



## Global Economic and Financial Outlook

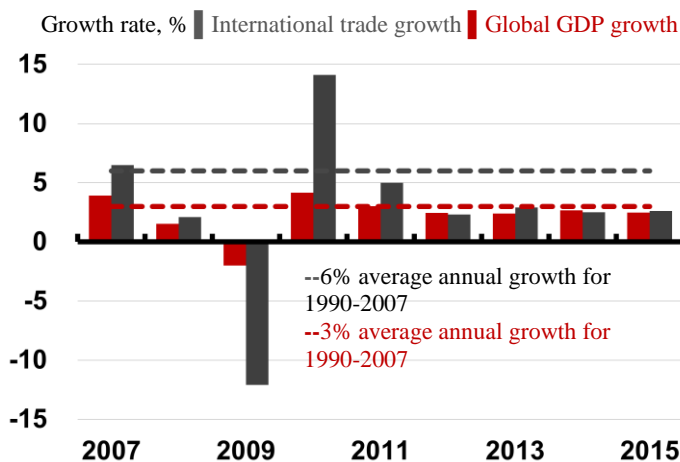
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### Highlights

- Global economy struggled with lower prices in 2015. The developed economies regained some steam on a weak basis, the emerging economies slowed down with Russia and Brazil trapped in recession, while the Asia-Pacific region was relatively stable.
- Global financial market saw greater volatility in 2015. Currencies of the emerging markets wallowed, stock market had a rollercoaster ride, commodity prices continued to slump, systemic financial risks were on the rise for some countries.
- Global economy in 2016 is expected to be lukewarm, financial risk pressure will be unabated as a result of the spillover effects of the US Federal Reserve's rate hike and US dollar appreciation.
- This report sets a column analyzing the implications of the "Trans-Pacific Partnership Agreement" (TPP) for the world economy, as well as the path of Fed's rate hike and its influence.

### Global GDP and Trade Growth



Sources: WTO, BOC Institute of International Finance

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## Explore New Drivers: World Economy Recovers on a Winding Path with In-depth Adjustment

### ——Global Economic and Financial Outlook (2016)

The global economy has slightly recovered in 2015, with consumer prices running at low levels. The developed economies have regained some strength on a shaky ground. Emerging economies have slowed down, with Russia and Brazil trapped in recession, compared to which economies in the Asia-Pacific region were relatively stable. In particular, amid market expectation of a rate rise by the US Federal Reserve, currency nose-dived in the emerging economies, the stock markets had large swings and commodity prices plummeted, fueling systemic financial risks in some countries. The global economy in 2016 is anticipated to have a mild expansion, with financial risk pressure unabated. There will be a larger disparity on monetary policies in the developed countries as the Fed's rate increases and a stronger dollar will pose spillover effect. This report sets a column analyzing the implications of the "Trans-Pacific Partnership Agreement" (TPP) for the world economy, as well as the path of Fed's rate hike and its influence.

## Part I Annual Economic Review and Outlook

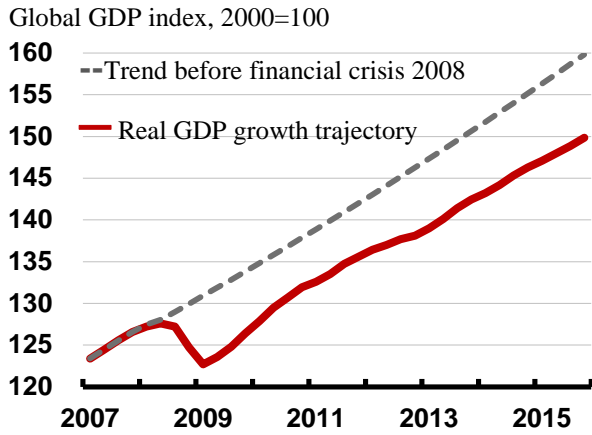
### I. Weakening dynamics of world economy

With a declining momentum, the global economy grows at an estimated rate of 2.6% for 2015, far from reaching its potential output. The growth rate of global GDP, foreign direct investment and international trade undershot expectations for the fifth consecutive year (see Figure 1 and 2). The lingering and far-reaching impact of the 2008 financial crisis, the aging population, the negativities of geopolitical unrest and natural disasters overlaid, leading to an in-depth adjustment in the global economic structure. As the engine of traditional industries is losing its strength, the size and growth momentum of the new industries is not yet built up, the global economy will be unable to make a strong return.

Given the long-term global economic weakness, supply-side structural reforms are imminent based on the following factors: **(1) Population and labor force.** On the one hand, the growth of the labor population slipped due to the impact of the crisis. In Europe, with high unemployment rate, the labor force was unable to return to production for a long time. In the US, even though the level of job status has been close to full employment, labor participation rate is at historic lows. On the other hand, the growing aging population in major countries bloated labor and production costs. The demographic challenge is not only a headache to the developed countries but also to the developing countries like China. **(2) Slower capital growth.** As revealed in many dimensions, corporates are hesitant to increase investment due to a dim business prospect, the financial institutions are reluctant to extend credit due to tougher regulatory constraints, and the government is unable to embark on expansionary fiscal policy under the weight of debt accumulation. **(3) Slowdown of total-factor productivity.** The marginal contribution of the management revolution and IT innovation to improve the productivity is declining, and the force of new energy, new

materials, green industry and other emerging industries has not been strong enough. Meanwhile, institutional deficiencies and political instability are constantly hindering productivity potential in Latin America, the Middle East, North Africa, Eastern Europe and other regions.

**Figure 1: Global Economy Lower than Potential Output**



**Figure 2: Global GDP and Trade Growth**



Sources: BOC Institute of International Finance, WTO

In 2015, the following influences weighed on the global economy: **(1) A long-lasting downswing of commodity prices.** Subject to a flurry of complex factors in supply and demand, commodity prices further dipped, rippling a substantial negative impact. Even though a lower commodity price benefits the countries of imports, it has a greater negative impact to the global economy in terms of resulting deflation pressure, declining revenues and investment in the countries of exports. The recession of South America and Eastern Europe is highly correlated to this. **(2) The geo-political influence.** This primarily concerns Europe, Middle East and the Africa Region. The Russian economy grappled with recession under the economic sanctions from the US and Europe amid the commodity price rout. The influx of large numbers of refugees from Africa into Europe led to huge economic and social costs. **(3) Spillover effect of the slowdown in the Asia-Pacific region.** Waning imports in the region blunted the economic growth of the energy and resources export countries. To make it worse, capital outflow of the emerging markets speeded up amid the expectations of the Fed’s rate rises.

Looking into 2016, we anticipate that the world economy will lumber on, with a GDP growth tipping slightly to 2.8% (Table 1), and with the trade growth edging up to 3.0%, not driven by improving supply and demand, but by normalization of some shocks: **(1) The developed countries will maintain the current trend of steady expansion.** Without unexpected shocks, economic growth in the US, euro zone and Japan will be 2.8%, 1.6% and 0.8% respectively in 2016, slightly picking up from 2015. **(2) The economic recession in Russia and some Latin American countries will be eased significantly.** Due to the low base effect and a limited room for further plunge of commodity prices, together with improving external conditions, these regions are predicted to improve their economic performance in 2016. **(3) External financing environment will stabilize.** The international financial markets tend to absorb the impact of the Fed’s rate increases, with lower level of volatility and improving financing conditions, conducive to the stabilization of the emerging economies. However, the above-mentioned factors are short-term drivers, the global economy is still facing a greater challenge to find new growth drivers. Infrastructure investment could be an important direction, and that’s why China is pushing hard the Belt & Road Initiative, which will not only meet the capital accumulation demand and improve the productivity in countries along the road, but also make full use of China’s surplus capacities.

The global monetary policy will still generally be accommodative in 2016. Till now, the major

economies have been on different paths for recovery. Among the developed economies, the US and the UK have economic expansions with their GDP volume rebounding to pre-crisis levels. Meanwhile, the unemployment rate continued to decrease, making the job market getting closer to full employment. In the Eurozone, however, deflation, high unemployment rate and mounting public debt dragged down the regional growth. Economic-weary Japan witnessed alternative presence of recessions as Abenomics achieved little success. It is estimated that the ECB will extend QE monetary policy and further reduce the interest rates, and Bank of Japan will take the similar initiatives, in stark contrast with the Fed and the Bank of England's rate hike trajectory.

In the emerging markets, the relatively stable Asia-Pacific region goes against from the commodity-crimping countries. As commodity consumer, the Asia Pacific Region benefits from the crumbling commodity prices to some extent, while Eastern Europe, the Middle East, North Africa and South America as the suppliers, are inevitably subject to the negative impact of the price plunge. Therefore, Asia still has a leeway for further accommodative monetary policies. The commodity production and export countries and regions are advised to follow the macroeconomic policy of the Asia Pacific region so as to strengthen support to their real economies.

According to estimation, global economic growth is still exposed to high risks in the future, particularly given the market reaction which could be violent to the Fed's rate rises. Various risks may exacerbate in Europe, including political risks such as breakup of the economic union, independence of some areas, and geopolitical clashes between the Eastern Europe and Middle East, social risks of the populism and terrorism, as well as the debt rout of Greece and other member states. In addition, commodity market remains bleak, exerting a negative impact on the emerging markets.

**Table 1: Key Indicators of Major World Economies (%)**

Region	Yr/Qtr Country	GDP growth rate			CPI increase			Unemployment rate		
		2014	2015 <sup>e</sup>	2016 <sup>f</sup>	2014	2015 <sup>e</sup>	2016 <sup>f</sup>	2014	2015 <sup>e</sup>	2016 <sup>f</sup>
America	US	2.4	2.5	2.8	1.6	0.1	1.1	6.2	5.3	4.9
	Canada	2.4	1.0	2.0	1.9	1.0	1.6	6.9	6.8	6.8
	Mexico	2.1	2.2	2.6	4.0	2.8	3.0	4.8	4.3	4.0
	Brazil	0.0	-3.0	-2.0	6.3	8.9	6.3	4.8	6.6	8.6
	Chile	1.9	2.0	2.5	1.9	4.4	4.4	5.9	6.4	6.6
	Argentina	0.5	0.4	1.0	21.3	16.0	25.0	7.1	7.3	6.9
Asia-Pacific	Japan	-0.1	0.5	0.8	2.7	0.7	0.4	3.6	3.5	3.5
	Australia	2.7	2.5	2.5	2.5	1.8	2.6	6.1	6.3	6.2
	China	7.3	6.9	6.8	2.5	1.4	2.0	4.1	4.1	4.1
	India	7.3	7.5	7.7	5.9	5.4	5.5	—	—	—
	South Korea	3.3	2.8	3.0	1.3	0.7	1.8	3.5	3.7	3.5
	Indonesia	5.0	4.5	4.5	6.4	6.8	5.4	6.1	5.8	5.6
Europe-Africa	Eurozone	0.9	1.5	1.6	0.4	0.2	1.0	11.6	11.0	10.5
	UK	2.9	2.5	2.3	1.5	0.1	1.5	6.2	5.6	5.5
	Switzerland	1.9	1.0	1.5	0.0	-1.1	-0.2	3.2	3.4	3.6
	Russia	0.6	-3.5	0.5	7.8	15.8	8.6	5.2	6.0	6.5
	Turkey	2.9	3.5	3.0	8.9	7.4	7.0	9.9	10.8	11.2
	South Africa	1.5	1.4	1.5	6.1	4.8	5.9	25.1	25.8	25.8
Global		2.7	2.6	2.8	3.5	3.3	3.4	—	—	—

Source: BOC Institute of International Finance ; Note: e for estimate, f for forecast

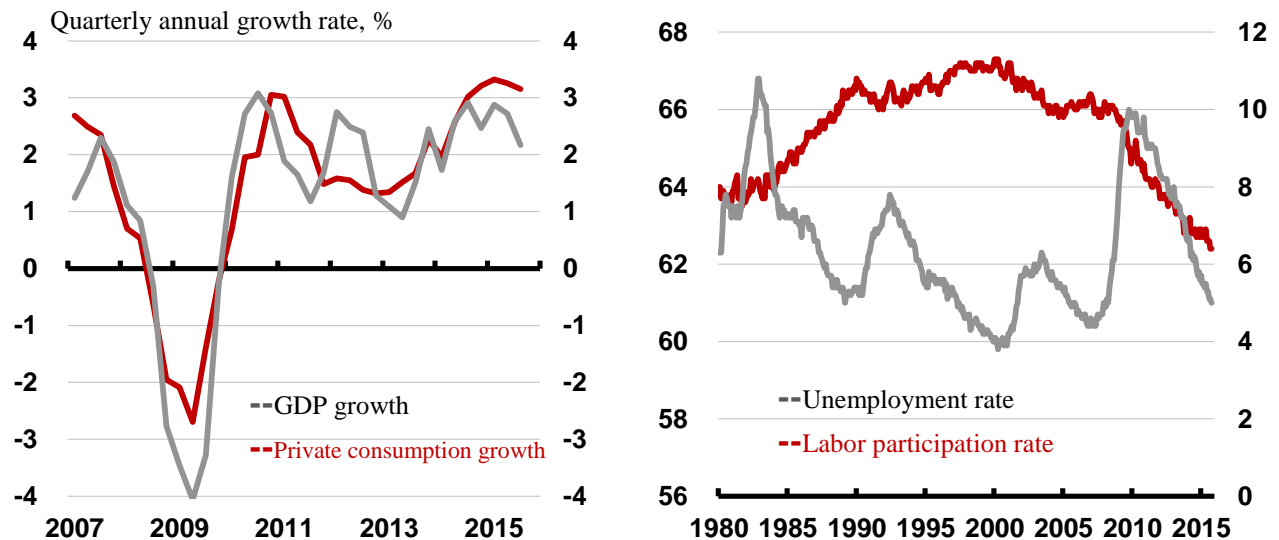
## II. North America’s economy steady, with less contribution from the US

North America has a decent economic performance in recent years. However, the protracted commodity price slump dealt a blow to the energy-reliant and resources-rich Canada. Meanwhile, the effect of a strong US economy on its neighboring countries is diminishing dramatically, leaving Mexico economy lackluster.

### II.1 US economy has a solid foothold, entering a rate hike cycle

The US grew at an annual 2.1% in the third quarter, and is estimated to increase by 2.5% for the whole year of 2015. We anticipate the US economy will have a moderate expansion at 2.8% in 2016. Against the backdrop of a weak external demand and falling net export contribution, domestic demand has been the main driver for US economic growth (Figure 3). US private consumption is projected to grow by 3.2%, at the fastest pace over the last decade and will maintain the growth momentum in 2016 due to the following factors: **(1) The continuously improving labor market.** The number of October initial jobless claims reached a new low over the past 42 years, with an unemployment rate falling to 5.0% (Figure 4) which will support income growth. **(2) Relentlessly low prices of crude oil and other commodities.** The inflation rate has been tamed, lifting real purchasing power of the residents. **(3) The factors strangling financial expansion lulled,** and the real estate market shows signs of continuous improvement, helpful to boost spending growth.

Figure 3: US GDP and Consumption Growth Figure 4: US Unemployment and Labour Participation Rate



Sources: Wind, BOC Institute of International Finance

Considering the subsiding base effects, quasi-full employment status and rising CPI pressure in 2016, the US Fed is poised to raise the interest rates as soon as in December for the first time in nearly a decade. The rate increases in 2016, 2-3 times with 25 basis points each, is believed to be modest. On the one hand, the US economy has not seen robust indigenous growth, and has particularly weak investment in the business and energy sectors; on the other hand, the external environment has been volatile, the reflux of international capital triggered by the expectation of the Fed’s rate rises beefed up dollar and suppressed the external demand, leaving the total demand insufficient.

## **II.2 Canadian economy rebounding, but at slower pace**

Hit hard by the nagging headwinds of the international commodity prices, and slower growth of business investment and inventory, Canada was in the mire of technical recession in the first half of 2015. In the second half of the year, the rebounding exports of non-energy products and investment has lifted Canada's headline economy above the level of growth potential. In general, the country's economy is expected to grow by merely 1% in 2015, and around 2% for 2016 driven by the following factors: (1) Despite a prolonged slump in commodity prices, the room for a further plunge is limited, and the growth of business investment and inventory is to pick up; (2) Canada's unemployment rate is down, the financial market is relatively stable, consumer spending is to grow; (3) an improving US economy will have a positive spillover effect on Canada.

## **II.3 Mexican economy ameliorating, better than the Latin America's average**

In 2015, the Mexican economy is thought to increase by only about 2.2%, largely missing the 5% target set by the Mexican government, but much higher than Latin America's average of -0.3%. The sluggish economic growth was primarily due to a weak construction sector, falling US demand and shrinking oil production. Mexico's economy is estimated to grow by 2.6% in 2016 with an historic-low inflation rate of 3%, primarily due to the following driving forces: (1) the Mexican government is launching a series of structural reforms conducive to the economic growth, including the telecom sector reform to lower the prices and attract foreign investment, energy reform to auction oil blocks, and banking sector reform to promote competition; (2) the falling power prices and the devaluation of the Mexican peso, coupled with an improving demand from the US, will bolster the exports of Mexico's manufacturing sector.

## **III. European economy: Western Europe stabilizes, Central and Eastern Europe grows in chaos**

The European economy is rather complex in 2015, while the Western European countries went through trials of the Greek debt crisis, terrorism and refugee influx, their Eastern counterparts were under huge impact of international oil downturn and geopolitical issues. The overall European economic situation is less than optimistic.

### **III.1 Eurozone economy reviving at a moderate pace**

The Eurozone expanded mildly in 2015, benefitting from lower oil prices, a weak euro, negative interest rates and quantitative easing initiatives. Private consumption has become the major driver for the economic growth. Investment remains weak despite consecutive growth, and net export contribution comes close to zero due to faint external demand. All the 19 member States in the Eurozone achieved growth except Greece.

Looking into 2016, we see multiple positive factors to stay, but the positive effect will continue to subside. The economic slowdown in the emerging markets and increasing global economic uncertainty will undermine the growth momentum in Europe, and the downside risk is still huge. Eurozone's future economic growth will depend on a sustainable and stable employment, consumption and investment. With abundant liquidity and cheap funds brought by the QE measures, investment in construction is to ratchet up in 2016, and the introduction of the European investment projects will further shore up investment. Apart from the QE policies, the ECB might further stimulate bank lending by levying fines on bank deposits. With oil price stabilizing and the deflation risk held in check, the Eurozone's CPI is anticipated to float to about 1% in 2016.

A large number of refugees swarming into Europe will increase short-term government spending in some member States, bolster demand and spur the economy. Furthermore, In the long run, the refugees will replenish the local labor force and have a positive effect on the European economy.

However, the recent terrorist attack in France will undoubtedly cast a shadow over the refugee policy, hindering the aviation and tourism sectors in the short term. In the meanwhile, rise of investor's risk aversion will impede the recovery pace in some countries to some extent. Generally speaking, the faltering global demand and lack of reform efforts in some of the member States will constrain the economic growth in the Eurozone, and mounting private and public debts pose high risks. The member States in the Eurozone should take a more rational fiscal policy to stimulate investment, implement structural reforms, and trim debts in order to underpin the growth momentum.

### **III.2 UK economic momentum waning**

The British economy continues to expand at slower pace and is expected to grow by about 2.5% in 2015. The continued robustness of the British economy relative to other European countries is mainly attributable to the increasing domestic demand as a result of low oil price. The GDP is mainly fueled by the services sector which is the strongest among all industries. The growth slowdown is due to the sliding construction and manufacturing output, sagging growth and stagnant economies in the Eurozone, and the geopolitical risks of Russia, Ukraine and the Middle East.

It is estimated that the British economy will continue its growth between 2.0%-2.3% in 2016. The country will maintain an accommodative monetary policy to secure a solid growth with consumer spending and business investment as the main drivers. Yet, as a highly globalized economy, the UK will be subject to a larger negative impact considering the above-mentioned internationally political uncertainty and increasing risks in 2016.

### **III.3 Greater divergences in Eastern Europe, pulled legs by Russia**

Despite external influences, the emerging markets in Eastern Europe achieved moderate growth. Thanks to the support of the European funds, these countries had an upswing in investments. The slump oil prices spurred consumption, particularly in Poland, Romania, and Czech Republic where the labor markets are stable and the GDP grows by more than 3.5%, above the average growth of the Eurozone. Bulgaria's growth was mainly export-driven, but its domestic demand weakened. Croatia regained some strength in 2015 after a six-year recession, but the unemployment rate and the public debt ratio remained high.

Russia had an economic recession. Turkish economy stalled due to political differences, geopolitical tensions in neighboring countries as well as weaker external demand. A depreciating lira and financial market turmoil triggered capital outflows from Turkey, causing uncertainty in the foreign capital-reliant country. With a weaker currency to boost exports and lower oil prices, the Turkish economy is about to grow by 3.5% in 2015 and 3% in 2016, lifted by the reviving EU economy. Under the US and European economic sanctions, Russia slid into recession, dragging down economies in the Central and Eastern Europe. It will take more time for Russia to step out of the recession if the geopolitical tension continues and crumbling oil price persists.

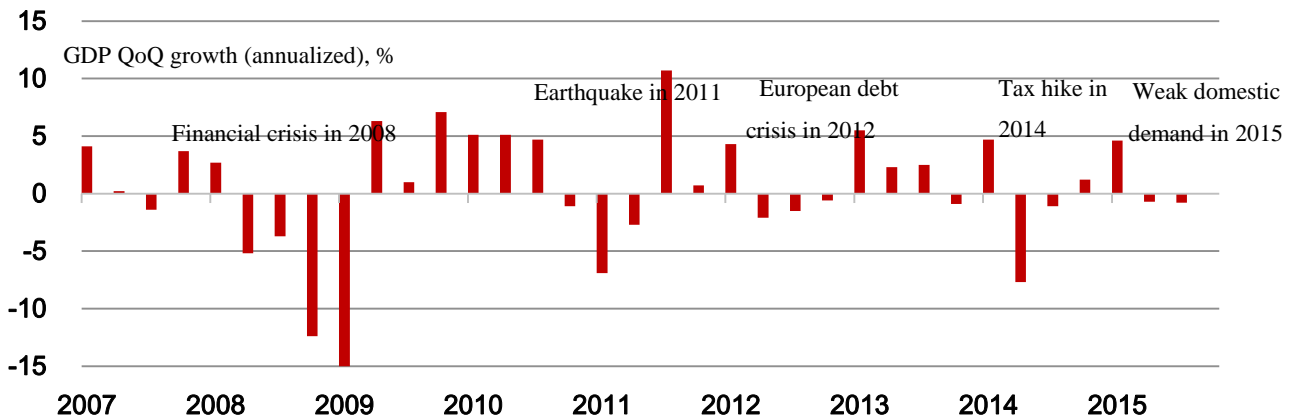
## **IV. Developed countries trapped in economic recession with emerging economies stabilizing in the Asia-Pacific region**

In 2015, major economies in Asia Pacific diverged obviously in terms of economic growth: Japan fell into technical recession again; major commodity exporters in Oceania saw their economic growth rates decline; but emerging economies including India, Indonesia, Thailand, Vietnam and the Philippines, rebounded to some extent, which propped up economic stabilization in this region.

#### IV.1 Japan was back in a technical recession again, which would be difficult to be shaken off in the short term

The second and third quarters of 2015 witnessed the Japanese economy fall into technical recession again, which was the fifth of its kind since 2008. In the corresponding period of 2014, the direct cause of such recession was that the government lifted the excise tax from 5% to 8%. But this time, it was mainly attributable to enterprises' reluctance to invest in equipments and slower growth in private consumption (see Figure 5). In the third quarter of 2015, private consumption increased at an annualized rate of 2.1%, while business investment decreased at an annualized rate of 5%, showing negative growth for two consecutive quarters. Warehouse and store inventories also reduced, dragging down the overall economic growth by 2.1 percentage points. In September 2015, Japan's consumer price index tumbled for two consecutive months, far lower than the expectation of its central bank. It is expected that Japan's GDP growth will come back to a positive rate of around 0.8% in 2016, but probably with greater deflationary pressure; the Japanese central bank will step up efforts to ease up and loosen its monetary policy for quantitative and qualitative easing as early as the beginning of 2016.

**Figure 5: Five Technical Recessions of the Japanese Economy since 2008 and the Major Causes**



Sources: Wind, BOC Institute of International Finance

#### IV.2 Falling commodity prices led to economic slowdown in Australia and New Zealand

Weak global demands, continued drops in commodity prices and economic slowdown in China are the key factors that affect the economic growth of Oceania. The economic growth rate of Australia in 2015 was estimated to be 2.5% merely, lower than the average level of 2.8% for the last decade; and growth were mainly by government and household spendings. However, a decrease in the actual net disposable income of residents adversely impacted household spending. Given the steep drops in commodity prices, a sluggish economy and low inflation, among other factors, the Australian central bank cut benchmark interest rates twice in 2015, which have remained at a record low of 2% since May. It is predicted that in 2016 business and consumer confidence will remain weak in Australia, and investment in the resources industry can hardly revive. But the central bank will continue with a loose monetary policy so as to facilitate the development of non-mining sectors and assist businesses with transformation.

The GDP growth of New Zealand was also lower than market expectation in 2015. The slowdown in the growth of the manufacturing and the construction industries eroded the stimulation effect of the agricultural revival and currency depreciation; and the contraction of demands in the international commodities market battered the country's economy heavily dependent on export trade. In 2015, its central bank cut interest rates three times, revised down inflation expectations by

the end of 2015 to 0.5%, but revised the same by the end of 2016 up to 2.2%, and lowered the GDP growth expectation for 2016 to 2.1%. It is estimated that the country's monetary policy will remain lax in 2016, with the likelihood of a rate cut in the first quarter.

### **IV.3 Emerging economies in Asia Pacific will hold steady**

In 2015, the emerging economies in this region grew by 6.5%, lower than the 6.8% recorded last year. Lately, India, Indonesia, Thailand, Vietnam and the Philippines, among others, staged a rally in terms of economic growth, and emerged as a major force in bolstering economic recovery and stabilization in the region. 2015 saw these emerging economies accelerate adjustment to their macro policies and step up efforts in reforms. India lifted the cap on foreign direct investment, cut down on government subsidies, lowered business taxes, and embarked on transforming into a global manufacturing center through a "Make in India" Initiative. Indonesia extended tax holidays for leading industries ranging from oil refining, infrastructure, to marine transportation, and telecommunications, and reduced fuel and electricity prices. Thailand stipulated a "Seven-Year Investment Promotion Strategy (2015-2021)", and would soon remove the regulation on daily minimum wages by the end of the year. The Vietnamese government offered tax incentives to foreign enterprises to cluster primary manufacturing of multinationals.

The acceleration in the integration of emerging economies, and regional trade cooperation have propelled the emerging markets in the region to maintain vigorous development. The "Trans-Pacific Partnership Agreement" was officially announced to be established and included a number of ASEAN members; the "Regional Comprehensive Economic Partnership (RCEP)" and the "Free Trade Area of the Asia-Pacific (FTAAP)" are in progress. Driven by a series of favorable factors, the emerging economies in the region are expected to sustain economic growth at the same level next year as in 2015, with GDP growth estimated to be about 6.4%.

## **V. Africa and Latin America likely to recover from economic downturns**

Overall, the economy of the Middle East, Africa and Latin America appeared sluggish in 2015, as a result of weak commodity markets, geopolitical instability and faltering outside demands, among other factors. But the situation is expected to be improved in 2016.

### **V.1 Economic growth slowed down in Southern Africa**

Given the economic slowdown in Southern Africa in 2015, the real GDP growth of the region is expected to decrease to around 3.8% for 2015, the lowest in six years. The decline in the prices of oil and other commodities, and the slowdown of the Chinese economy all contributed to the rapid economic slowdown in the region. The sharp price falls of primary export products in the international market caused substantial reductions in the trade income of major energy exporters such as Negeria, South Africa and Angola. With terms of trade deteriorating and economy in trouble, the GDP growth rates of the three countries in 2015 were 4.0%, 1.4% and 3.5% respectively, lower than the previous year. Unstable domestic factors in African countries, such as power shortage and labor strikes, also impede local economic development latently. But for oil importers like Kenya, falling oil prices could help improve their trade balance and keep inflation at a stable level; in addition, large-scale investments in infrastructure, increase in agricultural output and growth of the services sector will power the economic growth of Kenya, whose economic growth rate is expected to return to 6.5% in 2015.

Looking into 2016, with the gradual recovery of the global economy, stabilization and rebound of the prices of oil and other commodities, economic diversification and regional integration will speed up, foreign direct investment and remittances flow in constantly, and investment in infrastructure increase rapidly. As the economic situation improves continuously, economic growth of Southern Africa is expected to rise to 4.3%. Depressed commodity prices will bring

opportunities for the development of Africa's export substitution industries; and the continent's economic development will be boosted by the establishment of a more comprehensive industrial system, and increases in the business volumes of telecommunications, transportation and finance. On the whole, Africa remains to be a paradise for investment with great growth potentials.

## **V.2 The economic performance of the Middle East and North Africa was relatively steady**

In 2015, economic growth of the Middle East and North Africa declined as a result of substantial drops in international oil prices, sluggish demands worldwide and other factors, with the real GDP growth rate projected to be 2.3%. Radical decreases in oil export revenue led the international payment deficits and fiscal deficits of oil exporting countries to account for 1% and 8.4% of their GDP respectively, both being in the red for the first time in ten years. Nevertheless, thanks to growing external demands resulting from the economic recovery in Europe, stronger confidence at home and more effective fiscal and monetary policies, oil importing countries performed relatively well in economic terms; their real GDP growth is expected to rise from 3% in 2014 to 4% in 2015.

In 2016, economic growth in the Middle East and North Africa will accelerate and is likely to reach 3.8%, attributable to the gradual recovery of the world economy, stabilization and rebound of oil prices and the U.S. and Iran reaching agreement on the Iranian nuclear issue in favor of the political landscape in the Middle East. For the oil exporting countries, the stabilization and rally of international oil prices in 2016 will help them alleviate the situation of double deficits. Moreover, to change the abnormal development model of high dependence on the oil industry, the oil exporters have vigorously implemented development strategies for economic diversification in recent years, and have achieved some progress in non-oil sectors, with certain changes in the pattern of simply relying on the export of crude oil. Non-major oil exporters or oil importers have achieved obvious results after adjusting their economic systems over the years. The GDP growth rates of Egypt and Sudan were 4.2% and 3.5% respectively in 2015, and are projected to increase to 4.3% and 4.0% in 2016.

## **V.3 Capital flights led to economic recessions in Latin America**

Financial risks increased in Latin America during the year, owing to economic slowdown, depressed commodity prices, rising unemployment rates, substantial currency depreciation, serious inflation and capital flights. The region's GDP growth rate is projected to be -0.3% in 2015, 1.6 percentage points lower than 2014. Among major Latin American countries, Brazil, Argentina and Venezuela grew at a rate of -3.0%, 0.4% and -10.0% respectively, all pointing to grim economic situations. Local economies suffer from inflation as a result of currency oversupply and commodity shortage in the region. In 2015, the inflation rates of Brazil and Argentina are expected to reach 8.9% and 16.8%, with Venezuela's surging to 159.1%. In addition, due to sharp decreases in export revenue and rising expectation for the US Fed's interest rate hike, local people increase holdings of US dollars to avoid inflation, leading to capital outflows and severe currency depreciation in these countries. Moreover, a stronger dollar also exacerbates the debt risk of the region.

Against the backdrop of global economic recovery and stabilization of commodity prices, economic growth of Latin America will rally and possibly reach 0.8% in 2016, representing an increase of 1.1 percentage points over 2015. However, it should be noted that the region's internal factors have not improved fundamentally, so financial risks remain high as it is still plagued by single economic structures weakness, over-reliance on energy and commodity exports, sustained appreciation of the US dollar, capital flights and increasing debt burdens, among others.

## Part II Global Financial Review and Outlook

### I. Global financial stability under pressure

In 2015, anticipation for interest rate hikes by the U.S. Fed, the reform of the RMB exchange rate regime and other factors triggered off great fluctuations in the global financial markets, including, in particular, large foreign capital exoduses in emerging countries and regions, across-the-board exchange depreciation, acute gyrations in stock markets and continuously low commodity prices, imposing higher pressures on systematic financial stability. Going forward, the global financial market will continue to rise amid volatility in order to absorb various sorts of unstable factors.

#### I.1 Global financial stability: improved in developed economies but deteriorated in emerging economies

The changing trend of global financial stability in 2015 is that: **(1) financial stability of developed economies has improved to some extent.** The macro financial climate has continued to improve, as a result of broader economic recovery, better market confidence boosted by monetary policy, and lower deflationary risks in the Eurozone. With various basic conditions fulfilled, the U.S. Fed is prepared for an interest rate hike, which can help it alleviate excessive risk-taking. Improvement of credit conditions, stronger credit demand and signs of betterment of corporate sectors will stimulate increases in investment and risk-taking behavior. **(2) Risks shifted to emerging markets.** The emerging markets remain highly fragile, with shrinking risk appetite and greater market liquidity risk. Although many emerging economies have improved their policy frameworks and enhanced resilience to external shocks, several key economies face substantial domestic imbalances and lower growth. Furthermore, dependence on rapid credit growth has led to surging leverage ratios in the private sector. In addition, foreign exchange exposures keep widening driven by global factors. Borrowings and foreign exchange exposures have increased the vulnerabilities of emerging economies to tightening financial conditions worldwide.

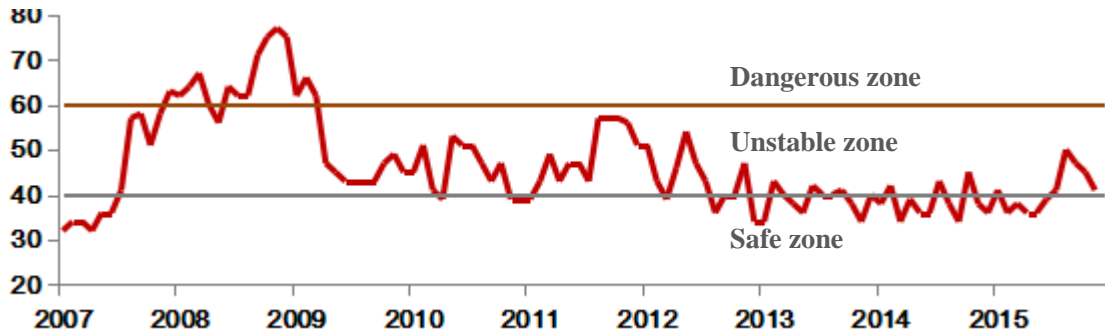
With the onset of the Fed's rate hike cycle, emerging economies will continue to confront various challenges in 2016. In the past few years, banks have thinner capital cushions and company profits and asset quality deteriorate in emerging markets, which has formed a vivid contrast with developed economies, where banks have committed to deleveraging, repairing their balance sheets, strengthening capital and financing arrangements. Against the backdrop of falling commodity prices and weaker growth, emerging economies are at greater risk of lower-grade sovereign ratings in the future. Pressures on sovereign ratings could intensify if contingent liabilities of state-owned enterprises have to be assumed by the sovereign, for example, from firms in the oil, gas, and utility sectors.

#### I.2 ROFCI of US shot up but fell back

In 2015, the overall risk of the American financial market showed a pattern of being low first and high later, and remained relatively stable in the first half of the year, with credit risk, market risk and liquidity risk all at low levels. The risk of financial crisis index (ROFCI) was still in the safe zone; but with turbulences in the global financial market, especially in emerging markets in August, the overall risk of the American financial market also surged, alongside rising credit risk, market risk and liquidity risk, and risk indicators of the stock market, corporate bond market, banking stocks, treasury market, interbank capital market and non-banking money market all deteriorating. Accordingly, the ROFCI rose to the unstable zone in the third quarter, and stabilized somewhat in the fourth quarter, but still in the zone (Figure 6). With the world economy, especially emerging

economies and financial markets gradually stabilizing and the Fed's monetary policy clearing up in 2016, financial market stability of the United States may improve, and the ROFCI might swing between the safe and unstable zones.

**Figure 6: Movement of the ROFCI**

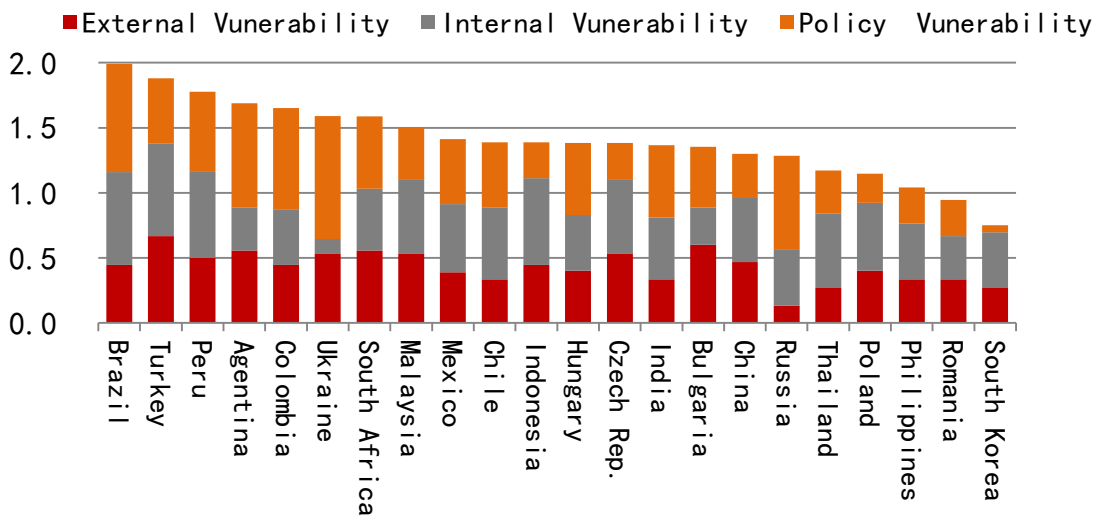


Sources: New York Branch of BOC, BOC Institute of International Finance

**I.3 Some highly vulnerable emerging economies remain to be chief concerns**

We ranked several major emerging countries by financial stability according to the latest Emerging Economy Vulnerability Index issued by the Institute of International Finance (IIF). In the fourth quarter of 2015, countries with the highest external vulnerabilities included Turkey and Bulgaria, countries with the highest internal vulnerabilities included Turkey, Brazil, Indonesia and Peru; and the most vulnerable countries by policy included Russia, Ukraine, Columbia, Argentina and Brazil. All in all, the chief concerns in 2016 should be the risk of financial crises in countries such as Brazil, Peru, Argentina, Columbia and South Africa (Figure 7).

**Figure 7: Financial Vulnerability Index of 22 Emerging Economies (November 2015)**

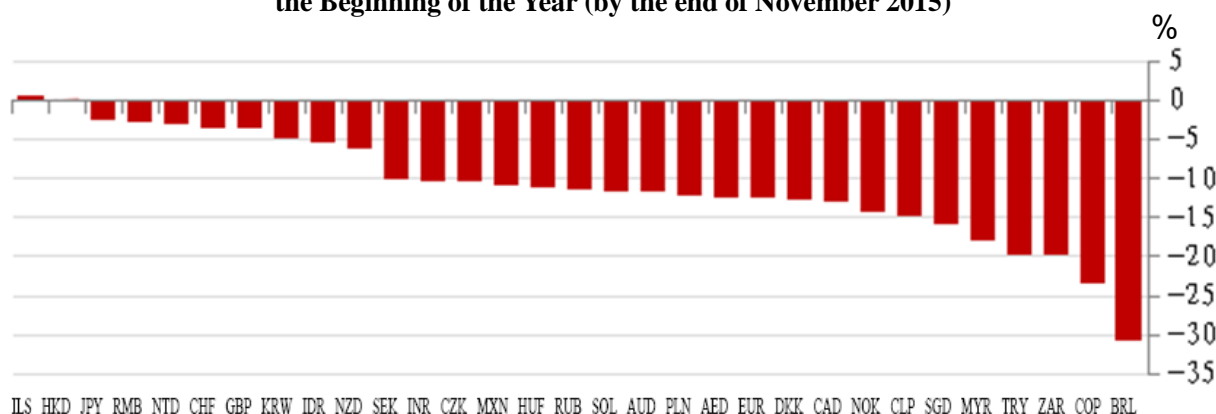


Sources: IIF, BOC Institute of International Finance

**II. Foreign exchange market: a stronger dollar dominated global trend**

In 2015, under the combined effects of a sluggish world economy and the anticipation for the Fed's rate hike, the global foreign exchange market was dominated by the US dollar alone, with other currencies depreciating in general, and exchange rate fluctuations aggravating (Figure 8). In the future, the global market will remain focused on the strengthening US dollar as a result of rate hikes by the Fed.

**Figure 8: Changes in the Exchange Rates of Major Currencies against the US Dollar as Compared with the Beginning of the Year (by the end of November 2015)**



Sources: Bloomberg, BOC Institute of International Finance

**The dollar index becomes stronger steadily.** The dollar index has kept rising steadily since the Fed announced its exit from QE in November 2014. This was mainly due to the steady recovery of the American economy, continued drop in the unemployment rate, stable inflation expectations and rising anticipation for rate hikes by the Fed in 2015. On March 13, the dollar index breached 100 points, hitting the highest level since March 2003, and stood above the 100-point mark again on November 27 (Figure 9).

**EUR, JPY and GBP all have depreciated to varying degrees.** The general weakness of the Eurozone's economy in 2015, consistently low benchmark rates and inflation levels, the Greek crisis, Catalonia seeking independence from Spain, and the terrorist attack in Paris have further exacerbated concerns over the stability of the euro. As a result of the anticipation for a rate hike by the Fed and more QE by the European Central Bank, the exchange rate of the euro against the US dollar declined; by the end of November, the former lost 12.6% of its value against the latter as compared with the beginning of the year. Owing to economic downturns overseas and inadequate business investments, Japan's economy fell into technical recession again in 2015, which, coupled with a loose monetary policy, drove down the exchange rate of the Japanese yen. On June 5, the exchange rate of the US dollar against the yen once exceeded 125, breaching a historical high recorded in 2002 for the first time. At the end of November, the exchange rate stood at 122.62, with the yen **depreciating** by 2.7% against the US dollar as compared with the beginning of the year. Also in this year, the British economy recovered continuously, but the manufacturing sector was still weak, and the Bank of England also maintained low interest rates. The pound sterling has also been **depreciating** against the US dollar. By the end of November, the exchange rate of GBP against USD was 1.5095, down 3.7% as compared with the beginning of the year.

**RMB also depreciates and the exchange rates of the yuan fluctuate more acutely.** With greater downward pressure on the Chinese economy and loose liquidity at home in 2015, the yuan has already been over-valued after a long-term appreciation, as the US dollar becomes increasingly strong. On August 11, the Chinese central bank adjusted the RMB central parity formation mechanism, making the RMB exchange rates more market-driven. The adjustment to the central parity and market exchange rates of the yuan caused wild fluctuations, marking the RMB exchange rates entering the "overshooting" model. Lately, the RMB exchange rates basically stabilized, showing a trend of two-way volatility; the price differential between onshore and offshore RMB exchange rates has narrowed from -1000 BPs in August to around -300 BPs now. By the end of November, the onshore RMB (CNY) and offshore RMB (CNH) exchange rates **depreciated** by 3.1% and 3.5% respectively as compared with the beginning of the year.

**The currencies of emerging economies and commodity exporting countries have depreciated substantially.** 2015 saw the continued slowdown in the growth of emerging economies, and anticipation for an interest rate hike by the Fed led to large-scale capital flights, aggravating the volatility of financial markets. MSCI and JPMorgan Emerging Market Currency Indexes dipped 5.1% and 12.7% respectively (Figure 10). Political unrest in Brazil, Turkey and Thailand, among others, has imposed further pressure on the currencies of emerging markets. The Brazilian real, Russian ruble, South African rand, Malaysian ringgit and Thai baht fell to historical low levels, and depreciated by 30.9%, 11.5%, 19.9%, 18.0% and 7.8% respectively at the end of November as compared with the beginning of the year. As international commodity prices continue to hover at low levels, the currency depreciation pressure on commodity exporting countries has increased; the Canadian dollar, Australian dollar and New Zealand dollar depreciated by 13.1%, 11.9% and 15.9%, respectively.

Figure 9: Trend of the US Dollar Index

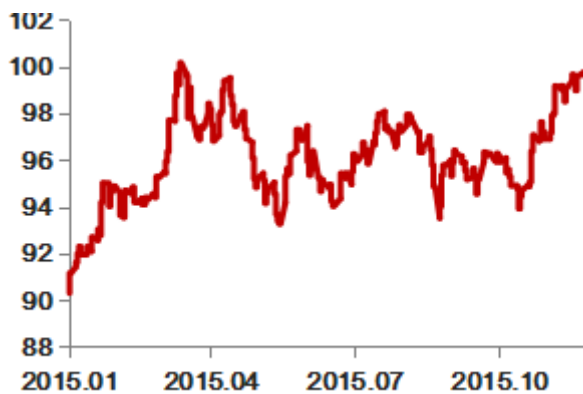
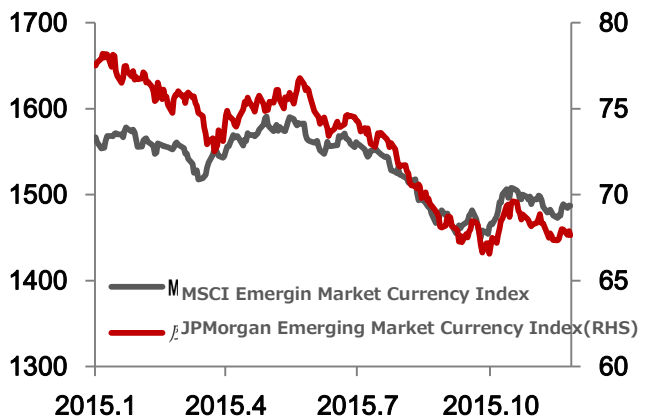


Figure 10: Emerging Market Currency Index



Sources: Wind, BOC Institute of International Finance

**In 2016, the Fed's rate hikes will be a core concern for the development of the foreign exchange market.** A rate hike by the Fed in December 2015 has become a high-probability event; in 2016, the United States will enter a moderate cycle of rate hikes. Although a strong dollar may bring certain negative effect on the trade and economic growth of the country, imposing pressure on the currency; the solid recovery of the American economy and a tightening monetary policy will strongly support the US dollar index, so the momentum of a stronger dollar will persist. Given the weak recovery of Europe and Japan, and notable divergence in their monetary policies from that of the United States, the exchange rates of the euro, yen and pound sterling against the US dollar will remain at low levels. Under new circumstances, the Chinese economy is still in the process of a power switch, facing relatively great downward pressures; with a basically loose monetary policy in place, the inclusion of RMB into the SDR can only support the exchange rates of the yuan to a limited degree in the short term. With an imminent rate hike by the Fed and turbulence in the international financial market, the yuan is still under depreciation pressure and relevant volatility increases. The material appreciation of the US dollar, persistently low commodity prices and financial market fluctuations will impose currency depreciation pressure on commodity importing countries and countries dependent on foreign capital or with large dollar-denominated debts, such as the Canadian dollar, Australian dollar, Brazilian real, South African rand, Chilean peso and Malaysian ringgit. In addition, global geopolitical risks will rise in 2016; the Syrian crisis and other regional conflicts may generate great spillover effects, causing acute volatility in the foreign exchange market and heightened risk aversion.

### III. Stock markets will diverge at different levels

#### III.1 Global stock markets fluctuated wildly in 2015

In the first and second quarters of 2015, the stock markets in Europe and the United States went up steadily with decreasing volatility, thanks to favorable factors such as the slow recovery of the American economy, implementation of the QE policy in the Eurozone, and easing of the Greek debt crisis. The PE ratio of the S&P 500 Index rose all the way to 27, and the CBOE Volatility Index (VIX) remained below historical average levels. In the third quarter, European and the US stock markets all tumbled significantly with volatility surging, as a result of the anticipation for rate hikes by the Fed and economic slowdown worldwide. The monthly mean value of VIX rose up to 28.4, higher than its historical average of 17.8, thus entering the dangerous zone. In the fourth quarter, major stocks markets in Europe and the United States went up amid turmoil, owing to a faster recovery of the American economy (Figure 11).

The stock markets of emerging economies fluctuated more acutely in 2015. At the start of the year, the stock markets rose by around 13%; then plenty of capital flowed out of emerging markets due to the anticipation for rate hikes by the Fed (Figure 12). The stock indexes of emerging market dipped by around 27% from April to August and remained at the bottom amid volatility afterwards. The stock market volatility of emerging economies kept rising in 2015, near the level reached during the European debt crisis in 2011. In addition, the correlation of emerging markets dropped before rising while the equity return dispersion rose before declining, raising the systematic risks of emerging markets.

Figure 11: MSCI Global Index and VIX

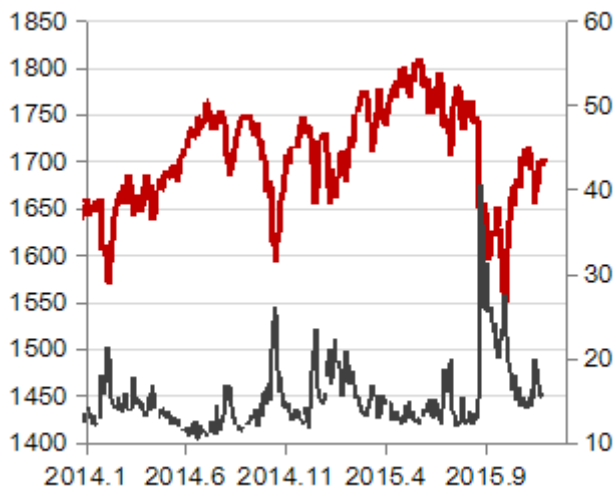
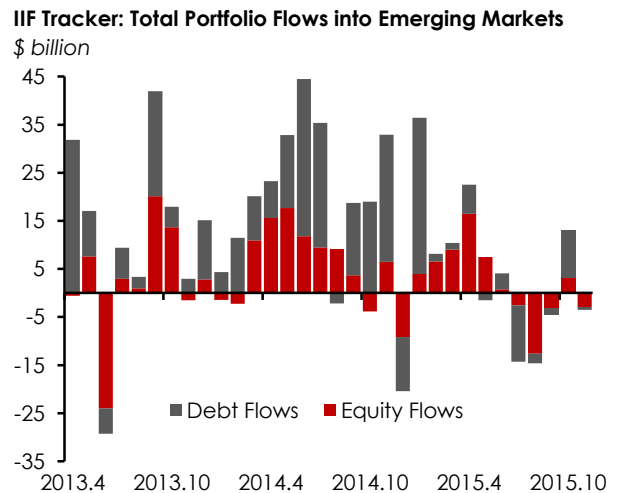


Figure 12: Short-term Capital Flows in Emerging Markets



Sources: Bloomberg, IIF, BOC Institute of International Finance

#### III.2 Global stock markets will diverge at different levels in 2016

The European and the US stock markets are expected to remain stable and rise moderately as a whole in 2016. The Fed's rate hikes will bring pressure on the US stock market in the short term. But the sustained recovery of the American economy, and the anticipation for more QE measures by the ECB and the Bank of Japan, among others, will prop up the European and US stock markets. Nevertheless, as the global security situation worsens, we do not rule out the possibility of "black swan events" occurring in these stock markets.

In 2016, the stock markets of emerging economies will continue to face grim challenges, and probably develop in different directions. After the rate-hike "boot" drops, the net capital outflow

speed of emerging economies may mitigate, but the reversal of global capital flows will continue, and international capital will keep flowing out of emerging markets to European and US markets. Emerging economies that have large amounts of foreign debts or that over-dependent on commodity exports such as Brazil and Argentina may be still caught in economic downturns, and their stock markets will continue with adjustment. Benefiting from good economic performance, the stock markets in the Asia-Pacific region may be the first to stabilize.

### **III.3 The impact of security situation on stock markets cannot be ignored**

The recent terrorist attack in Paris and the conflict between Russia and Turkey put the security situation in Europe into center stage. In addition to short-term shocks, the European security situation will exert long-term impact on global stock markets in three aspects. First, risk aversion mood rises all over the world; capital will evacuate from the markets of risky assets such as stocks and commodities and flow into safe-haven assets such as US dollars and gold. Second, the flare-up of the European refugee issue will intensify social conflicts and weaken the nascent economic recovery in the Eurozone. Third, the aggravation of geopolitical conflicts and terrorist attacks spreading worldwide will inhibit the development of international trade and investment, further undermine the world economy and impose persistent pressure on financial markets.

In the long run, the monetary policies of developed economies will remain in the spotlight across global stock markets. The Fed is likely to start a rate hike cycle from the end of 2015, but the central banks in the Eurozone, Japan, Canada and Australia will still implement loose monetary policies and provide liquidity and relatively low financing costs for emerging markets. Therefore, global liquidity will remain adequate, and capital will go after the stock markets of countries with sound economic structures.

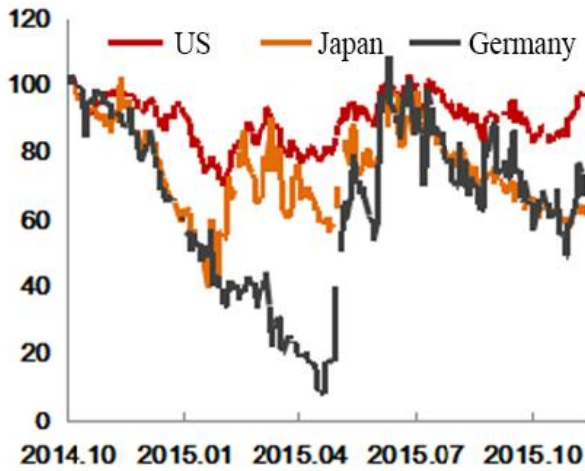
## **IV. Bond markets are likely to see yields on a rising trend**

### **IV.1 Global bond markets swung intensely in 2015**

The global sovereign bond market gyrated acutely in 2015. At the beginning of the year, most sovereign bonds worldwide terminated the trend of declining yields starting from the end of last year, with their yields rising amid volatility. But the yield of Germany's sovereign bonds, a benchmark in the continent, fell against the trend, hit the bottom on April 20 before climbing up rapidly and returned to the mainstream in mid-June. The second quarter of 2015 witnessed the yields of global bond markets scale new highs one by one. By the end of June, the highest yield of 10-year US treasuries reached 2.478%, up 48% in a period of four months. The highest yield of 10-year UK gilts once hit 2.188% in the year, up 64% over the lowest level. The yield of 10-year German bunds surged from a low of 0.077% to around 1%. The sell-off in the European bond markets has also spread to the Asia-Pacific region and some developing countries. The yield of 10-year Japanese government bonds increased by 160% during the year; and the yields of government bonds of Australia, Indonesia and Thailand, among others, all rose to varying degrees. Global bond markets saw a total of USD430 billion evaporation in this round of sell-offs.

In the second half of 2015, the yields of global bond markets decreased steadily, and picked up a bit at the end of the year. As global sovereign bonds fell steeply in 2015, only the Chinese bond market stayed relatively stable. The standard deviation of China's 10-year sovereign bond yield (year to date) was only 4.26, far lower than that of the sovereign bonds of developed countries which are long viewed as safe havens. The standard deviation of Germany's bond yield reached 43.29 (Table 2).

**Figure 13: 10-Year Government Bond Yields of the U.S., Germany and Japan**



**Table 2: 10-Year Government Bond Yields of Major Economies in 2015**

	Average (%)	Highest (%)	Lowest (%)	Standard Deviation (Index)
US	2.11	2.48	1.67	7.91
Germany	0.54	0.99	0.08	43.29
UK	1.82	2.19	1.33	10.79
China	0.37	0.53	0.21	19.02
Japan	3.46	3.72	3.01	4.26

Source: Thomson Reuters

**IV.2 Yields of global bond markets will decline slightly in the short term but rise in the long term**

So far, the adjustment of bond markets has basically come to an end. The yields of global bond markets gradually stabilized as of November 2015, and are expected to continue falling slightly in the short term. First, not one major central bank prepares to tighten monetary policy in the short run, so further massive sell-offs are unlikely. Second, commodity prices are too depressed to rebound; inflation expectations may fall again in the short term. Third, investors' risk aversion mood has risen after the terrorist attack in Paris, driving down the yields of European bond markets in the short term.

It is predicted that global bond markets will rise across the board as the US Fed tightens monetary policy in 2016. Rate hikes by the Fed will lift the yield of 10-year sovereign bonds to over 2.75%. The chance is slim that the ECB would terminate its asset purchase program in advance; under the QE policy, the spreads between 10-year German and 10-year US government bonds will widen further. On the precondition of stable economic growth, the Bank of England will follow the steps of the US Fed to raise interest rates and push up the yield of British sovereign bonds. Moreover, whether Britain will exit the EU will also impact the yields of its long-term government bonds: if it chooses to exit, its economic growth will be adversely affected, and the long-term government bonds will be seen as a safe haven.

**IV.3 Acute volatility of global bond markets is a normal process for discovering real value**

The root cause of the great fluctuation in 2015 was excessive underestimation of bond yields. First, the 10-year European sovereign bonds yielded lower steadily when the ECB implemented the monthly EUR60-billion bonds purchase plan in early 2015. Second, in mid-2015, commodity price falls and weak currencies of emerging economies resulted in impacts on the emerging financial markets. Weakness of such currencies brought inflation and debt pressures on emerging markets, and investors turned to purchase the sovereign bonds of developed economies, further pushing down long-term sovereign bond yields in developed regions.

The reasons for starting the value discovery process include: (1) The macro situation of developed economies' fundamentals is improving. Economic data in the Eurozone have shown signs of

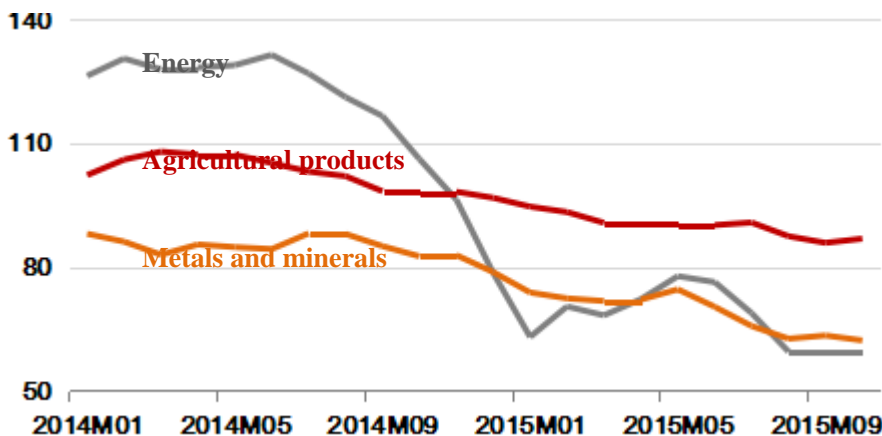
stabilization, and reminded the markets again of the ECB's tightening of monetary policy in the future. European bonds represented by German bunds were dumped as a result. (2) Commodity prices have rebounded after hitting the bottom, with deflationary risks lowered. The rally of oil prices has generated critical impact on inflation expectations in the Eurozone; bonds with a yield close to zero are no longer sought after in the markets, resulting in waves of sell-offs. (3) The US Fed once expressed that long-term US treasuries were over-priced. Global bond markets are under selling pressure at a faster speed; and sell-off mood has spread to Asia, with government bond yields in Japan, South Korea and India all rising substantially.

## V. Commodity markets remain sluggish

After a precipitous fall in commodity prices in the second half of 2014, the trend didn't stop in 2015 yet. As there was no obvious improvement on supply and demand fundamentals, the prices of energy, industrial metals and agricultural products almost dipped across the board in 2015, though the decrease rate was lower than 2014.

In the energy market, due to weak supply and demand fundamentals, geopolitical factors that used to push up oil prices failed to work in 2015. The military conflicts in Yemen and Syria were not enough to lift falling oil prices. The trading center of international oil prices has gradually lowered, with trading range gradually narrowing from USD40-70/barrel in the first half of the year to around USD40-50/barrel in the second half of the year. In the industrial metals market, the price of iron ore led the fall ahead of base metals. The economic slowdown in China, a major source of demand, made it insufficient to absorb the new capacity rushing into markets, so the prices of industrial metals were also on the decline. In the agricultural products market, the prices of most agricultural products fell under high-capacity and high-inventory pressures. But the prices of several products such as cocoa and refined sugar rose against the general market trend as a result of the El Nino effect.

**Figure 14: Price Index Performance of Different Commodity Markets**



Source: World Bank; Note: Supposing the price index in 2010 was 100 points

In 2016, global commodity markets will remain volatile and sluggish still. In terms of overall demand, the change in the economic development model and slower economic growth of China will curtail its need for commodities. India's new government is committed to becoming the new engine driving the growth of the world economy through reforms; but in light of its complex religious problems, low administrative efficiency of the government and other issues, it is not optimistic that it can replace China and become the new driver of increasing demand for commodities in the short term.

On the supply side, as the competition for oil market shares between OPEC countries and

non-OPEC countries represented by the United States and Russia still continues, and Iran also aims to start exporting crude oil in 2016, a high output situation is expected in crude oil markets next year. In the industrial metals market, the output of industrial metals will continue to rise in the short and medium term due to high input in earlier stages; some producing countries will maintain their output levels given the export advantages brought by currency depreciation and lower product costs. Therefore, most industrial metals markets will be still confronted with oversupply in 2016. On the other hand, low prices will phase out some high-cost capacity; the material decrease in capital expenditure for new capacity will prompt industrial metals markets to gradually return to equilibrium. In terms of agricultural product markets, it is essential to closely track the impact of weather conditions in major farming areas on actual output as different regions and agricultural products worldwide are subject to varied weather conditions. Moreover, energy prices will also affect agricultural product markets through cost factors and the demand for biological energy.

As regards the commodity market trend in 2016, it is necessary to pay close attention to the economic conditions of the United States, the Eurozone and major emerging economies, especially the economic growth trend of China, a major source of demand for commodities. In addition, the following events will also generate substantial effects: (1) The process of lifting the oil export ban on Iran. Based on current market expectations, the oil export ban on Iran is likely to be removed in the first half of 2016; then Iran will resume oil exports quickly to seize market shares lost previously. In the short term, Iran's 40 million-barrel offshore oil inventories will impact the market; in the long term, the country is vigorously bringing in foreign capital to invest in and develop oil resources. (2) The rate hike process of the US Fed. With the gradual recovery of the US economy and continued improvement in its job market, it has become inevitable for the Fed to raise interest rates. A stronger dollar will bring pressure on commodity prices denominated in the US dollar. (3) Development of the El Nino phenomenon. The latest weather forecasts show, the current degree of El Nino effects could be deemed one of the most serious in history. The development of El Nino usually causes drops in agricultural products output in some areas, and then price surges. It is estimated that this time El Nino effects will persist till the end of the first quarter of 2016.

### Part III Analysis of Hot Topics

#### I. TPP Agreement has been reached basically, triggering the formation of a new international economic order

TPP (i.e. *The Trans-Pacific Partnership Agreement*), is an expansion of the regional free trade agreement (FTA) signed by Singapore, New Zealand, Chile, and Brunei in 2005, which were aimed at promoting trade liberalization in the Asia-Pacific region. To safeguard its economic and political interests in Asia Pacific, the United States joined the TPP negotiations in September 2008, committed to making it a comprehensive and high-level free trade agreement in the 21<sup>st</sup> century. Then Australia, Peru, Malaysia, Vietnam, Mexico, Canada and Japan joined the negotiations successively. In October 2015, the trade ministers of the 12 countries issued a joint statement, announcing the reaching of TPP agreement after over 5 years of negotiations.

The *TPP* consists of 29 chapters in three major aspects: (i) TPP negotiations cover all the areas of the FTA negotiations, including not only trade in goods, but also trade in service, investment and technology; (ii) TPP negotiations involve not only tariff cuts and other measures in respect of national borders, but also non-tariff barriers, domestic provisions and other measures within national borders; (iii) TPP negotiations include non-traditional FTA clauses, such as clauses on labor and environment, and sensitive subjects about small and medium enterprises, state-owned enterprises and transparency. Compared with the traditional FTA, TPP has made breakthroughs in

four aspects:

**First, breaking the traditional FTA model and reaching a comprehensive free trade agreement without exception.** Compared with WTO, TPP has covered the existing treaties and rules of WTO, deepened such rules and added new topics, such as labor protection, state-owned enterprises, environmental protection and transparency.

**Second, stressing free and fair trade.** TPP stipulates that its members must formulate similar or compatible rules and standards to ensure the freedom and fairness of trade. On trade promotion, TPP is more thorough; 100% free trade can eradicate all kinds of disputes in international trade.

**Third, paying more attention to labor and environmental issues.** TPP is enclosed with two independent but binding documents: *Agreement on Environmental Protection* and *Memorandum on Labor Cooperation*, the areas that many FTAs try to avoid.

**Fourth, rigorous enforcement mechanism.** Compared with APEC and ASEAN 10+1, TPP has set more practical and specific objectives, and its solutions are more direct, down-to-earth and efficient. For example, the "investor-state dispute settlement mechanism" grants an investor the right to use dispute settlement proceedings against a foreign government for large compensations, without the courts of the host country involved.

**Going forward, TPP may lead to the formation of a new international economic order. On the one hand, TPP may become an expanding path for the Free Trade Area of the Asia-Pacific (FTAAP).** At present, 12 TPP members account for around 40% of the world's GDP; with their total population approaching 1.1 billion, TPP has become the regional FTA with the largest GDP size. Meanwhile, South Korea is working on joining the TPP as the 13<sup>th</sup> member. Realizing the FTAAP is a long-term object for countries in Asia Pacific. According to the estimation of Asian Development Bank, by 2025 FTAAP will raise the global income by around USD2 trillion, with GDP increasing by about 2%. The possible paths for realizing the FTAAP include the US-led TPP and the Regional Comprehensive Economic Partnership (RCEP) actively promoted by China. TPP centers on rules and regulations, whereas RCEP focuses on traditional issues; but the standards of TPP are higher than that of RCEP. So far, TPP has been reached basically, but there is no substantial progress on RCEP. In addition, the United States is intervening on all fronts in the integration process of East Asia through TPP so as to guarantee its geopolitical, economic and security interests, and contain China's influence.

**On the other hand, TPP will rewrite the standards and rules for international trade and investment.** The world trade rules after the WWII were made by the United States and European powers through the WTO system. With the rise of BRICS countries and other emerging economies in recent years, emerging market economies are gaining an increasing right of speech and greater say under the original WTO framework. Given that the WTO decision-making mechanism is based on the principle of consensus, developed economies cannot obtain more trade benefits through WTO's multilateral trade system. The reason why the Doha Round negotiations stalled for years is that China and India, among others, could not reach consensus with the United States. Therefore, developed economies want to rewrite the rules and standards for international trade and investment and force emerging market economies to open up further, thereby reaping more benefits themselves. After the basic agreement on TPP was reached, the United States attempts to attract more countries to join in to form an international FTA arrangement, which will finally replace WTO and become a new multilateral trade system.

Of course, it still takes some time for the TPP to be officially signed. The existing member states still need to obtain the approval of their top leaderships and parliaments. Whether they can pass the agreement still depends on various procedural and political conditions; so it cannot take effect in

the short term. Judging by the contents of the agreement, that free trade rules be implemented among TPP members alone cannot be achieved overnight. Take the "zero tariff" rule for example, half of the 12 member states are emerging market economies, making it impossible to realize zero tariff immediately. Judging by the provision that "the United States will eliminate the 2.5% import tariff on Japanese automobiles within 25 years", it is evident that there is still a long way to go before the realization of zero tariffs.

## **II. First rate hike by the US Fed in ten years and its implications**

Starting from the second quarter of 2015, the US Fed mentioned it would proceed with the second item on agenda after exiting from QE – terminating the zero-rate policy, when talking about the "normalization" of narrow monetary policy. The US Federal Open Market Committee (FOMC) hinted at a regular meeting that the time of the first rate hikes by the Fed would depend on the then and anticipated US job market conditions and the evaluation result of the 2% inflation target, and various types of information possessed by the Fed on the development of financial and international markets. The turbulence of international financial markets in August 2015 unexpectedly put off the Fed's agenda of monetary policy normalization. After the FOMC meeting in September, the latest events taking place in the political sphere, macro economy and markets all pointed to the certainty of the first rate hikes by the Fed in mid-December.

**First, the attitudes of Fed officials with decision-making power.** In recent months, the hawks and doves in the Fed staged public confrontations in the media. Lately, the core camp headed by Fed Chair Janet Yellen, Vice Chairman Stanley Fischer and New York Federal Reserve Bank President William Dudley gained the upper hand – they all explicitly expressed their expectation for the first rate hikes by the Fed at the end of 2015. The memorandum of the October FOMC meeting showed the Fed was well prepared for rate hikes by the end of the year.

**Second, global financial markets have basically resumed stability and even shown signs of rebound.** The US dollar index once went weak as interest rate policies remained unchanged in September, which channeled capital into emerging markets, but rallied strongly till the Fed repeatedly implied rate hikes at the end of the year. Then global risky asset markets tended to stabilize obviously.

**Third, domestic consumer demand was strong and inflation expectations rose in the United States.** In the third quarter, the US GDP grew at a rate of 1.5%, appearing a little weak. But in terms of its composition, domestic consumption increased robustly by 3.2%. Meanwhile, non-farm payrolls in October were quite strong, with the number of new jobs far higher than market expectation, and the unemployment rate dropping to 5%; broad unemployment rate was 9% and labor wage per hour rose by 2.5%, which undoubtedly assuaged deflationary expectations.

**Fourth, credit (business and consumer credit) of the US commercial banking industry increased moderately.**

Generally speaking, the force in support of rate hikes by the Fed and normalization of interest rates prevailed. We expect the Fed will raise interest rates by 0.25% at the FOMC meeting in December. Currently, the US federal funds rate futures market shows a 70% or so rate hike probability. If any small-probability event of the remaining 30% occurs, the reason could be: surprisingly worse non-farm payrolls data for November, financial market conditions such as an abnormally surging dollar index and plunges across global stock markets, extremely weak holiday spending at the end of the year, or considerable recession of the services sector, among others.

**Rate hike paths of the Fed in the coming two years.** Given the current conditions of and expectations for the US job market and inflation, markets' conservative estimation about America's long-term labor productivity and future population growth, and domestic demand characteristics of

its current economic structure, we are of the opinion that the US economy will maintain the momentum of moderate growth in 2016-2017, and the Fed will proceed with the normalization of its monetary policy at a slow pace. According to the futures market data for November 2015, the probability of rate hikes at the next five FOMC meetings is 70% (December 2015), 64% (January 2016), 49% (March 2016), 42% (April 2016) and 31% (June 2016). 2016 will witness the economies in other regions of the world gradually bottom out or recover, with America's rate hike speed not too radical. When the economies in the Eurozone and of China gradually stabilize or even rebound in 2017, the divergence of global monetary policies will decrease; the frequency of rate hikes may be higher than 2016; and the federal funds rate is expected to reach 3% or so by the end of 2017.

The Fed's rate hikes bring both pros and cons to the US economy: firstly, with higher expectations for short-term interest rate increases, short-term, medium-term and long-term market rates will respond in advance by rising, with the yield curve steepening and capital costs at risk of increasing in all aspects. But that may also drive rising demand in the housing mortgage market and the growth of the US real estate market. Secondly, the super-low interest rate regime since 2008 has spawned lots of abnormal profit-seeking mechanisms in the US financial market, causing surging risks in many areas. The activation of currency normalization will make such distortions return normalcy, and disrupt irregular profit-seeking mechanisms. Thirdly, the Fed's rate hikes may affect the income redistribution process. The transfer of income and resources from debtors to creditors will favor individual/institutional savers or fixed income earners, and promote long-term investment and economic growth. Rate hikes will also exert impact on the finance of the US government as higher interest rates will increase the debt servicing costs of the government. Last but not least, rate hikes with inflation still at a low level will further suppress inflation, and impose higher pressure on the appreciation of the US dollar, bringing certain negative impact on US exports.

As for global markets, the formal start of a rate hike cycle by the Fed will have significant influence on the rest of the world, especially emerging market economies which have borrowed heavily in US dollars; commodity exporting countries will even face dual pressures as a result. But for most emerging economies, global financial markets will absorb some of the impact by way of fluctuations prior to rate hikes, as the subject of monetary policy normalization or rate hikes of the US Fed has been discussed for a long time, and the rhythm of this rate hike cycle is projected to be extremely slow.

Moreover, it should be noted that as an increasing number of foreign debts of emerging market economies are denominated in local currencies, and the maturity mismatch between assets and liabilities is far lower than that in the crisis 20 years ago, the late-coming rate hikes may negatively affect emerging economies by causing foreign capital outflows, but the impact on non-commodity exporting countries could be put under control. In addition, many emerging market economies have adopted prudent monetary policies or proactively managed their inflation targets, which can fend off the impact of increases in interest rates.

But we should also be mindful that when the Fed tightens monetary policy and raises interest rates, the Eurozone, Japan and China are still mired in economic downturns and hence need to maintain ultra loose monetary policies. Such policy-based differences may heighten speculation and volatility in international foreign exchange markets and possibly cause new risks of imbalance. As history has shown, there is usually a time lag (about six months or so) for rate hikes by the US Fed to generate effects on the real economy. If the Fed raises interest rates by 25 basis points in December, the resulting impact on markets should be controllable.

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