

## Global Economic and Financial Outlook

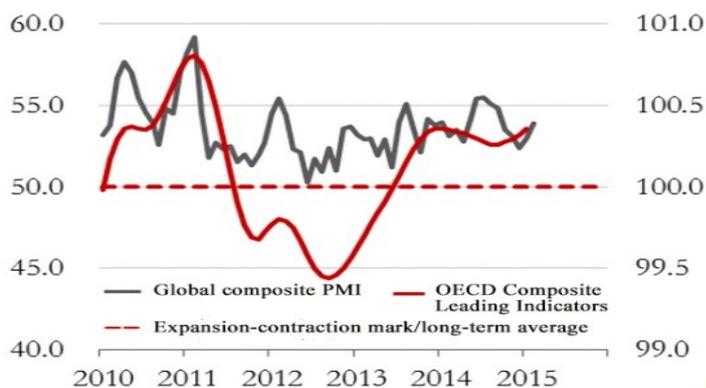
Q2 2015 (Issue 22)

March 30, 2015

### 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 PMI and OECD Composite Leading Indicator



Source: Institute of International Finance, BOC

### BOC Institute of International Finance Global Economic and Financial Research Team

**Team head:** Chen Weidong

**Deputy heads:** Cao Yuanzheng

Zhong Hong

**Members:** Wang Jiaqiang

Liao Shuping

Chen Jing

Wang Youxin

E Zhihuan (Hong Kong)

Huang Xiaojun (New York)

Lu Xiaoming (New York)

Qu Kang (London)

**Contact:** Wang Jiaqiang

**Tel.:** 010-66592331

**E-mail:** wangjiaqiang@bankofchina.com

# Global Economy in New Normal

## Global Economic and Financial Outlook (Q2 2015)

Since 2015, central banks around the globe have carried out easing monetary policies, including interest rate cuts, reduction on reserve requirement ratios (RRR) and quantitative easing (QE). Eased geopolitical turmoil and an extended negotiation on Greece's debt restructuring have redressed market confidence and positively support economic recovery. The global financial situation is generally stable, however, with potential risks. International financial market has witnessed increasing volatility, featuring the continued appreciation of the US dollar and falling commodity prices. Overall, the global economy has stepped into a new normal of slower growth, low inflation, differentiated patterns of development and constant financial volatility. This report focuses on the global deflation risks, the medium and long term trend of US dollar, and the impact of the geopolitical crisis in Europe and capital outflows in Asia's emerging markets.

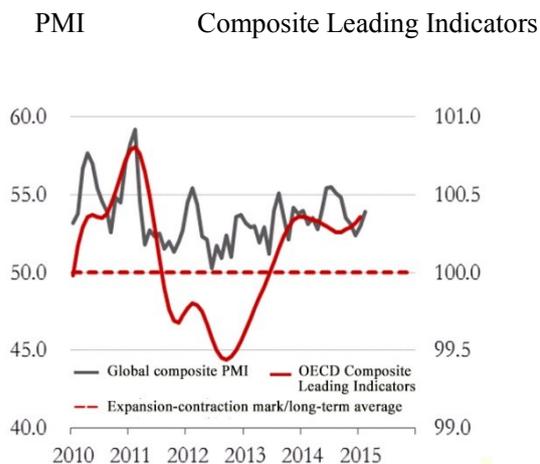
### Part One Quarterly Review and Outlook

#### I. Global economy into “new normal” of slower growth, low inflation and uneven patterns

In the first quarter of 2015, the interest rate hike by the US Federal Reserve has become one out of the three risks that market concerns. Appreciation of dollar siphons the global capital back to the US, leading to depreciation of other currencies, drained liquidity and even a double dip of the economies in other regions. However, the weaker-than-expected US economy dismisses the possibility of Fed's rate hike in the first half of this year, leaving buffer time for the economic recovery of emerging markets. The second risk is the debt problem of Greece. Greece's radical government has engaged in a fight with the EU partners on its debt restructuring. If the bailout deal cannot be approved, the exit of Greece from the EU will trigger a new round of European debt crisis, strangling the Euro Area economies which have just bathed in the hope of recovery. Fortunately an extension of four-month financial rescue program has mitigated the European debt risk. The third risk is the geopolitical crisis in Ukraine. If the political wrestling of the US, the Europe and Russia on the Ukraine problem fails to deliver a peaceful solution, the regional warfare will deal a heavy blow to the European economies. A truce agreement reached by Russia, Germany, France and Ukraine in February has temporarily staved off the regional crisis. The diluted risks will help stabilize the global economy, although the prospect remains unclear.

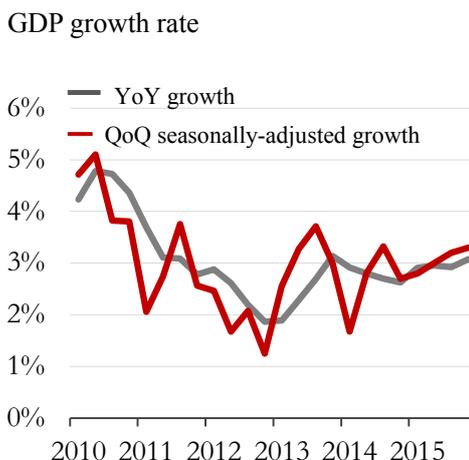
Looking at the global Purchasing Managers' Index (PMI) and OECD Composite Leading Indicators, the global economy is in the course of a slow recovery with increasing momentum since early 2015 (Figure 1). According to the indices we tracked, the quarter-on-quarter seasonally-adjusted global GDP growth in of the first quarter of 2015 is 2.8%, basically the same with the 2.7% growth recorded in the fourth quarter of 2014. The year-on-year global GDP growth is 2.9% in the first quarter, outpacing a 2.6% growth in the previous quarter (Figure 2). The US economy posts a solid growth in the first quarter, with an estimated GDP growth of 2.0% (quarter-on-quarter seasonally-adjusted GDP growth, same below). Economic growth of the Euro Area reaches 2.0%, faster than the previous quarter. Japan's economy increases 2.5%, flat from the fourth quarter of 2014. The emerging economies are generally steady, but Russia and Brazil witness negative economic growth.

**Figure 1: Changes on global PMI and OECD Composite Leading Indicators**



Source: Institute of International Finance, BOC

**Figure 2: Global economic performance and forecast**



Under the impact of falling commodity prices embarrassing goods prices, the CPI in the US and the Euro Area fall year-on-year. The price index in China and India also slide significantly (Figure 3), which imply the rising risk of global deflation. In response to the economic downturn and deflation risks, central banks of major economies have cut interest rates, lowered RRRs and taken QE measures in the first quarter of 2015. The European Central Bank (ECB) QE policy drew global attention, and central banks in other European countries went even further by introducing negative interest rates. In the Asia-Pacific region, China, India, South Korea, and Australia synchronized interest rate cuts. By the end of March 2015, almost half of global economies counted by the GDP have cut their interest rate already. American economy is the exception. The solid economic performance and new low of unemployment rate since the financial crisis provide increasing expectation of the Fed’s rate hike. In response to the high inflation, Brazil’s central bank had to raise interest rates significantly to six-year high (see table 1).

**Figure 3: Price index change of major economies (CPI YoY, %)**



Sources: Wind, Institute of International Finance, BOC

**Table 1: Actions of major central banks in Q1 2015**

Central Bank	Current rate	Changes in Q1 2015	Note
China	5.35%	Interest rate cut in February	RRR cut in February
India	6.75%	Interest rate cut in January and March each	
Indonesia	7.50%	Interest rate cut in February	
Australia	2.25%	Interest rate cut in February	
South Korea	1.75%	Interest rate cut in March	
Denmark	-0.75%	Interest rate cut in February	Negative interest rate
Russia	14.00%	Interest rate cut in February and March each	
European Central Bank	-0.20%	QE initiatives	Negative interest rate
Poland	1.50%	Interest rate cut in March	
Sweden	-0.10%	Interest rate cut in February	Negative interest rate
Switzerland	-0.75%	Interest rate cut in January	Negative interest rate
Romania	2.25%	Interest rate cut in February	
Turkey	7.50%	Interest rate cut in February	
Canada	0.75%	Interest rate cut in January	
Brazil	12.75%	Interest rate rise in January and March each	The only one with rate hike
Peru	3.25%	Interest rate cut in January	

Looking into the second quarter, the world economic growth is expected to strengthen, yet still not strong enough. Driven by the synchronized easing monetary policies from major central banks, global liquidity will remain relatively abundant. Low commodity prices leave little room for further falling, which is expected to boost consumer spending, although deflationary pressure remains. The global economy in the second quarter is expected to grow about 3% quarter-on-quarter, and we maintain our projection for the world economic growth at 3% (see Table 2). Uncertainty remains since the US Fed may raise interest rate in the second half of this year, Greece may fail to strike a new bailout deal, European debt crisis may rekindle, and the massive international capital outflow could trigger a domino effect of debt crisis in the emerging markets.

From a longer-term period of view, we believe that the global economy has entered a “new normal” that shows several features: first, slower growth and low inflation. Global overcapacity, insufficient technological innovation, lack of investment and consumption, de-capacity, deleverage, etc., drag monetary policy into the “liquidity trap” defined by Keynes in the last century---Market participants are insensitive to interest rates, no matter how low the rates are; demands of real economy remains lackluster; prices are stagnant. Second, uneven growth. Facing the different situations in different stage of economic cycles, macroeconomic policies vary from country group to country group and among individual countries. In the context of globalization, the divergence triggers large fluctuation in exchange rates, massive international capital flows and increasing trade protectionism, hindering the global economy from a robust growth. Third, geopolitical conflicts intensified. The global economy and international political structure have undergone dramatic changes. Public debt predicament and stagnant economic strength weaken the US and other major economies abilities of provide public safe products globally. Meanwhile, emerging political force has not grow strong enough to remedy the gap of global governance. These result in the outbreak of geopolitical turmoil and terrorist attacks, which have exerted downward pressure on investor’s confidence and global economic recovery. Under the “new normal”, how major countries better coordinate for international governance is an inescapable topic worldwide.

**Table 2: Global economic performance and forecast on major economies (%)**

Region	Y/Q Country	2013	2014	2015 <sup>f</sup>	2014				2015			
					Q1	Q2	Q3	Q4	Q1 <sup>e</sup>	Q2 <sup>f</sup>	Q3 <sup>f</sup>	Q4 <sup>f</sup>
America	US	2.2	2.4	3.0	-2.1	4.6	5.0	2.2	2.4	3.1	3.0	3.0
	Canada	2.0	2.5	1.8	1.0	3.8	3.2	2.4	1.0	1.5	2.0	2.0
	Mexico	1.4	2.1	3.0	1.4	4.2	2.1	2.7	3.0	3.1	2.8	2.8
	Brazil	2.5	0.0	-0.5	-0.7	-2.4	0.3	0.5	0.0	-1.0	0.0	0.5
	Chile	4.1	1.8	2.5	2.7	-0.3	1.5	4.0	4.0	1.5	3.0	2.0
	Argentina	2.9	-1.0	-0.5	-2.7	3.1	-2.1	1.0	-0.5	0.0	0.0	0.5
Asia-Pacific	Japan	1.6	0.0	1.0	5.1	-6.4	-2.6	1.5	2.1	1.8	1.5	1.0
	Australia	2.0	2.7	2.5	4.4	1.9	1.4	2.2	2.2	2.4	2.8	3.0
	China	7.7	7.4	7.2	6.1	8.2	7.8	6.1	5.5	6.5	7.5	7.5
	India	6.4	7.2	7.5	7.6	6.9	8.9	6.7	7.5	7.3	7.5	7.8
	South Korea	3.0	3.3	3.5	3.8	2.0	3.7	1.5	3.5	4.0	3.5	3.5
	Indonesia	5.6	5.0	5.5	4.7	4.9	4.9	5.1	5.0	5.5	5.6	5.8
Europe & Africa	Eurozone	-0.5	0.9	1.2	1.1	0.3	0.7	1.3	1.5	1.5	1.5	1.5
	UK	1.7	2.6	2.8	2.7	3.0	2.6	2.2	2.5	2.8	3.0	3.0
	Switzerland	1.9	2.0	1.0	1.8	1.2	2.6	2.4	0.5	1.0	1.0	1.0
	Russia	1.3	0.5	-3.0	-0.1	0.6	0.1	0.0	-5.0	-3.0	-2.0	2.0
	Nigeria	5.4	6.5	7.0	—	—	—	—	—	—	—	—
	South Africa	2.2	1.5	2.5	-1.6	0.5	2.2	4.1	3.0	2.0	2.0	2.0
Global GDP		2.5	2.6	3.0	1.7	2.8	3.3	2.7	2.8	3.0	3.0	3.2

Note: Quarterly GDP growth rate refers to QAAR GDP growth, e for estimates and f for forecast. Source:BOC

## II. Global finance: steady but increasing fluctuations

### II.1 Overview of financial market

**Money market.** Global money market are stabilized amid rising credit risks, larger fluctuations and falling liquidity in the secondary market in the first quarter. Factors that impact negatively on the market stability are: reforms details on money funds are revealing by the US and EU's regulators, though with limited near-term impact, will reduce attractions to investors; Basel III liquidity coverage ratio that was implemented in January 2015 requires more liquid assets for money funds and causes banks to cutting issue of money funds, demanding more highly liquid assets; low interest rates in the Euro Area may prompt fund managers to pursue higher risks funds, which in turn reducing yields of money funds in Euro Area and raising yields of money funds in the US and the U.K.. The major factors that impact positively the market stability is the prudence of fund managers on credit risk, market risk and liquidity risk. Besides, the US Fed's overnight repos and end of the QE program will release some high-quality short-term assets to relieve market pressure.

**Stock market.** The stock market of advanced economies are more sensitive to central bank policies. The Fed's QE exit and expected interest rates normalization will attract foreign capital inflow. The volatility of the US stock markets rose slightly in the beginning of this year, and this trend may extend into the second quarter. While international capital flew out of the Euro Area, the liquidity was injected into markets following the implementation of QE and a cheaper euro, boosting the stock performance of the Euro Area. PE ratio of the MSCI Europe Index rose to 15 in the first quarter. However, the limited decline of the long-term interest rates in the Euro Area may constrain the PE ratio from further climbing.

**Bond market.** Demand for European government bonds have exceeded supply, driven by risk-aversion sentiment, rising bond prices and deflation expectation. Due to short supply, 25% of the government bonds had shown negative yields in the first three months of this year, which may become more widespread in the higher risk countries in the second quarter. Low government bond yields will propel investors to high-risk bonds, emerging market bonds and alternative assets. Alternative assets have already accounted for a quarter of the global pension portfolio and the share is likely to rise further. Corporate- government bond spreads may be further narrowed. These induce rising credit risk and lower market liquidity. Large-area of adopting interest rates will mitigate the effect of QE in Euro Area, which may imply losses of both investors and the ECB, market mispricing and misevaluation on risk, so as to expose market into more uncertainty. Given that, the ECB has set a floor interest rate of -0.2%. In addition, risks of high-yield corporate bonds in developed markets, particularly in the energy sector, may go up and continue in the second quarter. Liquidity of government in the U.S. and other advanced countries are shrunked in Q1, which is expected to be relaxed in Q2 due to the launch of QE in the Euro Area.

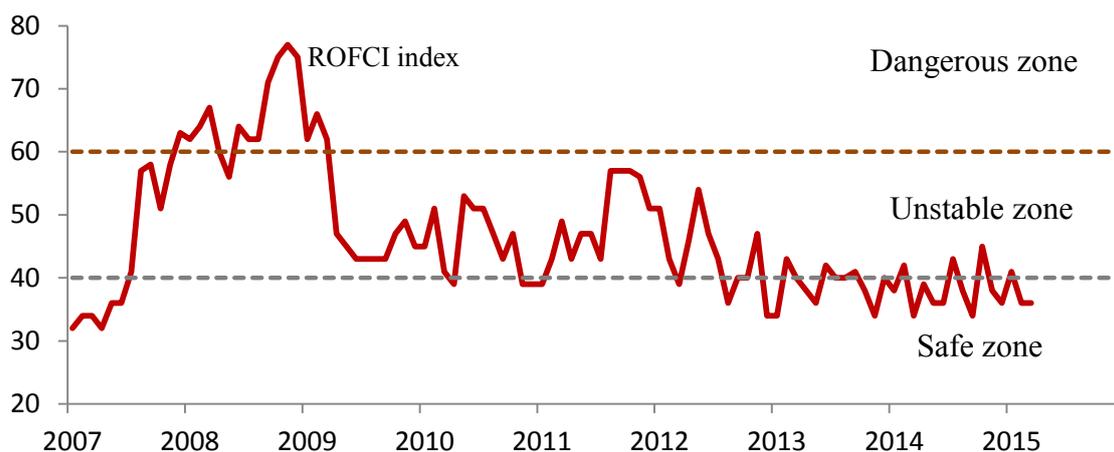
**Forex exchange market.** Divergence of monetary policies leads to unexpected appreciation of the US dollar with a short-term record speed since the 1970s. Accordingly, the depreciation of euro against the dollar is deeper than expected to 12-year recorded low. With the varying of monetary policies, a weak euro and the fluctuations in the forex market will be carried over into the second quarter. The Japanese yen, the British pound and the Australian dollar may adjust accordingly, while emerging market currencies still face a heavy pressure of depreciation. Over the past few years, the low interest rate in the US had encouraged arbitrage activities of the US dollar against other currencies. However, the strengthening dollar and highly volatile forex market minimize such arbitrage opportunities. In the first quarter of this year, prospection of US rate hike, the dollar appreciation and QE policy in the Euro Area have push the reversed arbitrage behaviour. In Q2, such behaviour may be more active to stimulate cross-boarder capital flows and market fluctuation.

**Commodity market.** Oil price has rebounded in a short-run due to less supply in the Middle East and surging demand during winter. The rebound, however, may not be able to sustained given sufficient supply and lack demand. Spread of price between WTI and Brent crude oil will be wider, as the growing production in the U.S. will further push down price of WTI crude oil products. On the contrary, global inventory buildup may not increase such quick, which results in a rising price of Brent oil products. In Q2, the WTI crude oil price is estimated to fluctuate in the range of \$45-\$50 per barrel and Brent crude oil price may rebound to \$55-\$60 per barrel.

## II.2 US financial risk monitoring indicators close to the unstable zone

We monitor the status and major sources of the US financial market risks through the Risk Indicators of Financial Crisis (ROFCI) based on 12 core indicators of 8 areas, which shows the overall risk status of the US financial market and crisis probability. By comparing its level and changes in the first quarter of 2015 with the historical data, the average ROFCI is 37.66 falling from 39.66 a quarter before, still remaining in the safe zone. More specified, the index jumped into the unstable zone in January, and back to safe territory in February and March. The major risks are involved in money market and forex exchange market. Relative safe area are stock market, inter-bank market, corporate bond market, bank stock and bond markets. In the second quarter of this year, as the U.S. is expected to take a different monetary policy from other major economies, volatility of the financial market is expected to rise slightly close to the unstable zone (see Figure 4).

Figure 4. Trend of ROFCI



Source: Institute of International Finance, BOC New York Branch

## II.3 Financial risk monitoring in emerging markets

The improving economic performance in the emerging markets (EM) since second half of 2014 release pressures upon their financial markets. The overall financial risks have reduced in the first quarter of 2015. External impacts are the major shock to the EM financial stability, such as The U.S. tightening monetary policy and a strong dollar drive capital flow out from EMs. Those countries, which heavily rely on short-term funding, have larger proportion of external debt, adopt floating exchange rates but limits in foreign reserves, and/or have current account deficit, may be hit hardest.

**Cross-border capital flows.** Capital flows in EM economies regain stability after the turmoil and net capital outflow in December 2014. Net capital inflows of USD23 billion and USD12 billion was recorded in January and February respectively this year, injecting more liquidity to the stock market than to the bond market. The trend may be sustained in the second quarter, giving growing investor's appetite and the introduction of the QE in the Euro Area.

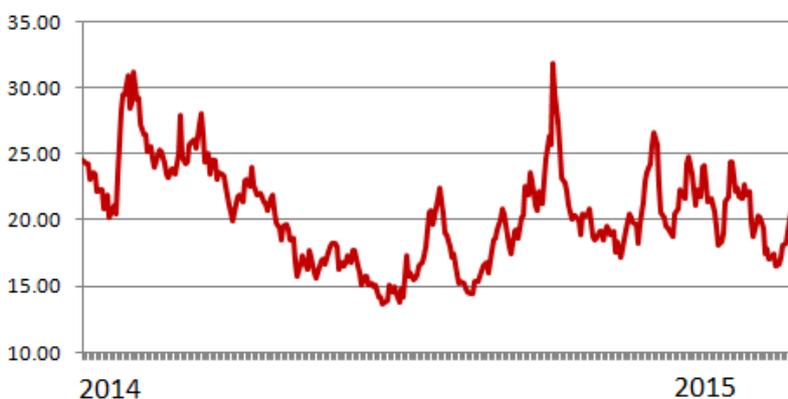
**Stock market.** The following indicators signal the overall low risks in EM stock markets and good prospects for growth in the second quarter of this year. (1) The PE ratio of the MSCI Emerging Markets has risen much slower than the advanced markets since 2014, with the forward PE ratio (TTM) at 11.5, slightly higher than the 10-year average of 11, but lower than 16 in the advanced markets. (2) The EM volatility index (CBOE) has shown signs of stability. (3) Market correlation dipped below the historical average of 0.2, the correlation between the stock and bond markets fell back to 0.55 from 0.75 high, while correlation between EM stock market and global bond market rebounded. (4) The stock return dispersion falls below the historical average of 9%.

**Corporate bond spreads.** Spreads on corporate and government bonds slowed down after experiencing a rapid gain in the fourth quarter of 2014. High-yield bonds account for about 12% in the newly issued corporate bonds, well below the level of developed markets, with an upturn though.

**Forex exchange market volatility.** Forex trading volatility continued to shore up with a strengthening US dollar and disparity of monetary policies by major central banks. And the momentum is likely to sustain in the second quarter. Depreciation of euro and yen prompted some emerging markets particularly the Asian central banks to cut interest rates and keep local currency at low values, which will trigger a currency war and bigger price swings in the forex market.

**Debt risk.** A strong U.S. dollar has exerted pressures of dollar shortage and payment of debt upon EM economies with a larger proportion of dollar-denominated debt outstanding. Brazil and Turkey face the most serious situations among them: the exchange rates have once depreciated over 18% and 12%, respectively, against the US dollar. The currency depreciation places great pressure on their debt.

**Figure 5. Emerging Markets ETF Volatility Index (CBOE)**



Source: The US Federal Reserve

## Part 2 Country and Regional Prospects

### I. North America

#### I.1 The United States: a solid growth

The United States has entered into a phase of solid growth, despite the cold weather in the first quarter of 2015.

The real GDP growth is estimated to be around 2.4% yoy in Q1 2015, accelerating from a 2.2% expansion in the prior quarter. The unemployment rate falls to about 5.6%. CPI is estimated to go down to around 2.5% due to oil price slump and appreciation of the US dollar. The growth in personal consumption expenditures is expected to slow down to 3% from 4.2% in the previous quarter, dragged by sluggish fuel sales, cold weather, weak retail and home sales, especially drop in spending on durable goods such as cars and furniture. Fixed investment growth will fall to 3.8% from 4.5% in the fourth quarter, considering fewer new home constructions in the off-season and shrinking energy production and investment due to the falling oil price. Government spending is to rise about 2.3% as an important driver for growth.

In Q2, the real GDP in the U.S. is expected to grow about 3.1% yoy, and the jobless rate will further fall to around 5.4%. As rising labor costs will help ease deflation pressure, the CPI and PPI will grow around 2.1% and 1.2% respectively. The personal consumption expenditures are expected to grow at about 3.3%, supported by the improving employment, increasing disposable income and net assets. Receding seasonal factors and low oil price will facilitate spending on construction, home decoration, and gardening. The rebounding home prices and more accessible loans for mortgages and consumption will boom spending on house and other durable goods. Reducing of vacancy rates will also underpin property investment to about 10%. As a result, the overall fixed investment is expected to 5.6%. Due to a strong dollar and weak external demand, the US export may lag behind import and results in a headwind to the economy by negative net export.

Given a strengthening US dollar and weak external demand, the deficit of current account and the trade deficit are likely to further expand. However, with an accelerated GDP growth, it is estimated that the ratio of current account deficit to the GDP will fall to about 2.04% in the first quarter of this year from 2.3% in the previous three months, and maintain at around 2.0% in the second quarter.

US fiscal health have improved with increase of tax revenues, and the fiscal deficit is getting closer to the target rate of 2.6% in 2015 from 2.8% in 2014. However, the US government debt ceiling issue relapses again. The government loses its authority to borrow unlimited money after March 15 with an outstanding debt that has already exceeded the ceiling of USD18 trillion. The Congress has neither raised the debt limit nor empowered the nation's borrowing authority. To solve the issue, the US Treasury Department may take contingent measures by November this year to avert the debt reaching the ceiling and the government defaults.

The Fed kept the federal funds target rate unchanged at 0-0.25% in the first quarter of this year. However, Yellen said that the zero-rate era would come to an end and the Fed was preparing for a rate hike in a congressional hearing in February. At the FOMC meeting in March, the Fed threw up the word "patient" in maintaining the current rate and its forward guidance, which indicates preparation for a rate hike at any subsequent meeting. So far there is a 40% possibility, according to market expectations, that the Fed will raise the interest rate by 25 basis points in June. Meanwhile, the Fed will continue its practice to roll over matured treasuries in the first and second quarter, and reinvest treasury securities and principals of maturing mortgage-backed securities (MBS) in government-sponsored MBS to maintain its sizable balance sheet unchanged.

## **I.2 Canada: losing impetus**

Canada's real GDP grew at a stronger-than-expected annual rate of 2.4% in the fourth quarter of 2014. The momentum extended to the first quarter of 2015, primarily driven by strong personal spending facilitated by the low oil price. Fixed investment growth slowed. Weak Canadian dollar and accelerated US economic recovery benefit Canada's export of the non-energy sectors. However, downside risks are revealed in Canada: firstly, continuing falling prices eliminate nominal GDP growth in Q4 2014, eroding corporate profit and government revenues; secondly, the

inventory investment that contributed 1.8% of the GDP in Q4 2014 leave little room for further growth in inventory investment; thirdly, Canada, as a net exporter of crude oil, has suffered by oil prices collapse. Reducing production and shrinking oil product exports have led to falling profits and rising unemployment, and are headwind to investment, consumption and exports so as to the economy; fourthly, the household debt ratio has risen to record high, which will limit further consumer spending. Those negative factors may result in Canada's real GDP growth to fall to 1.0% in the first quarter of 2015. In the second quarter, with the property investment and exports improving, the GDP growth may rebound to 1.5%.

## II. Europe

### II.1 Euro Area: bottoms out by consumption

Euro Area economy has shown evidence of bottom out with two signs: on one hand, stimulated by the low oil prices, consumption in the Euro Area rose to 1.2% in the fourth quarter of 2014 and 3.6% for the whole year, the highest since the financial crisis in 2008 and largest increase since 2006 respectively; on the other hand, German economy has shown impetus of rebound. In the fourth quarter of 2014, the German GDP rose 0.7% quarter-on-quarter, with consumption contributing 0.5 percentage point, equipment investment rose 0.4% with a reversal turning, and construction investment rose 2.1%. Investment and consumption had expanded for two consecutive quarter, which make Germany less reliant on exports. Germany is playing a more important role in the Euro Area. Furthermore, the Germany's fiscal surplus accounted for 0.6% of its GDP in 2014. It is the first time that each level of governments had achieved fiscal surplus since the German reunification (in 1990), making more room for fiscal support to the economy.

Meanwhile, the ECB has initiated QE program of 1.08 trillion euros in March 2015, achieving major breakthroughs in the following regards: (1) purchase of quality sovereign debt is included in the QE program for the first time. (2) 20% of risks involved are shared among the Euro Area countries. (3) the ECB mulls to purchase future sovereign debts in crisis-strapped countries like Greece. Euro Area member states starts sharing specific country's risk, which is a key milestone for becoming a fiscal union from original trade union and monetary union. The QE policy by ECB, although may not be able to solve the fundamental problems in the Euro Area, will lower the euro exchange rate, stimulates exports and enhance confidence. This strengthen Euro Area countries' capacity of bearing the cost of structural reforms.

In the second quarter of this year, the uncertainties of Greek debt problem and EU's tension with Russia could have a negative effect to the Euro Area, while structural reforms may have certain costs to pay in the short term. Nevertheless, low oil price, low exchange rate and low interest rate will underpin consumption and investment growth and enhance export competitive power in the Euro Area.

### II.2 the U.K.: sustainable recovery

Britain's economy grew by 0.5% qoq in the fourth quarter of 2014, keeping the trend of eighth consecutive quarters. The annual economic growth reached 2.6% in the whole year of 2014, which is the fastest since 2007. The unemployment rate fell to 5.7%, the lowest since the second quarter of 2008. Specified into sectors, the services sector contributed the most with a output of 8% higher than the level in early 2008. In general, the U.K. has walked out of the recession.

The British general election and expected interest rate hike are the major events in the second quarter of 2015. British general election will be held on May 6, bringing near-term uncertainty. Currently, approval rate of each the two major parties, the Conservative Party and Labour Party,

hovering at around 30%. There is little probability of ending up with a single party rule. The Liberal Democratic Party in current coalition government with the Conservatives will be the biggest loser. According to the current opinion polls, the new coalition may not be able to grab majority of the seats no matter sponsored by the Conservatives or the Labour Party, resulting in either a hung parliament when no single political party wins an overall majority in the House of Commons, or a national government (a coalition of the Conservatives and Labour Party). Political wrestling in the U.K. could lead to uncertainty in the macroeconomic policy and pressure to the economy from a long perspective.

In terms of monetary policy, the U.K. has kept its benchmark interest rate at 0.5%, a historic low for nearly six years. Although the Bank of England implied rate hike, it is unlikely to do so in 2015 for the following reasons: (1) the current inflation rate is below the target rate, the central bank is not pressured to raise interest rates. Britain's current inflation rate is 0.3%, significantly lower than the central bank's target rate of 2%. (2) Against the backdrop of a global race for currency depreciation, raising interest rate will appreciate Pound, which undermines the Britain's economic growth.

Despite the political and policy uncertainties, the economy in the U.K. is back on track of growth. The rebound in the Euro Area also helps the U.K.. We expect the country's economy to sustain at current energetic stage in the second quarter of 2015.

### **II.3 Emerging Europe: encumbered by Russia**

The growth outlook of emerging Europe is negatively affected by the economic trouble in Russia to shrink in 2015, a negative level for the first time since 2009. The recent economic performance suggests that the growth rate of emerging Europe falls to -0.4% yoy in first quarter of 2015. Turkey, as the locomotive of the region, also reveals the sign of slowdown. Besides, the oil prices collapse, although benefits other emerging European economies for lower inflation pressure, will damage Turkey and Russia with current current account deficit, soaring prices and tightening monetary policy environment. In the year of 2015, Russia is facing the risk of deeper recession, with expectation of over -5% the first quarter and another -3% for this year. The recession in Russia will have spillover effect to its surrounding economies.

## **III. Asia-Pacific Region**

### **III.1 Japan's economy slowly turning the corner**

The lackluster of Japanese economy was continued in 2014 due to the stimulus fatigue and hike of the consumption tax. The economic growth doesn't turn into positive until the last quarter of 2014. Since then, the diminishing impact of the Japanese consumption tax, slowly recovering residential consumption and increasing equipment investment and improving exports have underpinned Japan's economy up to 0.6% qoq in the fourth quarter of 2014. Nevertheless the whole year GDP growth was remain below zero to -0.9% in 2014, first negative growth since 2009. Nevertheless, in the first quarter of 2015, Japan's economy will continue its trajectory of expansion from the fourth quarter of 2014. Its GDP is expected to grow about 0.5% over the previous quarter.

In the second quarter of 2015, oil price collapse will reduce costs and inflation, which facilitates residential investment and corporate performance. Meanwhile, supply-demand equilibrium in job market will increase both salary level and job creation, so as to benefit income growth and consumption expenditures. However, Japan's personal have already reached a high level, and domestic demand has limited room for further expansion. Corporations are prudent for fixed investment. It is only large well-established corporation that could afford raises in pay and bonus

for employees, while smaller firms have not joined in. As such, the Japan's economy is estimated to ameliorate in the second quarter of 2015, but at a slower pace of around 0.4%.

### **III.2 Australian: slower growth with jobless rate hitting 12-year high**

Australian economy is a victim of bias towards a single structure. The plummet of commodity prices and plunging profit of the exports cause the growth rate of Australian economy to unexpected 2.7% in 2014, comparing with the 3.5% long-term average. The country's economy will face headwind of not only sliding commodity prices, declining mining investment, but also tightening fiscal policy. The negative impacts upon Australia continue in the first quarter of 2015. Unemployment rate climbing to as high as 6.4% in Q1 2015, the highest in 12 years. The economic growth rate is expected to expand about 2.2% yoy.

Looking into the second quarter, reenhancement is abuilding in Australia. In response to a weak economy, Reserve Bank of Australia announced its policy decisions on February 3, 2015, to cut interest rates by 25 basis points to 2.25%. The value of Australian dollar is also lowered in order to enhance economy. Although mining investment will still be a drag on the economy in the second quarter, consumer spending is expected to pick up, and non-mining investment will increase. Labor market will remain weak in the second quarter, with unemployment rate jumping to 6.5% from 6.3% a quarter before, and GDP is projected to grow 2.4%.

### **III.3 New Zealand: substantial with pressure of elevating interest rate**

In 2014, New Zealand's economy has achieved a substantial growth of 3.3%, the fastest since 2007. Boosted by the "holiday economy" of the Thanksgiving and Christmas, the fourth-quarter GDP grew 0.8% from the previous quarter. The overseas tourist spending increased 15%, lifting retailing, accommodation and catering industry by 2.3% accordingly. In addition, household spending grew by 0.6% in the year of 2014. Overseas travelers contributed a lot to New Zealand, among whom the visitors from the US, China and the U.K. increased spending, while Australian visitors spent less. Meanwhile, the New Zealand property sales revived with an expansion of 20%, turning around a downward trend in the previous quarters.

New Zealand economy is expected to continue outperforming other advanced economies. New Zealand's central bank expects an economic growth of 3.5% in the fiscal year 2015-16. The CPI may increase to the central bank's median target range of 1%-3%, adding to the pressure of an interest rate hike. However, uncertainties exist for New Zealand economy in the first half of 2015. The economic slowdown of China and Australia, New Zealand's top two trading partners, will weigh on the country's exports. A reduction of agricultural products will shadow the economic growth, as the dry weather will affect New Zealand's largest exports, the dairy and meat products.

### **III.4 Emerging Asia: varying in growth, easing monetary policy**

Since early 2015, emerging Asian economies sustained a moderate growth, fading inflation, and a further easy monetary policy. There is a divergence among major emerging economies in the Asia-Pacific region. On one hand, India and Indonesia have adopted active fiscal and monetary policies after the shift of their governments. Their economies hit new highs over recent years. On the other hand, Thailand, Malaysia, and South Korea are confronted by the deflation threat, adjusting their monetary policies accordingly to cope with a subdued growth.

**India's** new government launched a fiscal policy with "structural adjustment" as priority and a moderate "control on total". The interest rate cut in January and March is an attempt to fend off deflation and spur the economy as well as to keep the Indian rupee undervalued. Meanwhile, the new government of **Indonesia** focused on a tax system reform to increase tax revenues and gradually cut fuel subsidies, and transferred the fund to expand spending on infrastructure and

social welfare, thus rejuvenated the economy through increasing revenue streams, efficient use of funds and fiscal deficit cut. The slump of the international oil price eased pressure on **Malaysia**, a major producer of crude oil and other commodity products. Considering the government's new rules on the property market is yet to show its effect, the central bank of Malaysia has kept its existing monetary policy intact. For **Thailand**, the monetary policy is no longer guided by the core inflation rate since January 2015; it used the general inflation rate instead. Bank of Thailand trimmed key interest rate by 25 basis points in March to 1.75% to ramp up the economy. **South Korea**'s central bank lowered the benchmark interest rate on March 12 to 1.75%, a record low, in order to bolster economic growth and avert deflation. **Hong Kong**'s economy in 2015 is estimated to edge up 2.8%, with the underlying inflation rate further reduced to 3.2% or less. As Hong Kong will take milder approach in raising interest rates than the US, its benchmark interest rate is to be slightly up to 5.25% at the end of 2015.

Overall, emerging Asia economies have generally adopted easing monetary policies as a response of domestic (regional) economic slowdown by increasing liquidity and shoring up economic growth. Cutting interest rates also help these countries to process a preventative measure of currency depreciation, in response to the varying monetary policies among the US, Europe and Japan and fluctuations of exchange rates worldwide.

Emerging Asia is expected to expand by 6.2% in 2015, among which Southeast Asia is to increase about 5.1% with inflation rate of 3.5%. The emerging market in Asia Pacific is exposed to two risks: first, capital outflows from the US Fed's rate hike. The structure problems in economies remain hard to relaxing and combined with other factors to depreciate their currencies. Moreover, commodity market is likely to remain sluggish with further drop in the prices given the weak global demand, China's economic slowdown and the oversupply. A pessimistic outlook of the commodities market will be negative for the overall performance of the commodity-exporting countries.

## IV. Africa and Latin America

### IV.1 Africa: facing headwind

African economy has gone through a variety of challenges in 2014. Ebola outbreak dealt a heavy blow to the continental economy; mining and agricultural sectors were stagnant; tourism revenues also plummet. African export products suffered a price collapse, leading to sharp decline in trade revenues, deteriorating trade conditions and economic hardship of energy exporting countries like Nigeria, Algeria and South Africa. Meanwhile, the security situation is getting worse in Africa. Under the shadow of kidnapping, terrorist threats and other military actions, the tourism revenue in many African countries plunged. Overall, African economy grew 5.0% in 2014.

Sluggish raw material prices and grim security situation will remain the major challenges for African economies in the second quarter of 2015. However, following accelerated economic diversification and regional integration, capital inflow from foreign direct investment and overseas remittances, and rapid increase of infrastructure investment, the African economy will improve to some extent. Downturn in commodity prices provides opportunities for other substitutes exports. Africa will build up a more comprehensive industrial sector, and the business expansion of telecommunications, transportation and financial sectors will fuel the economic development. The continent is expected achieve 5.2% economic growth in the second quarter of 2015, of which, northern Africa will gain about 3.7%, southern Africa is expected to advance 5.5%.

Nigeria, Africa's largest economy, saw a faltering economy. Having a weak industrial base and relatively fragile balance sheet, Nigeria is under greater pressure of capital outflows and Nigerian

naira depreciated on the back of the expected Fed's rate hike. To stabilize the economy, the Nigerian government has taken measures including cutting on government spending, diversification by increasing non-oil income, lowering official exchange central parity rate and expanding the trading band, establishing Nigerian Development Bank to provide medium and long-term credit, and raising benchmark interest rate and RRR in private sector. Sharp decline in international oil prices also hit the South African economy. In the first quarter of 2015, with the negative impact of downward oil prices fading, the external demand improves for South African exports following the upturn of the Euro Area and Japanese economies. South Africa's GDP is expected to resume growth of about 2% in the second quarter of this year. However, power shortage and strikes are still potential obstacles to the economic development in South Africa.

#### IV.2 Latin America: headwind with wider divergence

The current low prices of the international crude oil and other commodities will add up economic risks for the Latin American countries dependent on exports of energy, raw materials and agricultural products. Weak external demand as a result of slowdown of some emerging economies made the trade conditions worse for the Latin American countries. The expected Fed rate hike siphoned capital out of the region, resulting in local currency depreciation and rising financial risks. From the domestic point of view, the investment in Latin America's major economies dropped in 2014, and the gross fixed capital formation fell 3.0% year-on-year, hitting a four-year low. Started in Argentina and Venezuela, high inflation drove up the general price level in Latin America. A sharply rising food price constrained the consumption demand. It is estimated that Latin America and the Caribbean economy grew 1.1% in 2014, the slowest pace since 2009. In the first quarter of 2015, international oil prices remain subdued, leaving some Latin American countries larger trade deficit, rising unemployment and high inflation. It is expected that Latin America economy will remain sluggish, and its GDP will grow about 1.2% in the second quarter of 2015.

Major economies in Latin America will continue to diverge. **Brazil** has a serious inflation problem and stagnant economy. In the first quarter of 2015, the CPI in Brazil reaches 7.7%. To offset the high inflation, the central bank of Brazil twice elevated the interest rates, pushing up the target rate to 12.75% from the original 12.25%. However, high financing cost impedes investment and economic growth. The economy still faces severe downward pressure in the second quarter and may show economic contraction. **Argentina** is suffering persistent economic downturn. Under the impact of the debt crisis and currency devaluation, Argentina's GDP fell 1.0% in 2014 from a year before. Its economic situation has not improved in the first quarter of 2015, with CPI and PPI remaining at high levels, the reined consumption, and tepid industrial production. Expectation of the Fed's rate hike has led to capital outflow, swelling debt costs and default risks for the country. Its capital market is also facing the huge challenge of currency depreciation pressure. It is less likely for Argentina's economy to rebound in the second quarter. Although oil price slump had some impact on **Mexico's** current account, driven by the economic recovery in the US, the Mexican economy continued to improve, with its GDP growing year-on-year 2.6% in the fourth quarter of 2014, up 0.4 percentage point from the previous quarter. Mexico's structural reforms in energy and telecommunication industries will continue to release positive effects, and a moderate inflation would also boost production and consumption. It is expected that Mexico's economy will maintain an upward momentum in the second quarter with its GDP growth to reach 3.1%, but it needs to concern against the risks brought by capital outflows and the US tightening monetary policy.

---

### **Disclaimer**

This Report was drafted by the Institute of International Finance BOC, and all the information cited in this report is publicly available.

Any view or estimate contained in this Report only represents the author's judgments to date, not necessarily reflects BOC's views. The Institute of International Finance may change this Report without notice, and shall not be held liable for update, correction or revision of this Report.

The contents and views contained in this Report are for reference only, which do not constitute any investment recommendation. BOC will not be liable for any direct or indirect profit/loss on investment caused by the use of any information provided herein.

The copyright of this Report is exclusively owned by the Institute of International Finance BOC, and shall not be reprinted, duplicated or published by any institution or individual. In case of any quote for distribution, it shall be indicated that the source is the Institute of International Finance BOC, and the report shall not be quoted, abridged and modified contrary to its original intention. The Institute of International Finance BOC reserves rights to investigate any infringement or quotation contrary to the original intention of this Report.

---