Global Economic Outlook 2014

“Looking Beyond Taper”

ICICI Bank Global Markets

Key themes in the global economy

Fed reverses easy policy-The road ahead

Improving US macro fundamentals led to reversal in policy stance
Fed policy reversal to weigh on EM capital flows

EM growth to face structural hurdles

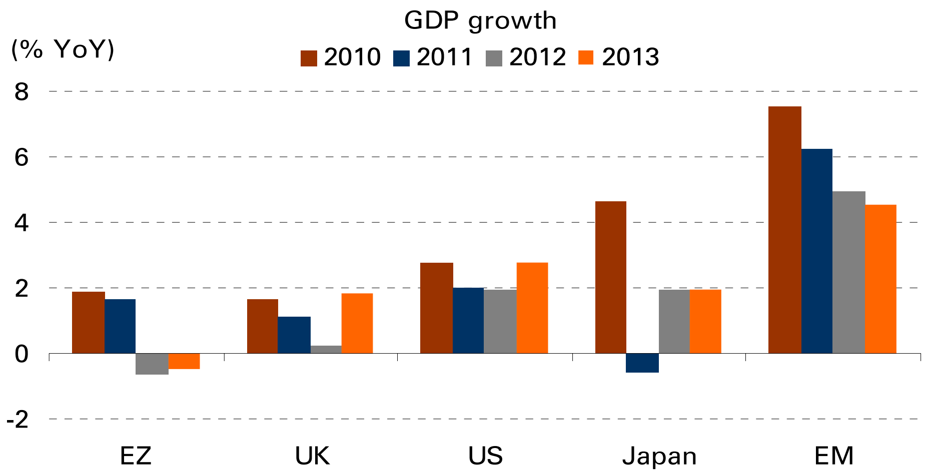
EM trend growth has slowed sharply amid structural issues
Reform gap needs to be bridged for return to high growth

Are “Trade Imbalances” a theme of the past?

Imbalances have narrowed while some nations yet to witness correction
Sharp pickup in GDP growth could pose a risk to recent improvement

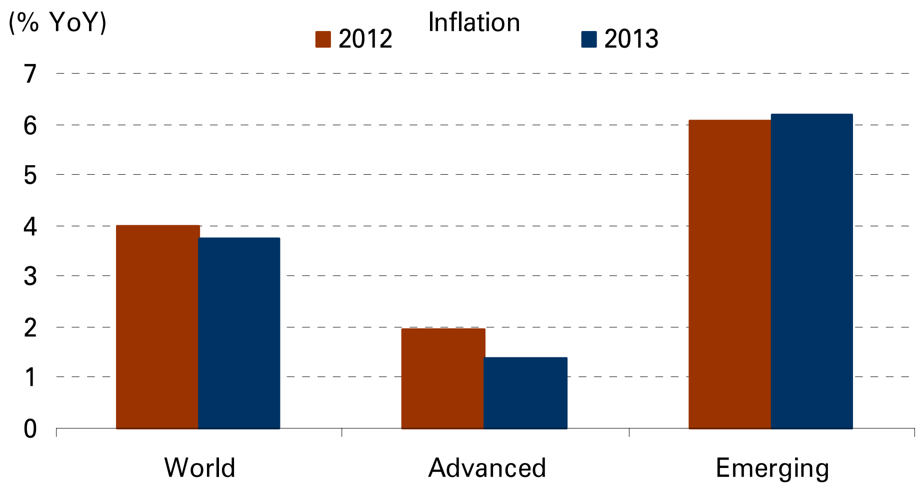
Year Gone By: DM and EM economies diverged in 2013

Advanced economies' growth improved in 2013 while EMs slowed



EZ- Eurozone; DM- Developed Markets; EM- Emerging Markets
Source: International Monetary Fund (IMF), ICICI Bank Research

However, inflation concerns worsened in EM economies…



Source: IMF, ICICI Bank Research

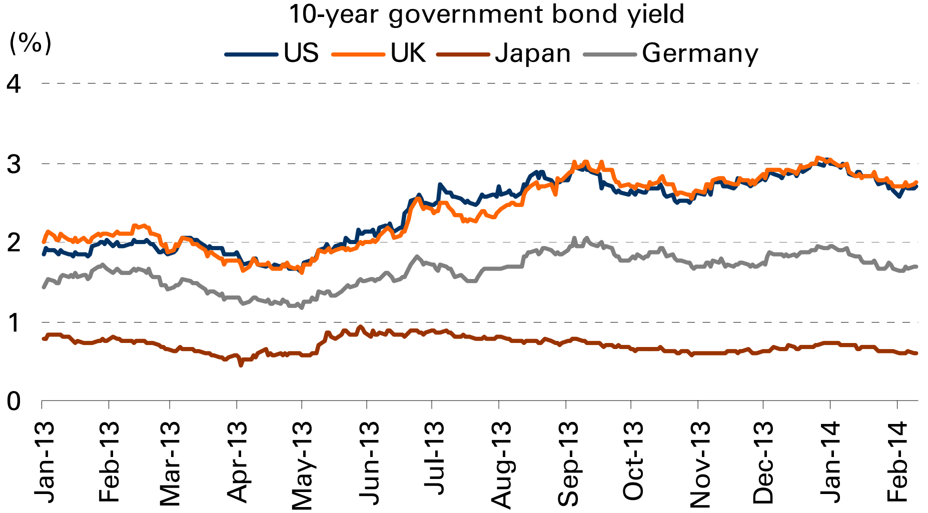
…thereby prompting some EM Central Banks to hike interest rates to check inflation; on the other hand most DMs maintained easy policy

Policy action by global Central Banks (2013)			
Developed markets			
United States	Started tapering of quantitative easing program	Eurozone	Reduced policy rate by 50 bps to 0.25%.
United Kingdom	Maintained asset purchase program at GBP 375 bn and policy rate at 0.5%	Japan	Changed monetary policy framework to target monetary base from overnight rate.
Emerging markets			
Indonesia	Raised policy rate by 175 bps	Brazil	Raised policy rate by 325 bps
South Africa	No change in policy rate	Turkey	Raised policy rate by 125 bps
India	Sharp reversal in policy stance. 75 bps repo rate cut till May-2013 followed by 50 bps hike in repo rate in H2-2013. Also, interest rate defense implemented to curb FX volatility.		

Source: ICICI Bank Research

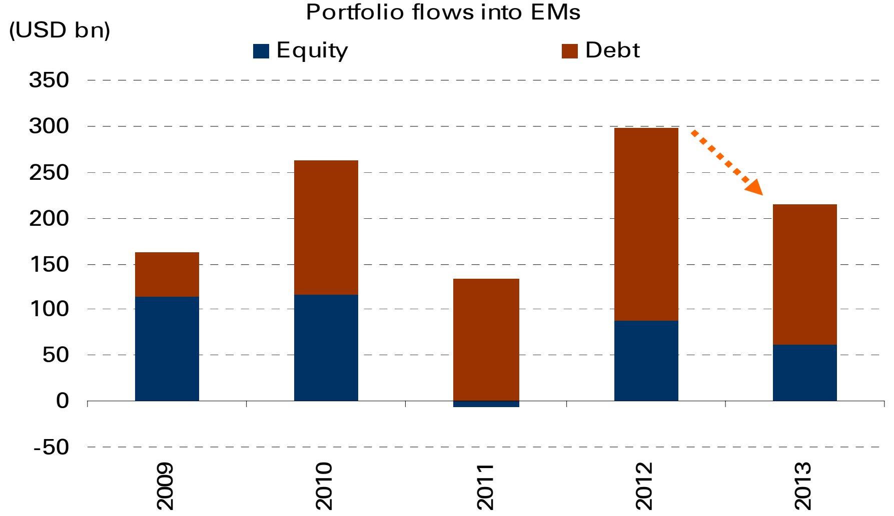
Financial markets witnessed increased volatility on Fed tapering

Rates are rising across the board…



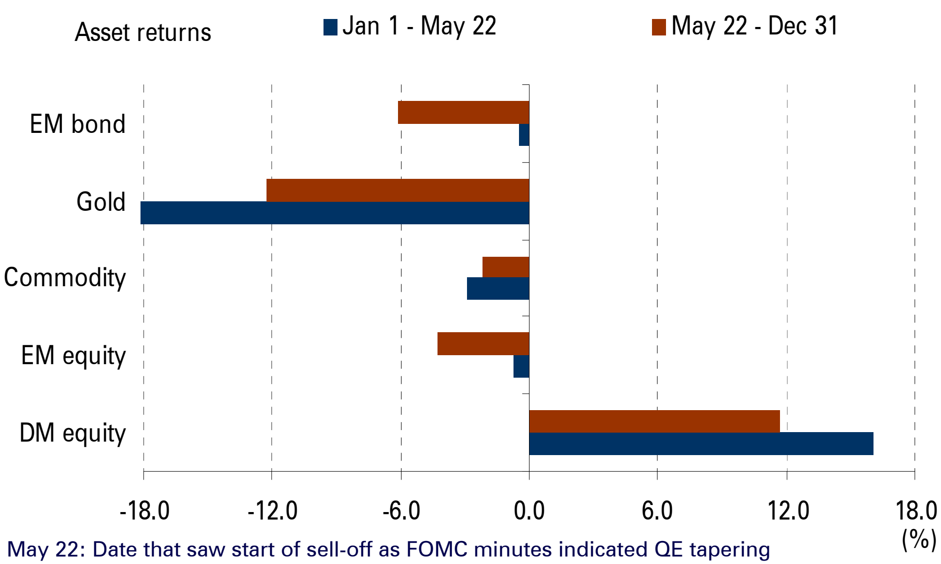
Source: Bloomberg, ICICI Bank Research

…and EMs have witnessed sell-off from foreign investors



Source: IIF, ICICI Bank Research

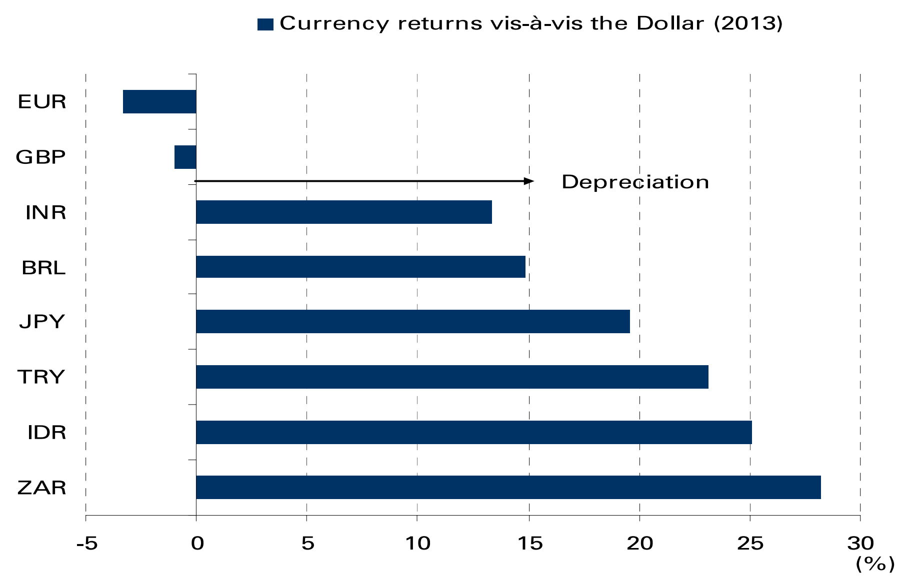
DM equities benefitted the most; gold lost its sheen



May 22: Date that saw start of sell-off as FOMC minutes indicated QE tapering

Source: Bloomberg, ICICI Bank Research

US Dollar strengthened against major EM currencies



Source: Bloomberg, ICICI Bank Research

Fed reverses easy policy-The road ahead

Major Central Banks infused liquidity post global financial crisis

Real interest rates moved into the negative territory in DMs
EM economies witnessed massive capital inflows

Improving US macro fundamentals led to reversal in policy stance

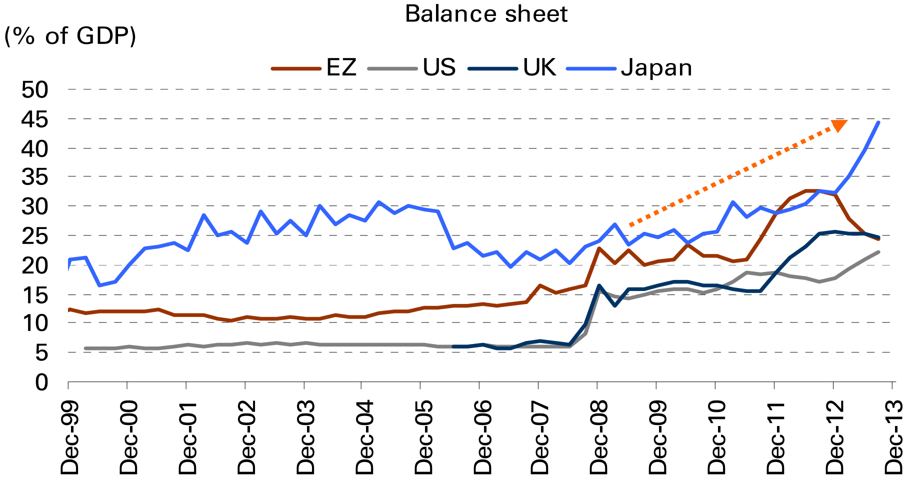
US recovery outpaces other DMs, though it remains modest
Fed to reverse the easy monetary policy stance very gradually

Fed policy reversal to weigh on EM capital flows

Impact could be partially offset by sharp pickup (if any) in EM growth

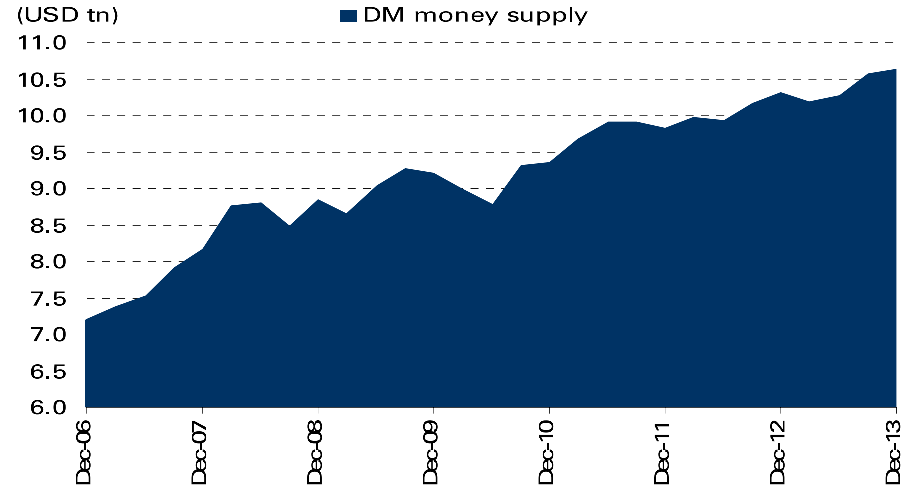
DM Central Banks' easy monetary stance led to drop in interest rates

DM Central Banks inflated balance sheets in response to the crisis…



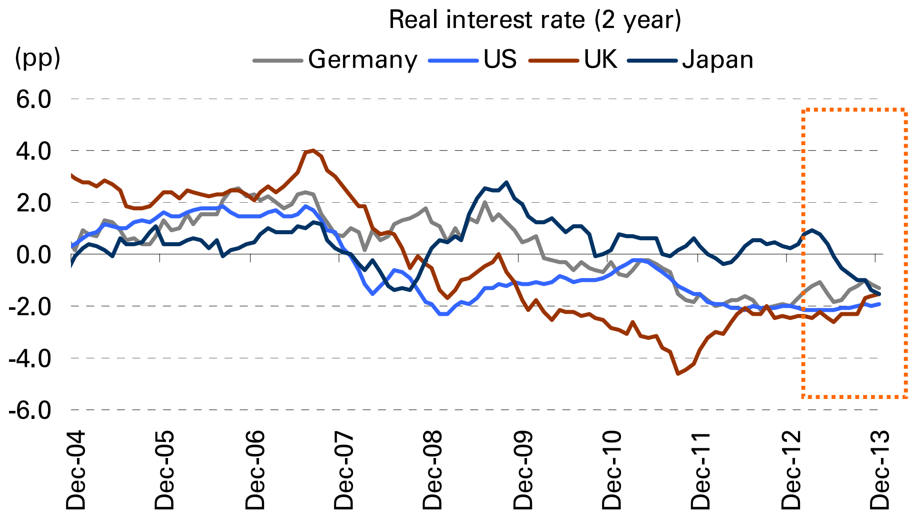
Source: Bloomberg, ICICI Bank Research

…which led to a sharp rise in DM's broad money supply



Source: Bloomberg, ICICI Bank Research
DM consists of US, EZ, UK and Japan

Consequently, real interest rates moved into negative territory…



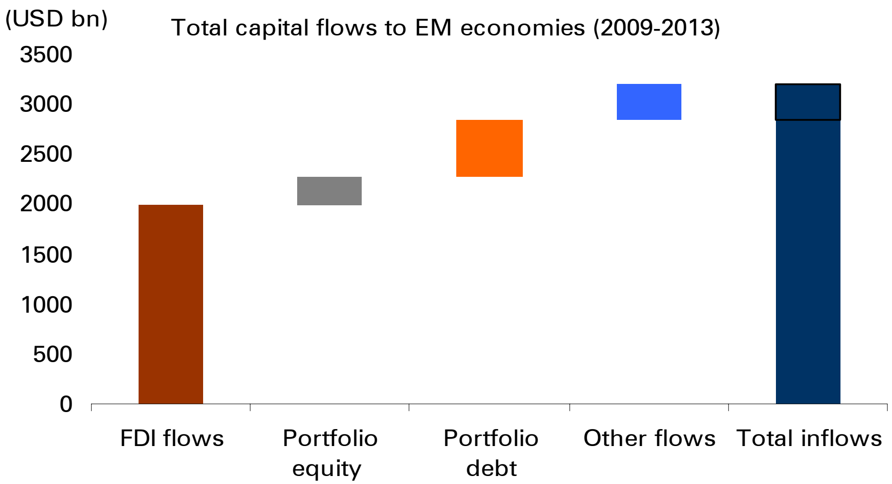
Source: Bloomberg, ICICI Bank Research

…which helped mitigate the impact of global financial crisis

- In response to the global credit crisis of 2008-09 and the subsequent Eurozone debt crisis, DM Central Banks injected ample liquidity in the global financial markets. As a result, their balance sheets increased significantly, which led to a jump in money supply measures.
- This, in turn, resulted in a sharp drop in interest rates. In fact, real interest rates went into negative territory.
- All these measures to ease monetary policy by major central banks in DMs helped reduce the severe effect of the Global Financial Crisis (GFC).

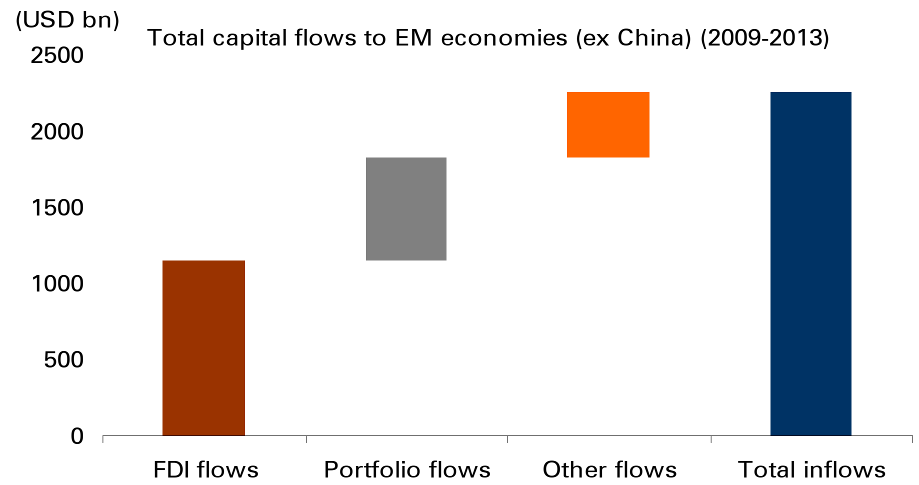
EM economies witnessed significant capital inflows

EMs witnessed significant capital inflows in recent years…



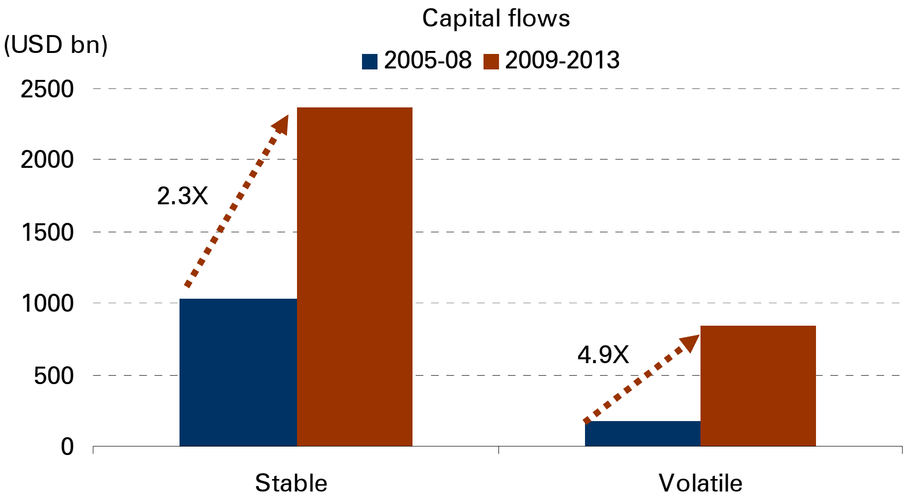
Source: Institute of International Finance (IIF), ICICI Bank Research

…with stable flows accounting for a major share of total flows



Source: IIF, ICICI Bank Research

However, volatile component saw relatively higher growth…



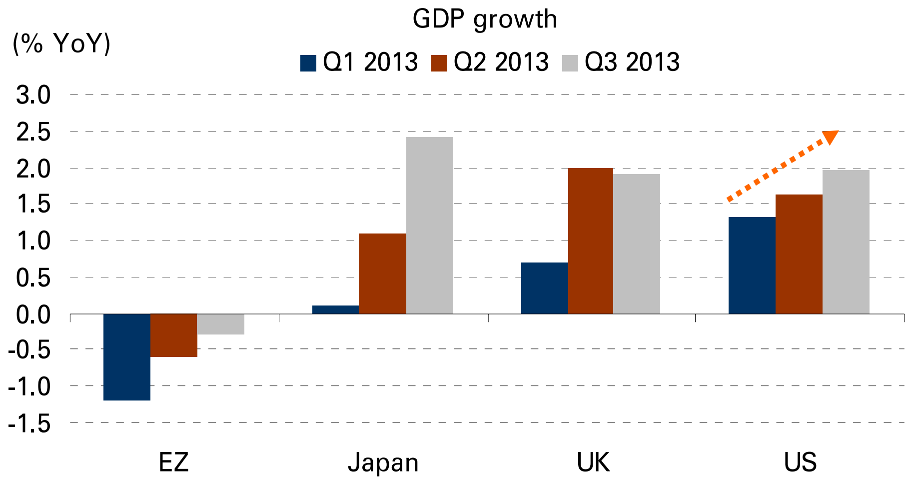
Source: IIF, ICICI Bank Research
Stable flows includes FDI and other capital (i.e. ECB and loans)
Volatile flows include portfolio flows

…thereby leading to increased vulnerability for EM economies

- EM economies witnessed significant capital inflows as DMs embarked on easy monetary policy. As per the IIF data, EMs received inflows to the tune of USD 3 tn during the 2009-2013 period.
- Stable flows (FDI, loans, ECB, etc) accounted for ~70% of the total flows to the EMs. Though the size of volatile flows (i.e. portfolio flows) are smaller as compared to stable flows, they have increased ~5 times during the period.
- Increased contribution of the volatile component creates higher external sector vulnerability for EMs in general and for current account deficit economies in particular.

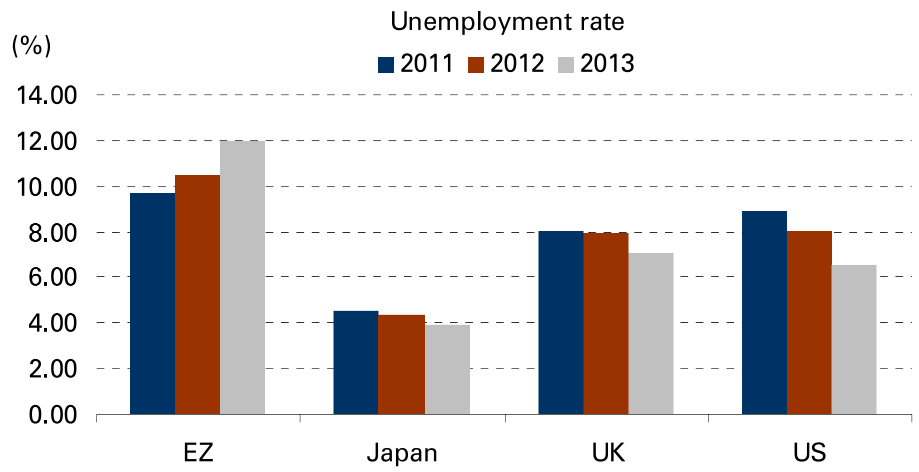
US leading other DMs in terms of economic recovery

Growth reviving in US, though remains subdued in other DMs



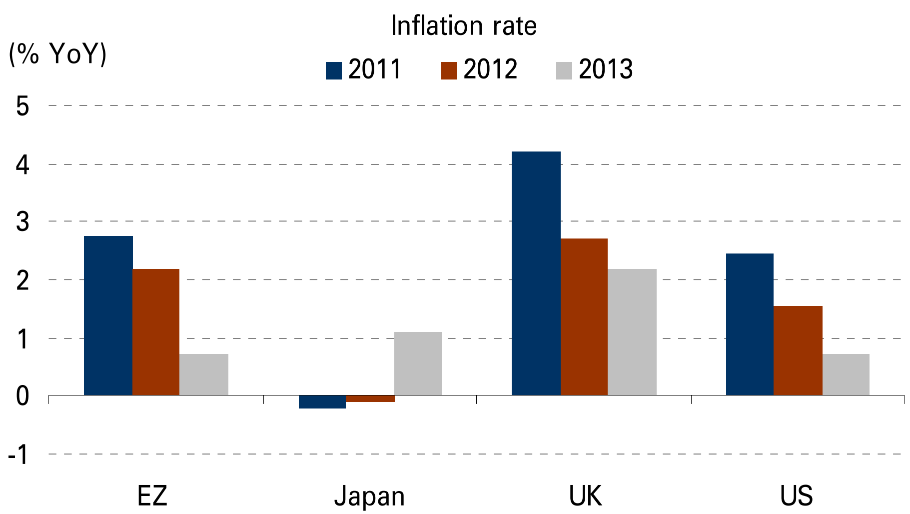
Source: CEIC, Bloomberg, ICICI Bank Research

US has registered a sharper fall in unemployment relative to others



Source: CEIC, ICICI Bank Research

Inflationary pressures remain muted in all major DM economies



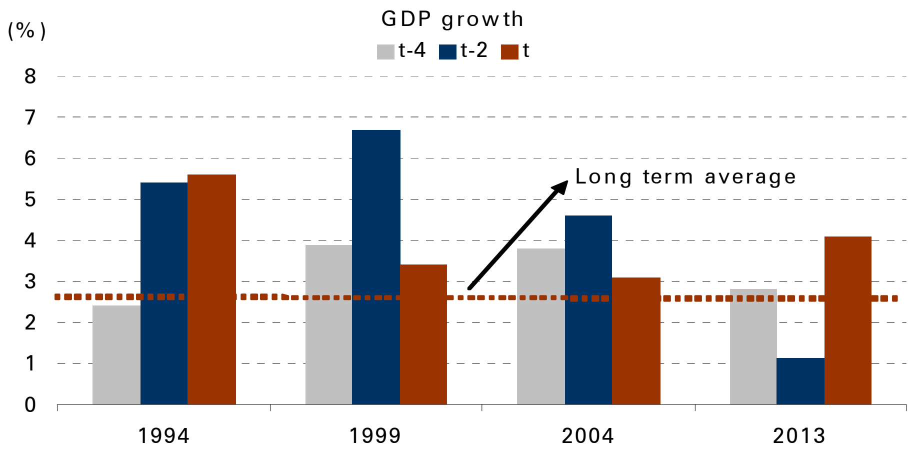
Source: CEIC, ICICI Bank Research

Fed tapers while other DM Central Banks remain accommodative

- US registered substantial GDP growth in 2013. Meanwhile, other DMs have witnessed lower and volatile growth.
- Barring EZ, labour market conditions have improved in all other economies, but US has witnessed a sharper decline in the unemployment rate.
- Low inflation is a key concern for DM economies.
- US Fed has embarked on tapering, while other major Central Banks are likely to maintain an accommodative monetary policy stance.

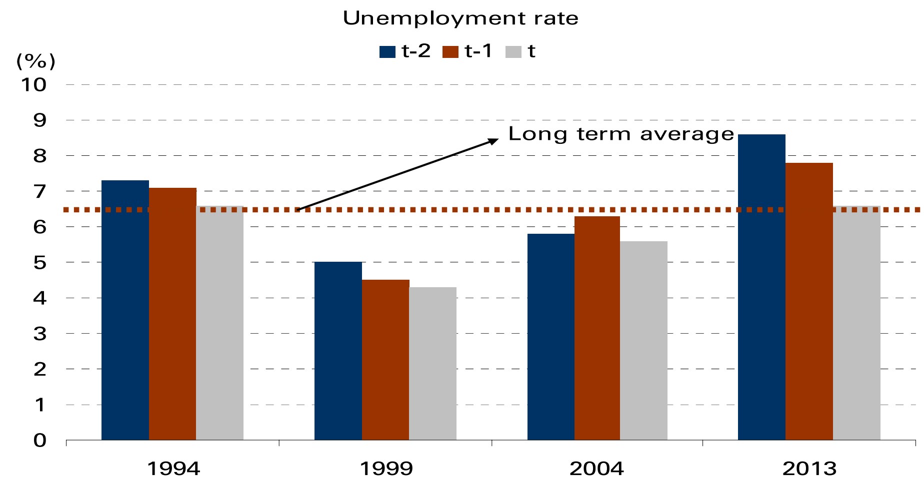
Lower US inflation vis-à-vis prior tightening cycles…

Historically, policy tightening motivated by above average growth…



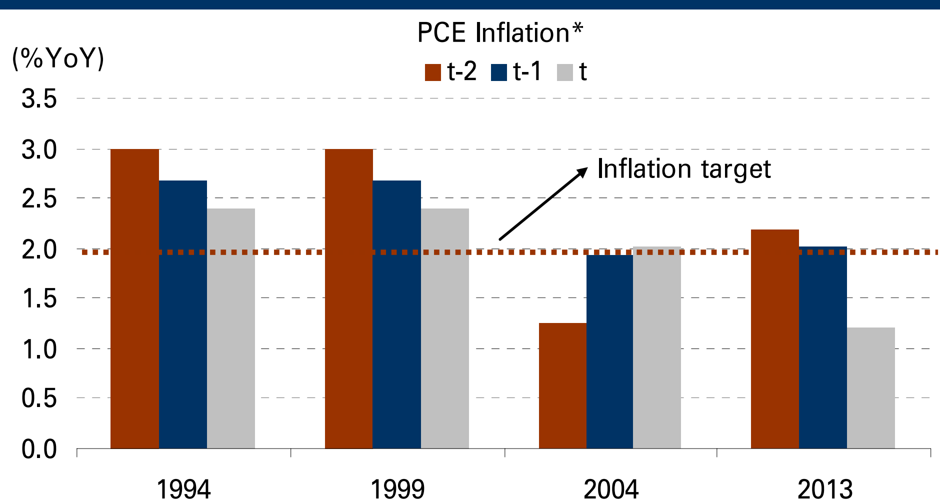
Source: IMF, ICICI Bank Research
t is Q1-1994/Q2-1999/Q2-2004/Q2-2013; t-2 and t-4 are 2 and 4 quarters away

…and unemployment rate lower than long term average…



Source: IMF, ICICI Bank Research
t-1 and t-2 are one and two years prior data

…along with inflation above the 2% target



* PCE inflation is private consumption expenditure inflation

Source: Bloomberg, ICICI Bank Research
t is annual average for inflation; t-1 and t-2 are one and two years prior data

However, lower inflation this time points towards gradual tapering

- Though GDP growth has improved recently, volatility in the growth is a cause of concern.
- Although the unemployment rate witnessed sharp improvement in 2013, inflationary pressures remain weak as compared to the previous cycles.
- All the conditions point towards a very gradual reversal in easy policy stance of the last few years.
- A sharp improvement in macroeconomic fundamentals will be crucial for aggressive tightening.

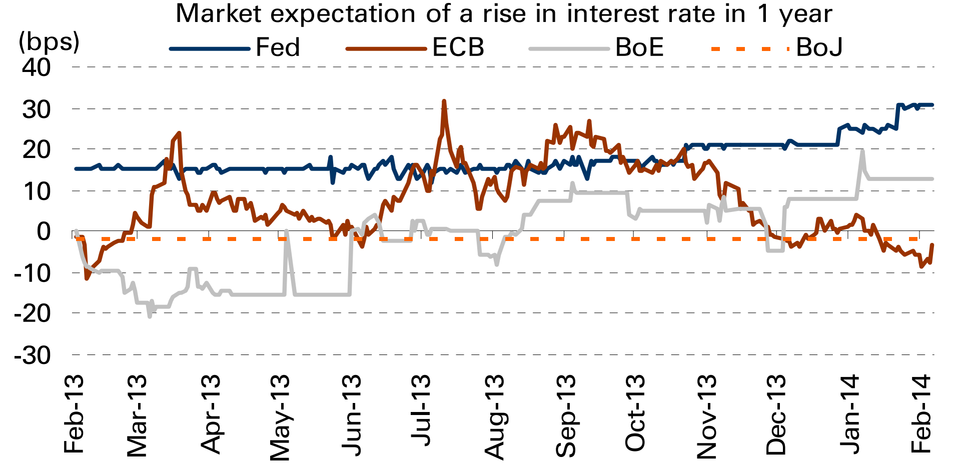
...yields case for gradual Fed exit strategy

Tentative time line of Fed Exit strategy

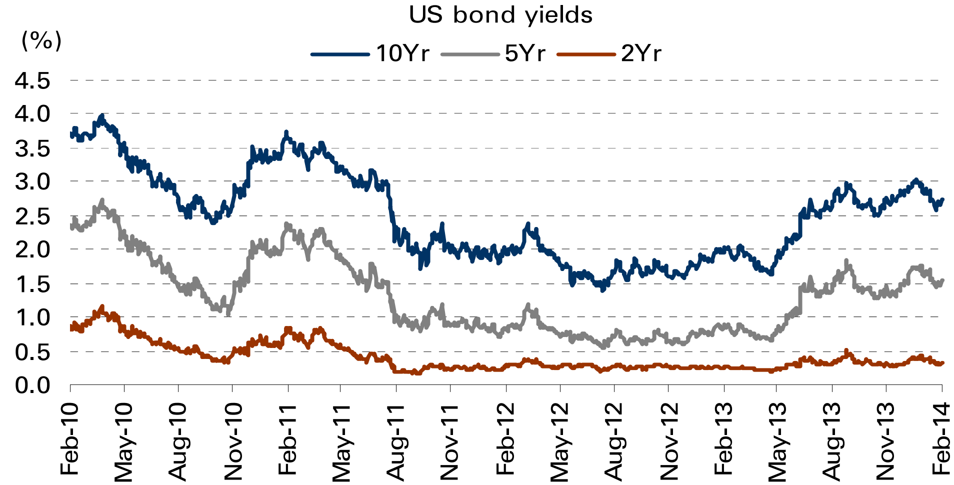
Time	Stance	Policy milestone
Jan'2013-Dec'2013	Easing	Purchase USD 85bn/month;MBS-USD40bn/month and Treasury-USD45bn/month
Jan'2014-Oct'2014	Easing	Gradually reduce purchases, in increment of USD 10 bn
Q4'2014-Q1'2015	On hold	Discontinue asset purchase; Policy rate on hold
Q1'2015-Q2'2015	Tightening	Stop reinvesting maturing MBS and Treasuries
Q2'2015-Q3'2015	Tightening	Begin raising Fed funds rate
Dec'2015	Tightening	Fed funds rate at 0.75% by year end 2015
Dec'2016	Tightening	Fed funds rate at 1.75% by year end 2016

Source: ICICI Bank Research

Market expects divergence in DM policy stance...



...though US rates are likely to rise very gradually



Source: Bloomberg, ICICI Bank Research

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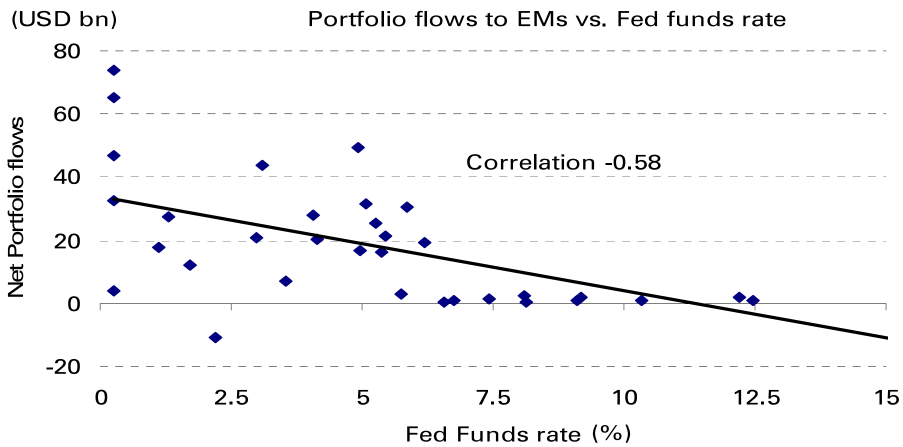
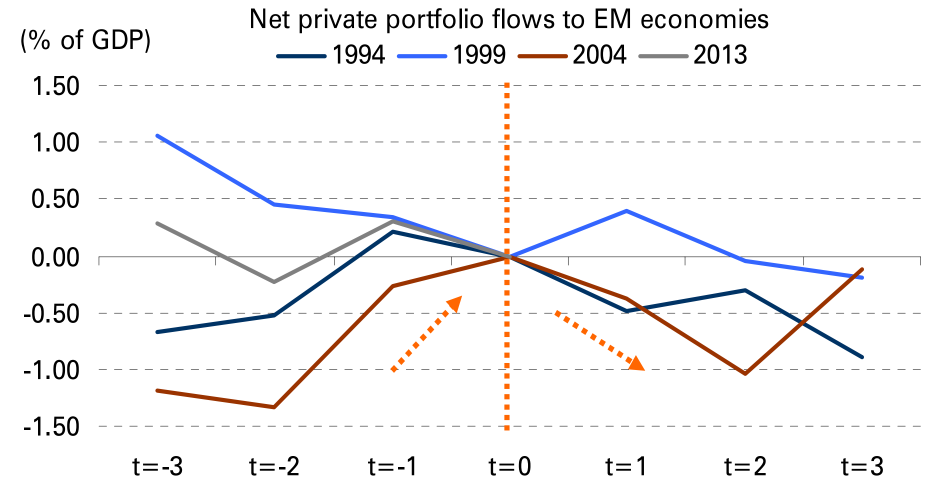
End of ultra easy monetary policy to weigh on EM capital flows

Inverse correlation between EM capital flows and Fed funds rate



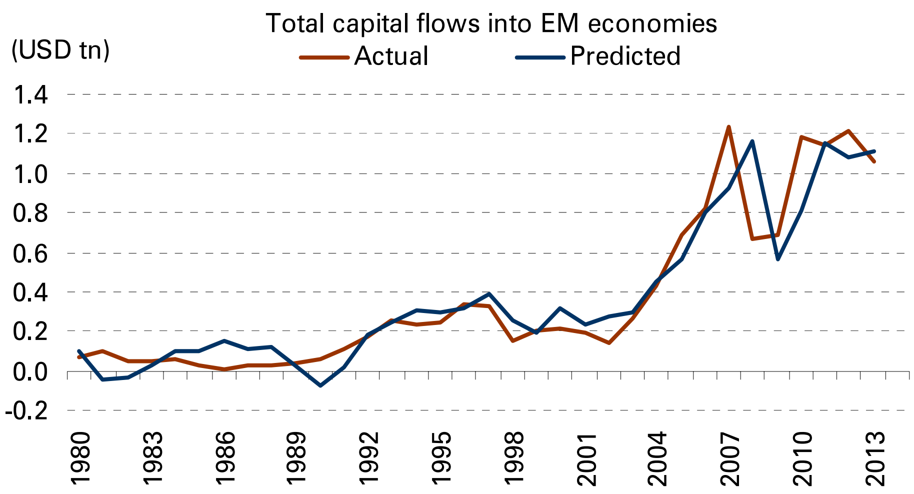
Source: IMF, ICICI Bank Research
EM economies: Brazil, China, India, Indonesia, Malaysia, Mexico, Philippines, South Africa and Thailand; Time period-1980/2013

In two of last three tightening cycles, EM capital flows slowed down



Source: IMF, ICICI Bank Research

Portfolio flows also respond to the EM growth prospects



Source: IMF, ICICI Bank Research
Net portfolio flows (t) = 0.53*net portfolio flows (t-1)+ 2.91*EM GDP (t) -1.26*US 10-year bond yield (t)

EM capital flows to slow down in 2014

- Our model shows total portfolio flows into EMs are a significant function of lagged (net) portfolio flows, US 10-year interest rate and EMs GDP.
- While EM capital flows are positively related with their GDP growth, they have an inverse relation with interest rates in the US. Thus, a decline in flows on the back of rise in US interest rate could be offset by a pick up in EM growth.
- Assuming that this year, EMs grow at the same pace as in 2013 and US 10-year yield climbs to 4.0%, capital flows in EMs could fall by USD 95 bn.

EM growth to face structural hurdles

Trend growth in emerging markets has slowed sharply

Components of aggregate demand such as consumption, investment, external sector and government finances show signs of deterioration

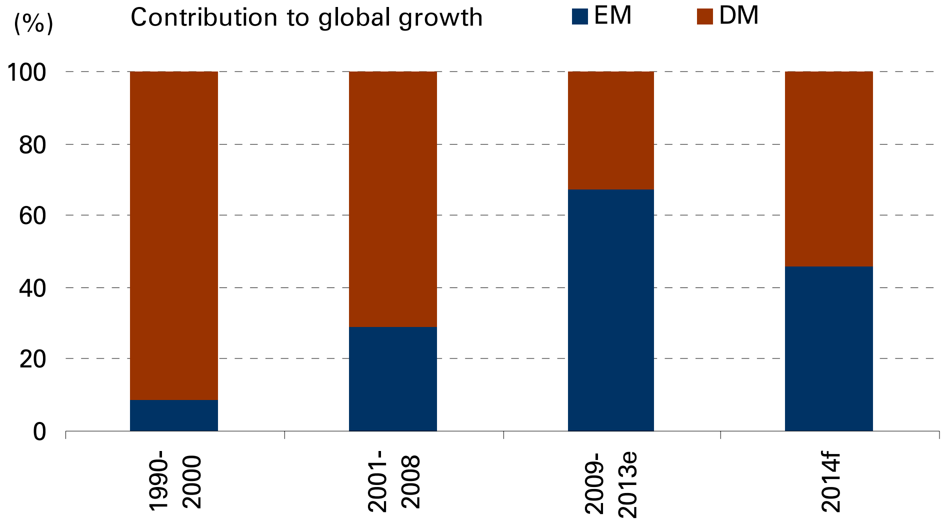
Reform gap needs to be bridged for return to high growth

Capital inefficiency, falling external surplus, lack of reforms along with drop in labour productivity to cause protracted slowdown

Vulnerable EMs at the cusp of political transition in 2014

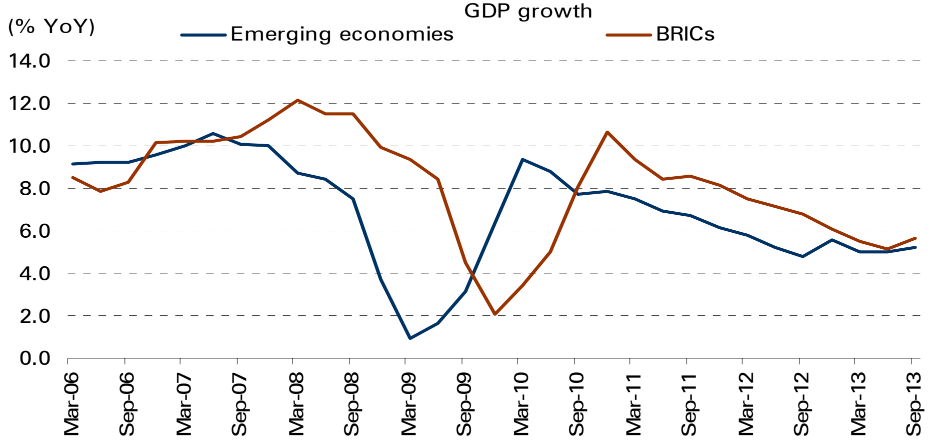
EM growth pick-up to be muted this year

Contribution of EMs to global growth is likely to fall in 2014



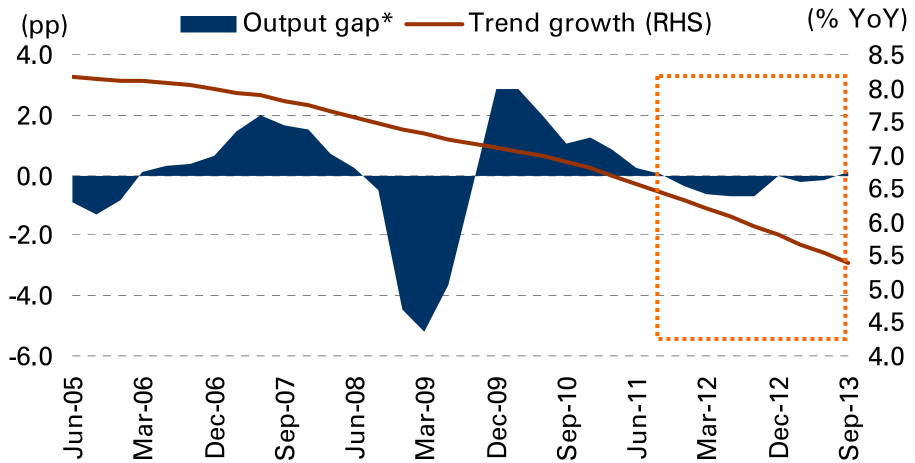
Source: IMF, ICICI Bank Research

Most emerging economies including BRICs have seen sharp decline



Source: Bloomberg, ICICI Bank Research
Emerging economies used in our analysis include Brazil, India, Russia, China, Indonesia, Thailand, Philippines, Malaysia, Mexico, Argentina, South Africa, Chile and Czech Republic

Trend growth has declined sharply in the past few years…



* Using HP-filter

Source: Bloomberg, ICICI Bank Research
All data on EMs are calculated using GDP-based weights

…leading to concerns of a possible structural slowdown in EMs

- EM economies contributed significantly to world growth over the past decade. However, in wake of the recent slowdown, its contribution is likely to decline going ahead.
- The slowdown in growth has also led to a sharp deceleration in trend output in the region.
- The BRICs growth story is also showing signs of faltering.
- In what follows, we investigate whether the EM region is undergoing a structural or a cyclical slowdown.

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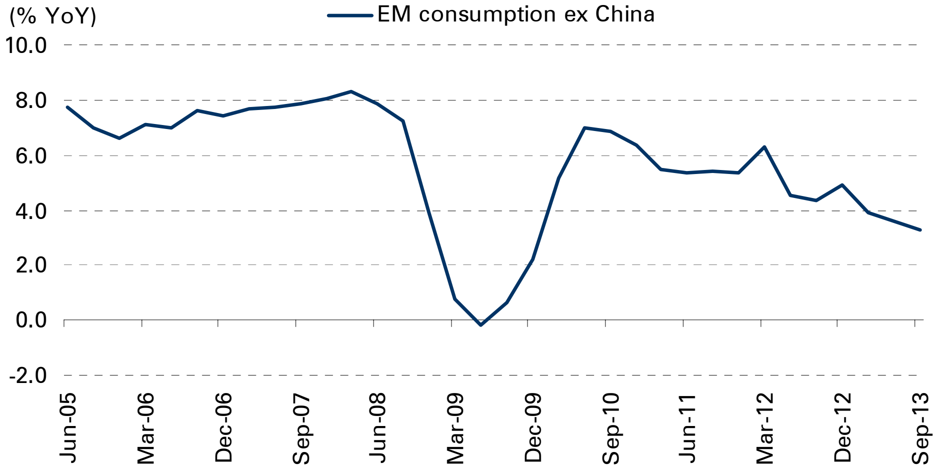
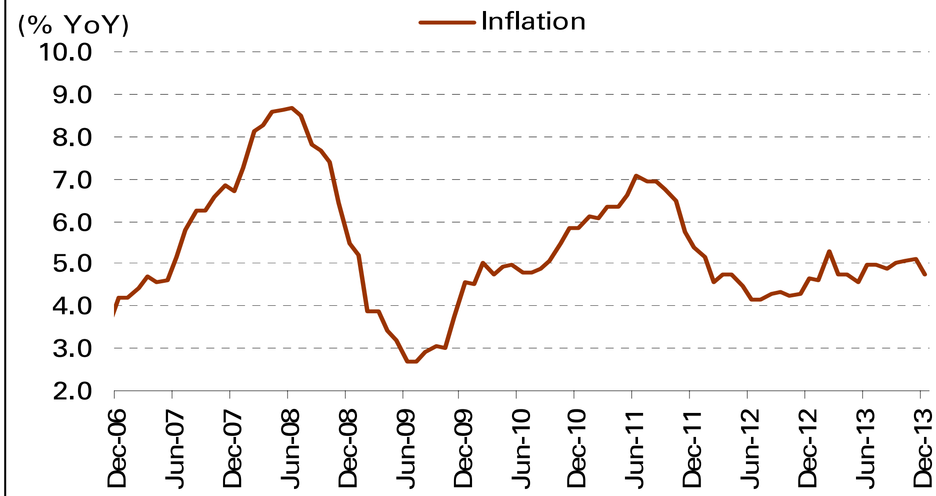
Weak consumption demand weighing on EM growth

EM private consumption demand has weakened…



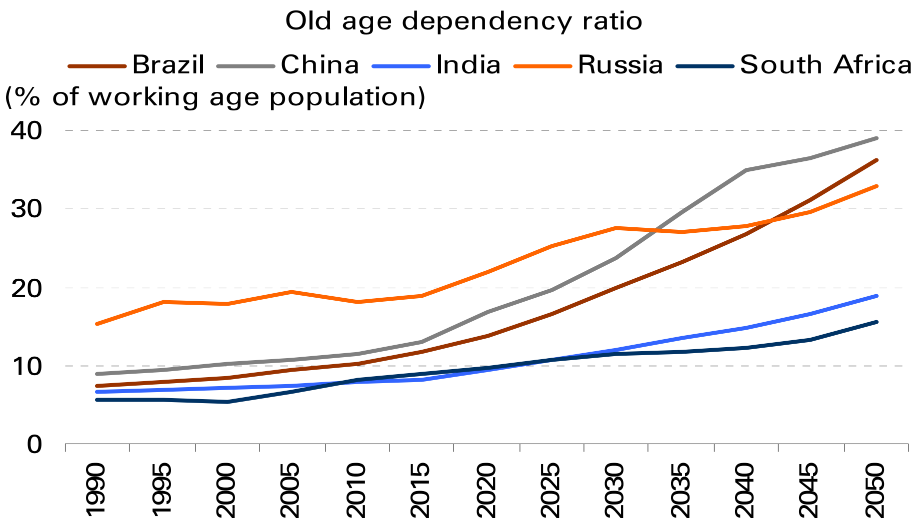
Source: Bloomberg, ICICI Bank Research
Emerging economies used in our analysis include Brazil, India, Russia, Indonesia, Thailand, Philippines, Malaysia, Mexico, South Africa, Chile and Czech Republic

…amid elevated inflation levels



Source: CEIC, ICICI Bank Research

Unfavourable demographics to weigh on long term prospects



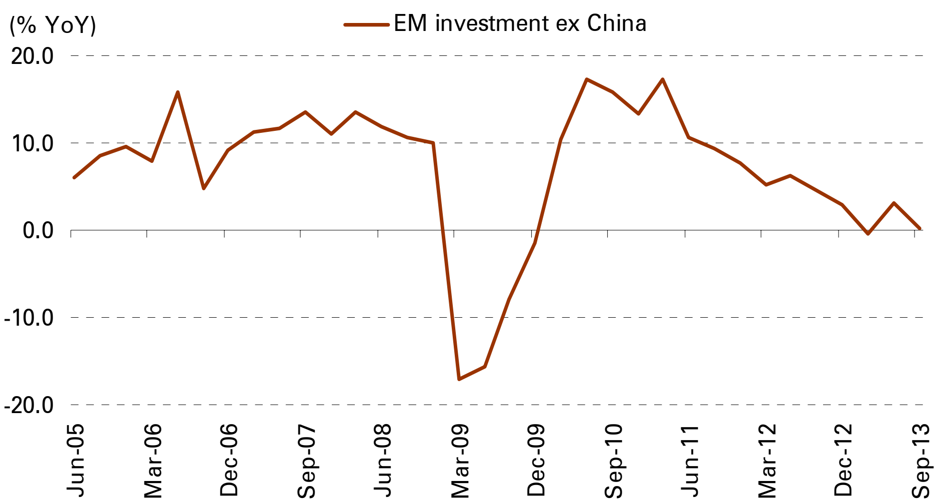
Source: United Nations (UN), ICICI Bank Research

Consumption is likely to witness muted recovery this year

- Consumption demand has fallen sharply as income growth has declined and elevated inflation levels are also weighing on it.
- Over the long term, unfavourable demographics in most countries (barring some) do not bode well for consumption demand.
- Consumption may see muted recovery as economic growth revives somewhat in 2014 but is unlikely to revert to its pre-crisis levels.

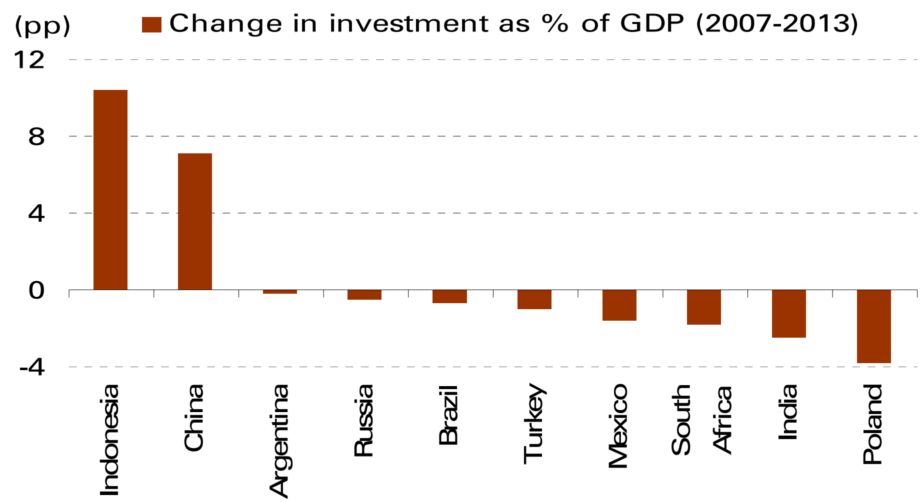
Investment remains stagnant with sharp recovery unlikely

Investment growth remains weak



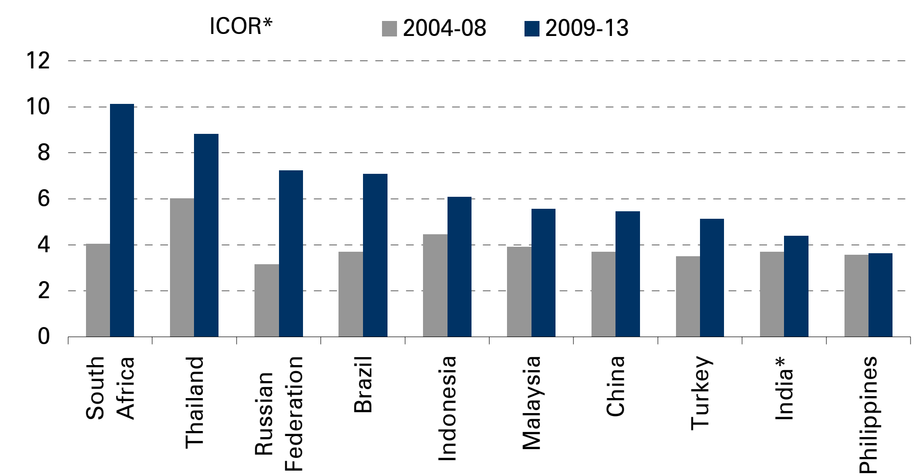
Source: IMF, ICICI Bank Research

Investment to GDP ratio is lower than pre-crisis levels for most EMs



Source: IMF, ICICI Bank Research

Rising ICORs reflect deterioration in investment efficiency



*ICOR: Incremental Capital Output Ratio

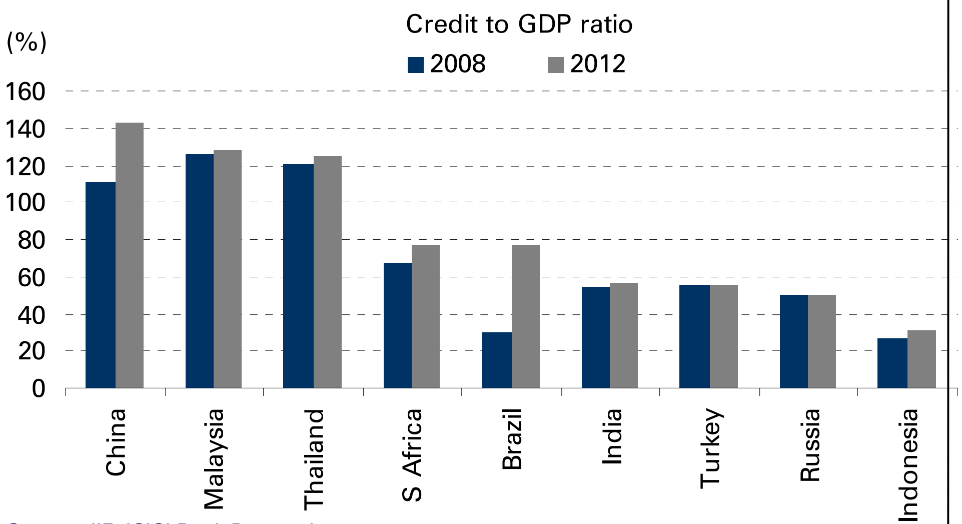
Source: Bloomberg, ICICI Bank Research

Investment recovery contingent on sentiment and demand revival

- Investment demand has stagnated amid an erosion of business sentiment, unfavourable global environment and weak domestic demand.
- Even in China, investment growth is close to decadal lows.
- Industrial production is reflecting the slowdown in capital formation. Investment inefficiencies are also rising as is evident from the increase in ICORs across the region.
- In 2014, investment cycle is unlikely to pick up in a robust manner until business sentiment improves and credible signs of domestic demand revival are seen.

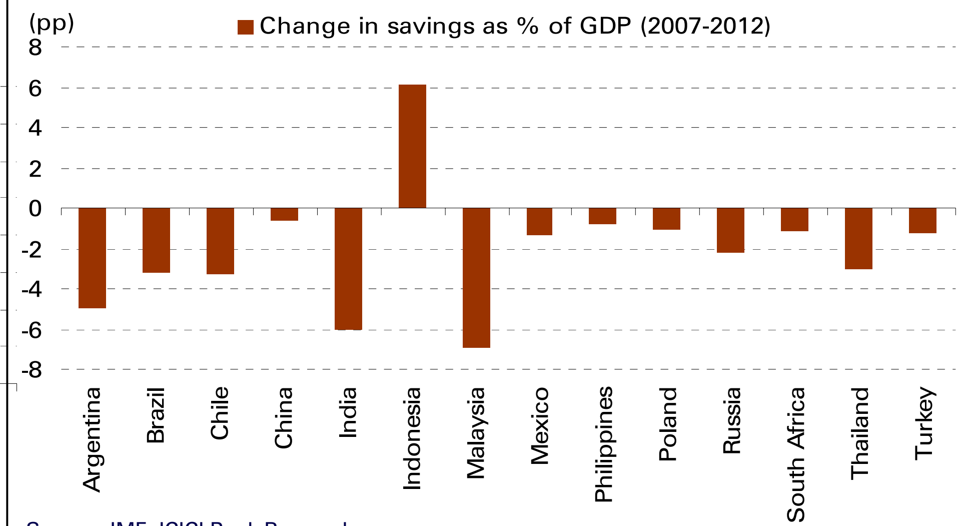
Leverage levels have risen amid low real interest rates

EMs have seen a considerable expansion in credit



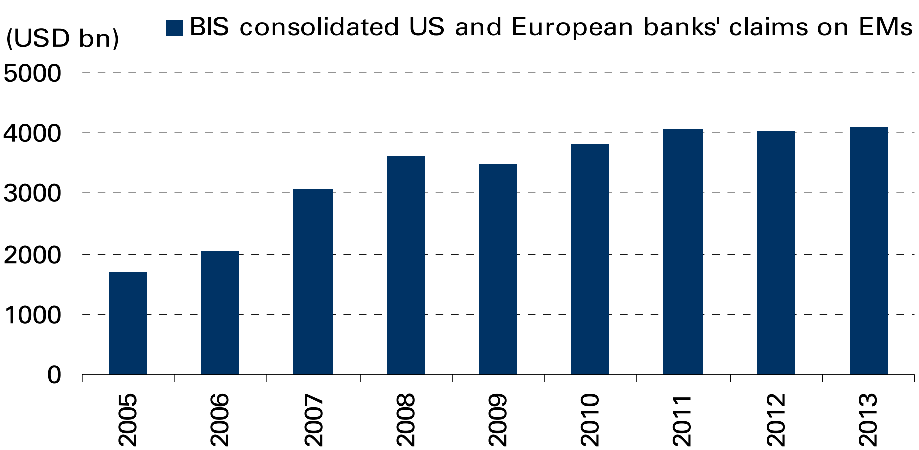
Source: IIF, ICICI Bank Research

Domestic sources of funds have reduced with declining savings rate



Source: IMF, ICICI Bank Research

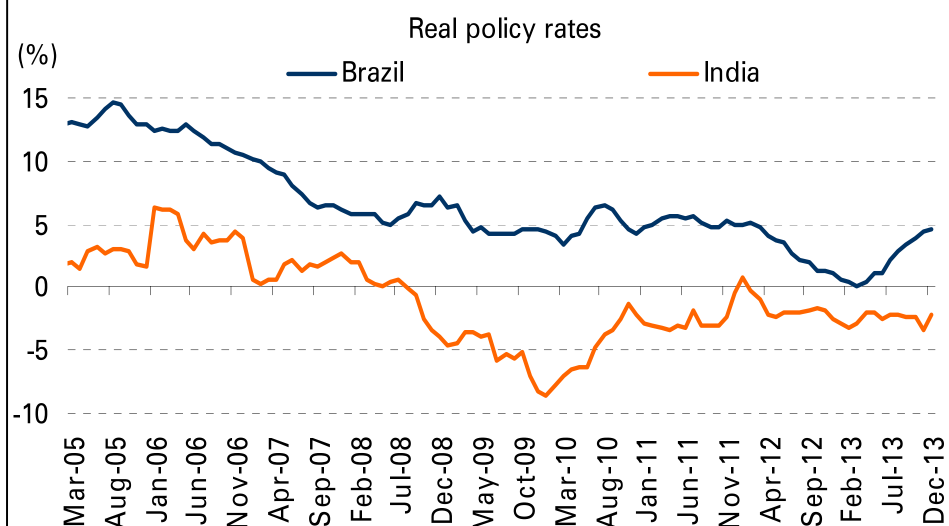
Dependence on foreign funds have increased significantly



Data for 2013 taken till September-2013

Source: BIS, ICICI Bank Research

Real policy rates across EMs have mostly trended downward



Source: Bloomberg, ICICI Bank Research

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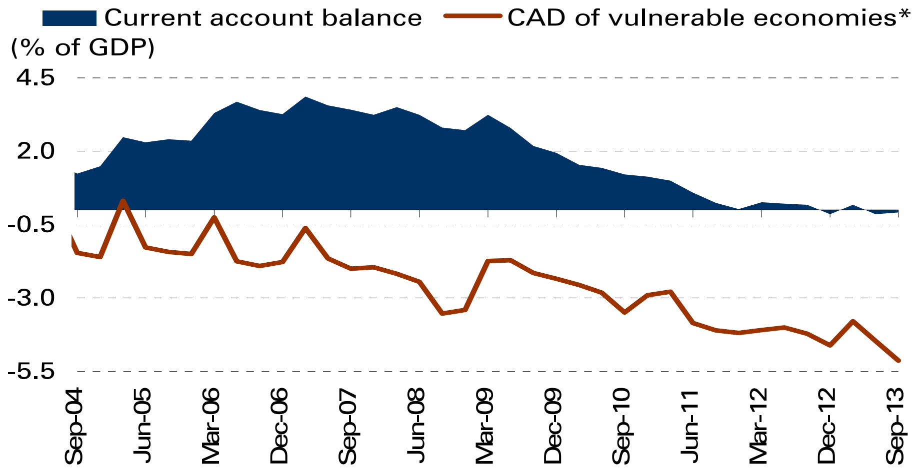
External balances have corrected sharply in post crisis phase

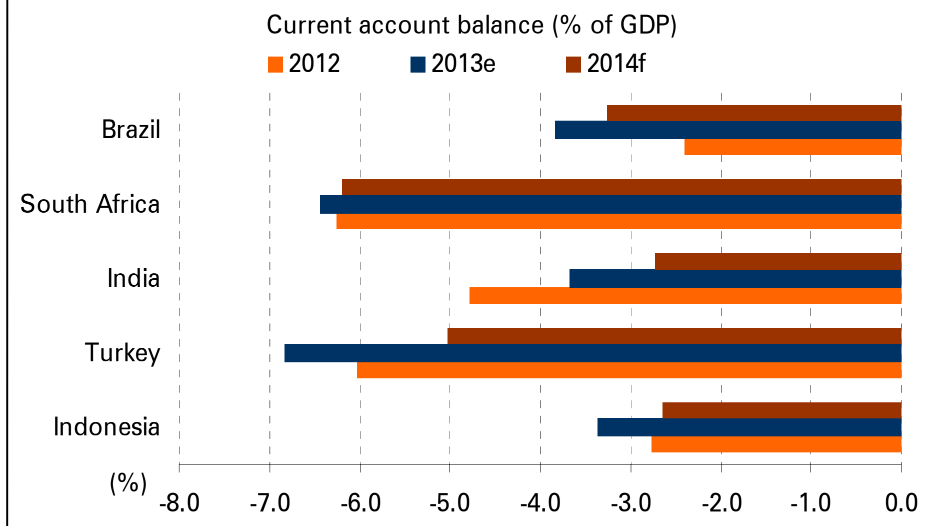
Sharp fall in EM external balance worsened by vulnerable countries



*Brazil, India, South Africa and Turkey

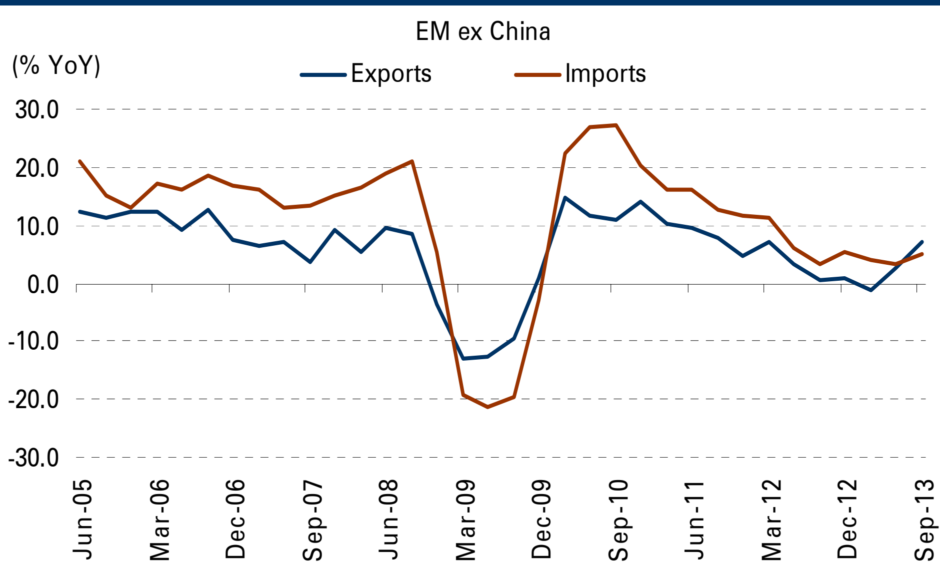
Source: Bloomberg, ICICI Bank Research

However, some correction in vulnerable economies is expected…



Source: Bloomberg, ICICI Bank Research

…on the back of rising exports and muted imports growth



Source: Bloomberg, ICICI Bank Research

Adjustments in CAD economies to support EM external balance

- EMs enjoyed high current account surplus for the better part of the last decade. However, the global financial crisis triggered a sharp correction in external balances and this surplus was sharply run down.
- A major contributor to this correction was China, which saw its surplus dwindle from more than 10% of GDP in 2007 to around 2.5% currently.
- Recent adjustments have occurred following the US QE tapering development, leading to a favourable correction in many vulnerable CAD economies.
- We expect this trend to somewhat continue in 2014 on the back of rise in exports supported by DM growth and muted imports as domestic fundamentals remain weak.

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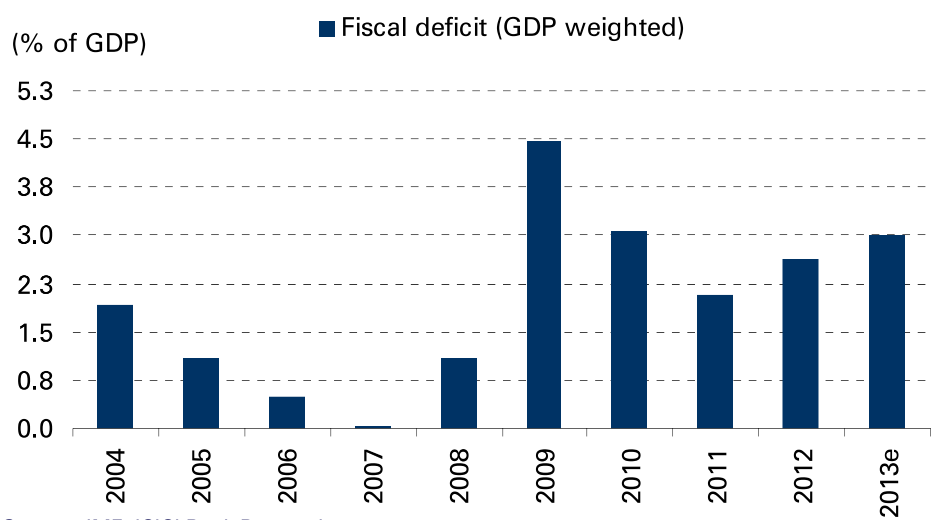
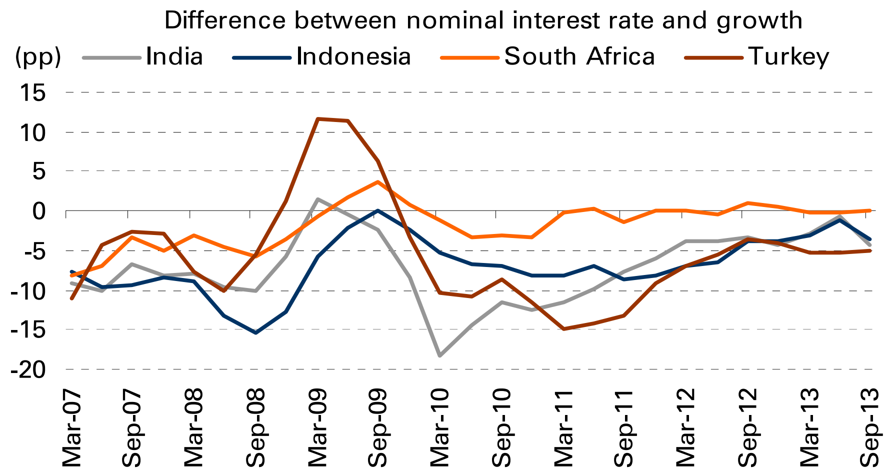
Fiscal conditions have started to deteriorate

Fiscal concerns in EMs are resurfacing



Source: IMF, ICICI Bank Research

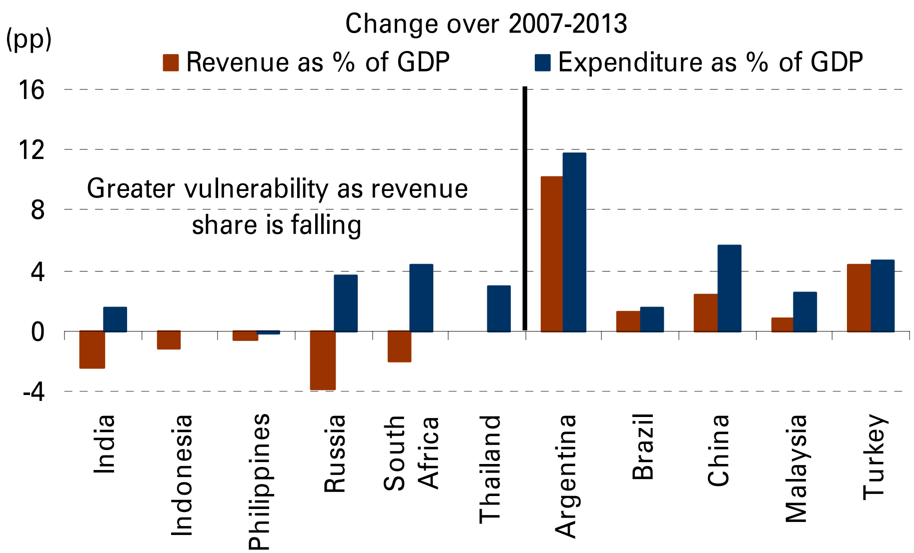
Debt sustainability metrics have worsened



Interest rate used is 10-year nominal sovereign yield

Source: Bloomberg, ICICI Bank Research

Revenue growth is increasingly falling short of spending growth



Source: Bloomberg, ICICI Bank Research

Commitment to fiscal sustainability is important for stability

- EMs had undertaken some fiscal consolidation after the stimulus administered during the Lehman crisis. However, over the last three years deficits have been rising again.
- Conventional debt sustainability indicators and relative growth rates of revenue and expenditure suggest that the fiscal scenario is worsening.
- Although the public debt levels are not yet a cause for concern in EMs, firm commitment to fiscal stability should be in place to ensure long term sustainability.

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Other structural factors worsening growth prospects in EMs

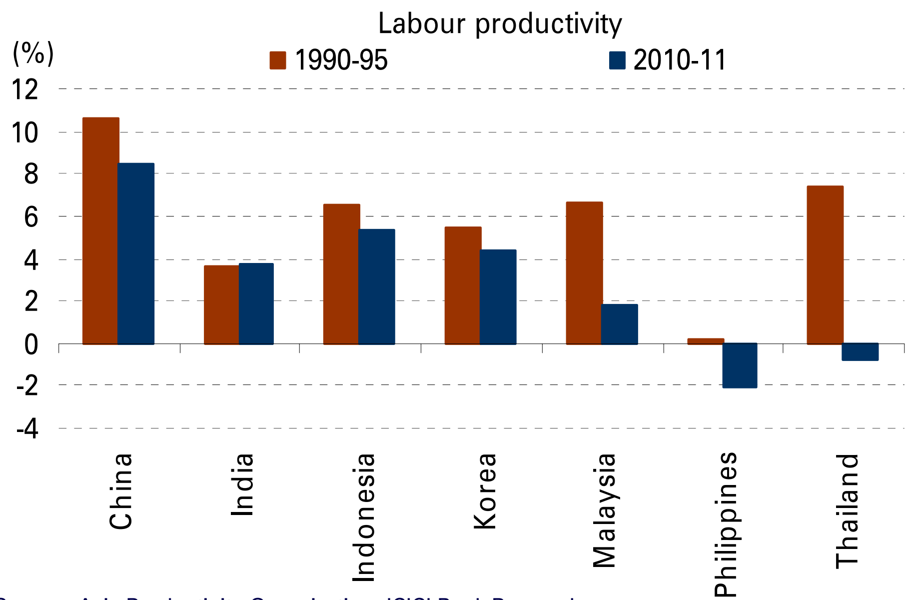
Most measures of institutional quality have also worsened across emerging markets…

Indicators	Emerging market (15)*		BRICs		Developed markets (G4)#	
	Rank (out of 148)					
	2008	2013	2008	2013	2008	2013
Diversion of public funds	91	102	71	80	25	24
Judicial independence	64	57	47	43	22	24
Wastefulness of govt. spending	88	94	74	77	77	62
Burden of govt. regulation	110	113	82	87	55	74
Quality of overall infrastructure	83	87	64	71	12	17
Quality of primary education	96	100	67	73	30	35
Secondary education enrollment rate	49	44	27	25	42	42
Time needed to start a business	98	103	75	83	30	35
Flexibility of wage determination	92	96	61	67	32	40
Ease of hiring and firing	96	96	67	70	54	46

*Emerging markets consist of BRICs, Indonesia, Thailand, Malaysia, Philippines, South Africa, Turkey, Mexico, Poland, Argentina, Chile and Czech Republic, # US, UK, Japan and Germany. No. of countries is 148. Ranks are GDP-weighted; higher ranks indicate deteriorating performance.

Source: World Bank, ICICI Bank Research

…along with declining labour productivity…



Source: Asia Productivity Organization, ICICI Bank Research

…underscoring the need for structural reforms in EMs

- Apart from the fact that conventional growth drivers such as consumption and investment are slowing, there is growing concern that the slowdown in EMs may be more deeply entrenched.
- A combination of unfavourable demographics, capital inefficiency, shrinking external surplus, lack of second generation reforms and a fall in labour productivity may lead to a protracted structural slowdown in EMs rather than merely a cyclical one.
- In this backdrop, active intervention from the Government and other policymakers is essential to reverse this situation.

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Most vulnerable EMs are at the cusp of a political transition

Country	Type of election	Expected poll period	Ruling party/coalition	Current leader(s)	Opposition
India	General	April-May 2014	United Progressive Alliance-2 (UPA-2) led by Indian National Congress	PM: Manmohan Singh	National Democratic Alliance (NDA) led by Bharatiya Janata Party (BJP)
Indonesia	Parliamentary	April, 2014	Party Democrat	President: Susilo Bambang Yodhoyono	PDI-P, Golkar, Gerinda
	Presidential	July, 2014			
Brazil	General	October, 2014	Worker's Party (PT) + Party of the Democratic Brazilian Movement (PMDB)	President: Dilma Rouseff	Social Democratic Party (PSDB), Brazilian Socialist Party (PSB)
South Africa	General	April, 2014	African National Congress (ANC)	President: Jacob Zuma	Democratic Alliance (DA), Congress of the People (COPE), Inkatha Freedom Party (IFP), Agang
Turkey	Local	March, 2014	Justice and Development party (AK party)	PM: Recep Tayyip Erdogan	Social Democrat(CHP), Nationalist(MHP), Kurdish(BDP)
	Presidential	August, 2014			
Thailand*	General	February, 2014	Pheu Thai Party	PM: Yingluck Shinawatra	Democrat Party

* Disrupted polls to be reconducted in April

Source: National Election Commissions, ICICI Bank Research

External vulnerability has increased across the board

Economy	Current account balance (% GDP)		External debt (% GDP)		Net short term external debt (% reserves)		FX reserves (% GDP)		Import cover (months)	
	2008	2013	2008	2013	2008	2013	2008	2013	2008	2013
Brazil	-1.7	-3.8	18.6	29.6	20.1	17.0	11.7	16.3	13.4	16.9
Russia	6.3	2.0	28.9	35.6	19.5	29.0	24.8	20.8	17.1	14.6
Turkey	-5.7	-6.8	39.4	49.3	78.1	116.8	9.6	11.7	4.4	4.6
India	-2.3	-3.7	18.3	21.8	17.9	40.2	19.8	12.8	10.5	6.5
Indonesia	0.0	-3.4	30.5	29.8	51.1	71.1	9.7	10.3	5.1	6.3
Korea	0.3	5.8	34.1	34.9	74.5	37.2	21.6	26.5	5.6	7.8
Malaysia	16.9	2.7	35.4	37.7	41.3	54.1	39.5	40.0	7.4	7.8
Philippines	2.1	2.6	37.3	30.1	37.0	21.9	19.1	27.2	8.0	15.3
Thailand	0.8	-0.4	28.0	36.6	30.9	40.2	39.9	40.2	8.3	8.3
China	9.1	2.4	8.6	8.3	11.7	16.3	42.8	35.3	21.8	21.9

Deterioration   Improvement   Little change

Source: Bloomberg, IIF, ICICI Bank Research

Are “Trade Imbalances” a theme of the past?

When and how did trade imbalances emerge?

Prior to 2008, savings glut emerged in major current account surplus nations which were parked in deficit nations

The financial crisis led to correction in imbalances

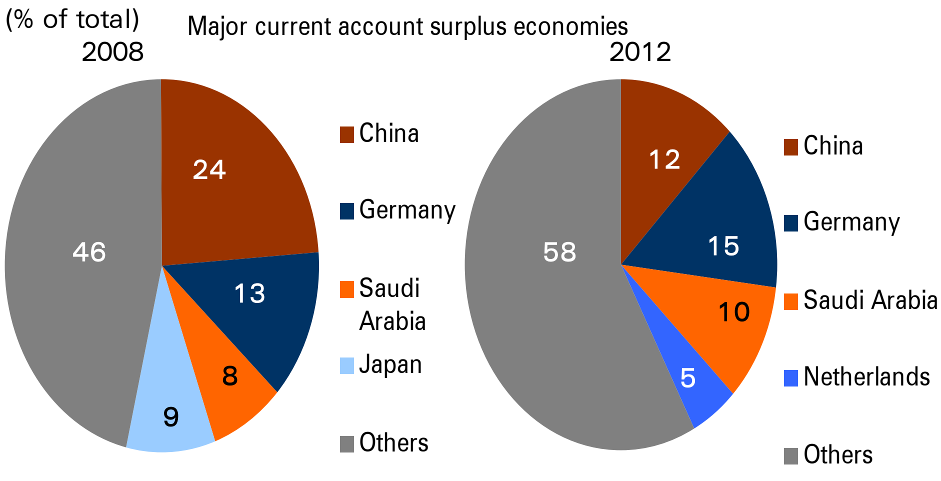
Deficit nations adjusted through improved competitiveness and lower investment while exports declined in surplus nations

Why are “Trade Imbalances” a relevant theme?

Not all nations have participated in the correction which poses risks that imbalances might worsen again

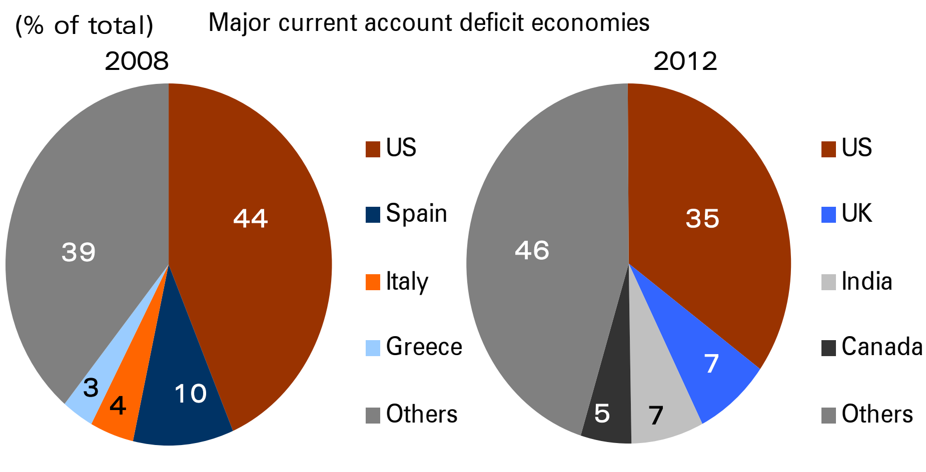
Trade imbalances remain in news: Are such concerns justified?

Germany replaced China as the largest surplus nation in 2012…



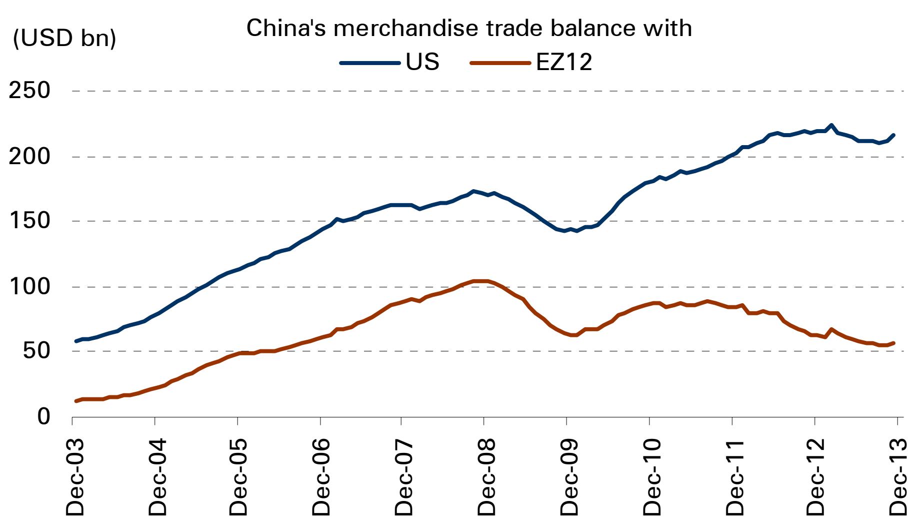
Source: International Monetary Fund (IMF), ICICI Bank Research

…and composition of major deficit economies changed post-crisis



Source: IMF, ICICI Bank Research

China's trade surplus with US has only risen post-crisis



Source: CEIC, ICICI Bank Research
Data based on 12-month sum

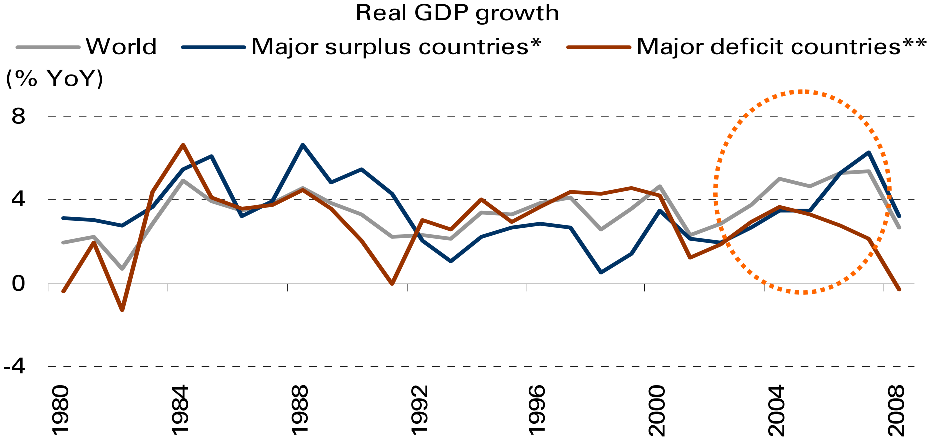
Trade imbalances remain in news

- In its latest semi-annual report released in October 2013, US pointed out Germany for running the highest external surplus in world. It also mentioned Germany's high competitiveness (which keeps its exports higher) has hampered rebalancing for other EZ members.
- Notably, though China's overall current account surplus has fallen considerably, US-China trade imbalance as yet remains a relevant concern.
- The next few slides seek to examine how far the post-crisis world has been able to reduce global trade imbalances and the challenges that remain at large.

ICICI Bank Global Markets

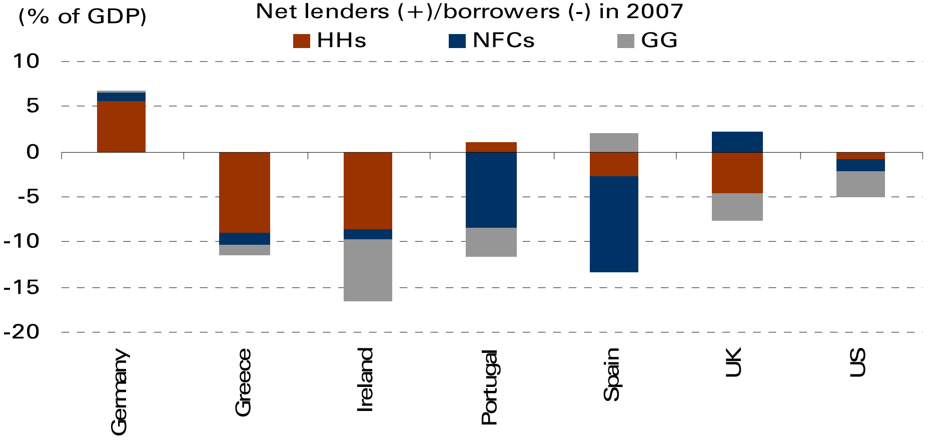
Recap: Severe trade imbalances emerged prior to 2008 crisis…

Real GDP witnessed one of its highest growth episodes in the run-up to global financial crisis…



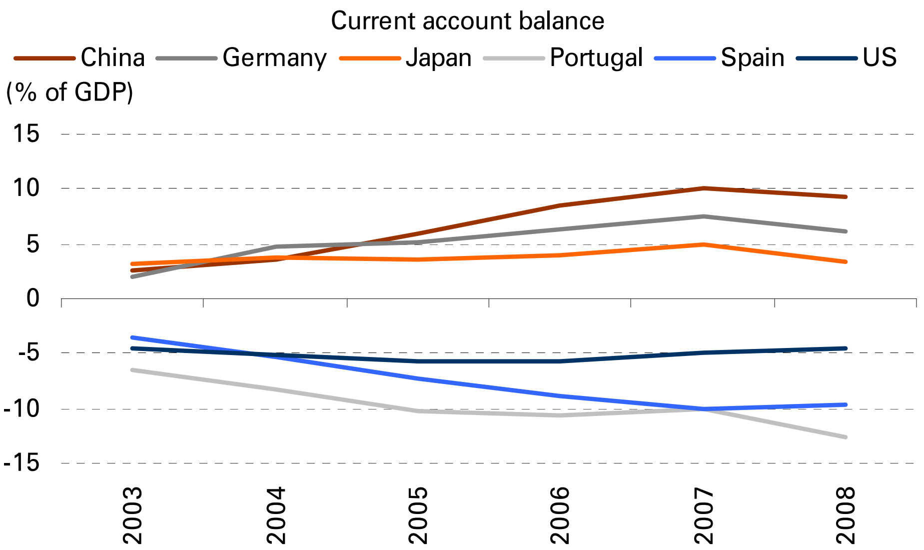
Source: IMF, ICICI Bank Research
* GDP-weighted average growth in China, Japan and Germany
** GDP-weighted average growth in US, UK and Spain

…as non-financial private sector in many developed economies borrowed significantly…



Source: CEIC, various national sources ICICI Bank Research
Net lenders (borrowers) imply higher (lower) savings than investments
Households (HHs), Non-financial corporations (NFCs) and General Government (GG)

…which was reflected in large trade imbalances



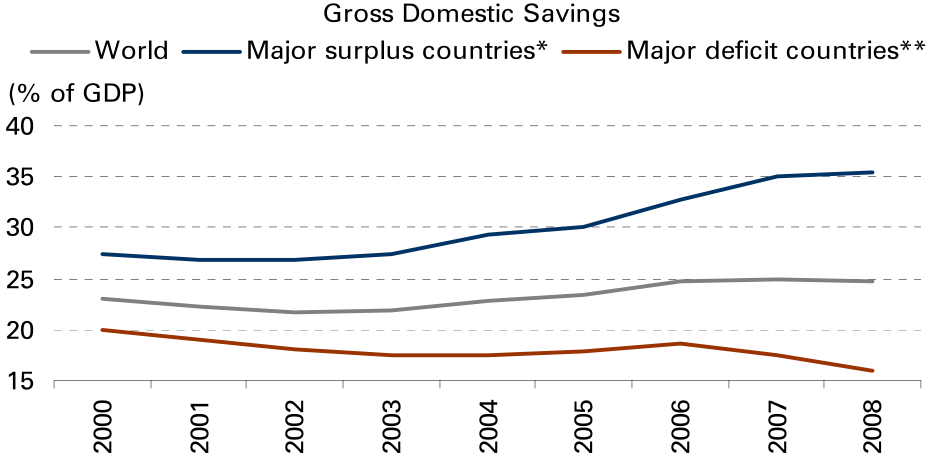
Source: IMF, ICICI Bank Research

High growth, driven by rampant borrowing, led to trade imbalances

- The world economy witnessed an average growth of 5.1% during 2004-07, marking its best four-year period in the previous three decades.
- High GDP growth was fuelled by rising leverage in most of developed markets, while economies such as China, Germany and Japan were major lenders.
- Consequently, cross-border movements of goods & services (and capital) surged sharply, which led to widening of current account balances in surplus and deficit nations.

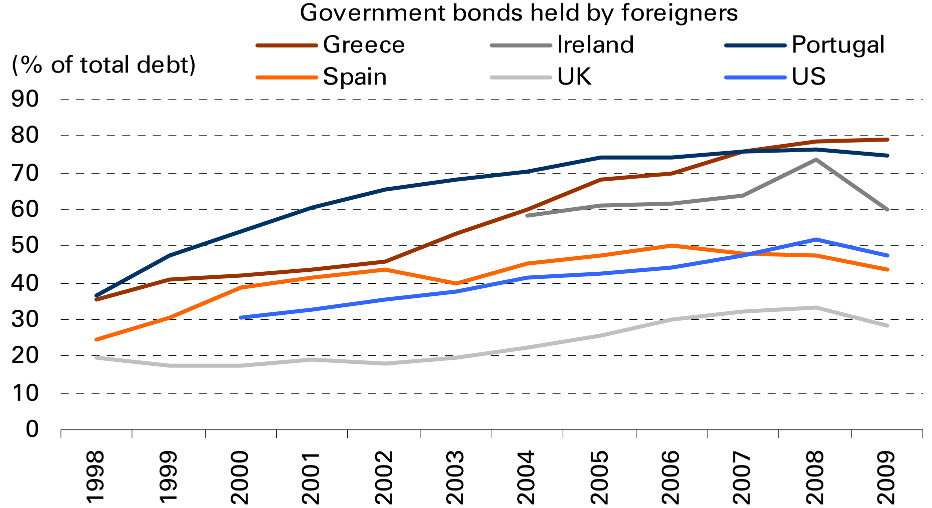
...and high savings in surplus nations flowed to deficit regions

Rising savings in most of the current account surplus nations....



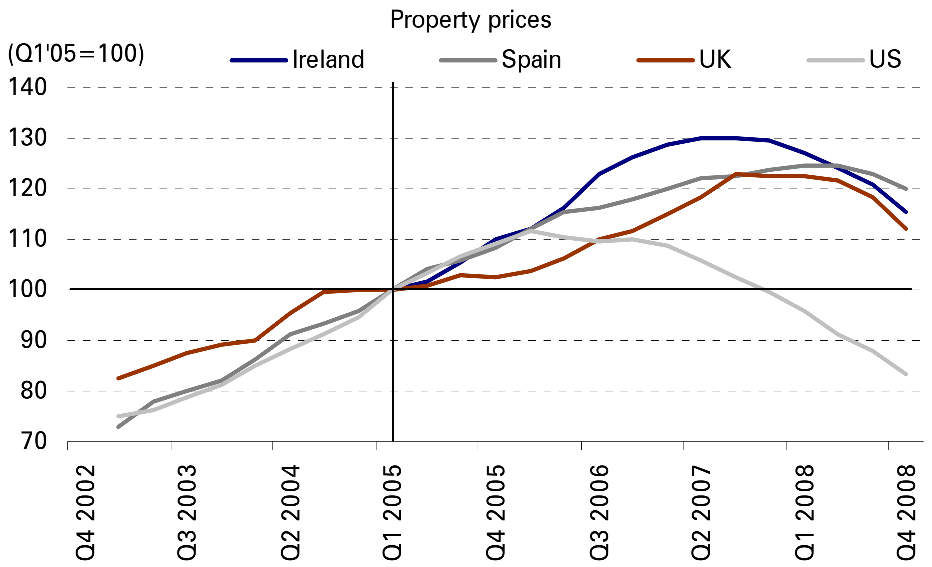
Source: IMF, ICICI Bank Research
* GDP-weighted average growth in China, Japan and Germany
** GDP-weighted average growth in US, UK and Spain

...were used to finance higher borrowings in deficit economies



Source: various national sources , ICICI Bank Research

Excess liquidity in deficit nations aided creation of housing bubbles



Source: Bank for International Settlements (BIS), ICICI Bank Research

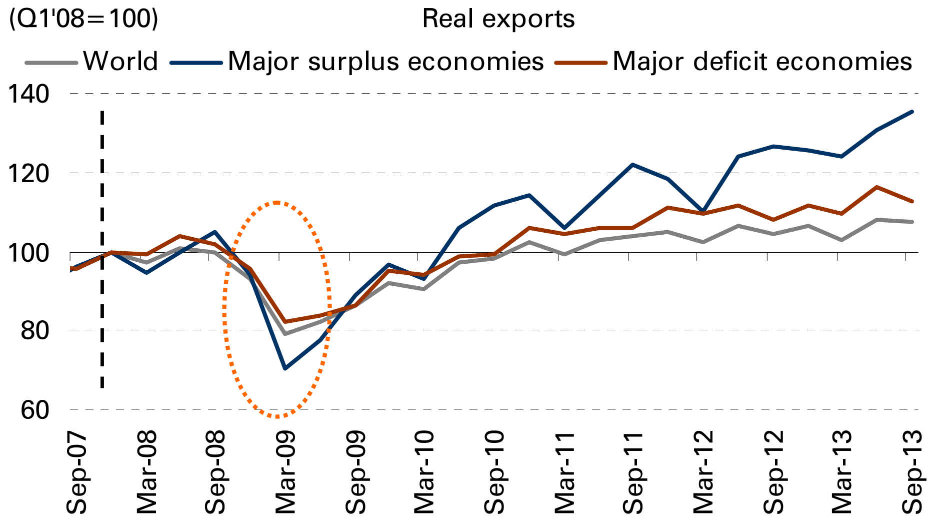
Surplus nations parked their savings in deficit regions

- Since current account balance (CAB) could also be analyzed in terms of difference between savings and investments, it is important to investigate their trends. Higher savings improves CAB and vice-versa.
- Savings rate (% of GDP) in major current account surplus nations rose from ~27% from 2000 to ~35% in 2008.
- Consequently, surplus economies started investing their savings in the deficit-economies, which were mostly developed markets that had increased their borrowings and consumption considerably.
- This rise in liquidity was one of the factors that led to housing bubble in some developed markets.

ICICI Bank Global Markets

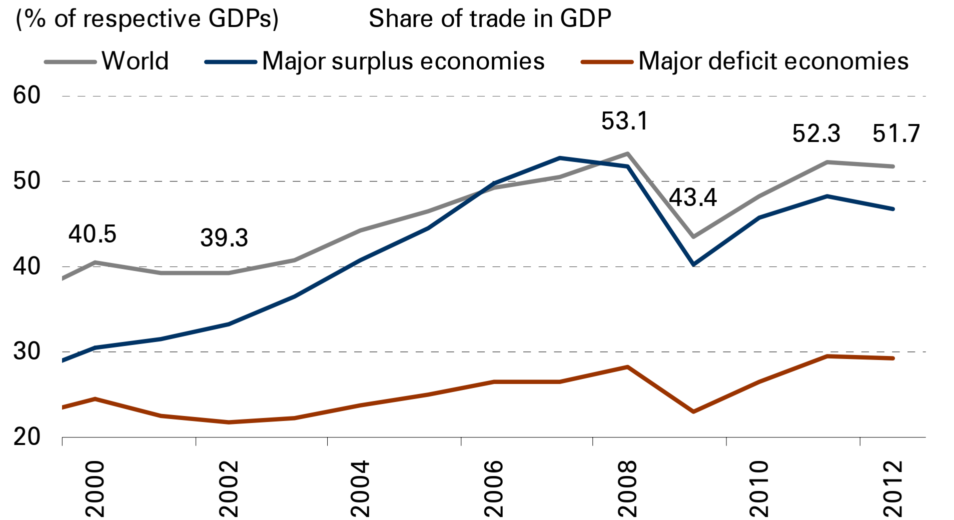
Global financial crisis led to a correction in trade imbalances…

Global trade declined sharply post-crisis…



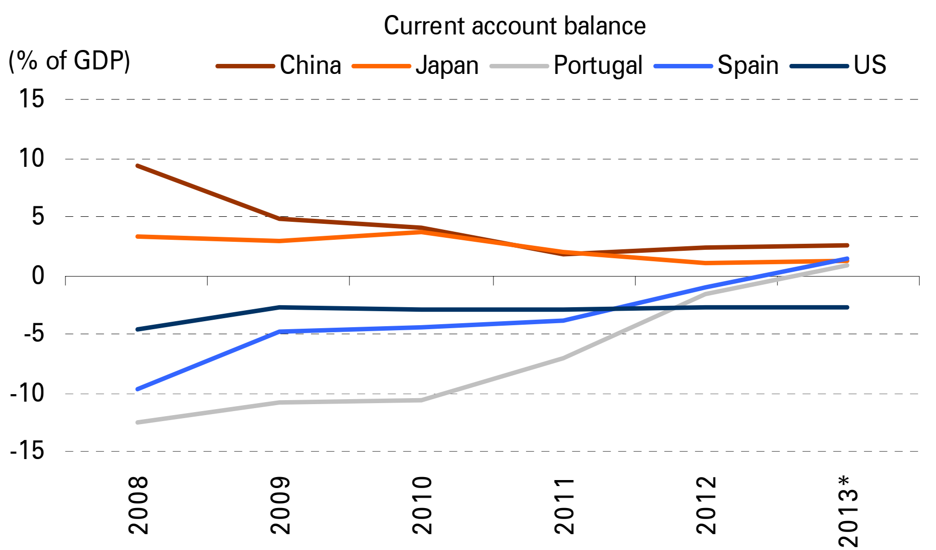
Source: United Nations Conference on Trade And Development (UNCTAD), ICICI Bank Research

… which has not recovered to its pre-crisis peak in surplus nations



Source: UNCTAD, ICICI Bank Research

Nevertheless, it certainly helped reduce trade imbalances



Source: IMF, ICICI Bank Research

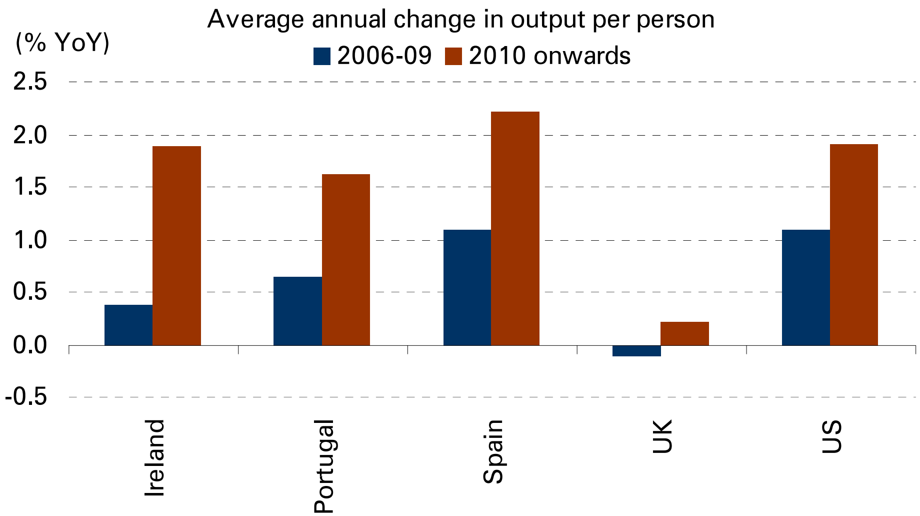
* IMF projections

However, countries met with varied success in reducing imbalances

- World trade had declined sharply in 2008-09 period owing to the global financial crisis.
- The effects of the crisis have yet not been fully reversed. Trade (as % of GDP) in largest current account surplus economy – China – remains at ~45% (2013), down from ~65% in 2006.
- Although the crisis has helped in reducing current account imbalances, the effect varies across countries. While some countries (like Spain) were able to substantially reduce deficits, US current account deficit held largely flat after edging slightly down in 2009.

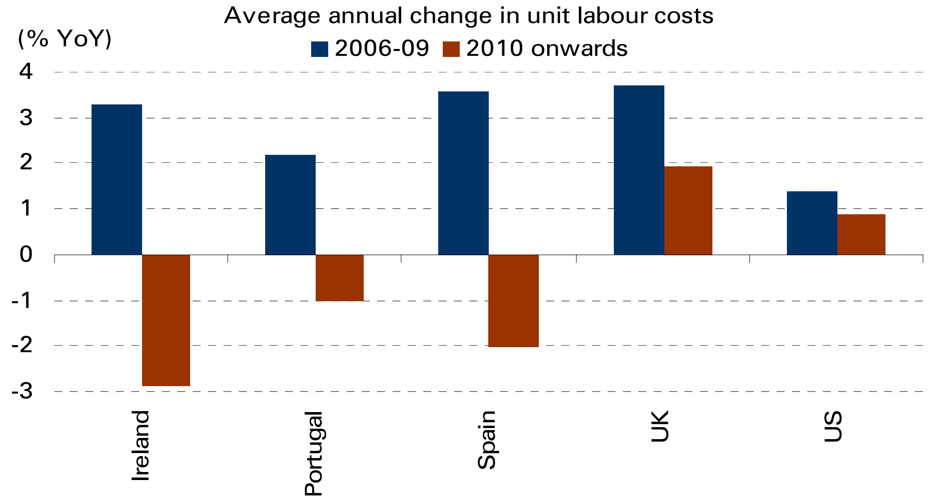
…as deficit nations improved competitiveness…

Productivity increased sharply post-crisis in deficit nations…



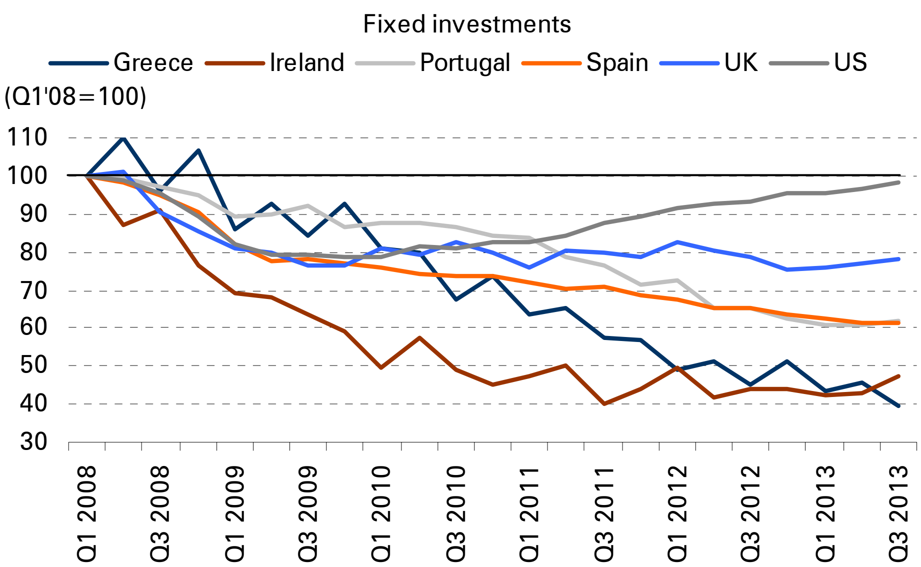
Source: ECB, Bureau of Labor Statistics (BLS), CEIC, ICICI Bank Research

…which along with lower labour costs improved competitiveness



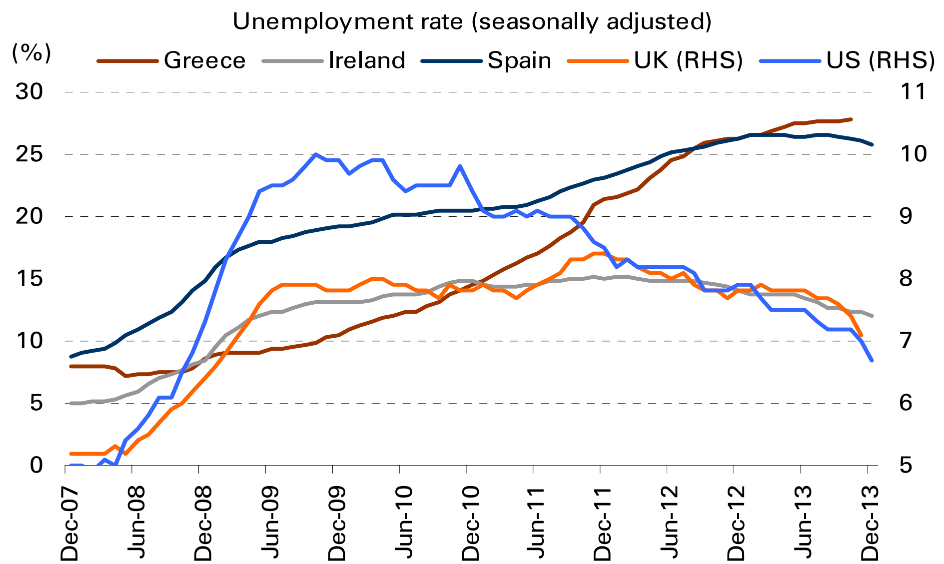
Source: ECB, BLS, CEIC, ICICI Bank Research

Sharp contraction in investments also helped reduce imbalances…



Source: Eurostat, Other national sources, ICICI Bank Research

…which led to higher unemployment rate



Source: CEIC, ICICI Bank Research

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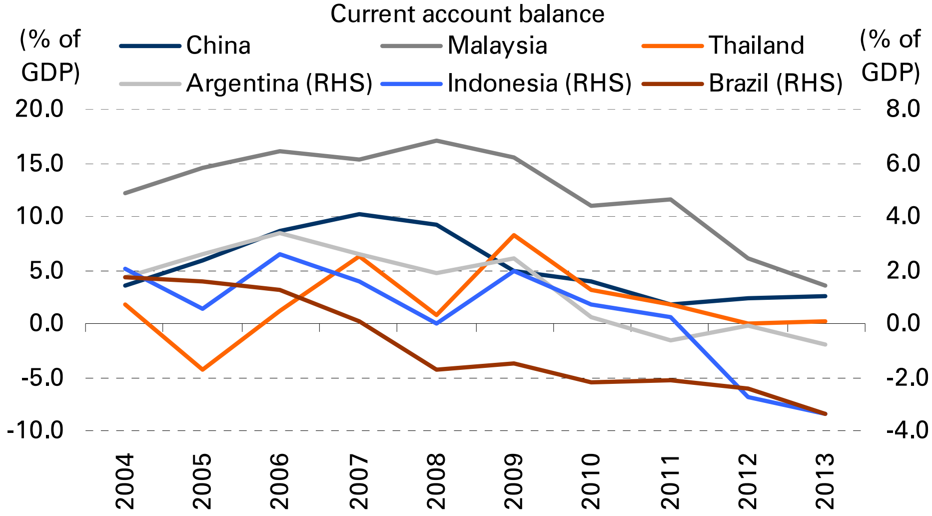
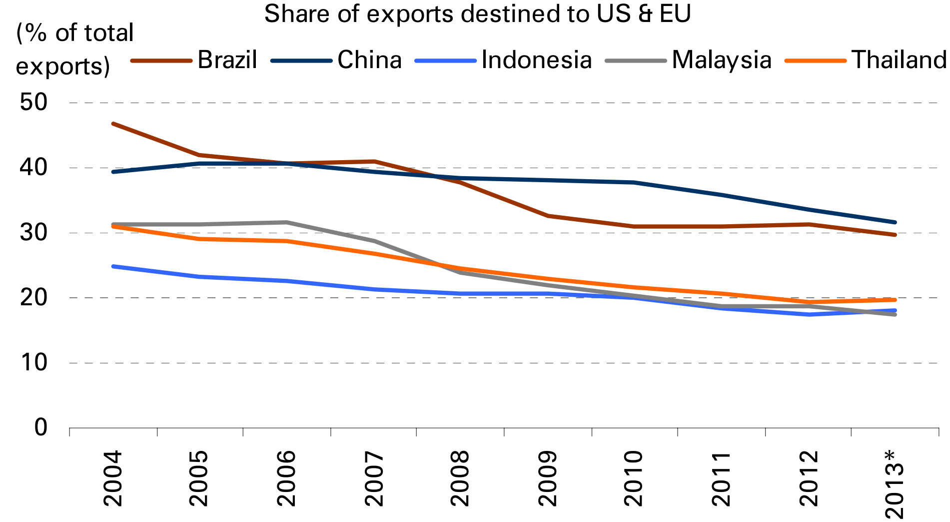
…and exports declined in surplus nations

Surpluses in many emerging markets also narrowed…



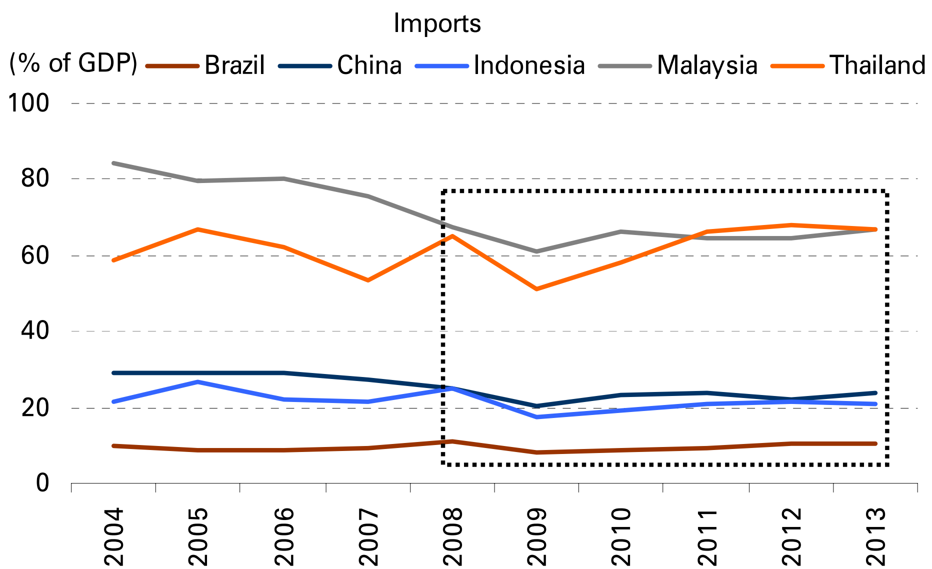
Source: IMF, ICICI Bank Research
2013 is IMF forecasts

…as their exports to the US and EU reduced sharply…



Source: CEIC, IMF, ICICI Bank Research
* till September 2013

…while imports have held steady around 2008 levels



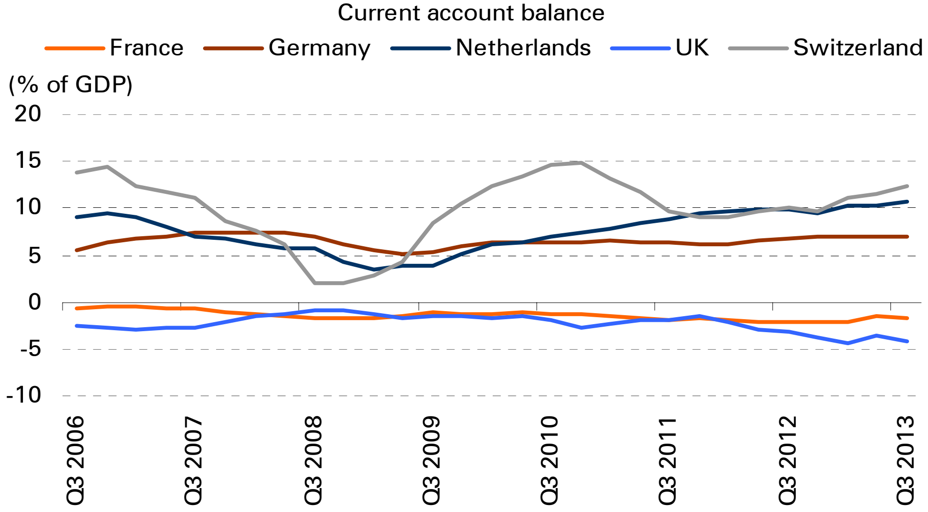
Source: Bloomberg, ICICI Bank Research
2013 data is for first half

Adjustments reduced trade imbalances in the post-crisis period

- In major deficit nations, improving competitiveness helped their exports, while reduced investments led to a decline in imports.
- In line with falling imports in major developed markets, many EM surplus nations witnessed a decline in their exports, primarily to the US and Eurozone.
- On the other hand, their (EM) imports have remained largely unchanged, as their domestic demand, especially investments, did not witness a sharp fall.
- Consequently, the current account surpluses reduced significantly in a number of EM economies.

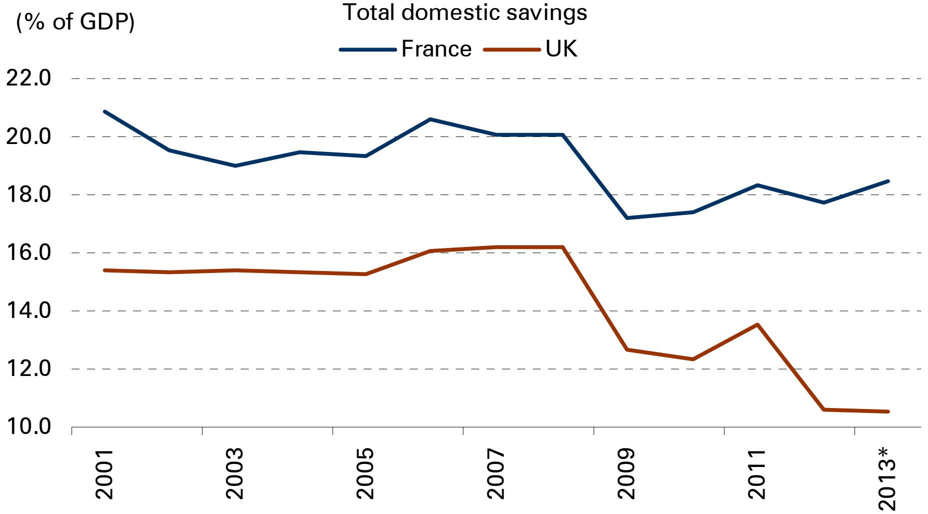
However, not all nations have participated in such correction

Some major economies continue to face trade imbalances…



Source: CEIC, ICICI Bank Research

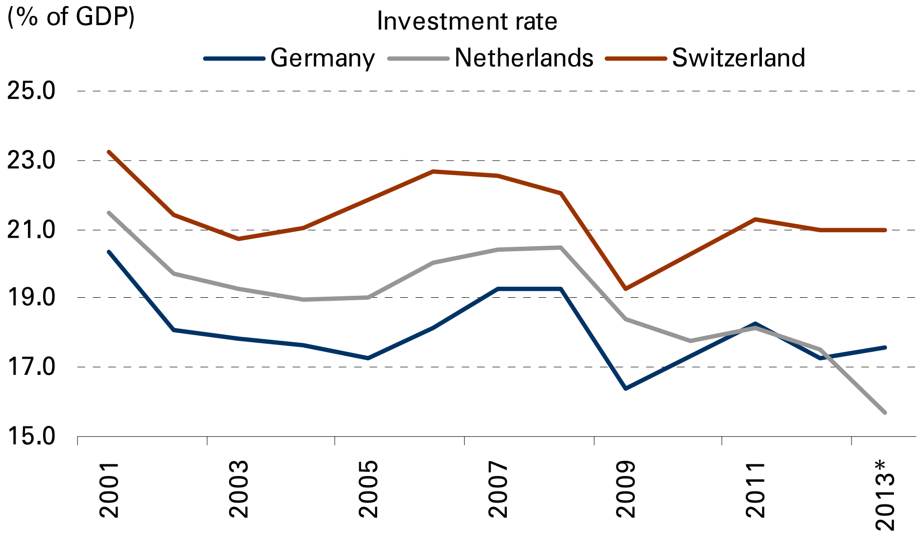
…as domestic savings have fallen faster in deficit nations…



Source: CEIC, National Sources, ICICI Bank Research

* H1 2013 for UK/France

…while investment rate has reduced in surplus nations



Source: CEIC, ICICI Bank Research

* IMF projections

Trade imbalances have not corrected in some major economies

- Despite witnessing one of the worst global crises since the Great Depression, some major economies in the world have not witnessed significant correction in their trade imbalances.
- Current account deficit in the UK and France has widened post-crisis, because their saving rate has fallen faster than investment rate
- On the other hand, investment rate in Germany, Netherlands and Switzerland has fallen further post-crisis, which keeps their surpluses high.

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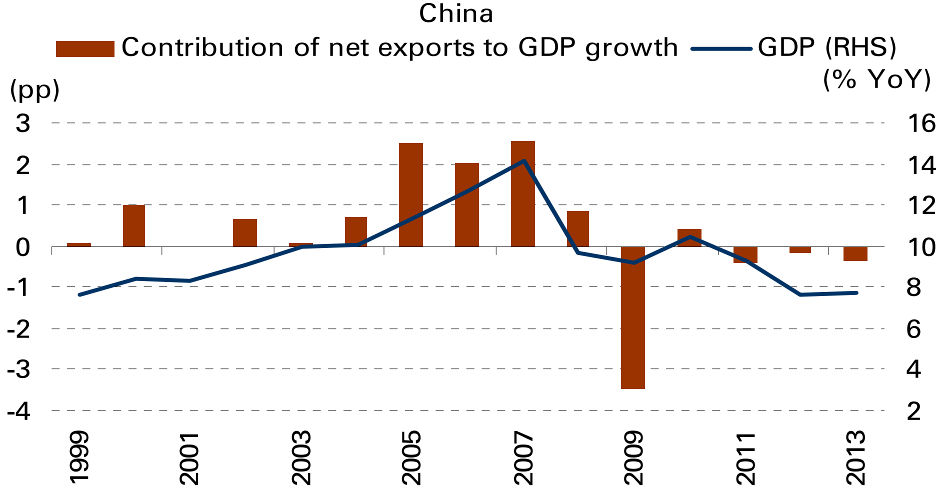
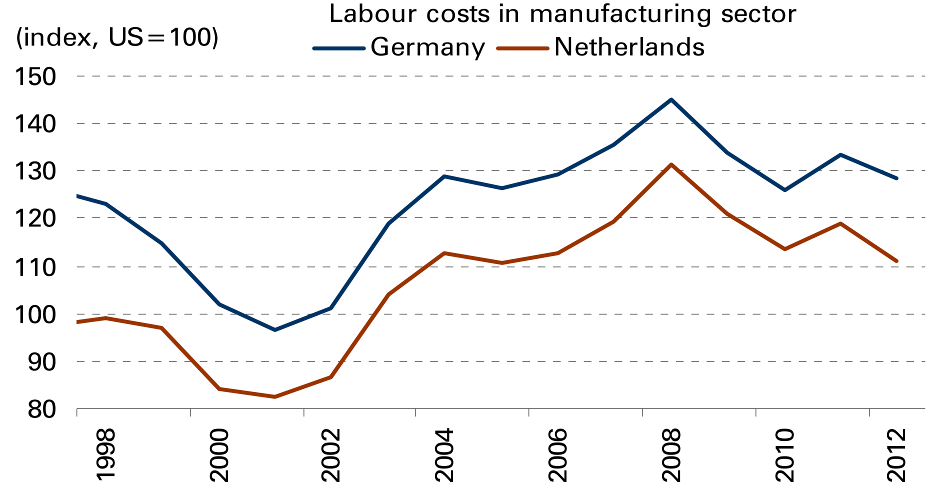
Key risks that might worsen imbalances again

China's policymakers might again resort to export-promotion if GDP falls faster than expected



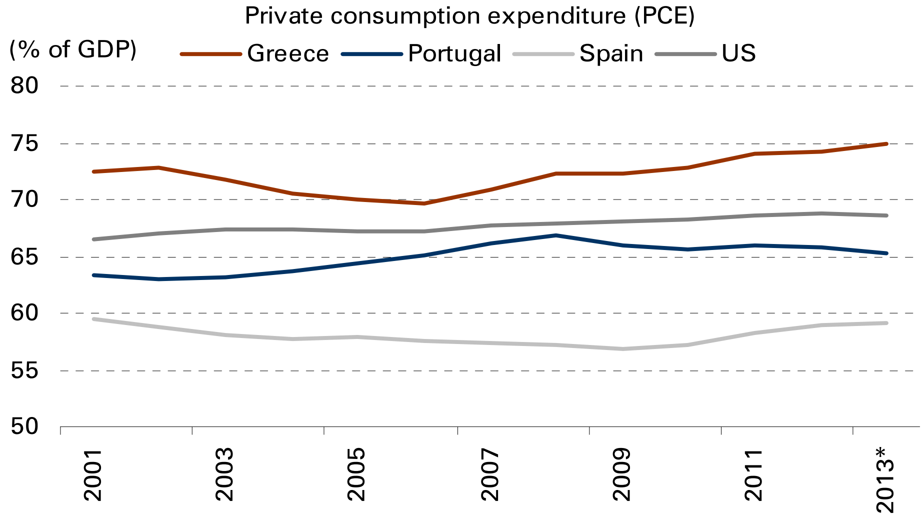
Source: CEIC, ICICI Bank Research

Continuous fall in German and Dutch labour costs likely to keep their surpluses high



Source: US Bureau of Labour Statistics, ICICI Bank Research

Many deficit nations continue to rely heavily on consumption for demand creation



Source: CEIC, ICICI Bank Research

* Full-year for the US; first three quarters for euro members

A number of risks remain which could worsen trade imbalances again

- Although China's current account surplus has fallen sharply from 10% of GDP in 2007 to currently around 2.5%, risks remain that policymakers might again resort to export-promotion in case growth falls below the Government's comfort level.
- Labour costs in some surplus nations continue to fall in comparison to the US which indicates that their current account surpluses could remain high (or increase further) in the foreseeable future.
- Despite reduction in external deficits (as % of GDPs), private consumption remains high in many developed markets which could lead to higher imports, widening their deficits again.

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Gsec Desk	(+91-22) 2653-1001-05	FX Derivatives	(+91-22) 2653-8941/43
Interest Rate Derivatives	(+91-22) 2653-1011-15	Commodities Desk	(+91-22) 2653-1037-42
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