February 2016

Global Economy Watch

The dollar, oil, China and the UK's £1 trillion export challenge

Dear readers,

The global economy is experiencing a potentially dangerous cocktail of a strong dollar, low oil prices and a continued slowdown in China.

In the US, the value of the dollar is higher than it has been at any time since 2006. One of the effects of this was seen in the latest US GDP estimate for 2015 Q4 — GDP grew by 0.7% on an annualised basis— with net exports dragging down overall output growth by around half a percentage point. This is likely to play on the mind of the Fed and so the pace of interest rate rises will probably be slower than might have been anticipated in December. With these factors in mind, we have lowered our projection for US GDP growth in 2016 to 2.3%.

Oil prices fell to below $30 per barrel in January and remain weak. With no material action from OPEC states and Iranian oil supplies gradually coming back onto the market, we think that prices will remain low for the foreseeable future. This is exerting significant pressure on the public finances of oil exporting economies. For net oil importers, however, lower oil prices are projected to continue to hold down inflation rates and consequently, interest rates.

China's economic stresses can be seen in its financial market volatility and the rapid run down in its foreign exchange reserves. These developments pose a particular risk for emerging economies in South East Asia due to their close supply chain links with Chinese businesses, as well as commodity exporters around the globe.

Finally, in this edition we have taken a closer look at the UK's export strategy. Like many economies, the UK government set a goal in 2012 to increase UK exports to £1 trillion by 2020. Looking at the trade figures shows that the UK still has a long way to go to hit this goal. However, after adjusting for exchange rate movements, the UK's performance looks better than it might first appear. With time running out to hit the goal, we've answered some strategic questions to help guide the UK's export strategy.

Kind regards

Richard Boxshall

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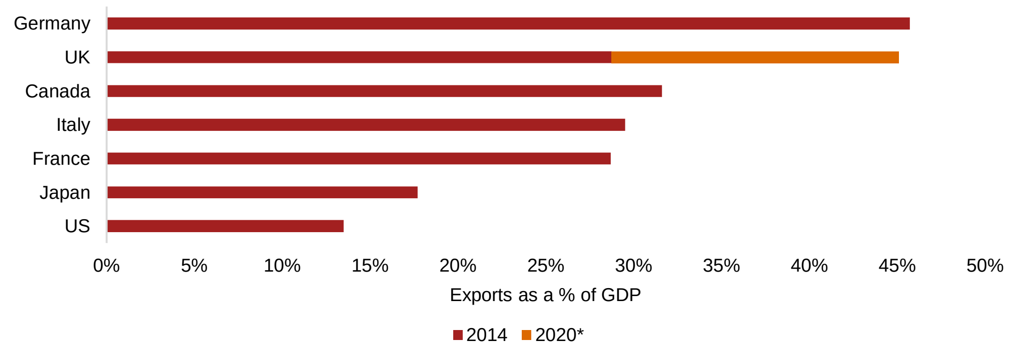
Fig 1: Based on current nominal GDP projections, relative UK exports would need to increase to German levels in order to reach the £1 trillion goal by 2020



*Assumes that UK exports reach £1 trillion and nominal GDP grows in line with our GDP and inflation projections

Sources: PwC analysis, OECD, IMF

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Economic update: Cocktail of emerging market risks not going away

Not such a happy hour for emerging markets

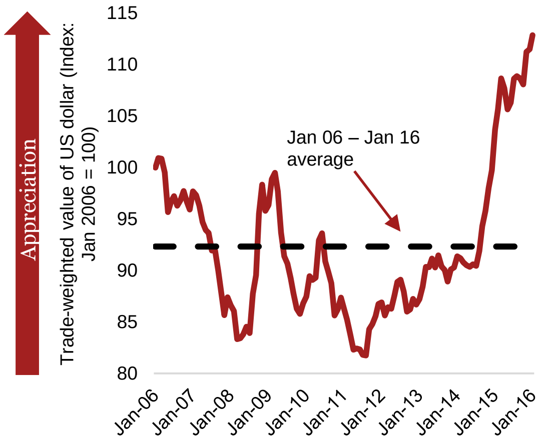
The global economy is experiencing a potentially dangerous cocktail of a strong dollar, low oil prices and a continued slowdown in China. Each of these can be viewed as a downside risk for the emerging economies:

- The US dollar is now much stronger in trade-weighted terms than it has been at any time since January 2006 (see Figure 2). Households, corporates and governments in emerging market countries with relatively high levels of dollar-denominated debt, such as Turkey and Russia, remain vulnerable to further fluctuations in the dollar.
- Oil prices fell to below $30 per barrel in January and remain weak. In the absence of a material shift in OPEC's stance, and with Iranian oil supplies gradually coming back onto the market, we expect prices to remain lower for longer. Economies that depend heavily on oil revenues to fund government spending could face short-term liquidity problems and will need to take action to ensure their public finances become more stable and sustainable over the medium-term.
- China continues to be a source of concern as it seeks to rebalance its economy. Economic growth slowed to 6.9% last year, there has been extreme volatility in the Chinese stock market and the People's Bank of China has been running down its foreign exchange reserves to protect the RMB. The risks these developments pose is particularly pronounced for emerging economies in South East Asia due to their close supply chain links with Chinese businesses, as well as commodity exporters around the globe.

With these trends unlikely to abate in the short-term, there could be challenging times ahead for some emerging markets.[1]

[1]We will provide a more detailed review of recent emerging market trends in our next edition.

Fig 2: The trade-weighted value of the US dollar is around 22% above its Jan 06 – Jan 16 average value



Sources: PwC analysis, Datastream, Federal Reserve

Tough ask: Three questions to help guide the UK's export strategy

The UK government set tough export goals during 2011 and 2012 to:

- increase exports to £1 trillion by 2020; and
- increase the number of exporters by 100,000 to 288,000 by 2020.

In 2014, 10.8% of enterprises in Great Britain were exporters which was slightly lower than in the previous year (11.6%). With the 2020 goal creeping up, we have posed three questions that should be considered by the UK export agency.

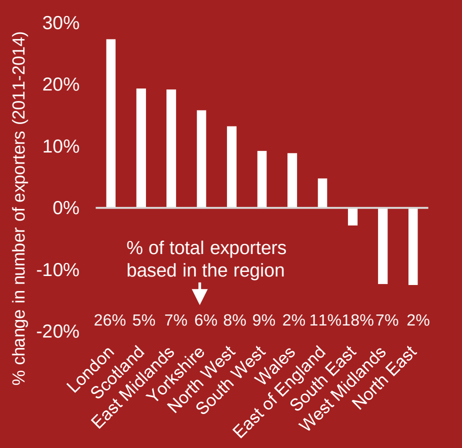
Small, medium or large – which businesses to support?

At a high level, large businesses have the scale which can make a difference to headline export numbers. However, small and medium-sized businesses tend to be more agile and flexible to changes in international markets.

Which businesses to support depends on which of the government's two export goals is being considered.

In 2014, there were around 221,300 exporting businesses,[1] meaning the number of exporters has to rise by around 67,000 by 2020 to hit the goal. To get close to this figure, policymakers will need to offer support to small businesses (1-49 employees). There are over 2 million of them, making them the largest category. Even if every medium-sized business (50-249 employees) and large business (250+ employees) started to export, this would only add around 27,000 new exporters, some 40,000 below the number required to hit the goal. Small businesses are the key to achieving the aim of 100,000 new exporters.

Fig 3: London saw the biggest increase in the number of exporters between 2011-14



Source: ONS Annual Business Survey

Getting close to the £1 trillion export goal, by contrast, will probably mean supporting large businesses to export as they are likely to be able to bring a larger quantity of goods and services to international markets.

Which regions to support?

London is already experiencing fast growth in the number of exporters and around a quarter of exporting businesses are based in the capital (see Figure 3). Therefore, to get close to the 2020 export goals, we think that policymakers should focus their attention on providing support to businesses in some of the other regions which have witnessed an impressive increase in the number of exporters in recent years.

Scotland has experienced a large increase in the number of exporters and, at the beginning of March, UK Trade & Investment, Scottish Enterprise and the Scottish Council for Development and Industry are hosting a series of export roadshows.

But the type of support provided matters as well. For example, around two thirds of exporters experienced significant barriers (regulatory, commercial and financial) when entering new overseas markets.

Facilitating introductions between UK businesses and local agents or distributors for example, could actually help overcome some of the more tedious issues.

The future of UK exports – goods or services?

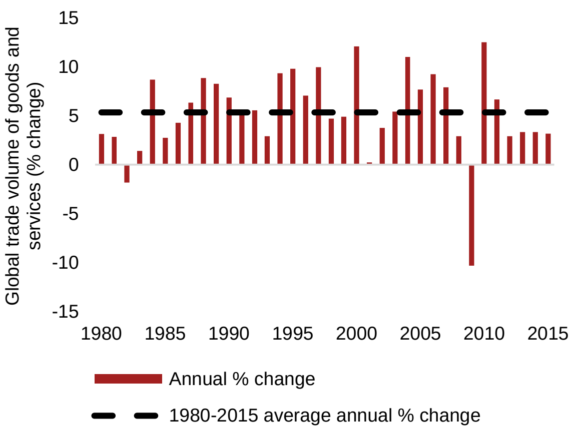
Our analysis on page 3 shows that, in the short-term, policymakers should provide support to businesses involved in selling both goods and services, such as motor cars and transport services.

But looking towards the medium- to longer-term, UK trade is trending towards services. The value of goods trade fell by 4.1% between 2011 and 2014 while the value of services trade increased by 16.3%. Services trade in 2014 also made up around 43% of total trade, up from 37% in 2004. As economic power shifts from the West to the East, large emerging economies like China and India will gradually begin to increase their demand for services. The UK has a comparative advantage in services and so could be in a strong position to cater for this higher demand. Policymakers should therefore gradually shift their attention to the services industry as the future source of export growth.

[1]This data is from the ONS Annual Business Survey which only covers Great Britain.

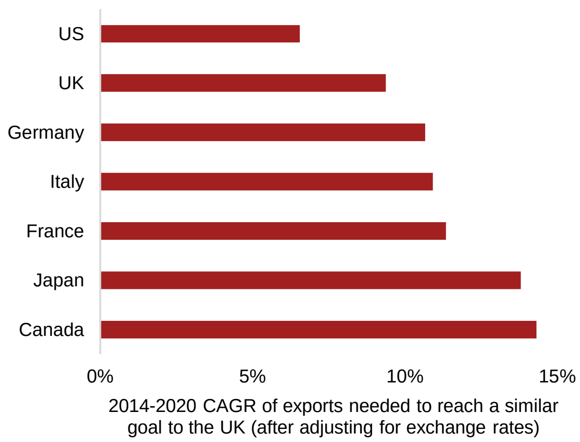
Exporting is hard to do

Fig 4: Global trade growth has been below its long-term average since 2012



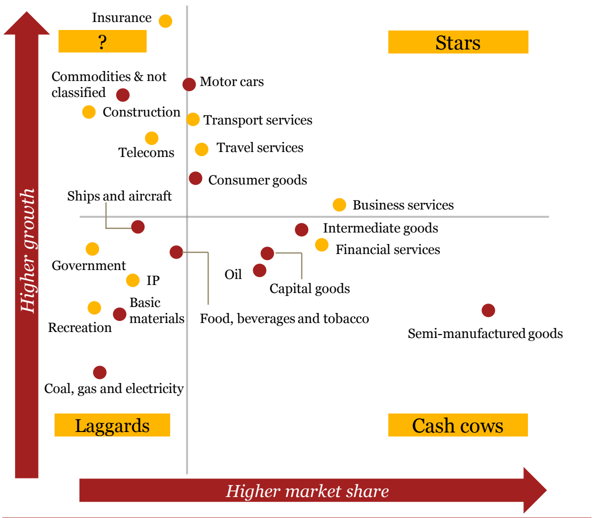
Sources: PwC analysis, IMF

Fig 5: If the rest of the G7 had been set a similar export goal, the UK would be one of the top performers



Sources: PwC analysis, OECD, BIS

Fig 6: The UK export agency should focus its attention on the stars in the short-term



Sources: PwC analysis, ONS Pink Book 2015

Notes: Goods-related services have been excluded from the ? section due to very high growth rates distorting the chart; the red dots represent goods and the yellow dots represent services; the axes represent the average 2010-14 market share and the total goods and services exports 2010-14 CAGR.

Exporting: a key policy for growth

During the financial crisis a key challenge that policymakers faced was to find new sources of economic growth. In the absence of domestic alternatives, selling abroad was a natural choice. So in a short period of time, boosting exports became a key economic aim for policymakers. But with everyone trying to do this, competition is stiff, so not all countries can succeed in hitting their export goals.

The UK has set ambitious export goals

The UK government is a good example to focus on as it set ambitious export goals during 2011 and 2012, which aimed to:

- approximately double total UK exports to £1 trillion by 2020; and
- increase the number of companies exporting by 100,000 by 2020.

The performance to date shows that the value of exports has grown, but so far at a significantly slower annual rate than the 8.1% required between 2011 and 2020 to meet the goal. Therefore, exports need to grow at an even faster rate of almost 12% per annum between 2014 and 2020 to reach £1 trillion.

At face value, the performance to date is disappointing. However, UK businesses have been asked to carry out a herculean task. According to our analysis the government's goal implies an export to GDP ratio of around 45% by 2020. Put another way, UK businesses have been asked to match Germany's ratio of exports to GDP in a relatively short period of time (see Figure 1).

Nominal goals ignore external factors

Setting nominal export goals without considering external factors has its limitations. It ignores international trade movements and, in fact, the growth of global trade volumes has been below its long-term average since 2012 (see Figure 4). It also assumes that market exchange rates will remain constant.

Accounting for the exchange rate movement that sterling has experienced since March 2012, the £1 trillion export goal would need to be downscaled to around £880 billion.[1] If the government followed this approach and targeted this new number instead, the required growth rate of UK exports needed to reach the goal would be around 9.4% per annum between 2014 and 2020. Though achieving this will still be very challenging as, in nominal terms, exports have only grown by around 1.1% per annum between 2011 and 2014.

The UK fares better when compared to the rest of the G7

How does the UK's export performance compare to the rest of the G7? To answer this question, we have considered a scenario in which the rest of the G7 were also set a goal to virtually double their exports. Based on their performance to date, and after adjusting for exchange rate movements, our analysis in Figure 5 shows that:

- the US would need to increase its exports by around 6.5% per annum between 2014 and 2020 to hit the goal; and
- the other G7 countries would need to increase their exports by 10-15% per annum between 2014 and 2020, which indicates that they would have a lot of ground to cover.

So compared to the other G7 economies, and adjusting for exchange rate movements, the UK is faring better than the headline figures would suggest.

Where might the UK government focus its attention?

The real challenge for any government is to identify which goods and services to focus its limited resources on.

As a first analysis (see Figure 6) we have looked at the UK's export performance since 2010 using a growth-share matrix. Using this approach, we find that there are some areas which could move actual exports closer to the £1 trillion goal.

Specifically, we find that the 'stars' category which includes motor cars, other consumer goods, transport services, business services and travel services could benefit from support in the short-term to help them transition to cash cows. Businesses which specialise in these sectors have the greatest chance of getting the UK close to the £1 trillion export goal.

And in the long-run we think that the 'question mark' category has the most promising potential to respond to government support. This includes services like construction and telecoms which will be increasingly in demand as living standards and population levels continue to rise.

In conclusion though, identifying the sectors that will respond the most to the government goal of increasing exports is a difficult task and should be subject to more research.

[1] Price effects could also have an impact on this number but we have not considered them in this piece of analysis.

Projections: February 2016

	Share of 2014 world GDP		Real GDP growth				Inflation			
	PPP	MER	2015e	2016p	2017p	2018-2022p	2015e	2016p	2017p	2018-2022p
Global (Market Exchange Rates)		100%	2.6	2.7	2.9	2.9	1.9	2.4	2.5	2.7
Global (PPP rates)	100%		3.2	3.2	3.5	3.4				
G7	32.0%	46.0%	1.8	1.9	1.9	1.9	0.3	1.1	1.6	1.8
E7	35.6%	25.4%	4.1	4.2	4.7	4.8	0.5	2.1	3.0	3.2
United States	15.9%	22.5%	2.4	2.3	2.3	2.3	0.1	1.3	1.9	2.0
China	16.6%	13.4%	6.9	6.5	6.0	5.7	1.5	1.8	1.8	2.8
Japan	4.4%	6.0%	0.7	1.3	1.3	1.0	0.8	0.9	1.1	1.4
United Kingdom	2.4%	3.8%	2.2	2.2	2.3	2.3	0.0	0.5	1.6	2.0
Eurozone	12.2%	17.4%	1.5	1.6	1.7	1.6	0.1	1.0	1.3	1.4
France	2.4%	3.7%	1.1	1.3	1.6	1.6	0.1	0.8	1.4	1.2
Germany	3.4%	5.0%	1.5	1.7	1.6	1.4	0.2	1.3	1.5	1.7
Greece	0.3%	0.3%	-2.2	-1.4	2.7	2.5	-0.4	0.1	-1.4	1.4
Ireland	0.2%	0.3%	6.5	5.0	4.0	2.5	-0.0	1.0	1.5	1.7
Italy	2.0%	2.8%	0.7	1.3	1.2	1.2	0.2	0.7	1.0	1.4
Netherlands	0.7%	1.1%	2.0	1.8	2.2	1.8	0.3	1.2	1.5	1.3
Portugal	0.3%	0.3%	1.5	1.6	1.7	1.2	0.5	0.8	1.4	1.6
Spain	1.4%	1.8%	3.1	2.6	2.3	2.0	-0.6	0.8	1.0	1.2
Poland	0.9%	0.7%	3.5	3.4	3.4	3.6	-0.9	0.8	1.3	2.5
Russia	3.3%	2.4%	-3.8	-1.1	0.9	1.5	15.5	8.7	7.3	4.0
Turkey	1.4%	1.0%	3.4	3.2	3.3	3.5	7.7	8.0	7.0	6.5
Australia	1.0%	1.9%	2.2	2.4	2.5	2.7	1.5	2.3	2.5	2.5
India	6.8%	2.7%	7.1	7.7	7.7	6.5	4.9	4.1	4.3	5.0
Indonesia	2.5%	1.2%	5.2	4.8	4.8	5.4	6.8	6.1	6.1	5.1
South Korea	1.6%	1.8%	2.6	3.1	3.6	3.5	0.8	1.5	1.8	3.3
Argentina	0.9%	0.7%	2.0	1.7	2.3	2.5	17.0	25.0	25.0	20.0
Brazil	3.0%	3.0%	-3.8	-3.6	0.7	3.0	9.0	9.0	6.5	5.0
Canada	1.5%	2.3%	1.3	1.8	2.2	2.2	1.1	1.7	1.9	2.0
Mexico	2.0%	1.7%	2.5	2.7	3.0	3.3	2.7	3.1	3.0	3.0
South Africa	0.7%	0.5%	1.5	1.0	2.0	2.5	4.6	5.6	5.4	5.3
Nigeria	1.0%	0.7%	3.2	3.7	4.3	5.0	9.0	10.0	9.5	8.0
Saudi Arabia	1.5%	1.0%	3.2	1.3	2.1	3.0	2.2	2.7	3.2	3.2

Sources: *PwC analysis, National statistical authorities, Datastream and IMF. All inflation indicators relate to the Consumer Price Index (CPI). Argentina's inflation projections use the IPCNu Index. Also note that the tables above form our main scenario projections and are therefore subject to considerable uncertainties. We recommend that our clients look at a range of alternative scenarios.*

Interest rate outlook of major economies

	Current rate (Last change)	Expectation	Next meeting
Federal Reserve	0.25-0.5% (December 2015)	Next rate rise may be delayed until later in 2016	15-16 March
European Central Bank	0.05% (September 2014)	More loosening expected in 2016	10 March
Bank of England	0.5% (March 2009)	No immediate rate rise likely	17 March

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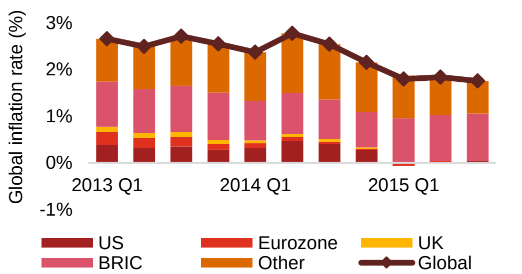
Chart of the month

The global inflation rate in the third quarter of 2015 was 1.8%, similar to the first and second quarters of the year. The US, UK and Eurozone are not having much of an impact on global inflation. However, Russia is contributing about 22% of global inflation while Brazil is also making a sizable contribution of around 17%.

Chart of the month: BRIC economies contribute more to global inflation in 2015 Q3 than the rest of the world combined



Note: Based on 2014 market exchange rate (MER) GDP weights
Sources: PwC analysis, Datastream, National Statistical Agencies

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