Global Economic Research

Global Economic Outlook

August 2015

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United States—Expectations of a pickup in US growth during the second half of 2015 and a tightening labor market suggest a September rate hike is likely.

Europe—The recovery remains on track and is being supported by improved consumer fundamentals. Greece-related risks have receded but are likely to return later in the year.

Japan—Higher core inflation raises the risk of early tapering.

China—Second-quarter data suggests the economy has been bottoming out.

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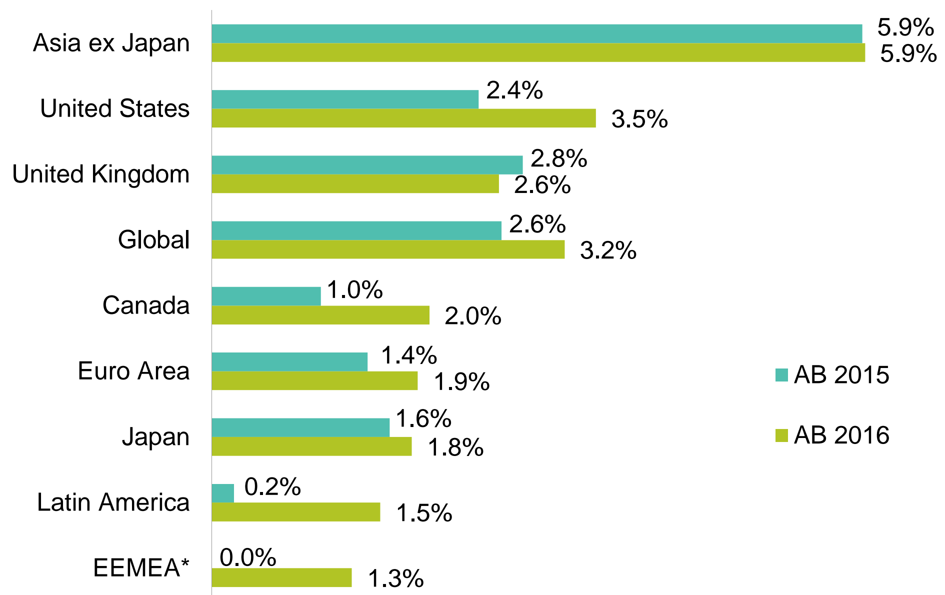
AB World Economic Growth Forecasts



As of August 1, 2015; calendar-year forecasts
*Emerging Europe, Middle East and Africa
Source: AB

Global Outlook

Global growth dependent on three main factors

Global growth remains modest as crosscurrents from weaker commodity prices and the changing pattern of global trade continue to hurt some countries, while benefiting others. We expect 2015 global growth of 2.6%, more or less in line with the forecasts of the past several months. In 2016, we expect it to quicken to 3.2%, with acceleration seen among emerging and developed economies.

The main issues for the global economy still center around the growth deceleration in China, the US recovery and the timing of official rate increases by the Federal Reserve, and the asset purchase programs in Japan and Europe.

China slowdown

In China, second-quarter year-on-year growth of 7% created the impression that the economy has started to stabilize. Yet the second quarter's growth performance was aided by a surge in financial sector activity, which lifted the growth rate by 0.5%. Industrial output growth continued to decelerate, hurt by ongoing weakness in exports. The weakness in trade and industrial output has spilled over to manufacturing investment. As a result, we still expect China's economy to muddle through and expand at roughly 6.5%.

Fed rate hike timing linked to US recovery

In the US, the Federal Reserve has opened the window to an official rate hike in the second half of the year, although the timing remains in doubt. In testimony before Congress in July, Fed Chair Janet Yellen said policymakers would prefer to raise official rates early and then move them up gradually thereafter, rather than wait and have to be more aggressive later. Still, the Fed has made it clear that it wants to see "some" further improvement in labor markets and to see the inflation rate move toward the central bank's 2% target over the medium term. Based on labor market trends, a modest rate hike for September looks likely.

Continuation of monetary easing in Japan and Europe

The asset purchase programs in Japan and Europe are expected to continue unabated for now. In Japan, there's been speculation that the program may not continue at its current scale beyond this fiscal year, which ends in March 2016. In other words, the Bank of Japan (BoJ) may start to taper purchases early next year. The program has been beneficial so far, mostly for weakening the yen, boosting asset prices and shifting inflation expectations. But the next phase of growth depends on whether the government will implement structural reforms.

In Europe, the European Central Bank (ECB) is committed to continuing its asset purchase program through September of 2016. Judging by the money and credit conditions in Europe, the program has been much more successful and offers credence to our view that the European economies are on a modest but sustainable growth path.

Given the divergence in monetary policies around the world, we still expect the US dollar to increase modestly relative to the major currencies over the forecast horizon.

US Outlook

Sluggish US growth in first half of 2015

In the second quarter, real gross domestic product (GDP) grew by an estimated 2.3% on an annualized basis. That followed an upwardly revised gain of 0.6% in the first quarter, according to the Bureau of Economic Analysis (BEA). Previously, first-quarter GDP was estimated to have declined by 0.2%. But even though that contraction in the early part of 2015 was revised away, the economy's performance in the first half of the year was still below expectations.

Weak energy sector

One reason for the first half's lackluster growth was the sharp and sudden collapse of capital spending in the energy sector. According to the BEA, investments in oil and gas exploration and mining collapsed at an annualized rate of 45% in the first quarter and 68% in the second. This two-quarter decline mirrors the sharp plunge in energy capital spending in 1986—another period in which domestic oil prices collapsed.

Increased manufacturing capex

The sharp drop in energy capital spending shaved 0.5% off the first quarter's real GDP growth rate and 0.7% off the second quarter's growth. At the same time, it masked a very powerful capital spending trend in manufacturing structures—primarily tied to the chemical industry building new smelters in the southwest. Indeed, the two-quarter annualized growth rate of 79% in manufacturing structures was the second-highest two-quarter gain in the past 50 years.

US growth to pick up in second half

Growth should pick up during the second half of 2015. The drag from the collapse in energy capital will fade, given that the oil rig count has stabilized. The powerful upturn in manufacturing-structures investment will become more dominant in the aggregate capital spending numbers. Also, we expect continued gains in real consumer spending—close to the second-quarter performance of 2.9% annualized growth. Along with that, we see further gains in housing investment, linked to the strong rebound in building permits. Thus, the US economy should be able to produce second-half real GDP growth in the 3.0%–3.5% range.

Lower growth potential…

From a historical perspective, the US economy growing at a 3% annualized pace is not that unusual, nor should it trigger any concern over domestic price pressures. But revised long-term GDP data suggest that the US growth potential is a lot lower than it used to be. The US economy grew only 2.1% over the past five years instead of the previously reported 2.25%, and growth in the private sector was downwardly revised to 3.0% from 3.2%.

…creates inflationary pressures

Thus, if the US economy's long-term potential growth rate is 2% or less, a growth rate of 3% for the second half of this year would place further downward pressure on domestic resources (labor) and upward pressure on domestic prices (inflation).

Tightening of labor markets

At this time, the upward pressure on prices appears modest. But there *is* upward pressure. For example, employer costs for labor seem to be moving up—although the weaker-than-expected 0.2% gain in the Employment Cost Index (ECI) for the second quarter does raise questions over tightness in the labor market and breadth of wage increases. The weakness in the second-quarter ECI was centered in sales and incentive-type compensation jobs. Yet the data don't square with business surveys and tax data. Upcoming reports on jobs and wages will offer more intelligence on labor-market tightness.

Increase in services prices

Upward price pressure is also showing in consumer prices for domestic services (such as medical care, education, transportation and rents). These were running at 2.5% in the past year, while the rate of increase in the first half of 2015 ran at 3.0% annualized—the fastest gain since 2008. To be fair, prices for consumer goods (motor vehicles, apparel, medical products and furniture) are still contracting at a rate of about 0.5% per year, owing to international competition and a strong dollar. Yet prices for consumer goods account for only 10% of the overall consumer price index, so the upturn in domestic services will ultimately dictate the trend in overall inflation.

At the July 29 Federal Open Market Committee (FOMC) meeting, policymakers upgraded their current assessment of economic growth. They noted better trends in consumer spending and housing, but acknowledged weaknesses in investment and net exports. Also, policymakers said that the labor markets have shown "solid gains,"

and that it would only take "some" further improvement in labor markets for the Fed to be in a position to lift the target on the official rate.

FOMC shift in language

We think policymakers purposely changed the language with respect to labor markets because of growing signs of wage pressures and favorable trends in leading indicators of employment—such as jobless claims, job openings and business surveys indicating labor shortages.

September rate hike likely

Although the FOMC's wording change doesn't guarantee an official rate hike in September, the path to the initial rate hike seems largely dependent on labor market gains and labor costs. And on that front we expect continued gains in the months ahead.

Europe Outlook

Consumer-led recovery

With sluggish emerging-market growth damping the stimulus from a weak euro, the euro-area recovery has been unusually dependent on consumption. So should we be concerned by signs of softer consumer-spending data in the second quarter? In our view, the answer is no.

More moderate second quarter

Indeed, part of the recent moderation in consumer-facing indicators is likely reflecting the extreme strength of earlier quarters. For example, retail sales growth rose by just 0.3% in the second quarter, but this followed strong gains of 0.7% and 1.0% in the final quarter of last year and first quarter of this year, respectively.

Likewise, car registrations were flat in the second quarter, but this followed very strong gains of 2.5% in the final quarter of last year and 4.0% in the first quarter of this year. Not to mention the fact that June's reading was the highest since December 2011 and 18% above the low reached in January 2013 (though still 23% below the precrisis peak).

What the second-quarter data are therefore likely to be telling us is that consumer spending growth is settling down to a more sustainable pace after heady gains around the turn of the year. In this respect, it's important to realize that the consumer revival in the euro area is not just about the oil price.

Not just about oil

Clearly, the lower oil price has been an important factor in recent months, helping propel real wage and salary income growth up to an annual 3.0% in the first quarter, close to the precrisis high. But the turning point for consumption happened long before the collapse in the oil price. And it was underpinned by a recovery in nominal wage and salary income growth, which has accelerated from 0.5% in the first quarter of 2013 to 2.7% now.

Income growth picks up…

The bulk of this improvement has been driven by a turnaround in employment growth—contracting at an annual rate of 0.9% at the beginning of 2013 but rising by 0.8% now. However, there are also tentative signs that wage growth is starting to recover—and not just in Germany. Even in the periphery, where wage growth has been under intense downward pressure in recent years, there are signs that the worst of the adjustment is over and that wage growth is slowly starting to creep up.

…and consumers start to borrow again

The recovery in consumer spending has also been supported by a pickup in credit growth. In the first half of the year, consumer credit rose by €3.2 billion, compared with decreases of €1.7 billion in the same period last year and €11.3 billion in the first six months of 2013. In annual terms, the growth rate of consumer credit is still soft, at

0.7% in the second quarter. But this is the fastest growth rate since early 2009 and a big improvement on the sustained declines seen in the interim.

The recent improvement in credit growth suggests that consumers have become less cautious and are finally willing to borrow again. There is strong evidence to support this in the ECB's latest bank-lending survey. Not only does this show that banks have loosened lending standards significantly in recent quarters—thus boosting the supply of credit—but also that the demand for consumer credit has shot up to the highest levels since the survey began in 2003.

So while the decline in the oil price has clearly provided an important boost to euro-area consumption, it's certainly not the whole of the story. There's also been an improvement in underlying fundamentals which should underpin consumption, and the recovery more generally, when the boost from the oil price starts to fade.

Japan Outlook

A "new" core CPI measure garners attention…

Traditionally, the indicator used to judge the underlying inflation pulse in Japan has been the consumer price index (CPI) excluding fresh food—the Japanese-style core inflation measure. But a range of alternatives has always been available, including a US-style core CPI, which excludes food and energy prices, and is sometimes referred to as "core core" among Japanese market watchers.

In its latest monthly economic review, the BoJ started to calculate and publish an additional metric—a CPI excluding fresh food and energy that lies somewhere between the US-style and Japan-style measures.

This announcement has been greeted with some cynicism. After all, the new measure is currently running above the alternative metrics, and trending up rather than down, thus suiting the BoJ's narrative. But the cynicism seems a bit extreme. The new measure seems to have emerged because the central bank recognized that both existing measures are flawed. The Japan-style version is impacted by swings in energy prices, while the US one ends up taking out almost a third of all items.

So this "new core" measure represents a good compromise. Yes, it's running on the higher side today, but that hasn't always been the case. And over the longer run, it hasn't much mattered which of these core CPI measures is used. The characterization of inflation behavior is roughly the same.

What would make a bigger difference, however, is the treatment of rent inflation. This component—the lion's share of which is imputed rent, not actual payments—accounts for almost 20% of the new core measure. Its recent behavior has been consistent, declining at around 0.4% per year. The view propagated by the BoJ and others is that a chunk of this decline reflects the failure to adjust rental costs appropriately for quality. This seems a bit arcane, but their estimates suggest that rectifying this could add 0.2 or 0.3 percentage points to the "new core" measure. With a CPI rebasing due next year, this is a live issue.

...further bolstering our view that tapering could start in early 2016

In any case, this technical discussion shouldn't distract us from the main point, which in our view is the idea that the BoJ remains eclectic in its approach to judging the inflation pulse. The addition of a new metric needs to be seen in this light. There are now a good half-dozen core inflation measures to look at, along with a range of inflation expectation surveys and relevant economic behaviors such as wage-negotiation outcomes.

In other words, the BoJ is not wedded to any one measure. To quote from the great Australian movie *The Castle*, it's more about "the vibe of the thing." To put it another way, what's the message coming from a broad range of indicators? At this juncture, the BoJ's characterization is that inflation remains on track to move higher. The "new core" measure bolsters that view.

All of this continues to push us toward a view that tapering—for fundamental reasons, rather than technical considerations—will be the BoJ's next move, not further expansion of its current quantitative/qualitative easing program.

Australasia Outlook

RBA sitting on its hands for now…

After cutting rates by 50 basis points during the first half of the year, the Reserve Bank of Australia (RBA) seems content to sit on the sidelines for now. On one hand, wage growth outcomes remain tepid, and commodity prices and mining-sector capital spending continue to be under downward pressure. On the other, the housing sector (prices and construction activity) is booming, and recent labor market outcomes have been better than expected.

The effect of sharply rising home prices on financial stability is a key concern. That explains the steps taken over the last month or so to tighten lending conditions for property investors. Our best guess is that these macroprudential measures will have some impact, but there's a lot of uncertainty.

What would bring the RBA back to the easing table? Three things, in our view. (1) Clearer signs that the housing sector is swinging from boom to bust. Obviously, we're not there yet. July's home price data showed the biggest month-over-month rise on record (monthly data back to December 1999). Prices were up 2.8% countrywide, 3.3% in Sydney and 4.9% in Melbourne. (2) Clearer signs that labor market damage from the mining bust and manufacturing downturn is dominating other more positive influences (including from housing). Again, it will take accumulation of evidence over a number of months. (3) A bout of Australian-dollar strength. While the RBA might think the adjustment so far is OK, it does not want to see the currency strengthen.

…RBNZ to continue easing

Across the Tasman in New Zealand, the easing cycle is likely to continue. The Reserve Bank of New Zealand (RBNZ) cut rates in June and July on concerns over the impact of significantly lower dairy prices and the looming end to the Christchurch reconstruction effort. Continued lower-than-expected inflation readings also contributed to the decision. With risks still skewed to the downside, we expect the RBNZ to deliver a couple more cuts before year-end.

Canada Outlook

Economic turnaround will be difficult

Canadian real GDP fell again in May (off 0.2%), its fifth consecutive monthly decline. The Bank of Canada (BoC) now expects second-quarter real GDP to decline 0.5% and full-year growth to be only 1%—roughly half of what it forecasted back in April. The economic contraction in May offered proof that an economic turnaround will be difficult to achieve. It also offered fundamental support to the recent 25-basis-point cut in official rates.

Manufacturing was the weakest component, falling 1.7%, with the overall goods-producing sector down for five months in a row. The service sector component dropped for the first time since January, contracting 0.1%. The likelihood of a technical recession in the first half of 2015 has increased.

Prior to the May GDP release, the BoC had already reduced its growth outlook and acknowledged at its July meeting that the transition from a housing- and consumption-led economy to one driven by exports and investment would be very difficult to achieve without a significant weakening of the exchange rate.

In order to generate the necessary currency adjustment, the BoC opted to reduce official rates again, even though it acknowledged that the move would create the potential for financial instability given current high levels of household debt.

BoC Governor Poloz appears to be campaigning for even more currency weakness to help the economic growth and inflation transition in Canada. In his opening statement at the July meeting, he stated that the prospect of an interest-rate increase in the US would be welcome and that monetary policy operates through different transmission channels, with long-bond yields and the exchange rate being the most important.

2Q growth forecast reduced to –1.2%

For now, we think our forecast of 1%-to-1.5% growth in 2015 still looks accurate, but we reduced our 2Q growth forecast to –1.2% from 1.7% last month.We expect the currency to trade in the range of C$1.30 to C$1.35 per US dollar in the second half of the year.

Emerging-Market Outlook

Latin America: The past month was a difficult one for emerging markets. Commodity prices decreased gradually while expectations of a US interest-rate hike before year-end grew. Local currencies weakened and bond spreads widened during July. Near the end of the month, Brazil's announcement about a much weaker fiscal outlook raised the odds of sovereign-rating downgrades, an event that could have systemic implications.

Brazil: Weaker fiscal outlook elicits ratings action

On July 28, S&P revised its outlook for Brazil's sovereign foreign currency long-term debt rating to negative from neutral while affirming the rating at BBB–. The revision reflected the perception of higher risk surrounding the implementation of the macroeconomic adjustment plan. S&P zeroed in on execution risk, given the less cohesive situation in Congress and the deeper-than-expected contraction in economic activity. The agency now expects that results from the policy adjustment will take longer to materialize, thus increasing the risk of slippage.

The outlook change took place after the authorities revised down this year's primary fiscal surplus goal from 1.1% to just 0.15% of GDP, and the 2016 target from 2% to 0.7% of GDP. The authorities also established a 1.3% target for 2017 and a 2% goal for 2018. In addition, the new 2015 target is dependent on securing revenues stemming from a still-to-be-approved bill on repatriation of private capital, as well as infrastructure concessions and the reduction in the payroll tax exemption. If those revenue sources fail to materialize, there could be a primary deficit of as much as 0.3% of GDP this year.

The combination of high interest rates and low economic growth implies that Brazil must generate a primary fiscal surplus of more than 2% of GDP in order to stabilize its public debt/GDP ratio. The new set of targets implies that the debt dynamics will remain unfavorable at least until 2018. In addition, given President Dilma Rousseff's record low support and the volatile nature of domestic politics amid ongoing corruption investigations, Brazil's ability to deliver more fiscal tightening over the

coming years is questionable. What's more, 2018 is an election year, and that usually puts pressure on the government to spend.

S&P now expects gross general debt as a proportion of GDP to reach 64% this year, up from 59% in 2014, and to reach 69% by 2017. General government debt, net of liquid assets, is expected to jump to 53% of GDP this year and to 60% in 2016, from 47% in 2014. The debt interest burden is expected to surpass 20% this year, compared to 15% in 2014.

The timing of S&P's announcement was surprising, especially considering that the agency was the most recent to downgrade the rating and that it assigns the lowest rating to Brazil of the three largest agencies. If anything, Moody's was expected to move first, possibly in August, downgrading the sovereign rating by one notch and possibly even leaving it on negative outlook. S&P's earlier move may actually fuel further expectations that Moody's will downgrade and revise the outlook to negative.

We also expect Fitch to downgrade the rating to BBB– later this year. Until recently, our base-case scenario was that Brazil would keep its investment-grade status. Given the challenging political scenario faced by the administration, the official acknowledgment of weaker fiscal numbers and a subdued growth outlook, S&P's clues about possible triggers for downgrade suggest that it is now more likely than not that Brazil will eventually lose its coveted investment-grade status.

After the fiscal announcements were made, focus shifted to the central bank, which eventually lifted the target Selic rate by 50 basis points to 14.25%. Policymakers hinted that this would be the end of the current hiking cycle. The weaker fiscal outlook, however, suggests that monetary policy may have to remain tight for longer in order to reach the inflation target, thus keeping short-term rates high until next year. The longer end of the BRL curve, on the other hand, already reflects significant risk. Given the meager growth outlook, long rates are likely to be somewhat anchored.

Fiscal concerns were validated with the release of June's fiscal figures, which showed a BRL9.3 billion deficit for the consolidated public sector, versus expectations of a BRL5.4 billion imbalance. On a 12-month basis, the deficit increased by BRL7.2 billion to BRL45.7 billion (0.8% of GDP), and the nominal deficit surpassed the 8% of GDP mark. Given the precarious state of the real economy and the unfavorable seasonality of fiscal spending, the government may not be able to deliver the much-reduced primary surplus target that it announced last week.

One bit of good news came from the external-account dynamics. The trade surplus has been increasing gradually on the back of subdued imports and increased exports (thanks to a weaker currency). The gap between the current account deficit and foreign direct investment has narrowed. Finally, export-oriented industries are doing better. According to official data, the volume of manufactured-product exports increased by almost 5% year over year during the second quarter after several quarters of contraction.

Mexico: A step up in terms of FX intervention

Banco de México (Banxico) left its target interest rate unchanged at 3% for the 13th consecutive month, as expected. The bank said the balance of risks to GDP growth had deteriorated in recent weeks, as the pace of activity expansion continued to moderate. Investment and exports weakened while consumption expanded, the result of current labor market dynamics and subdued inflation. Banxico estimates that the economy is still operating under a negative output gap, so it doesn't expect any generalized pressures on prices from the demand side in the near future. Pass-

through from currency depreciation to prices has remained limited, showing only on durable goods.

Declines in the prices of basic materials and telecommunications services also contributed to an improved short-term inflation outlook. Banxico continues to expect both headline and core inflation rates below 3% this year and at the 3% target in 2016. Future policy rate decisions will depend on incoming data, particularly with regard to exchange-rate behavior, the relative monetary stance between Mexico and the US, and the magnitude of the negative output gap.

Meanwhile, the Exchange Commission (composed of members of the central bank and the finance ministry) announced an increase in the number of dollars to be auctioned daily to "reinforce the mechanisms to provide liquidity to the currency market." In the third quarter, Banxico will increase the amount of daily dollar auctions without a minimum price to US$200 million from US$52 million (totaling US$3.2 billion), and it will reassess the policy at the end of the period. Since July 31, the auctions of dollars with a minimum price remain at US$200 million per day, but the price will be adjusted up by 1% from the fix of the previous working day, instead of the prior 1.5% adjustment.

With these changes, Banxico is signaling that it is concerned about the recent depreciation of the peso. Given the weak state of the economy, the bank is indicating that it is willing to intervene by selling its dollar reserves rather than hiking the funding rate. Banxico does not target a given exchange-rate level, but it is concerned about the effect of heightened peso volatility on financial stability. It has plenty of ammunition to deploy to smooth out currency movements. At the end of July, international reserves stood at over US$190 billion, and the authorities also have some US$70 billion from the IMF's flexible credit line.

Weak trade data but not deteriorating

Asia ex Japan: Trade performance across the region remains lackluster. The grim outlook is also reflected in the PMI surveys, which have hovered around their lowest level in three years. Only exports to the US are still expanding. Exports to Europe and intra-Asian trade continued to decline.

Lack of catalyst for export growth is more worrying

In additon to the cyclical downturn, there is the absence of any catalyst likely to drive Asia's export growth in the months ahead. This is because the exceptional growth in trade of electronic components, especially by Northeast Asian exporters, had been boosted by mobile devices. However, recent signs suggest the global shipment of smartphones and tablets to developed markets and even to China has plateaued. If demand doesn't rebound, regional export growth may be more moderate going forward.

China's 2Q GDP buoyed by service sector

In China, GDP growth held at 7% year over year in the second quarter, confounding market expectations of a sharper slowdown. The upside contribution came mostly from service sectors, thanks to increased consumer consumption. However, that consumption was boosted by the rise in local stock markets, a trend that came to a sudden halt with July's sharp correction. That doesn't bode well for continued strong consumer spending in the second half.

What's more, industrial output growth in the second quarter was slower than in the first. Agriculture was more or less the same. So, with a reduced boost from services, GDP growth over the next two quarters will probably be below 7%.

A more important trend is the slowdown in nominal GDP growth from nearly 20% to 7.1% in the second quarter. This has negative implications for China's debt servicing capability beause it lowers income, earnings and return-on-capital potential.

Even the official data suggest the economy reached a bottom in the second quarter, and we don't see much momentum that would support a rebound, particularly with the stock market sell-off hurting consumption and investment. Fiscal policy also remains constrained.

For the rest of the region, second-quarter growth figures released by Singapore, South Korea and Taiwan showed a bigger deterioration in trade performance than the market had expected, even though domestic consumption has been stable. Future GDP readings could lead to a downward revision of growth expectations, which together with a renewed decline in oil prices should provide central banks with the room to maintain accommodative monetary policies.

Food inflation concerns dissipate

As for the inflation outlook, we think market concerns about the risk of El Niño conditions are premature. In the past, it required an extended run of El Niño conditions to disrupt food supplies. What's more, not every episode of El Niño in the past resulted in food price inflation. The effect of El Niño on food prices also operated with a lag. For now, the El Niño/Southern Oscillation (ENSO) index has only registered an uptick for two months and has yet to reach its highest level. That suggests the risk of food price inflation isn't a near-term concern.

Moreover, unlike during the food inflation cycles of 2008 and 2011, Asian economies are now running below potential. That means secondary inflation effects shouldn't be a major concern. We don't think short-term food price volatility will prompt a monetary policy response. An easing of monsoon conditions in India also eased market concerns about the risk of food inflation. The regional inflation outook remains benign.

Russia's recession bottoming out after much weaker 2Q

Emerging Europe, Middle East and Africa: In Russia, monthly indicators showed tentative signs that the recession was gradually bottoming out. This was clear in the sequential growth rates, which indicated that the seasonally adjusted output indicator declined on average 0.9% month over month between January and March and 1.1% from April to May, but was up 0.7% in June. In year-over-year terms, however, there has been a visible deterioration during the second quarter. The preliminary composite output indicator, a good proxy for real GDP, contracted 6.1% year over year in the second quarter after falling 2.3% in the first.

Disinflation to resume after July speed bump, but upside inflation risks increased

Meanwhile, after three consecutive months of deceleration, inflation rose in July to 15.6% year over year from 15.3% in June because of the utility price hike. But even this was less than expected, and disinflation should resume after August, thanks to the base effects from last year's food import ban.

The main caveat to this expectation, as well as our policy rate call, is the recent unfavorable dynamics in global oil prices, which have declined by close to 25% since mid-May and caused the ruble exchange rate to depreciate by nearly as much. Such ruble weakness, unless soon reversed, will put upward pressure on core inflation during the rest of the year and will likely dampen the expected pace of disinflation and rate cuts. A threat by the Kremlin to expand last year's food import ban to include additional countries (in response to an additional layer of anti-Russia sanctions announced by the US Treasury earlier this month) could also reduce the benefit of favorable base effects in food price inflation by pushing up the prices of dairy and seafood.

Growth weakness and falling "trend inflation" justify easing…

Despite the July disinflation speed bump and the headwinds from falling oil prices, the Central Bank of the Russian Federation (CBR) continued to cut its policy rate in late July but slowed the pace of easing to increments of 50 basis points, as we had expected. However, to justify additional accommodation, the CBR got creative by announcing that its new, nontraditional measure of "trend inflation" is a more reliable indicator of inflation dynamics for conducting monetary policy. The measure, according to the CBR estimate, fell for the first time since February 2014 and reached 11.5% year over year in June. This, combined with economic weakness and the expectation of further disinflation over the next 12 to 18 months, was enough to convince the CBR to continue the easing cycle last month. But recent ruble depreciation will make further cuts of 50 basis points contingent on the behavior of inflation data.

…but ruble depreciation creates risks to our rate call

For now, we continue to expect the CBR will keep cutting the policy rate during the remainder of the year in 50-basis-point clips, assuming that the oil and ruble weakness reverses somewhat. As for the ruble, the CBR decided to suspend its daily FX purchases, aimed at gradually rebuilding its foreign exchange reserves from US$363 billion to US$500 billion over the next three years. This is designed to make the ruble exchange rate more stable in order to preserve room for further rate cuts.

In Turkey, coalition negotiations have borne no fruit so far…

In Turkey, coalition negotiations have made little progress over the last month. On July 9, President Erdogan started the clock for the parliamentary parties to form a coalition (they have 45 days). Should they fail, the president has the right to call early elections, and Mr. Erdogan has already expressed his preference for a snap ballot in early November.

After several rounds of "exploratory" meetings between Erdogan's AKP party and the other parliamentary parties, the nationalist MHP decided to stay out of government for now. This dashed our hopes for what we thought would be the most market-friendly outcome. Meanwhile, the heads of the AKP and the CHP negotiation teams concluded that there remain a "number of issues that will be impossible to agree upon" owing to "serious differences" of opinion. We believe the status of President Erdogan, Turkey's foreign policy and the AKP's past education policy will the be most difficult sticking points to overcome. As a result, the pendulum seems to be slowly but surely shifting toward early elections in November.

…and geopolitical conflicts help keep rates on hold

To further complicate matters, a terrorist attack by the Islamic State has led to a dramatic change in Turkey's strategy toward Syria. After resisting for more than a year the calls by the US to get involved in the military operations against IS in Syria, Turkey's military began air strikes against IS positions late last month and granted the US (and other allies) access to its military base for launching attacks against IS.

At the same time, Turkey also restarted attacks against the pro-Kurdish PKK militias in northern Iraq, effectively ending the two-year ceasefire and putting the future of the Kurdish peace process in question. The attacks against the PKK, which is considered a terrorist organization in Turkey, were officially justified by the increase in PKK violence and kidnappings inside Turkey after the June elections and especially in the aftermath of the IS terrorist attack. We believe the anti-PKK air strikes, which both President Erdogan and the Kurdish political leaders labeled as the end of the peace process, likely further contributed to the breakdown in coalition talks, given the CHP's support of the Kurdish cause and its favoring of a less activist foreign policy, especially in the Middle East region. Some critics of the AKP party have gone as far as to argue that the air strikes were a tactical move by the AKP to (re)capture the nationalist vote and punish the pro-Kurdish HDP party ahead of possible early elections in November.

In any case, continued political uncertainty and heightened geopolitical tensions over Syria and the Kurdish question will represent a strong headwind for Turkish assets, especially with the Fed expected to start its tightening cycle soon. It will likely force the Central Bank of Turkey to maintain a cautious monetary policy, despite easing inflation pressures, by keeping its repo rate on hold and lira liquidity tight. Given the uncertainties, we believe that the next move on interest rates will be up, not down, although the timing is difficult to call at this stage.

South Africa's central bank delivered another 25 b.p. hike…

In South Africa, the South African Reserve Bank (SARB) hiked interest rates by 25 basis points to 6.00% at its July meeting, an outcome that was hotly debated prior to the decision. Despite the weak economic data flow, the SARB has sent a signal that it intended to stay ahead of the curve by continuing its gradual policy normalization cycle ahead of the start of the Fed tightening (potentially in September). We had expected the decision to be a close call, but thought for a number of reasons that the SARB would wait until September to act.

…despite deteriorating economic outlook…

First, the second-quarter consumer and business confidence surveys were the weakest readings in more than a decade, painting a bleak outlook for an already weak economy constrained by an unstable electricity supply, falling commodity prices, and crippling structural rigidities in the labor markets and infrastructure. To underscore the point, retail sales, along with mining and manufacturing data, surprised on the downside in their May readings. Meanwhile, the prices of the commodities that South Africa exports continued to fall, with iron ore and coal prices down about 60% and 30%, respectively, since the end of 2013, and gold and platinum prices down about 30% since the end of 2012. All these factors have been guiding continuous downward revisions of the 2015 and 2016 growth forecasts since the beginning of the year. Most recently, according to the July Monetary Policy Committee statement, the SARB lowered its own GDP growth forecast to 2.0% for 2015 (from 2.1%) and 2.1% for 2016 (from 2.2%).

…and reduced upside risks to inflation

Second, the energy regulator decided last month against granting a further 14% tariff increase to the state-owned electricity company Eskom, which would have caused a substantial further increase in the headline inflation rate. Yet despite all this, the SARB went ahead and asserted its hawkish bias by delivering a hike. We now believe the hike in July means the SARB will likely leave rates unchanged in September and deliver another 25-basis-point hike in November.

Polish political dynamics point to populism after October elections

In Poland, the rise in popularity of populist parties ahead of October elections continues to be the focus. The opposition and populist party, Law and Justice (PiS), is leading in opinion polls, followed by the incumbent Civic Platform (PO) and then by the newly formed Kukiz party, which supports many of the PiS proposals. Parliamentary elections are slated for October 25, and the polls support the notion that a coalition of PiS and another populist party (most likely Kukiz's) could form the next government.

The PiS promises to increase fiscal spending by up to 2.7% of GDP. The party's PM candidate, Beata Szydlo, is suggesting reversing the extension of the retirement age, returning the pension system to a defined benefit system from the current defined contribution one, awarding a child tax credit and increasing the tax-free allowance. We believe that the increase in fiscal spending planned by the PiS does not have any credible offset in terms of higher revenues. Furthermore, it used to be assumed that the PiS party would not interfere with the independence and inflation-targeting mandate of the National Bank of Poland (NBP). However, a PiS MP, the party's "economic specialist," was quoted as saying last month that his party wants the central bank to assume a broader mandate and become more active in supporting

the economy. The PiS, which will likely dominate the appointments of eight out of 10 Monetary Policy Council members next year, would like the NBP to have access to tools like the Bank of England's Funding for Lending program. We would expect Poland's sovereign credit quality to deteriorate should the elections turn out as currently predicted by the polls. The only good news here is that Poland is starting from a very strong credit position relative to most of its regional peers.

Lower commodity prices put countries on divergent policy paths

Frontier Markets: The continued decline in commodity prices remains the central focus for many frontier economies. As oil prices hover around US$50 and copper prices near a six-year low, countries that have relied too heavily on revenues generated from exporting raw materials are finding themselves in a precarious financial and political position. The lack of these dollar inflows has put currencies under increased pressure, pushed up inflation and required a rethink of policy responses now that a commodity rebound seems less likely. We have seen a greater amount of policy divergence as a result. Oil exporters like Angola and Nigeria have enacted stringent capital controls to stem the demand for dollars, including publishing import bans on a variety of goods or charging 20% haircuts for depositing into USD accounts.

On the fiscal front, countries that need to make up for lost revenues have passed tax policies that have ended up constraining output. Many have had to be rolled back, such as one in Zambia on the mining sector. In response to the fiscal strain, the IMF has increased its role by providing aid and assistance without punitive conditionality to many countries willing to undergo structural reform, including Ghana and Senegal. Sadly, the correct prescriptions are often unpopular and do not yield uniform results.

As we head into the second half of the year, we believe the frontier space remains an attractive destination for capital. But currency volatility and divergent policy decisions will require increased scrutiny in order to tell winners from losers.

AllianceBernstein Global Economic Forecast

August-15

	Real Growth (%)				Inflation (%)				Official Rates[1] (%)		Long Rates[1] (%)	
	4Q/4Q		Calendar		4Q/4Q		Calendar		EOP	EOP	EOP	EOP
	2015E	2016F	2015E	2016F	2015E	2016F	2015E	2016F	2015E	2016F	2015E	2016F
Global	2.8	3.2	2.6	3.2	2.1	2.5	1.8	2.4	2.01	2.23	3.26	3.58
(PPP Weighted)	(3.3)	(3.7)	(3.0)	(4.3)	(2.6)	(3.0)	(2.4)	(2.8)				
Industrial Countries	2.2	2.5	2.0	2.6	1.0	2.0	0.5	1.9	0.42	0.92	1.86	2.34
Emerging Countries	3.9	4.4	3.8	4.3	3.9	3.4	4.1	3.4	4.87	4.58	5.84	5.89
United States	2.5	3.4	2.4	3.5	1.3	2.7	0.4	2.7	0.63	1.75	2.75	3.25
Canada	0.6	2.4	1.0	2.0	1.4	2.5	1.0	2.1	0.50	0.50	1.65	2.50
Europe	1.9	2.0	1.7	2.0	0.8	1.3	0.3	1.3	0.14	0.28	1.25	1.74
Euro Area	1.7	1.9	1.4	1.9	0.8	1.2	0.2	1.2	0.05	0.05	1.00	1.50
United Kingdom	2.9	2.2	2.8	2.6	0.6	1.6	0.2	1.6	0.50	1.25	2.35	2.75
Sweden	2.7	3.0	2.8	2.9	0.3	2.1	0.0	1.5	-0.35	0.00	1.15	1.75
Norway	1.8	2.4	1.6	2.1	1.9	2.1	1.9	2.2	1.00	1.25	2.00	2.50
Japan	3.0	1.4	1.6	1.8	0.6	1.5	0.8	1.2	0.10	0.10	0.55	0.90
Australia	2.6	2.1	2.4	2.2	1.6	2.0	1.4	2.0	2.00	2.00	3.00	3.25
New Zealand	1.5	1.3	2.3	1.5	0.7	1.7	0.2	1.6	2.50	2.50	3.50	3.50
Asia ex Japan	5.9	6.0	5.9	5.9	2.0	2.6	2.0	2.4	2.99	2.85	3.85	4.11
China[2]	6.5	6.5	6.7	6.5	1.6	1.9	1.4	1.8	2.20	2.00	3.30	3.60
Hong Kong[3]	2.2	3.2	2.0	2.8	2.5	2.5	3.2	2.3	0.75	1.25	1.83	1.41
India[4]	7.9	7.4	7.2	7.3	5.7	6.2	5.3	5.9	7.25	7.25	7.90	8.30
Indonesia[5]	5.1	5.3	4.8	5.1	5.4	4.1	6.3	4.4	7.25	6.50	6.50	6.80
Korea[6]	3.2	2.8	2.7	3.1	-0.3	1.6	0.2	1.0	1.25	1.25	2.10	2.00
Thailand[7]	3.3	3.9	3.3	3.9	0.1	2.6	-0.5	2.0	1.25	1.25	2.60	2.90
Latin America[8]	0.6	2.0	0.2	1.5	6.2	4.3	6.0	4.5	9.17	8.33	9.90	9.31
Argentina	0.1	1.3	0.4	0.7	20.0	25.0	21.0	28.0				
Brazil	-1.0	0.9	-1.7	0.5	9.0	5.3	8.6	5.7	14.25	12.00	13.00	11.75
Chile	3.5	4.0	2.9	3.6	3.0	3.0	3.0	3.0	3.00	3.75	4.75	5.10
Colombia	3.0	3.0	2.9	3.1	3.5	3.3	4.0	3.5	4.50	5.25	7.25	7.65
Mexico	2.9	3.7	2.6	3.3	2.9	3.2	3.0	3.1	3.25	4.00	6.40	6.60
EEMEA	0.1	1.2	0.0	1.3	8.9	5.8	10.2	5.9	7.40	7.16	9.09	9.01
Hungary	2.8	3.0	3.0	2.9	1.9	2.5	0.0	2.4	1.35	2.50	4.25	4.50
Poland	3.9	3.5	3.4	3.7	0.5	1.8	-0.6	1.5	1.50	2.25	3.75	4.00
Russia	-2.6	-0.5	-2.5	-0.5	12.4	6.5	15.7	7.2	9.25	8.00	10.55	10.15
South Africa	2.2	2.2	2.4	2.3	6.0	5.7	4.9	5.8	6.25	7.00	8.70	9.40
Turkey	3.3	3.5	2.6	3.5	8.0	7.0	7.5	6.1	8.00	9.00	9.75	9.90

1) Official and long rates are end-of-year forecasts.
Long rates are 10-year yields unless otherwise indicated.
2) China: Official rate is considered the 7D repo rate and 10-year government bond yield.
3) Hong Kong: Base rate and 10-year exchange funds yield
4) India: Overnight repo rate and 10-year government bond yield
5) Indonesia: Intervention rate and 10-year government bond yield
Source: AllianceBernstein

6) Korea: Overnight call rate and 10-year government bond yield
7) Thailand: 1-day repo rate and 10-year bond yield
8) Latin American Inflation and Rates includes Brazil, Chile, Colombia, and Mexico
Note: Real growth aggregates represent 31 country forecasts, not all of which are shown.
Note: Blanks in Argentina are due to the distorted domestic financial system so we do not forecast.

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