Questions

Is China causing trouble for the global economy?

How will the US Federal Reserve decide what to do next?

Now that the Greek situation has been resolved, is Europe out of the woods?

Why have developed economies been growing so slowly?
China Growth

- Official growth in 2015 is the lowest since 1990
- True growth could be much lower
- Deceleration due to
  - Weak exports resulting from high valued currency
  - Weakening investment resulting from excess capacity

China Real GDP Growth

Source: Federal Reserve
China
Unsustainable imbalances

- Excessive investment driven by debt
- $6.8 trillion in waste
- Too much heavy industry leads to declining margins
- Property prices declining
- Government prevents investors from losing money. Thus there is no moral hazard
- Banks face potentially huge losses
China
Policy response and consequences

• Central bank eases monetary policy in order to boost credit market activity
• Investment not boosted
• Funds flowed into equity market, fueled by margin debt. Collapse of equity prices was inevitable
• Clumsy effort to stem equity market collapse has hurt confidence
• Equity prices down 40 percent, remain 50 percent above level in early 2014
China
Currency depreciation

- Until two years ago, central bank bought dollars to prevent appreciation
- Now, with capital flowing out, central bank has been selling dollars to prevent depreciation
- Recent devaluation was meant to stop capital outflows. That failed.
- Capital continues to flow out, central bank continues to sell dollars.
- Expect further depreciation

![Foreign Currency Reserves](Source: Federal Reserve)
## China
### Myth versus reality

<table>
<thead>
<tr>
<th>Myth</th>
<th>Reality</th>
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<tbody>
<tr>
<td>China’s equity market collapse caused global share prices to fall</td>
<td>The global share price correction was long overdue. News about China’s weak growth had an impact, but not China’s stock market</td>
</tr>
<tr>
<td>China’s slowdown will lead to a global recession</td>
<td>China’s footprint in the global economy is big, but its impact on the US and EU remains relatively modest</td>
</tr>
<tr>
<td>China’s economy is a house of cards</td>
<td>Despite massive imbalances, China has many strengths, especially in the services sector</td>
</tr>
<tr>
<td>China’s government can reverse the downturn through monetary policy</td>
<td>China needs fundamental reforms that have been discussed but not implemented</td>
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</tbody>
</table>
Big emerging markets
Challenges

• Expected tightening of US monetary policy boosts capital costs in EMs, hurts investment
• Expected higher returns in US, and low commodity prices, causes capital outflows
• These factors weaken currencies and force tighter monetary policy in EMs
• Slow growth in:
  • Brazil
  • Turkey
  • Russia
Strong US dollar

Conflicting consequences

Reasons:

- Lower oil prices
- Strong US economy
- Aggressive monetary policy in ECB, Japan, China

Impact:

- Lower inflation in US, boosts US consumer spending
- Hurts US exports, US corporate profits
- Possibly delays Fed action on interest rates
- Helps exporters in Europe, Japan
- Hurts external debtors in emerging markets
Low oil prices

Conflicting consequences

- Due to
  - *US fracking*
  - *Weak global demand*
  - *Saudi increase in output*
  - *Prospective increase from Iran*
- Boosts consumer spending globally
- Creates disinflationary pressure
- Boosts value of dollar
- Hurts growth in oil exporting countries

Oil production in key markets

Source: Oxford Economics
Is the US economy strong or weak?

- Consumer spending strong due to:
  - Increased wealth
  - Reduced debt
  - Improved cash flow
  - More jobs
  - Lower energy prices

- Housing market strong due to low borrowing costs, strong job growth

- Exports weakened due to high dollar, not because of China

- Investment weak due to dollar, oil

Source: Federal Reserve
USA

What next for the Fed?

• Why postpone raising rates?
  • Inflation is low, expectations are low, dollar and oil are suppressing inflation, and labor market still has slack. Market doing Fed’s job

• Why act sooner?
  • Financial markets distorted by long period of low interest rates
  • Fed needs to act before inflation actually becomes a problem

• When the Fed acts is less important than the path interest rates take

Source: Federal Reserve
Eurozone

ECB aims to reflate

- Quantitative easing (massive purchases of government bonds)
- Intended impact:
  - Suppress euro
  - Boost inflation
  - Lower borrowing costs
  - Boost asset prices
  - Compel more risk taking

Money and Credit Growth
Percent Change Over Year-Ago Level

Source: Federal Reserve
Eurozone
Signs of improvement

- Positive impact of cheap oil
- Employment accelerates
- Rising retail sales
- Credit market conditions improve
- Stronger growth in Italy, Spain, Ireland. France remains weak.

Source: Federal Reserve
Eurozone
Europe still at risk

• Risk spreads elevated due to fears about future of euro
• German industry weakened
• Unemployment remains high
• Extremist parties boost their popularity
• Refugee crisis might undermine European unity

Source: Federal Reserve
# Slower global growth

## A new world

<table>
<thead>
<tr>
<th>Quandary</th>
<th>Explanations</th>
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<tr>
<td><strong>Why has growth decelerated?</strong></td>
<td>• Global excess capacity</td>
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<tr>
<td></td>
<td>• Financial market stress</td>
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<td></td>
<td>• Lack of fundamental innovations</td>
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<td></td>
<td>• Slower labor force growth</td>
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<tr>
<td><strong>What are the consequences of slow growth?</strong></td>
<td>• Slower growth in living standards</td>
</tr>
<tr>
<td></td>
<td>• Lower growth threshold for high inflation</td>
</tr>
<tr>
<td><strong>Is there reason for optimism?</strong></td>
<td>• Today’s innovations could pay off spectacularly</td>
</tr>
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<td></td>
<td>• Spending on R&amp;D is growing rapidly</td>
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</tbody>
</table>
## Global economy
### Risks and opportunities

<table>
<thead>
<tr>
<th>Region</th>
<th>Risks</th>
<th>Opportunities</th>
</tr>
</thead>
</table>
| USA             | • Political dysfunction  
• Fed error  
• Higher oil prices | • Positive demographics  
• Innovation  
• Financial market strength |
| Europe          | • Lack of financial market reform  
• Political opposition to integration  
• Refugees | • Refugees  
• Weak euro  
• Pent up demand |
| Middle East     | • Syrian conflict widens  
• Instability in Gulf countries | • Iranian economic renaissance |
| East Asia       | • Conflict in South China Sea  
• Major slowdown in China | • TPP  
• China reforms |
| Latin America   | • Argentina, Brazil, Venezuela | • Mexico, Colombia, Chile, Peru |
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