

Global Economic and Financial Outlook

Annual Report 2015 (Issue 21)

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Highlights

- So far, global economic recovery has been confronted with further differentiation and insufficient endogenous driving forces. Relaxed policies and the withdrawal of short-term factors will accelerate growth in 2015 which, however, will be exposed to potential risks such as policy differentiation and regional turbulence.
- Fluctuations in global financial markets are influencing different economies in different ways. The US dollar is expected to be stronger, but commodities will see downward movements in price. There will be further divergence in global Bond markets, imposing higher solvency pressure on emerging markets.
- Global monetary policies are coming to a new watershed. It is expected that the Federal Reserve (Fed) will kick start the interest rate increase in the latter half of 2015, while the euro area and Japan will adopt more easing policies. Policy differentiation will exert new effects on global capital flows.
- The US will see stronger economic recovery; Europe will face more difficulties; Japan is expected to be trapped in poor economic growth; Asian EMs will continue at a speed exceeding the others; Africa will maintain the momentum of development; Latin America, on the contrary, is expected to be lackluster.

Global Economic Trend of 2011-2015

%	2011	2012	2013	2014	2015
Developed economies	1.7	1.2	1.4	1.8	2.2
US	1.6	2.3	2.2	2.2	3.0
UK	1.1	0.3	1.7	3.2	2.8
Japan	-0.5	1.5	1.5	0.9	1.0
Euro Area	1.6	-0.7	-0.4	0.8	1.0
Emerging economies	6.2	5.1	4.7	4.4	5.0
China	9.3	7.7	7.7	7.4	7.2
India	6.6	4.7	5.0	5.6	6.5
Russia	4.3	3.4	1.3	0.2	0.5
Brazil	2.7	1.0	2.5	0.3	1.5
Global economy	2.9	2.4	2.5	2.6	3.0

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A New Inflection Point along Recovery

- Global Economic and Financial Outlook (2015)

The year of 2014 has witnessed continued divergence in global economic recovery, and insufficient endogenous driving force for economic growth. With patterns of withdrawal of the U.S. Fed's quantitative easing policy and more easing policies in Europe and Japan, these have brought violent fluctuations in the international financial market. Looking to 2015, easing political environments will continue and the global economy is expected to accelerate in growth with an absence of shocks in the short-term. However, risks remain arising from policy divergence and regional turbulence. More specifically, the U.S. will accelerate in growth, the European economy will be stagnant and Japan will be trapped in poor economic growth. EM Asia will continue at a speed exceeding all others; Africa will maintain its' momentum of development; Latin America, on the contrary, is expected to be lackluster.

I. Global economy: more divergence along recovery, insufficient endogenous driving force

The global economy has undergone some frustrations since it began to recover in the latter half of 2009. Negative factors in 2014, such as abnormal weather in the US, adjustment of the excise tax in Japan and sanctions imposed by Europe and the US on Russia, damaged growth. Alongside the recovery, imbalance in growth rates was demonstrated with Anglo countries (the US, UK, Australia and Canada) resilient to crisis, but the euro area and Japan were stagnant. EM Asia was energetic; however, Eastern Europe, Latin America and Middle East were restless. The weak global recovery should be attributed to, apart from short-term factors, insufficient endogenous driving force.

The demographic dividend is diminishing. Aging population, shrinking labor force and high post-crisis unemployment rate in developed countries have limited the contribution of human capital to economic growth. Sluggish structural reforms and the reluctance of numerous young people and women in Europe and Japan to enter into the labor market are problems beyond the capability of short-term macro policies. Besides, some EMs, such as China, are facing the turning point of demographic dividend and are steeped into the "new-norm".

Capital accumulation is subject to supervision. As a source of economic growth, it has been significantly restricted since the financial crisis, partially because of weak financial institutions and poor transmission of monetary policies. More strict supervision on financial sectors has weakened the support of the financial sector and to the economy in the short-run. Since the crisis occurred, most countries have suffered from low credit, more severe capital accumulation bubbles through self-cycling in the financial system, and low efficiency of injecting capital into the real economy.

There has been no signal regarding sufficient technological innovation availability. Technological innovations that can be translated into productive forces did not emerge after the financial crisis, failing to boost fixed asset investment and consumption upgrading. Mobile internet was the continuity of the IT movement, shale gas revolution reduced the global energy price, which has made up for the decrease of investment in the traditional energy industry, and developed countries saw recovery of the real estate market with low technological content.

Looking into the future, we project a new inflection point along global economic recovery, although it is still difficult to resume the pre-crisis average growth rate of 3.4%. Assuming no

unexpected shocks, the global GDP growth rate may be above 3.0% in 2015, reversing the declining tendency of lingering on/at 2.5% in the past (Figure 1); the price will maintain stability in general, but the commodity price will decline and the euro area will be under great pressure of deflation.

Figure 1: Forecast of global economy

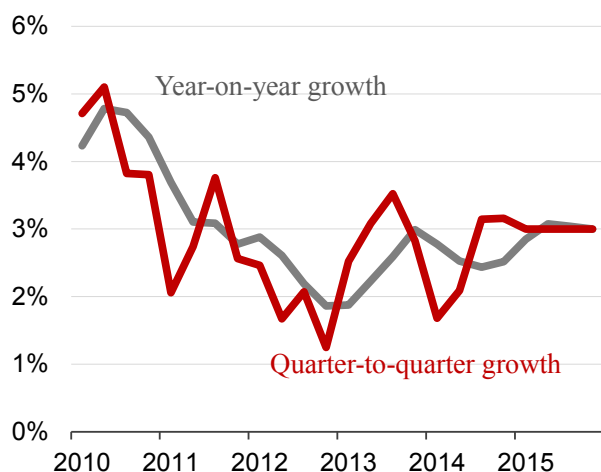


Table 1: Growth forecast of major economies.

	2011	2012	2013	2014	2015
Developed	1.7	1.2	1.4	1.8	2.2
US	1.6	2.3	2.2	2.2	3.0
UK	1.1	0.3	1.7	3.2	2.8
Japan	-0.5	1.5	1.5	0.9	1.0
Euro area	1.6	-0.7	-0.4	0.8	1.0
Emerging	6.2	5.1	4.7	4.4	5.0
China	9.3	7.7	7.7	7.4	7.2
India	6.6	4.7	5.0	5.6	6.5
Russia	4.3	3.4	1.3	0.2	0.5
Brazil	2.7	1.0	2.5	0.3	1.5
Global economy	2.9	2.4	2.5	2.6	3.0

Source: Institute of International Finance BOC

To be specific, the global economic recovery is strengthened mainly by following elements: (1) short-term factors impeding economic recovery may be alleviated or disappear. The US, Japan and euro area will see accelerated economic growth in 2015, which will benefit other countries through trade (Table 1); (2) major mature economies will continue their easing of monetary policy. Pressure of financial consolidation on Euro Area countries will be reduced, and the relaxed macro policies will push economic recovery further. Financing conditions by the capital market will be improved so as to fill the real economy; (3) despite negative effects on the exporting country, lower commodity prices helped reduce the trade deficit of the importing country, so as to promote investment and consumption. It made a contribution, to some extent, to cooperative infrastructure development, and construction in the Asian-Pacific region which is an important production base; (4) the global economy progresses towards re-balance. The US, the engine for developed countries, and China which can represent developing countries, have both made outstanding performances in adjusting their respective economic structures. “Re-industrialization” and “shale gas revolution” in the US have become a new source of endogenous driving force and have broken energy restrictions. China has made considerable progress in adjusting its industrial and distribution structures and reducing external dependency.

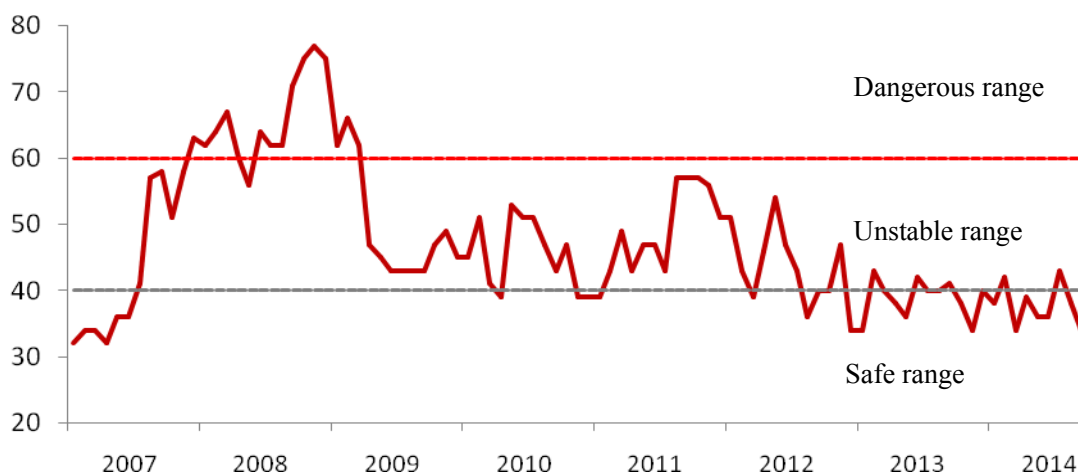
Nevertheless, potential risks exist, and there should be concerns. (1) out-of-control risk of the Fed’s QE withdrawal pace, exposes EM countries to capital outflow and currency depreciation, especially those with double deficits and high dependency on external financing; EM Europe may also be affected by higher yields of the US government bond and exchange rate fluctuations; (2) Ebola virus control and prevention remains open to doubt and may damage the global economy. So far, related prevention, treatment and research have produced significant costs. According to estimates by the World Bank, Ebola prevention and control will cost Africa USD 32billion. European and American countries will also face considerable outlays in this regard. The total expenditure is still unpredictable. In the most extreme case, international customs will be closed due to rampant virus outbreaks, retarding world trade and international investment; (3) geopolitical

problems in Eastern Europe may become more complex and remain for a considerable period of time. Negative economic effects due to the Ukraine crisis on the euro Area and Russia have been viewed. If the international community fails to establish an effective coordination mechanism, the conflict in Ukraine is likely to persist, adding endless pressures on the global economy. It is already reasonable to say that the Ukraine has pushed the confrontation between Western countries and Russia into a pattern of the “Cold War” again. Such new confrontation and conflict will impose far-reaching influences on the global political and economic structures.

II. Global financial system: stable but with shadow banking risks

Since the outbreak of the financial crisis, countries have improved the stability of their economic and financial systems with structural adjustment, such as: European and American banking industries have cleaned up their balance sheets, strengthened their capital and maintained sound improvement; European and American countries have tightened macro-prudent supervision over their banking industries and the credit market, reducing the possibility of a re-occurrence of systematic risks in the banking industry; the global current account imbalances have been reduced by 1/3 in 2013 from 2006; and the US and other major countries have seen improvement in their fiscal deficits and debts. However, the stable condition remains fragile with increasing fluctuations since this autumn. The risk of financial crisis index (ROFCI) has moved within the safe range throughout 2014, with an average value of 38.45 that is slightly lower than the previous year. The index transitory fluctuated during the beginning, mid and October of the year, to the unstable range. In general, credit risks remain at high levels but tended to be comparatively stable and decline; market risks and liquidity risks were at low but are inclined to increase.

Figure 2: Risks of financial crisis index (ROFCI) tendency



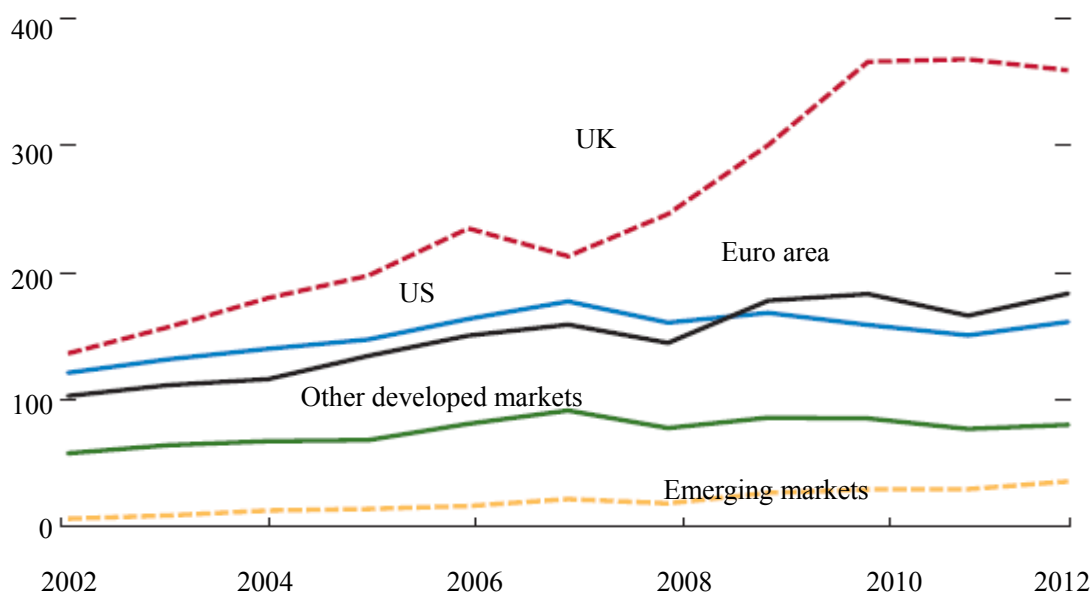
Source: Institute of International Finance BOC, New York Branch of BOC

Major potential risks in the financial industry in 2015 include:

(1) Risk involved in monetary policy. Previous easing policies of major markets increase dependence of the real economy on the financial market and liquidity conditions. The real economy exposes greater sensitivity to policy changes. On the contrary, it should be noticed that the US economic growth may impact positively upon the global economy and offset the negative effects of policy tightening.

(2) Shadow banking risks. Sufficient liquidity, prolonging low interest rates, strict supervision on banks and other factors drive capital flows into non-banking and high-risk assets. The global shadow banking industry continues to expand its size to USD27 trillion in 2013. Among them, the proportion of UK's shadow banking to GDP ratio was twice that of other parts of the world (Figure 3) In the US, the issuance of CDO, CLO, high-yield corporate bonds, high-leverage loans, secondary loans and ABS have drastically increased since 2011 to the pre-crisis level. The features of shadow banking such as high leverage ratio, maturity and liquidity mismatch is likely to induce systemic risks. The contribution of shadow banking to systematic risks in the US has risen from 23% in 2009 to 33%, higher than that in other mature markets. The shadow banking industries in emerging markets, especially in China, have rapidly expanded, although, not like the case in mature markets, are limited in their domestic market and with little spillover effect.

Figure 3: Size of global shadow banking industry



Source: IMF Financial Stability Report, October 2014.

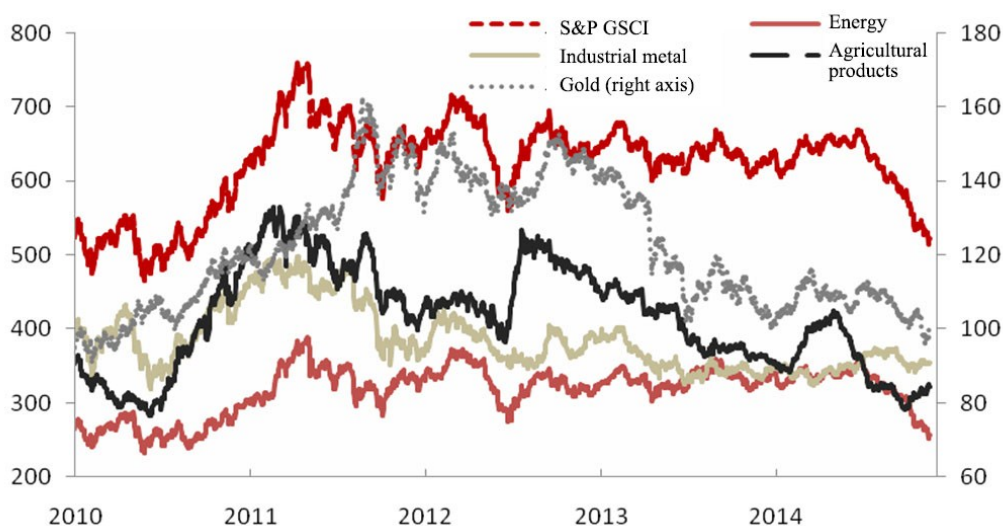
(3) Risk of vulnerable emerging markets. As the US tightened its monetary policy and appreciated its currency, capital began to flow out of emerging markets, leading to lower MSCI of such markets; besides, some emerging markets saw currency depreciation and more fluctuations. Foreign capital in emerging markets is mostly direct investment with low liquidity. Due to generally low liquidity, although net capital inflow in such markets will be obstructed, drastic capital flight is barely possible. However, we should pay attention to risk transmission caused by capital outflow in some such markets, which has been demonstrated in the slowing of economic growth of the market. Capital flight will make the growth even more sluggish through depreciation of domestic currency, higher interest rates and lower asset prices, thus triggering the outbreak of another financial crisis. Countries with unstable financial markets, with poor capacity, high government debt, current account deficits and less dependency on exports are particularly vulnerable. For example, emerging markets like Turkey, Brazil, India, Indonesia and South Africa have vulnerabilities too severe to be ignored.

III. Commodity: falling with varying spillover

Since the latter half of 2014, commodity price has drastically dropped to record lows in the past

four years. As of November 12, S&P GSCI closed at 528.13, 21.04% down from the highest level of the year on June 20 and 14.87% lower than the year beginning. Among commodities, energy prices have experienced the longest drop in the past six years. WTI light oil and ICE Brent crude oil saw decreases of 21.75% and 27.84% YTD, respectively. Prices of agricultural products and gold were YTD 7.39% and 5.59% low, respectively (Figure 4).

Figure 4: Commodity GSCI



Source: Bloomberg

Unexpected falls of commodity prices is mainly attributed to the following reasons: firstly, the US dollar value is proceeding strongly and the interest in the U.S. is expected to rise, take pressures on commodities which are priced in terms of USD; secondly, stagnant economies in Europe and a slowdown in China reflect reduced demands for commodities; thirdly, supply of commodities continued to surge by a combination of factors. For instance, US sales, biological and deep-sea technology brings burgeoning production on crude oil. OPEC countries have sustained high output levels despite a weakening price outlook. After reaching the new low for crude oil prices, Saudi Arabia, Iraq, Iran and Kuwait have reduced the official oil price, indicating that OPEC countries value market shares more than profits from high prices regarding the new output pattern.

Giving the lackluster condition of the commodity market, hedge funds have cut their positions in this market, implying the finance attribute pricing of commodities is drawing to a close. According to CFTC, WTI crude oil long position continued to drop, with non-commercial trade based net position dropping to the record low for the past one and a half years. According to ICE active futures of Brent crude oil, as of November 12, 2014, only 44,200 net positions have been managed by funds. The position was even in short during the fourth quarter.

It is expected that in 2015, commodities will see further price declines. WTI crude oil price will be no higher than \$80/bbl; Brent oil will be at prices between \$80-90/bbl. Agricultural products will bounce back quarter by quarter; gold will stand at the low price of \$1,200 per ounce for adjustment; and the industrial metals will be slightly less expensive.

The falling price of crude oil will not affect the overall situation of shale oil production in the US. Traditional oil producing countries are now in a dilemma: maintaining the output at low price levels will lead to lower incomes; however, reducing production may lose market shares. Lower oil prices may reduce the investment in R&D of new and most costly technologies, thus affecting future exploration technologies. On the other hand, however, it can also stimulate further

innovation of the currently mature oil extraction technologies to increase extraction efficiency and capacity. As a matter of fact, the price of \$80/bbl will not hit US shale oil production, since the cost of shale oil producing ranges from \$40/bbl to \$90/bbl with an average of \$60/bbl. With the current international price, no profits will be made if each barrel costs over USD80, but the rest will not be affected.

The slump in crude oil prices affects exporting countries in different ways. Russia was affected most, while OPEC countries less. Russian public finance depends highly on energy exports, with oil and natural gas exports contributing almost a half to its fiscal revenue and accounting for 8.9% of GDP. According to calculations from the Savings Bank of the Russian Federation, the crude oil price must be maintained at \$104/bbl to keep balanced expenditure and income. However, a price slump will not bring about a collapse of the Russian economy. Russia insists that foreign exchange reserves and a free floating exchange rate with the ruble can mitigate the effects of a price slump. Furthermore, the country is capable of standing firm in the case of \$80/bbl. Unlike Russia, OPEC countries export oil to many areas, and they can partially avoid price slump risks through structural adjustment of the oil price. For example, Saudi Arabia lowered the official price of oil exported to the US, but increased that for Asian markets.

IV. Global foreign exchange market

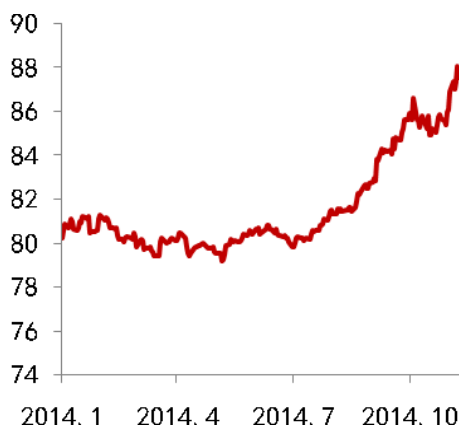
IV.1 Stable increasing dollar index

On October 29, 2014, the Federal Open Market Committee announced halting the purchase of new bonds by November; the Federal fund rate will be maintained in the target range of 0-0.25%; and it declared strong employment growth, the previous expression of “obviously insufficient utilization of labor resources”. QE withdrawal drove the dollar index to soar to a new high since July 2010. After that, the market focus has shifted to the timing and pace of lifting interest rates. Taking into consideration the hawkish-trend to outcomes in October, the Fed basically maintained the same stand and it is expected to manage the exit from zero interest rates in the latter half of 2015. Considering the generally encouraging US economic recovery, international capital flowing back to the US and the higher expectation for rate increases by the Fed, US dollar will become increasingly stronger, and the dollar index will grow steadily in the next year (Figure 5).

IV.2 Further depreciation of euro against US dollar

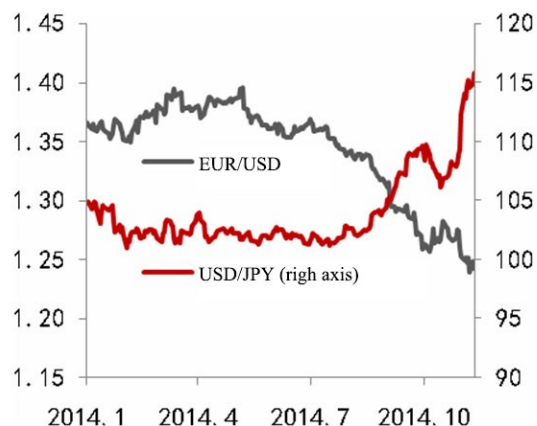
The economic situation in the euro area has been stagnant in 2014 with sustained pressures of credit and deflation risks and shrinkage of the ECB balance sheet. The economies of the whole area have experienced downturn pressures, which have brought more burdens to the European Central Bank to further relax monetary policy. Weak economic fundamentals and loose monetary policy bore down on the euro exchange rate. As of November 11, the exchange rate of the euro against the US dollar was 1.2424, down by 9.04% compared with the beginning of the year. In 2014, the euro area will continue to adopt a quantitative easing policy, and may purchase more bonds, which will malign the euro in the international monetary market. The exchange rate of euro against US dollar is expected to further slump to below 1.20 (Figure 6).

Figure 5: USD index



Source: Wind

Figure 6: Exchange rate of Euro and Yen



Source: Wind

IV.3 Japanese yen depreciation accelerated by Japan's qualitative and quantitative monetary easing policy

At the end of October 2014, the central bank of Japan lowered the GDP growth expectation of 2014 to 0.5% from 1% in July. To curb economic development from declining, it announced its decision on purchasing more financial assets and expanding its QQE policy. The annual stimulation object for the monetary base has been increased from JPY60-70 trillion to JPY80 trillion, and the purchase of Japan's government bonds has gone up from JPY50 trillion/year to JPY80 trillion. The duration of the government bond has been prolonged from four to seven years to seven to ten years. The Government Pension Investment Fund (GPIF) released the structural adjustment policy at the same time, to increase the holding of overseas stocks and bonds and hold less government bonds. QQE expansion was beyond market expectations, and the Japanese yen was sharply depreciated. The yen index of the day dropped by 2.39%, and the spot exchange of the Japanese yen against the US dollar increased by 5.46% from 109.23 to 115.19 on November 7.

In 2015, QQE expansion and increased foreign asset position of GPIF will impose more pressure on the Japanese yen for depreciation. As the Abe Administration may push up the excise tax from 8% to 10% next October and also consider taking hedge measures concerning monetary policy after the tax increase, it is expected that the Japanese yen will continue to be depreciated and the spot exchange rate of JPY against USD will reach about 125.

IV.4 Slight appreciation of RMB exchange rate with fluctuations

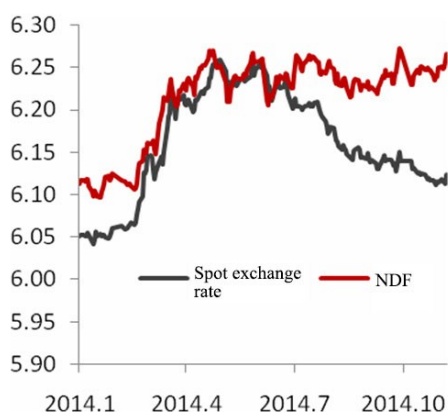
Persistent current account surplus, and huge foreign exchange reserves of China, have shielded the country from US dollar appreciation. No essential changes occurred to the liquidity abundance in the international market, and it is highly possible for China to become a destination of foreign capital flow, which will push the RMB to become stronger. As of November 11, 2014, the spot exchange rate for the RMB against the US dollar was 6.1252, increasing by 1.23% from the beginning of the year. In 2015, China will enter the "new normal" economic development model, in which the negative effects of previous stimulation policies will gradually become weaker and cease to exist, reform bonuses will be gradually released, and the recovery of the real estate market will substantially re-energize related industries. As a major energy importer, China will see a much higher trade surplus due to the international oil price slump. In general, it is more likely for

the RMB to appreciate than depreciate, but substantial appreciation in the short term will be poorly fueled, and the RMB/USD exchange rate will rise slightly through two-way fluctuations (Figure 7).

IV.5 Exchange rate tendency of other currencies

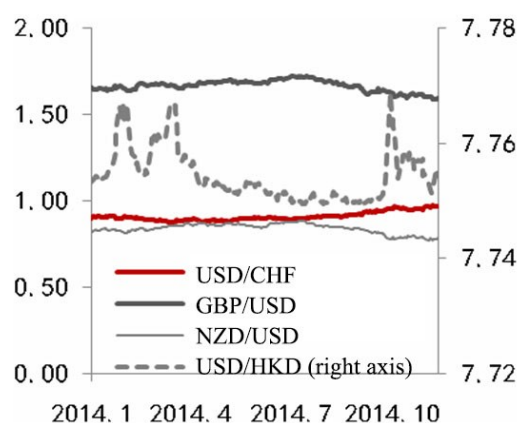
Despite an encouraging recovery in the U.K., worse budgeting and falling international oil prices have brought pressure on the pound. We can hold an optimistic view for the pound in 2015, but the relative advantage of US dollars can hardly be offset. With a bleak outlook for the European economy, it is possible the Swiss Franc will depreciate against the US dollar (Figure 8).

Figure 7: RMB spot exchange rate and NDF



Source: Wind

Figure 8: Exchange rate of other major currencies



Source: Wind

V. Global bond market

V.1 Divergence of ME's government bonds, secondary market depth in the US caused concern

In 2014, the bond market of developed economies generally presented three major features, namely, declining yields of US and European bonds, further differentiation between the US and Europe and concern over the secondary market depth. Due to low long-term inflation expectation and lack of fuel for economic growth, US bonds saw yields falling and a smooth and gradual spread curve.

The yield of major US and European government bonds, which used to be basically the same, began to vary from each other from 2013. In 2014, the US saw this figure descending, but slower than that of Germany, further widening the yield gap (Figure 9). That should be attributed to the greater difference between the US and Europe in terms of economic recovery and monetary policy, namely, the market expectation for Fed's QE withdrawal and uncertainties caused by resistance of core countries in the euro area against the accommodative policies of the European Central Bank.

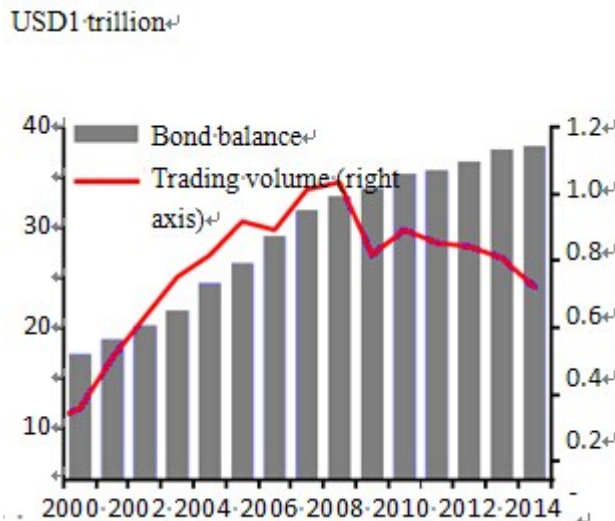
In 2014, the liquidity in the secondary bond market of the US dropped continuously. Since the outbreak of the financial crisis, the US bond market has constantly grown from USD32.7 trillion in 2008 to the current USD38.2 trillion, while the daily trading volume has dropped from USD1 trillion in 2007 to the present USD690 billion (Figure 10). Insufficient market fluctuations caused by low interest rates, plus risk appetite of marketing makers was dampened by strict supervision, significantly reducing market-making activities. Corporate bonds held by market makers in the US

have dropped from USD235 billion in 2014 to the current USD60 billion. That implies liquidity and depth of the US secondary bond markets is now much lower than the pre-crisis level.

Figure 9: Yield of US and European 10-year government bonds



Figure 10: Size and trading volume of the US bond market



Source: Wind, IIF

In 2015, the US will maintain the current economic fundamentals, tighten monetary policies as scheduled, and maintain a smooth yield curve for government bonds. There is faint possibility for further differentiation in monetary policies between the US and euro area, and the government bond yield difference will remain unchanged or be narrowed consequently. Close attention should be paid to the liquidity indicator of the US secondary bond market, considering the huge possibility of an interest rate increase by the Fed in 2015. An excessively fast bond yield increase will lead to a fire sale, and insufficient depth makes a liquidity crunch highly possible, causing systematic risks that can by no means be ignored.

V.2 High issuing but big repayment pressure on EM’ s bonds

The year 2014 has experienced a decrease of the bond market followed by a rise in emerging markets. The JP Morgan Emerging Market Bond Index (EMBI) yield dropped from over 6% in the year beginning to the current 5.8%. Affected by the expectation for an interest rate increase by the Fed, the spread between EMBI and the US government bond yield has bounced back from the lower level in the mid-year to the current value of over 300 base points (Figure 11).

Figure 11: Government bonds spread tendency of emerging economies and the US.



Source: Bloomberg

The bond market of emerging economies presents the following features in 2014:

Firstly, bond issues reached to a new high. The prolonged low interest rate in the global market, climbing asset prices and low fluctuations, lead to investment needs for high risk premium assets, and stimulated the issuing of EM bonds. The issuing of non-financial corporate bonds in emerging economies has maintained the trend of fast growth since 2010, and reach a YTD USD4.5 trillion figure. The proportion of corporation bonds in GDP of some emerging countries, though lower than that of developed countries, has been close to 100%.

Secondly, violent fluctuations in trading spread became normal. Due to a prolonged lack of liquidity in the secondary market, the spread of trading in the secondary bond market of emerging economies has increased from the pre-crisis two to four base points, to the current seven base points. Despite sharp fluctuations, the spread still was as high as six to eight base points in 2014, indicating that the spread of trading in violent fluctuations has basically become normal.

In 2015, the bond market of emerging economies will be mainly affected by monetary policy change of developed countries. As the Fed will manage to lift the interest rate, global liquidity will be changed, bringing with it considerable pressure regarding debt service to companies with excessive leverage in some emerging economies. Besides, similar to the situation in developed countries, insufficient liquidity in the secondary bond market of emerging economies may cause systematic risks, which are worth close attention.

VI. Global monetary policies

VI.1 At diverging stages of global monetary policy

In 2014, since countries are in different stages of recovery, global monetary policy is becoming complicated. “Divergence” has become a keynote. Mature economies have broken their synchronized easing policies. New Zealand took the lead with raising the interest rate, the Fed

completely concluded QE, the US and the UK intended to change their interest rate policy, The European Central Bank adopted a negative interest rate, which has never been seen before, and the central bank of Japan purchased more assets. Likewise, emerging economies have varied monetary policies. Countries like Russia and Brazil increased consecutively their interest rates and intervened in the foreign exchange market to counter pressure of inflation and currency depreciation, while Chile, Turkey, Hungary and some other countries lowered the benchmark interest rate to assist stimulating economic growth.

Behind differentiation of policies are differences in the economic and financial structure. The ultimate goals of the monetary policy include sufficient employment, stable commodity prices and better economic growth and balance of payments. Through years of practice and evolution, central banks of developed economies have usually targeted only or primarily stable commodity prices, while those in emerging economies take multiple goals in consideration. Indeed, such goals may change. Especially during a crisis, the monetary policy usually focuses more on economic growth or employment, and sometimes on financial stability with forward-looking guidance. For example, the Fed included employment promotion into the goal of its monetary policy at the end of 2012, and used the unemployment rate as an indicator linked with forward-looking guidance, to provide a new theoretical basis for continuing the monetary easing policy.

The aforementioned goals must be realized through proper monetary policies, including regular and irregular tools. The financial system of developed economies was hit immediately when the global financial crisis erupted. To counter the crisis, major central banks used regular tools like interest rate cuts, which failed to effectively stimulate economic recovery. In this case, numerous irregular measures played a vital role, especially quantitative tools including such overall policies as general quantitative easing and structural policies like “Operation Twist” and directed credit (e.g. Funding for Leading Scheme in UK).

Underlying the policy and tool differences, different goals regarding monetary policy are the apparent reason. However, varying economic conditional and financial structures are indeed the base. In general, the US, UK and other economies, with direct financing as the mainstay, smooth transmission of the interest rate and high independence of the central bank, usually affect the rate expectation. This has been achieved by adjusting the benchmark interest rate or the turnover of government bonds, and take quantitative easing measures only when the economy is weak and falls into the liquidity trap. On the contrary, the euro area, Japan and other economies with indirect financing taking the dominance, division of the financial market and lack of interest rate elasticity, usually affect the bank’s liquidity by direct credit expansion and crunch. Canada, Australia and some other countries take the benchmark interest rate adjustment as the major tool, since their banking industry takes a very high proportion and little hit by the financial crisis, and the interest rate policy still works.

Table 2: Monetary policy goals of central banks in major developed economies

Major Central Banks	Policy goal	Latest economic indicators in 2014
Fed	Full employment+ Stable commodity price (2%)	GDP 3.5% (Q3); unemployment rate 5.8% (October); CPI 1.7% (September)
EUROPEAN CENTRAL BANK	Price increase rate slightly lower than 2%	GDP 0.2% (Q3); unemployment rate 11.5% (September); CPI 0.4% (October)
CENTRAL BANK OF UK	Price increase rate 2%	GDP 3.0% (Q3); unemployment rate 2.6% (October); CPI 1.2% (September)

CENTRAL BANK OF JAPAN	Price increase rate 2%+QQE	GDP -1.6% (Q3); unemployment rate 3.6% (September); CPI 3.2% (September)
CENTRAL BANK OF CANADA	Price increase rate 2% +Floating exchange rate	GDP 2.45% (Q2); unemployment rate 6.5% (October); CPI 2.11% (September)
CENTRAL BANK OF SWITZERLAND	Price increase rate below 2%	GDP 0.58% (Q2); unemployment rate 3.1% (October); CPI 0% (October)
RESERVE BANK OF AUSTRALIA	(Mid-term goal) Price increase rate 2%-3%+Full employment + Economic boom+ People's wellbeing	GDP 3.1% (Q2); unemployment rate 6.24% (October); CPI 2.3% (Q3)
RESERVE BANK OF NEW ZEALAND	(Mid-term goal) Price increase rate 1%-3%	GDP 3.5% (Q2); unemployment rate 5.4% (Q3); CPI 1.0% (Q3)

Note: Quarter-on-quarter annualized rate at constant price for GDP of the US, Europe, Japan and UK, year-on-year rate at constant price for GDP of Canada, Swiss, Australia and New Zealand.

Source: Wind, central banks of different countries, classified by the author

VI.2 Divergence will be retained in 2015, interest rate upward movements elevating concerns.

In 2015, with an unstable engine for sustainable recovery of the global economy, some countries will continue their accommodative policies, but policies of different countries will vary even more.

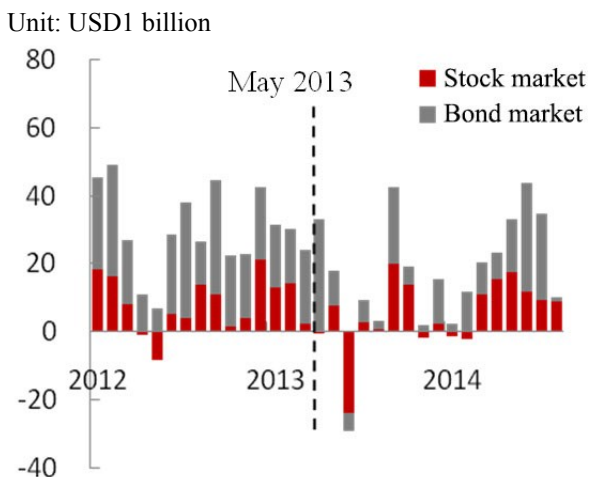
Due to low inflation in the euro area and Japan, their central banks are expected to provide more liquidity to the market. The asset purchase program of European Central Bank will last for at least two years, aiming at activating the credit market and rebuilding confidence of companies and consumers. Mario Draghi once said that this program will restore the balance sheet of the European Central Bank to the level at the beginning of 2012. According to this estimation, EUR1 trillion will be added to the balance sheet through the purchase of asset-backed securities (ABS) and covered bond and the Targeted Longer-term Refinancing Operations (TLTRO). The central bank of Japan will continue the current QQE policy. The US and the UK, based on a gradual and optimistic estimation of inflation and employment, will carefully adjust their interest rate policies according to the market situation, and are expected to start rate increases no sooner than mid2015. Some emerging countries will be affected in terms of the exchange rate and financial market by uncertainties accompanying the aforementioned differentiation among developed countries, and will be confronted with more challenges of the monetary policy. For example, Russia will continue to increase the interest rate so as to curb inflation and ruble depreciation. India, Indonesia and other countries highly depending on foreign capital will strengthen capital regulation to prevent capital outflow and an asset price slump caused by the Fed's rate increase. Some commodity exporters in the Middle East and Latin America will relax their monetary policies to counter the pressure of economic downturns.

Expectation for an interest rate increase affected global capital flow. Recent years saw a great deal of international capital flow into emerging markets under the effect of accommodative monetary policies of developed economies. Among others, the spillover effect of Fed's QE policy was an important trigger of international capital flow. As shown by IFF's research, every time when the Fed accounted the QE policy, a large amount of capital flowed into emerging markets. The capital inflow to emerging economies was slowed in May 2013 when the Fed declared the possibility of

reducing asset purchases (Figure 12, Figure 13).

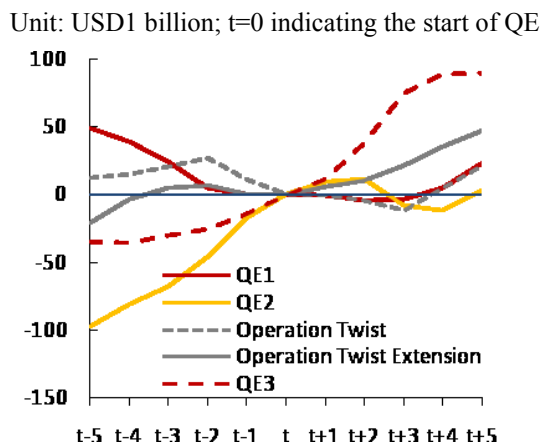
At present, QE has been officially withdrawn, and rate increase has been put on the agenda. Considering the global importance of the US dollar and the size of the capital market and fund management in the US, the negative effects of future rate change on emerging markets can by no means be taken lightly. Fortunately, some such effects will be offset by the accommodative monetary policy adopted by central banks of Europe and Japan. In general, capital inflow to emerging economies was maintained in 2014 at the same level as in the previous year.

Figure 12: Capital flow of emerging markets



Source: IIF

Figure 13: Fed’ s QE and capital flow of emerging markets



In 2015, expectation for the Fed’s interest rate increase will significantly affect the global capital flow, intensify capital fluctuation and shock some economies as a result. Among such possibly affected economies, Brazil, Indonesia, Russia, South Africa and Turkey are less capable of resisting external risks and will thus be exposed to comparatively high overall risks, due to severe current account deficits, excessive credit growth and high involvement of foreign investors in local bond markets.

VII. Specific regions and countries

VII.1 The United States

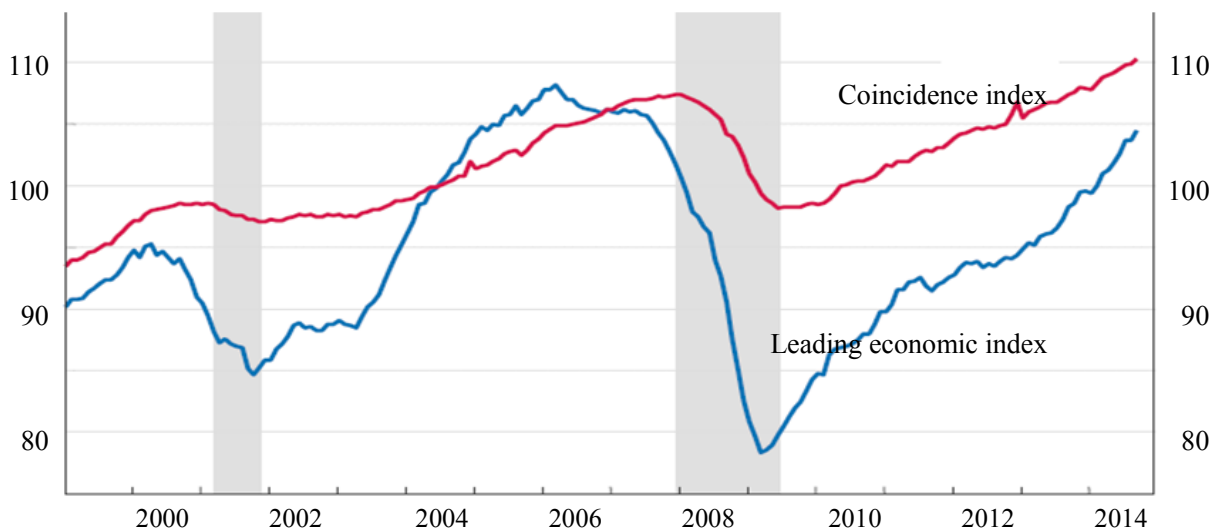
2014 has been an important year for the US economic recovery, since it contains endogenous momentum of sustained economic expansion and is on track for stable growth. Balance sheets of both households and companies have basically become healthy. The household monthly average liabilities and expense/disposable income ratio dropped to below 10% in 2014, the lowest level ever. The total corporate after-tax profits increased by 9.67% annually on average in this year to reach a record high; the demand deposits and the total amount of cash hit a record high with the annual average growth rate of 27.8%, accounting for 9% of all assets. Investors regained their confidence, as the total demand was improved and economic policies became more certain in 2014. Corporate investment in software and equipment increased rapidly and even faster than the total fixed asset investment, and companies have been preparing for production expansion. Among all driving forces, stable consumer expenditure and accelerated investment in non-housing fixed assets with the proportion growing from 10.9% during the economic recession to 12.2%, provided more

impetus for sustained GDP growth.

The US public finance has been much improved. Along with increasing fiscal income, fiscal deficits dropped from the highest level 10% to 2.8% in 2014, lower than the average value for recent 40 years, and government expenditure made a strong and positive contribution to GDP, instead of a negative or weak positive contribution as in previous years.

The following leading economic index shows that the US will maintain moderate growth in 2015 (Figure 14).

Figure 14: Conference Board leading economic index and coincidence index (the year 2004=100)



Source: The Conference Board

Firstly, the average working hours per week, in the manufacturing industry climbed to 42.1 in 2014 from the lowest 39.3, establishing a new record; furthermore, the number of new applicants seeking unemployment payments each week steadily dropped to below 300,000 in 2014, which is close to the lowest level in the history, implying a sustained employment increases.

Secondly, ISM manufacturer new order index was in the expansion range in 2014 and exceeded the historical value average; the manufacturer new order index of consumer goods reached a record high and has maintained this soaring momentum recently. What is more, the manufacturer new order index of non-national-defense capital goods has also broken previous norms to establish a new record and has been dramatically rising more recently. All these show an obvious expansion tendency of the manufacturing industry.

Thirdly, the increasing credit leading indicator in 2014 indicates possibly stronger support of credit for future economic growth.

Fourthly, the consumer confidence index rebounded, albeit in a limited way through fluctuations, and stood at 85, lower than the historical average value, implying constant but limited consumer expenditure expansion in the US.

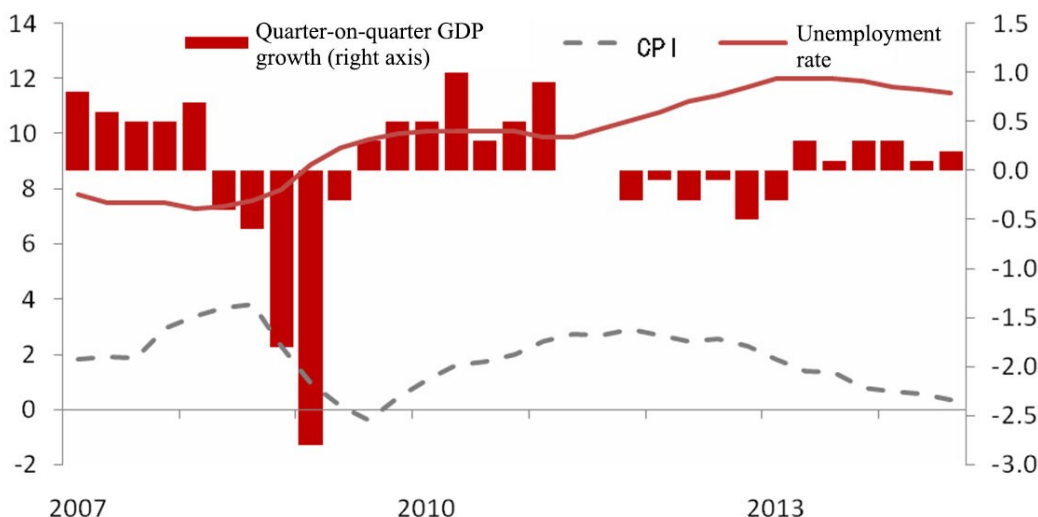
Fifthly, the Conference Board leading economic index has in large part maintained the momentum of increase since the recovery began, but was still below the pre-recession highest level.

Both fundamental factors and the latest leading index indicate the possibility of faster US economic growth, and the US economy will enter a stage of almost overall recovery and comparatively stable growth. The US is expected to see its unemployment rate drop to 5.4% and real GDP growth rate ascend to about 3.0%, and then to embrace a stage of stable growth.

VII.2 Europe

The euro area will brook a weak recovery which may take a moderate pace in 2015. The adjusted quarter-to-quarter GDP growth rate in the third quarter of 2014 was 0.2%, slightly higher than 0.1% in the second quarter. The year-on-year increase in the third quarter stood at 0.8%, the same as that of the previous quarter. At present, the unemployment rate of this area is as high as 11.5%, slightly higher than 11.7% at the beginning of the year, and the inflation rate is only 0.4% (Figure 15).

Figure 15: Major economic indicators for the euro area



Source: Eurostat

Economic recovery in the euro area remained weak, maybe mainly because of the poor growth of industrial production. In 2014, the industrial production (not including the construction industry) made an insufficient contribution to economic development of the region, and particularly impeded the economic growth of Germany where the manufacturing industry plays a major role. In terms of demand, private consumption remained low, but investment improved and increased at a rate unsurpassed during past three years. The external demand, as insufficient as it was, became the major reason for economic stagnation in Germany, since it caused a consecutive export slump of manufactured goods.

A recently downward movement in the price of crude oil has helped the recovery of this region, as it lowered costs. Although it dampened the effects of European Central Bank's inflation stimulation measures, the low inflation rate of this area has provided a sound foundation for further accommodative monetary policy.

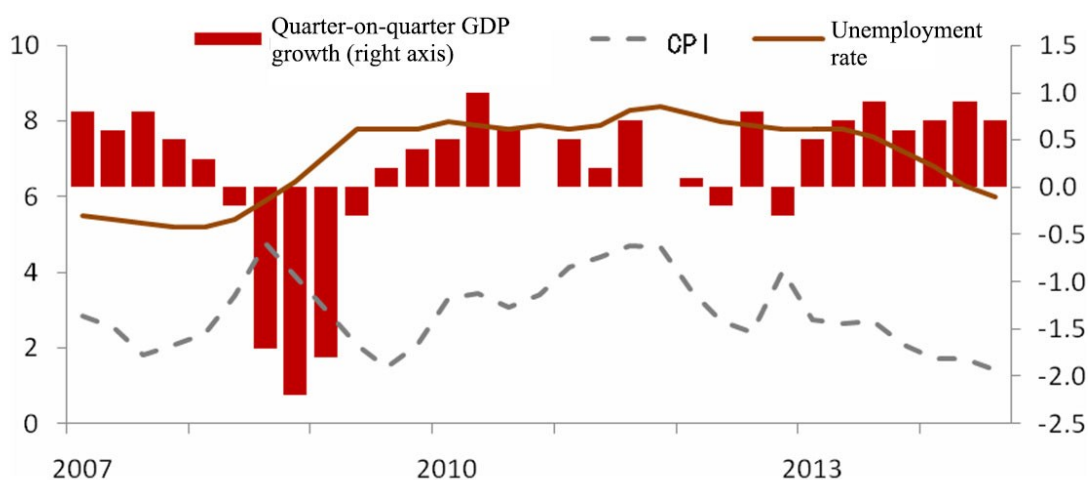
The European Central Bank embarked on a bond purchase program since October to further expand its balance sheet and prevent the inflation rate from getting lower. Along with the completion of the stress testing and asset quality appraisal for European banking industry, the differentiation in the financial sector will be effectively restrained, and banks will be encouraged to gradually increase credit. In addition, the euro area seemed to relax its fiscal policy. The European Union has approved the fiscal budgets of Italy and France whose fiscal deficits in 2015 are much above the level stipulated in EU Fiscal Compact framework.

The euro area has been confronted with influences and challenges from US monetary policy. The Fed has concluded the asset purchase program in QE3 as scheduled, and begun to normalize its interest rate, while the European Central Bank is still under pressure for adopting a more accommodative monetary policy.

In 2015, a weaker euro and gradual stable growth of the German economy, will fuel the economic recovery of the euro area. However, it will remain weak, due to factors like considerable restraints in terms of the fiscal policy, high unemployment figures, insufficient credit from banks and geopolitical risks (especially the Ukraine crisis). The European Central Bank's new stimulation policies will yield tangible effects in 2015. If economic indicators in the first quarter of 2015 are unsatisfying, euro area countries may reach agreement to intensify such stimulation measures, like complete quantitative easing policy and the purchasing of government bonds of member states of the euro area. In brief, we think the euro area will maintain a moderate pace of recovery in 2015.

The UK: stable growth with an emphasis on sustainable development. Stable growth in 2014 has laid a more solid foundation for UK's recovery. With the quarter-on-quarter GDP growth rate of 0.7% in the third quarter of 2014, UK has maintained positive growth for seven consecutive quarters, making the longest growth period since the financial crisis outbreak in 2008. The year-on-year GDP growth rate in the third quarter stood at 3%, the same as the average level from 1997 to 2007. Its unemployment rate dropped to 6%, getting close to the pre-crisis level. Furthermore, the UK's inflation rate continued to decline in 2014 and maintained a low level since the crisis (Figure 16). Despite all these indicators, the country maintained the record-low benchmark interest rate of 0.5%, and continued its quantitative easing policy.

Figure 16: Change of UK's major economic indicators



Source: Office of National Statistics

In terms of major sectors driving the economic recovery, private consumption and investment pulled the economic growth of the UK, as indicated by significant improvement of consumer confidence and retail index. Due to insufficient external demand and especially the sluggish economic growth in the euro area, the net export made a limited contribution to the UK's economy. The increasing fiscal deficits prevented the government spending and playing a role in pulling economic growth.

Among all industries, the service industry grew faster than the manufacturing and construction industries. The output of the former in 2014 has exceeded the pre-crisis level, and that of the latter industries was also increasing but far below the pre-crisis level. In 2014, the producer price index

dropped and effectively supported the recovery of the manufacturing industry, but the growth potential of the manufacturing industry was handicapped by the weak economic development and demand in the euro area. The construction industry showed an upward momentum but its development in the latter half of 2014 allowed for no optimism, as its year-on-year growth rate dropped by 0.3% in August, the first negative growth since May 2013. Despite strong growth, the housing construction industry will be affected by the cooling of housing prices in the UK.

The average remuneration kept declining in 2014, despite the good recovery momentum and falling unemployment rate. Besides, house prices grew much faster than the residents' income. The UK's real estate market has begun to cool down after several years of rapid growth; in particular, the quarter-on-quarter growth rate of the housing price in London began to decline.

The year 2015 will possibly see a turning of the UK's monetary policy. As the country provides a more solid foundation for its economic growth, a gradual interest rate increase is highly possible to maintain sustainable economic development, which will enhance lending costs, affect people's enthusiasm in consumption and commercial activities, and further cooling down of the real estate market. Private consumption will become the most important driving force for growth. Along with a falling unemployment rate, the current labor abundance will change. Actual wage growth will begin to increase in 2015, to further stimulate personal spending and support the sustainable development of the real estate market. Almost all real-estate-related crises are caused by late market intervention to the cooling process. The fact that the UK's real estate market has begun to cool down now shows the market can develop in a sound and sustainable way.

VII.3 Japan

As Abenomics has been applied in more sectors, the Q1 2014 Japanese real GDP growth rate reached 1.6%, and then was hit by a rising excise tax. The real GDP shrank by 1.8% in the second quarter and maintained this negative growth (about -0.4%) in the third quarter due to a slow upturn of individual consumption and insufficient investment potential in corporate equipment. Despite slowing and declining growth rate, the GDP saw a more severe drop than expected. The growth rate of the third quarter is an important base for Abe Administration to determine whether to increase the excise tax from 8% to 10% in October 2015. Therefore, the unexpected shrinking pushed the government to postpone the excise tax increase. Bad weather and natural disasters in the summer handicapped Japan's economic development. When such factors receded, the country showed weak recovery. The central bank of Japan expanded the scale of its monetary stimulus to counter the pressure of a slump in commodity prices caused by weak growth and a fall in the price of oil. However, the country is still confronted with consumption, export and labor force insufficiencies. Therefore, the country is expected to maintain negative growth in the fiscal year of 2014.

In 2015, Japan will benefit from intensified monetary stimulus, a favorable taxation policy and increased public investment, which will drive an increase of household income, consumption, corporate earnings and equipment investment. On the other hand, it will be affected negatively by hiking commodity prices and sluggish consumption recovery caused by difficulties in enhancing average remuneration and export decline due to recession in emerging market economies. In general, Japan's economy will be basically on track for recovery, but with the actual growth rate being about 1%.

VII.4 Asian EMs

Asian Emerging economies grew most rapidly in 2014. Slowing down, due to reduced global exports and decelerated growth of China in the first half of 2014. The emerging Asian economies' growth regained its momentum as pulled by domestic and external demands in the latter half of the

year. It is expected that the actual growth rate of such economies will reach 6.6% in 2015 from 6.5% in 2014. Among them, Thailand which may pacify the present political tension, and push economic growth drastically upward from 1.5% in 2014 to about 4.0% in 2015, and maintain the overall inflation rate at a moderate level of around 4%. The price level in India will remain above 7.5%. Some countries will see improved balance of payments and fiscal conditions (Table 3).

Table 3: Economic and financial indicators prediction of major Asian emerging countries

	Real GDP		CPI		Unemployment		Current account		Fiscal budget		Interest rate	
	(Year-on-year growth rate %)		(Year-on-year growth rate %)		rate (%)		(GDP %)		(GDP %)		of the central bank (%)	
	2014	2015	2014	2015	2014	2015	2014	2015	2014	2015	2014	2015
India	5.5	6.5	7.8	7.5	-	-	-2.0	-2.1	-	-4.3	8.0	7.7
Indonesia	5.2	5.5	6.2	5.8	6.1	6.0	-3.1	-2.6	-2.4	-2.0	7.5	7.6
Thailand	1.5	4.0	2.3	2.5	0.9	0.8	1.6	1.0	-2.4	-2.2	2.0	2.5
Malaysia	5.7	5.2	3.2	3.6	3.1	3.1	5.1	5.3	-3.5	-3.0	3.3	3.5
Philippines	6.3	6.5	4.3	3.9	7.0	7.0	3.1	2.6	-2.0	-1.9	4.3	4.4
Vietnam	5.6	5.8	5.0	5.8	4.4	4.4	4.4	3.6	-6.1	-5.5	-	-

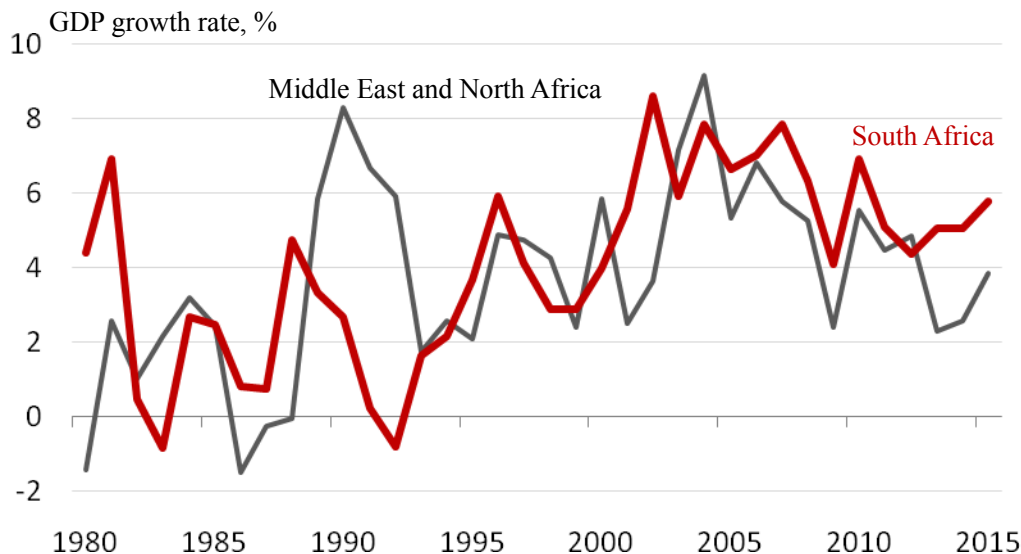
Source: Bloomberg, Institute of International Finance BOC

However, emerging Asian economies will be confronted with more uncertainties in their economic operation. Among them, major risks are from the poor foundation for capital inflow, especially the debt capital inflow, against the background of expectation for the Fed's interest rate increase and the careful change of the global appetite for risk. Among emerging Asian economies seeing drastic expansion of private debts in past years, some still depend excessively on external financing (like India and Indonesia), or have an over high proportion of foreign capital in the financial market, and some others are incapable of effectively reducing their debts in 2015 (like the Philippines). Besides, emerging Asian economies have yet to completed their structural reforms, and have to "wait and see" whether they can gain new growth momentum in the transformation to "new normal" economic development.

VII.5 Africa

The economic performance in Africa in recent years has been eye-catching. Africa's GDP totaled around USD2.3 trillion in 2014, equaling Brazil's economic aggregate and growing at a speed second only to that of Asian-Pacific emerging markets. Furthermore, Africa made contributions to global economic growth of twice that made by Japan. From 2000 to now, with an annual average GDP growth of 5.0% and 6.0% respectively (Figure 17), the Middle East and North Africa have totally overcome recessions and disturbances which were evident in the previous two decades and have become a new focus of global investors. They have imposed a huge influence on the global economy compared to their economic size, as they are major suppliers of such primary commodities as energy and resources.

Figure 17: GDP growth in Africa



Source: IMF, Institute of International Finance BOC

Economic growth of Africa was driven by the following factors. First, the commodity price hike driven by global demands has boosted income growth, infrastructure construction and industrial investment and development in this region. Second, Africa is much more stable now, than in the 1980s and 1990s, which provides a more favorable environment for economic growth. Third, better macroeconomic policies and investment environment have created conditions for capital flow and money supply in this region.

Hit by the global financial crisis and affected by local political instability in the past five years, the real economy in Africa has under gone more violent fluctuations. In particular, under the influence of commodity price slumps, the Arab Spring, Syrian wars and other major events, North Africa saw its annual average GDP growth rate drop to 3.5%. The economic growth in Africa is expected to be more rapid in 2015 than in the previous year. The growth rate for the northern region will increase from 2.6% in 2014 to 3.8% in 2015, and that for the southern part will be up from 5.1% to 5.8% (Table 4). Among all countries in this region, oil exporters, such as Nigeria, Angola and Gabon, may be affected by an energy price downturn, while oil importers like Egypt, Sudan and South Africa will benefit from that. Severely Ebola-hit Guinea, Sierra Leone, Libya and other countries will suffer from drastic growth rate decline.

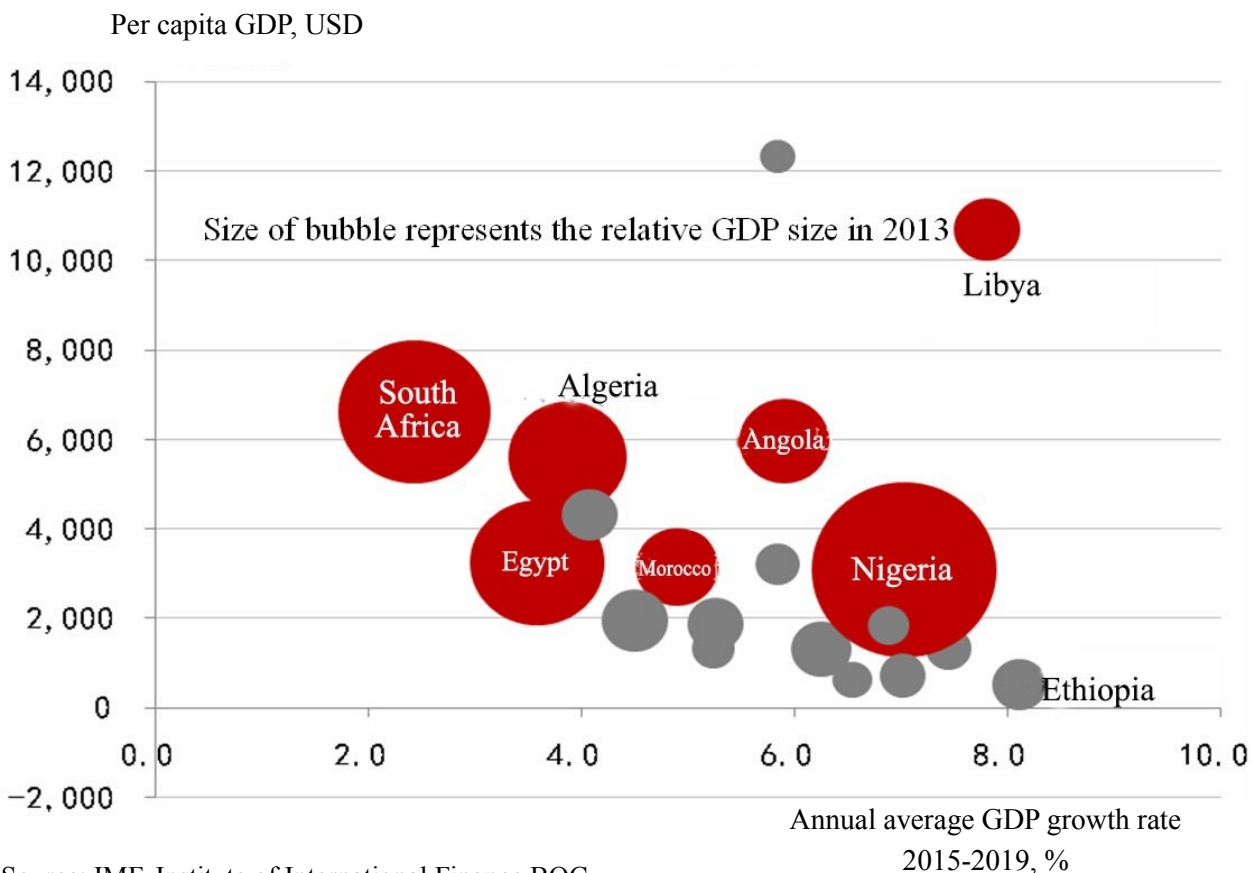
Table 4: Growth prediction of major economies in the Middle East and Africa

USD100 million, %	GDP 2013	2011	2012	2013	2014	2015
North Africa		4.5	4.8	2.3	2.6	3.8
Egypt	2,714	1.8	2.2	2.1	2.2	3.5
Algeria	2,125	2.8	3.3	2.8	3.8	4.0
Morocco	1,038	5.0	2.7	4.4	3.5	4.7
Sudan	667	-1.2	-2.7	3.3	3.0	3.7
Libya	655	-62.1	104.5	-13.6	-19.8	15.0
Southern Africa		5.1	4.4	5.1	5.1	5.8
Nigeria	5,218	4.9	4.3	5.4	7.0	7.3
South Africa	3,508	3.6	2.5	1.9	1.4	2.3
Angola	1,242	3.9	5.2	6.8	3.9	5.9
Kenya	550	7.6	4.6	4.6	5.3	6.2
Ghana	478	15.0	8.8	7.1	4.5	4.7
Asian emerging market		7.7	6.7	6.6	6.5	6.6
Eastern European emerging market		5.5	1.4	2.8	2.7	2.9
Latin American emerging market		4.5	2.9	2.7	1.3	2.2

Source: IMF, Institute of International Finance BOC

In general, Africa will still be the land of milk and honey for investors, thanks to its rapid economic growth. Nigeria, Angola, Morocco and Kenya are worth attention for the large size and rapid growth potential of their economy. Among them, Nigeria performed particularly well as the outstanding leader of all African economies. Despite wide corruption, oil theft and rampant rebellion by Islamic extremists in the northern part of the country, its real economy maintained fast growth, making the country an economic star in Africa. In 2012, Nigeria saw its revised GDP doubled to USD510 billion, and replaced South Africa to become the biggest economy in Africa. The annual average GDP growth rate was 8.2% during 2000 to 2013, and is expected to increase from 7.0% in 2014 to 7.3% in 2015 and maintained at 7.0% from 2015 to 2019.

Figure 18: GDP growth rate of top 20 economies in Africa of five years



Source: IMF, Institute of International Finance BOC

Among countries in northern Africa, Libya has presented the most remarkable changes in its economic situation. Affected by February 17 Revolution and constant protests in oil fields and ports, Libya saw continuous recession and its economic growth dropped to about 20%. With improved domestic stability in 2015, the economic recovery rate is expected to reach 15%, but considerable risks will remain. Since August 2014, the “Islamic State” (IS), an extremist group in the Middle East has been hit by troops of the US and Europe in Iraq and Syrian. If it is driven out of these two countries, it may go to Libya and other countries. Darna, a port city in the north of Libya, pledged allegiance to the IS recently, indicating no optimism for stability and economic prospects.

VII.6 Latin America

Latin American countries slowed down their economic growth to varying degrees. On the one hand, domestic demands were weak, since supply bottlenecked and policy uncertainty harmed people’s confidence in business and reduced investment, plus higher unemployment rate and sluggish wage growth. On the other hand, a deteriorating external environment also retarded economic growth. QE withdrawal in 2014 caused a reduction of foreign capital flowing into Latin America and impeded corporate investment. Tardy economic growth and weak external demand of OECD countries led to constantly high trade deficits and worse trade conditions for this region. It is estimated that the real GDP of Latin America and Caribbean regions grew by 1.3%, a year-on-year, a decrease of 1.4 percentage points. Among them, the real GDP grew by 3.8%, down by 0.4 percentage points year-on-year in Central America, 0.7% or 2.5 percentage points lower than the previous year in South America, and 3.8% or 0.6% percentage points on the yearly basis in the Caribbean region. The sluggish growth in this region was mainly attributed to the slow growth in

Brazil and Argentina. Brazil was haunted by severe stagflation; in addition, investment and consumption were curbed by tightened financial conditions and constant low levels of confidence in business and consumption. Argentina has not yet ended the debt crisis that broke out 13 years ago, or may fall into the same trouble; besides, with sharply decreasing international reserves, the country has been under great pressure for currency depreciation and is confronted with much more risks of an economic hard landing in the short term. In 2014, Brazil and Argentina grew respectively by 0.3% and -1.7%. In Mexico, since the introduction of multiple structural reform measures, the country has witnessed improved economic development and real GDP growth of 2.4% in 2014, or a year-on-year increase of 1.3%.

In 2015, Latin America will embrace gradual recovery, a more solid macroeconomic foundation, resilience of domestic demand and achievements due to the structural reform in some countries. Therefore, its real GDP is expected to grow by 2.2% in 2015, 0.9 percentage points higher than that in 2014. However, given the low growth potential, laggard infrastructure construction and severe structural problems, this region should push ahead with structural reforms, enhance infrastructure investment and boost sustainable development.

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