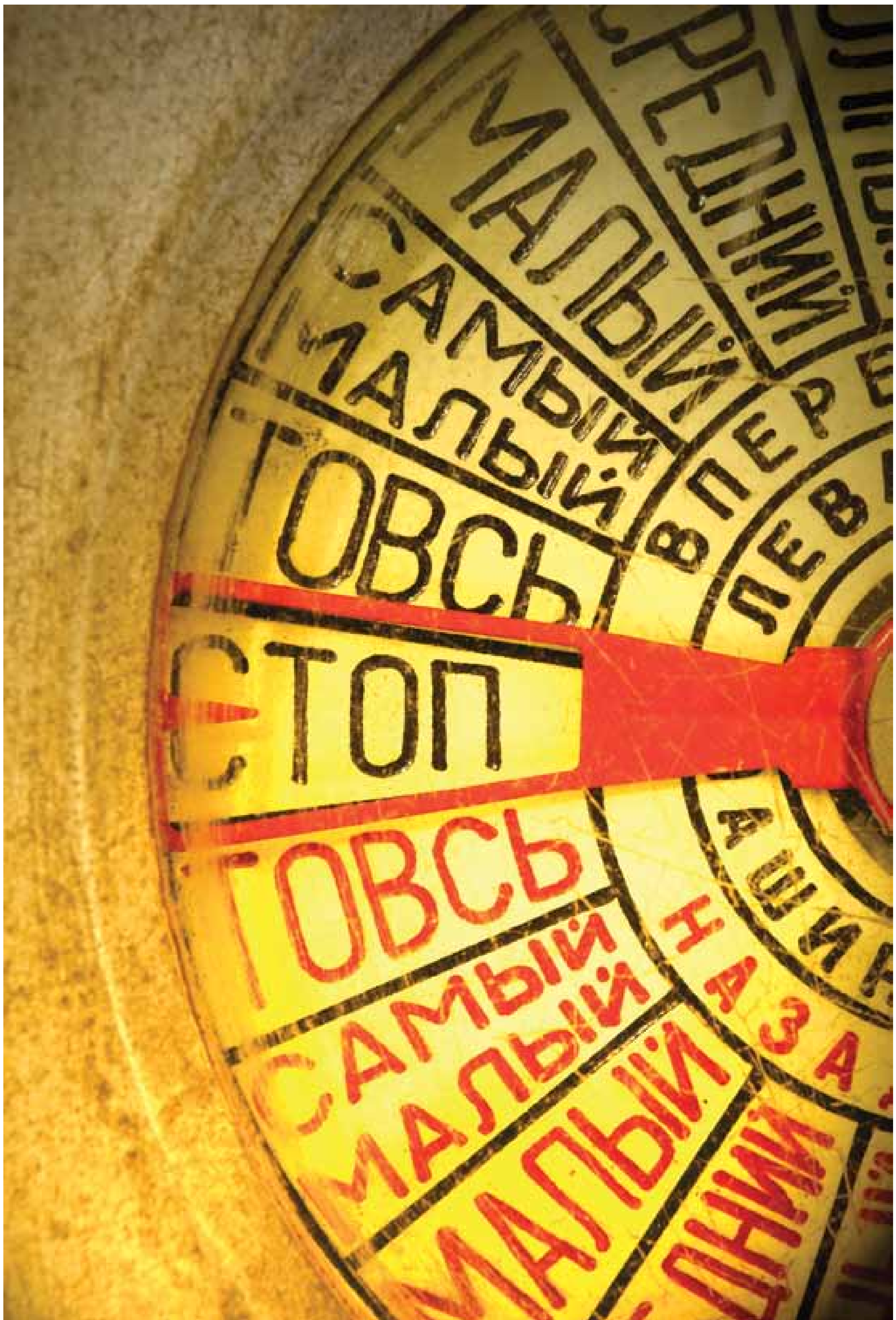
The United Kingdom has seen a reasonably strong recovery but now faces growing headwinds from government spending cuts and a still-retrenching consumer. The most likely outcome is for a slow rebalancing of the UK economy towards industrial production, exports and capital spending, with the consumer and government playing a lesser role as drivers of growth. Our own feeling is that this will deliver a continued if unspectacular recovery.

RUSSIA



Russia: Turning point for policymakers

by Dr. Ira Kalish



Russian policymakers face some difficult choices. That is, they must balance concerns about growth with worries about potential inflation.

The current situation

The Russian economy is recovering at a modest pace relative to other big emerging markets. In the second quarter of 2010, real GDP grew 5.4 percent over the previous year. This was up from 2.9 percent in the first quarter and followed a dismal decline of 7.9 percent for all of 2009. The heat wave and wildfires that Russia experienced during the summer of 2010, while causing a dampening of activity during the summer, will not likely have a lasting negative impact on growth.

Most sectors of the Russian economy grew during the first half of the year. Exports, consumer spending and business investment all rose, while government spending growth slowed. Recent figures point to a dramatic slowdown in exports, however. After surging 18.6 percent in the first quarter, export growth decelerated to just 1.9 percent in the second quarter, with this performance owing to weaker external demand for commodities. Imports, on the other hand, accelerated in the second quarter, rising 21.5 percent. This indicated improved demand in the economy. Indeed consumer spending remained strong in the second quarter, rising 4.2 percent on the back of rising real wages. In fact, real wages in July were up 7.1 percent over the previous year. This performance came on the heels of a drop in real wages during 2009. To some extent, real increases in consumer incomes reflect rising government pension payouts.

Finally, business investment in Russia was up by 5.1 percent, rising for the first time since before the recession. One area of concern, however, is the manufacturing sector which saw a considerable slowdown in growth in September. This may reflect weakening global demand as well as the effects of a stronger ruble.

Inflation is down considerably from a year ago. Consumer prices rose 5.5 percent in July over the previous year, down from a rate of 12 percent in July 2009. Yet inflation has recently accelerated with prices up 6.1 percent in August and 7.0 percent in September. This likely reflects the impact of the summer drought. Food prices have accelerated owing to the heat-induced drought and wheat production is expected to be down by roughly 30 percent for 2010. In addition, concerns exist that inflation will continue to rise due to the lagged effects of relaxed monetary and fiscal policy.

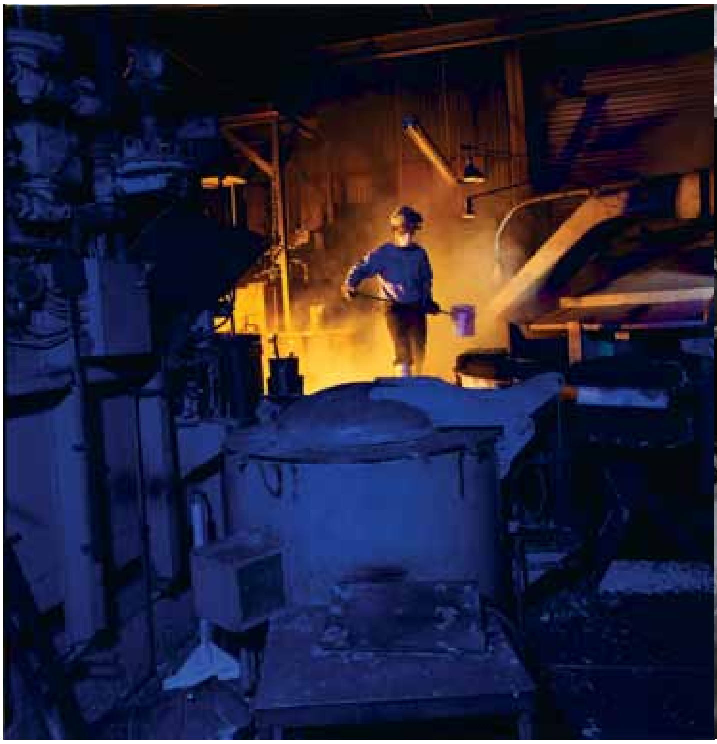
Policy balancing act

Russian policymakers face some difficult choices. That is, they must balance concerns about growth with worries about potential inflation. They must balance the impact of currency values on the trade balance with the impact on inflation. Finally, they must weigh the desire to invest in new infrastructure with a desire to limit the growth of government debt. The choices made on these issues will have a significant impact on business confidence and on the willingness of foreign businesses to invest in Russia.

After a period of stimulus, the government appears determined to reduce the size of the deficit. That may be politically easier to do now rather than wait until 2012 when there will be a new presidential election. Fortuitously, government revenue is rising faster than anticipated, the result of higher than expected oil prices. In addition, there is currently some spending restraint, although the lagged effects of stimulus continue to boost consumer incomes. In addition, pension costs continue to rise. In any event, fiscal policy is at least becoming more neutral. This should help to keep a lid on the growth of government debt. Still, deficits are foreseen for the next several years given that the price of oil is considered to be below the point at which the government breaks even. On the other hand, a degree of fiscal restraint implicitly assumes that the private sector is on a self-sustaining recovery path and that government stimulus is no longer necessary.

As for monetary policy, it is now neutral after a long period of lowering interest rates. Concerns about a high-valued ruble (especially against the weak euro) and the weakness of recovery is keeping the central bank from tightening despite concerns about the possibility of higher inflation, especially on the heels of the drought.

Interestingly, the central bank has explicitly committed itself to eventually implementing a policy of floating exchange rates. The result would be that monetary policy would be solely focused on keeping inflation low regardless of the direction of the currency. It is not clear when such a policy will be introduced. If it were to be introduced now, the effect would probably be to allow the ruble to rise in value. This would hurt the competitiveness of Russia's non-commodity exports. On the other hand, it would help to lower inflation by reducing import prices.



For now, the lagged effects of expansionary monetary policy are still being felt. In May, the broad money supply was up over 30 percent from the previous year. While money supply expansion is likely to ease soon, such rapid growth will likely lead to higher inflation in 2011.

The external environment

High and stable oil prices have been beneficial to Russia during 2010. Given that there is a consensus outlook for higher energy prices in the next few years, this bodes well for Russian export and government revenues. On the other hand, weak investment in new energy production in recent years means that the total volume will not necessarily increase.

One long-term issue of interest is Russia's desire to join the World Trade Organization (WTO). Russia is currently the largest economy in the world not a member of the WTO. As of October 2010, Russia and the United States reached agreement on terms for Russia's entry into the WTO, thereby clearing the last significant obstacle to Russian entry. In the long term, this could be quite significant. WTO entry means that Russia will be on an equal footing with other emerging markets when seeking access to the world's major export markets. It could lead to more investment in Russia's non-commodity export-oriented industries and help Russia to diversify away from excessive dependence on commodities. Finally, by lowering barriers to the entry of foreign goods and services into Russia, it will impose the discipline of the market on Russian businesses.

Brazil: Too much of a good thing

by Dr. Ira Kalish

...the biggest short-term challenge will be one that many other world leaders would envy. That is, rather than trying to make the economy grow, the new president will have to prevent the economy from growing too fast.

Economic Outlook

As of this writing, it is unclear who will be the next president of Brazil. The initial election results mean that Dilma Rousseff, the candidate chosen by President Luiz Inácio Lula da Silva as his preferred successor, will now face a runoff election against Sao Paulo Governor Jose Serra. It remains uncertain who will win the runoff. Yet whoever wins will have to work with a Congress dominated by Lula's leftwing Workers' Party (PT).

Once a new president does take office, the biggest short-term challenge will be one that many other world leaders would envy. That is, rather than trying to make the economy grow, the new president will have to prevent the economy from growing too fast. When Brazil experienced very rapid growth in the past (mainly in the 1950s and 1960s), such growth was usually accompanied by very high inflation, even hyperinflation. Thus the recent momentum, especially the blistering growth now taking place in 2010, is unusual in that inflation remains very low by historic standards. Indeed, real GDP in the second quarter of 2010 was up 8.7 percent over the previous year yet inflation this year is expected to be about 5 percent. Still, there is a general consensus that such rapid growth is considerably more than Brazil can sustain without creating serious bottlenecks that could ultimately lead to ballooning inflation.

On the positive side, the new president will benefit from a surge in tax revenue, the result of a strong economy. Thus the fiscal deficit will likely decline from an already relatively low level. Furthermore, engineering a slowdown in growth is not that difficult. It entails a tightening of monetary policy that is already well under way. The growth of the broad money supply has dropped from year over year growth of 39.5 percent in January 2009 to 10.6 percent in July 2010. In addition, a slowdown in growth across Europe and the United States suggests that the rapid pace of Brazilian export growth will lessen somewhat in the coming year.

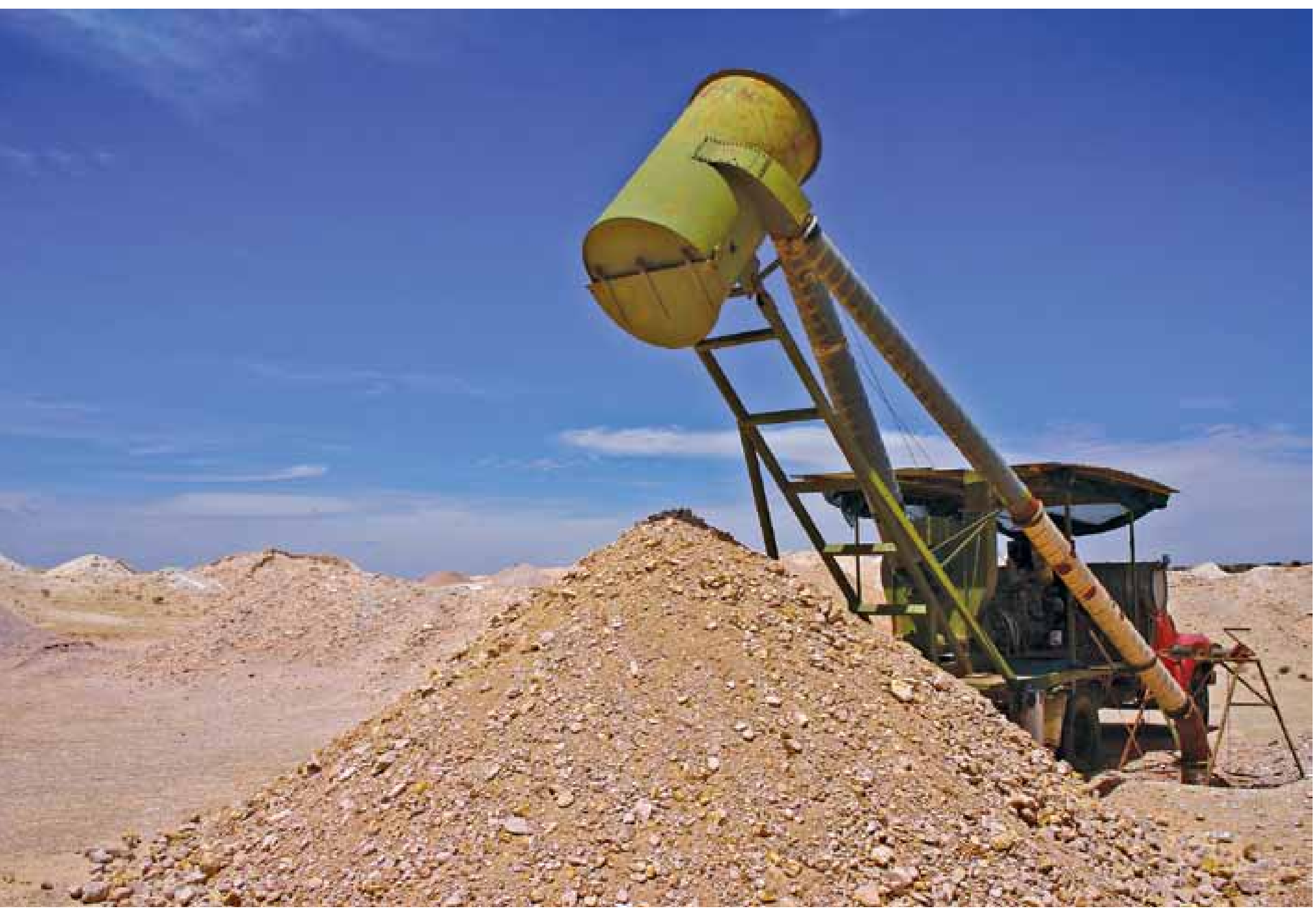
So what are the major challenges that the new president will face? First, the currency has risen in value, thereby hurting the competitiveness of non-commodity exports. This is the result of monetary policy tightening as well as massive inflows of foreign capital. This is one of the factors holding back further monetary tightening. It also explains recent moves by the central bank to weaken the currency. Yet the problem is likely to persist given the historically low interest rates in the United States and Europe compared to those of Brazil, the high level of global liquidity, the attractiveness of Brazilian investments and the increased supply of Brazilian bonds being issued by companies. Unfortunately, Brazil is caught between a rock and a hard place. The currency would drop if there were a significant loosening of monetary policy, but it would also risk significant inflation.

Second, structural changes are necessary to enable Brazil to grow faster. This might entail more government spending on infrastructure and education, reform of the tax system and changes to the regulatory environment. It might also mean labor market reform, pension reform, de-regulation, privatization of infrastructure development and restraints on public spending.

Pralhad Burli is a
Senior Analyst at
Deloitte Research, India

Australia: Navigating political crossroads

by Pralhad Burli



Australia's GDP is expected to grow at 3 to 3.5 percent in 2010 but estimates for 2011 range between 2.5 to 2.9 percent. The country's momentum will likely be dampened by a rollback in stimulus expenditures and a moderation in China's growth rate. Furthermore, Australia's housing prices will likely decline and, as interest rates rise, consumption expenditures would probably fall, further diluting the country's GDP growth. Economic reforms may be implemented more gradually as balancing the goals of independent members of Parliament will probably be a challenge for the Prime Minister.

Australia's growth in the last cycle was punted by government funding and healthy global demand. At the peak of the financial crisis, the stimulus plan pursued by the Australian government allowed the country to recover from the downturn sooner than its peers. At the same time, growth in China and India has been strong, providing a ready market for Australia's commodity exports. A rise in contract prices for coal and iron ore ensured strong revenues. Although commodity prices have declined, Australia's terms of trade will likely remain high over the next year. Further, consumption expenditures along with a boom in the housing market and construction industry also propped up GDP.

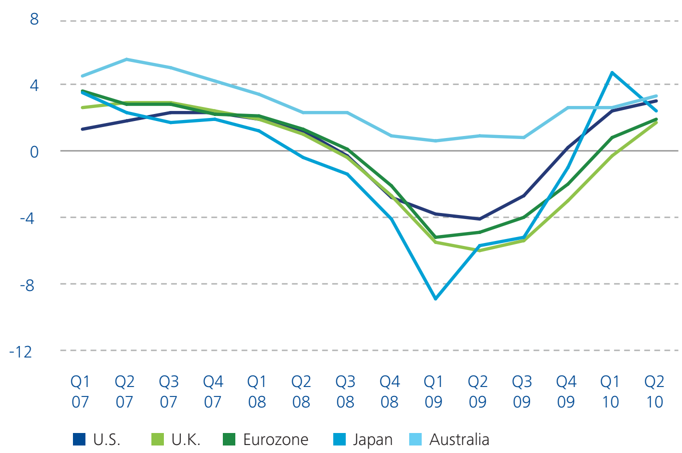
In the future, austerity measures in developed countries and a possibility of weakening demand from China makes Australia's export revenues vulnerable. However, other Asian countries are important markets for Australian exports and that may partially offset a slowdown in exports to China. A relatively comfortable public debt situation does not necessitate a dramatic reduction in public sector expenditures, but authorities will likely keep a close watch on the fiscal deficit. Increased tax revenues and reduced stimulus expenditures will likely lower the deficit to less than 3 percent of GDP in 2010 and below 1 percent in 2011.

While inflation increased during the first half of 2010, it will likely rest between the 2 to 3 percent range proposed by the central bank. In May 2010, the central bank set interest rates at 4.5 percent and kept it unchanged since. Given the high levels of household debt, consumption expenditures are highly sensitive to interest rate movements. The uncertainty about the global recovery prompted the central bank to tread a cautious path to ensure that domestic demand does not shrink prematurely. While a strengthening Australian dollar helps restrain imported inflation, if capacity constraints and global demand exert undue pressure on inflation, the Reserve Bank of Australia may step in to revise interest rates upwards. In that scenario, interest rates may be increased to 5 percent to bring inflation down to acceptable levels.

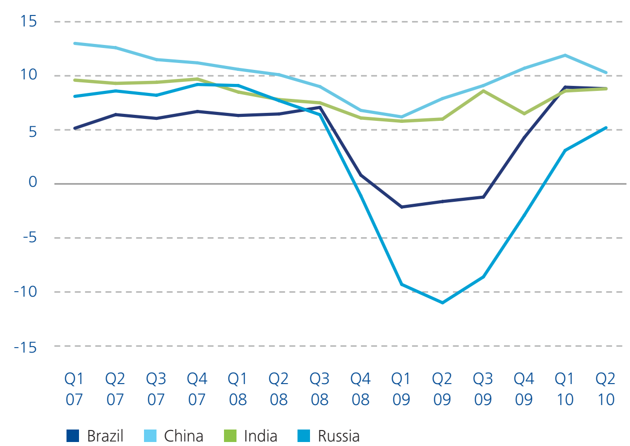
Overall, Australia is expected to record positive growth in the coming quarters and perform better than most industrialized nations. Global economic conditions, however, hint at a slower growth rate compared to 2010. The new government may face the challenges of coalition politics and the reform process may be relatively sluggish. Public investment is set to decline as various stimulus projects are completed, but a likely increase in private investment and Asia's demand for resources provide a positive outlook.

Appendix

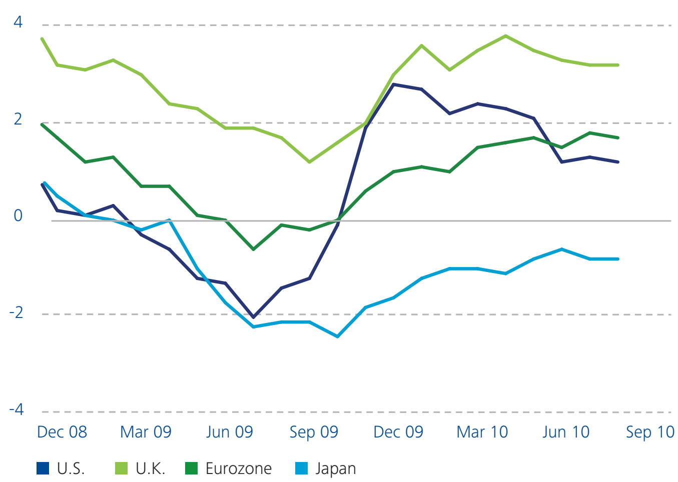
GDP Growth Rates (YoY %)*



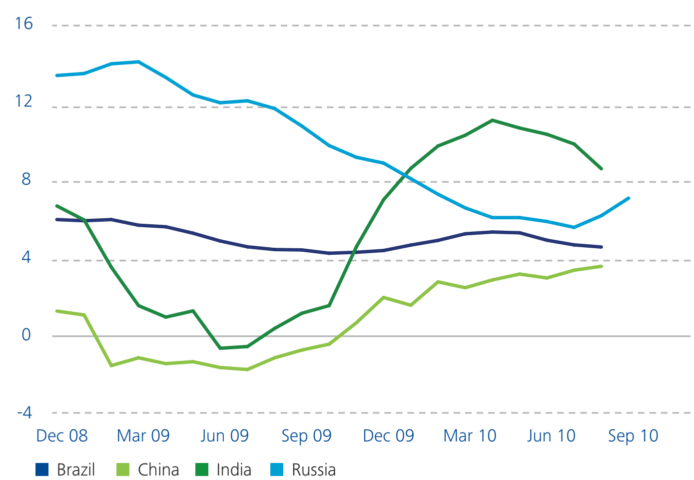
GDP Growth Rates (YoY %) *†



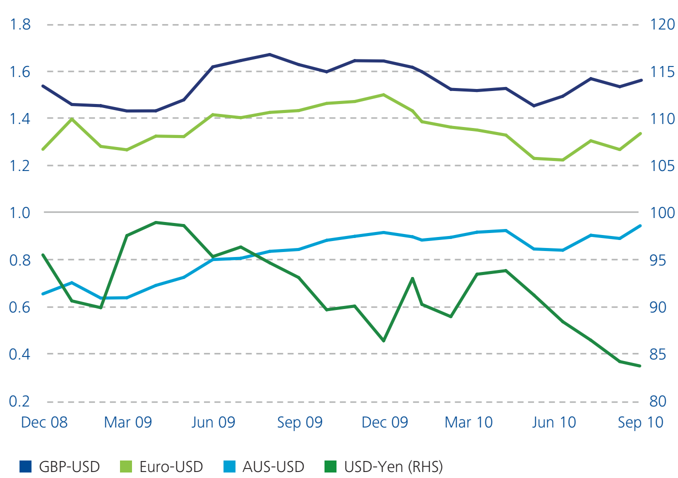
Inflation Rates (YoY %)*



Inflation Rates (YoY %)*



Major Currencies vs. the US Dollar*



Source: *Bloomberg †India's fiscal year is April-March

Yield curves (as on October 05, 2010)*

	U.S. Treasury Bonds & Notes	U.K. Gilts	Eurozone Govt. Benchmark	Japan Sovereign	Australia	Brazil Govt. Benchmark	China Sovereign	India Govt. Actives	Russia
3 Months	0.18	0.56	0.53	0.11	4.54	10.67	1.90	6.25	
1 Year	0.24	0.58	0.76	0.12	4.68	11.72	1.93	6.50	1.58
5 Years	1.22	1.58	1.46	0.25	4.94	11.942 (4 years)	2.69	7.78	
10 Years	2.48	2.93	2.25	0.95	5.01	11.94	3.35	7.93	5.45

Composite median GDP forecasts (as on October 05, 2010)*†

	U.S.	U.K.	Eurozone	Japan	Australia	Brazil	China	India†	Russia
2010	2.7	1.6	1.6	3.05	3.15	7.1	10	8.3	4
2011	2.5	1.9	1.4	1.4	3.55	4.5	8.9	8.5	4.5
2012	3.1	2.4	1.7		4.11	4.5			4.5

Composite median currency forecasts (as on October 05, 2010)*

	Q4 10	Q1 11	Q2 11	Q3 11	Q4 11	2010	2011	2012
GBP-USD	1.56	1.55	1.55	1.57	1.56	1.56	1.56	1.62
Euro-USD	1.3	1.32	1.3	1.29	1.28	1.3	1.28	1.31
USD-Yen	86	88	91	93	95	86	95	97.5
USD-Brazilian Real	1.75	1.74	1.75	1.75	1.7	1.75	1.7	1.85
USD-Chinese Yuan	6.68	6.63	6.55	6.48	6.4	6.68	6.4	6.18
USD-Indian Rupee	45.5	45	44.6	43.9	43	45.5	43	42.5
USD-Russian Ruble	30.5	30	30.5	30.12	29.77	30.5	39.77	27.15
AUD-USD	0.92	0.93	0.92	0.91	0.91	0.92	0.91	0.85

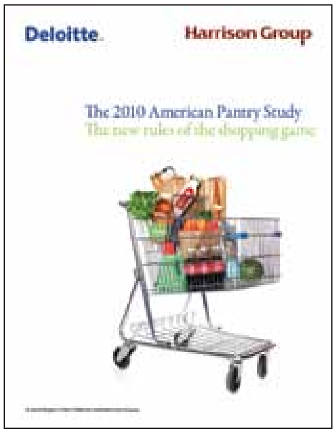
OECD Composite leading indicators (Amplitude adjusted)

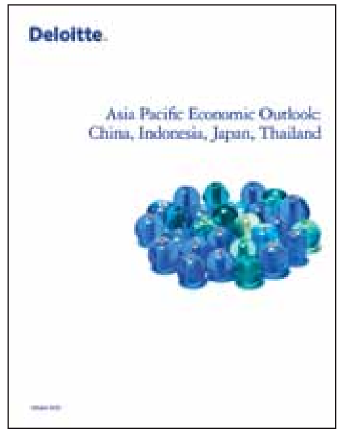
	U.S.	U.K.	Eurozone	Japan	Australia	Brazil	China	India	Russia
October 2008	94.6	94.5	93.7	96.8	99	90.8	93.8	94.9	92.9
November 2008	92.8	93.8	92.5	95	98.2	87.4	93.3	94.7	89.8
December 2008	91.2	93.3	91.7	93.4	97.4	85.2	93.6	94.8	87.6
January 2009	90.1	93.1	91.3	91.9	96.7	84.3	94.5	95.2	86.5
February 2009	89.7	93.2	91.4	91	96.1	84.7	95.7	95.8	86.3
March 2009	89.8	93.6	92.1	90.8	95.6	86.2	97.1	96.7	86.8
April 2009	90.5	94.4	93.1	91.1	95.4	88.2	98.5	97.6	87.9
May 2009	91.7	95.5	94.4	91.8	95.4	90.6	99.8	98.4	89.5
June 2009	93	96.8	95.8	92.8	95.6	92.9	100.9	99.2	91.4
July 2009	94.4	98.2	97.3	93.9	96.1	94.8	102	99.8	93.4
August 2009	95.7	99.6	98.6	95.1	96.8	96.4	102.7	100.2	95.3
September 2009	97	100.9	99.8	96.3	97.6	97.6	103.3	100.6	96.8
October 2009	98.1	102	100.8	97.5	98.3	98.5	103.7	100.9	98
November 2009	99.2	102.8	101.6	98.7	99.1	99.2	104	101.2	98.8
December 2009	100.2	103.4	102.3	99.8	99.8	99.7	104.1	101.5	99.5
January 2010	101.1	103.8	102.8	100.8	100.5	100.1	104.1	101.6	100.2
February 2010	101.8	103.9	103.2	101.5	101.2	100.5	103.9	101.5	100.8
March 2010	102.4	104	103.6	102	101.7	100.6	103.6	101.4	101.4
April 2010	102.7	103.8	103.8	102.3	102.1	100.6	103.2	101.2	102.1
May 2010	102.7	103.5	103.8	102.5	102.3	100.4	102.7	100.9	102.7
June 2010	102.6	103.2	103.8	102.8	102.5	100	102.2	100.7	103.3
July 2010	102.4	102.9	103.8	103	102.6	99.6	101.7	100.6	103.8
August 2010	102.3	102.7	103.7	103.3	102.4	99.3	101.3	100.4	104.3

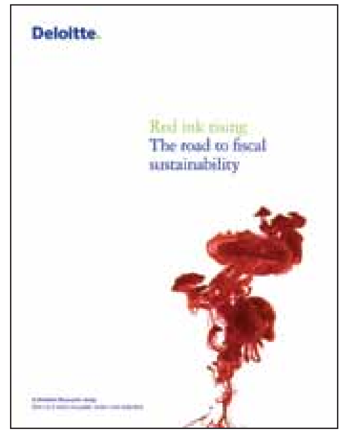
Note: A rising CLI reading points to an economic expansion if the index is above 100 and a recovery if it is below 100. A CLI which is declining points to an economic downturn if it is above 100 and a slowdown if it is below 100. Source: OECD

Source: *Bloomberg †JP Morgan

Additional resources







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Contact information

Global Economics Team

Pralhad Burli
Senior Analyst
Deloitte Research
Deloitte Services LP
India
Tel : +91.40.6670.1886
e-mail: pburli@deloitte.com

Dr. Elisabeth Denison
Senior Economist/Director
Corporate Dev. & Strategy
Deloitte & Touche GmbH
Germany
Tel: +49.89.29036.8533
e-mail: edenison@deloitte.de

Dr. Ira Kalish
Director, Global Economics
Deloitte Research
Deloitte Services LP
USA
Tel: +1.213.688.4765
e-mail: ikalish@deloitte.com

Siddharth Ramalingam
Senior Analyst
Deloitte Research
Deloitte Services LP
India
Tel : +91.40.6670.7584
e-mail: sramalingam@deloitte.com

Dr. Carl Steidtmann
Director, Chief Economist
Deloitte Research
Deloitte Services LP
USA
Tel : +1.303.298.6725
e-mail: csteidtmann@deloitte.com

Ian Stewart
Chief Economist
Deloitte Research
Deloitte & Touche LLP
UK
Tel: +44.20.7007.9386
e-mail: istewart@deloitte.co.uk

Global Industry Leaders

Consumer Business
Lawrence Hutter
Deloitte MCS LLP
UK
Tel: +44.20.7303.8648
e-mail: lhutter@deloitte.co.uk

Energy & Resources
Peter Bommel
Deloitte Netherlands
Netherlands
Tel: +31.6.2127.2138
e-mail: pbommel@deloitte.com

Financial Services
Chris Harvey
Deloitte LLP
UK
Tel: +44.20.7007.1829
E-mail: caharvey@deloitte.co.uk

Life Sciences & Health Care
Robert Go
Deloitte Consulting LLP
USA
Tel: +1.313.324.1191
e-mail: rgo@deloitte.com

Manufacturing
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Deloitte & Touche GmbH
Germany
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Public Sector
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Deloitte & Touche LLP
UK
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U.S. Industry Leaders

Banking & Securities and Financial Services
Jim Reichbach
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Deloitte LLP
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e-mail: jbigalke@deloitte.com

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Greg Aliff
Deloitte LLP
Tel: +1.703.251.4380
e-mail: galiff@deloitte.com

Public Sector (Federal)
Robin Lineberger
Deloitte Consulting LLP
Tel: +1.517.882.7100
e-mail: rlineberger@deloitte.com

Public Sector (State)
Bob Campbell
Deloitte Consulting LLP
Tel: +1.512.226.4210
e-mail: bcampbell@deloitte.com

Telecommunications, Media & Technology
Phil Asmundson
Deloitte LLP
Tel: +1.203.708.4860
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