



Global Economy Watch

Has the need for governments to support the financial sector in times of crisis been removed?



Dear readers,

March saw a lot of action on the global economic stage.

Chinese policymakers announced a 6.5-7% target range for real GDP growth this year. Our own projections suggest that Chinese economic growth in 2016 may come in at around 6.5%, but risks remain weighted to the downside.

Closer to home for me, another major policy announcement was the UK Budget (see Figure 1). Through some targeted tax cuts for small businesses, savers, drinkers and drivers the Chancellor has offered some short-term sweeteners. But he will need to increase the fiscal pain again significantly in 2019-20 if he is to hit his ambitious £10 billion surplus target for that year.

This was the Chancellor's last major fiscal policy announcement before voters go to the polls on 23 June to decide whether or not the UK should remain in the EU. On 21 March we launched a report, which was commissioned by the CBI, on the potential economic implications of the UK leaving the EU. We estimate that UK GDP per capita could be between 0.8% and 2.7% lower in 2030 in our two 'Brexit' scenarios than if the UK remains in the EU, depending in particular on the UK's post-exit trading and migration arrangements with the EU. This long term outcome would be negative but not disastrous, but the short term impacts could be larger given the increased uncertainty that would follow a vote to leave. For more details see our website [here](#).

March was also a big month for the ECB, which announced an extensive additional stimulus

package. One important part of this is the TLTRO (targeted long-term refinancing operations) package, which will provide banks with ultra-cheap borrowing in a bid to ease credit conditions and encourage loans to the real economy. This could positively impact business activity by bringing forward investment plans, but it is hard to estimate exactly how large these effects will be in current uncertain global economic times.

Moving to a global issue, we have reviewed the progress that has been made since the financial crisis in reducing government support for the financial sector in times of crisis.

The G7 have pushed through significant reforms aimed at reducing government exposure to banks, ensuring that a banks' shareholders and creditors pay their share in the event of a bank failure through bail-in mechanisms.

The pace of reforms in major emerging markets has been markedly slower. This could be an area to watch out for in the face of the dangerous cocktail of risks that these emerging economies are facing and some early evidence of non-performing loans increasing.

For the reverse link, banks' exposure to weaknesses in the government sector, the same progress has not been made. Latest available data shows that banks in the Eurozone economies like Germany, Spain, Portugal and Italy have similar levels of exposure to their government's debt as Greek banks did during the bailout. This link is harder to break but may become a more prominent area for global policymakers in the pursuit of financial stability.



Kind regards

Richard Boxshall

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Fig 1: The Chancellor faced a tricky challenge in keeping his budget deficit reduction plans on track despite deteriorating economic conditions

Comparison of key OBR forecasts in this Budget and last Autumn Statement					
Public sector net borrowing (£ billion)*	2015/16	2016/17	2017/18	2018/19	2019/20
Autumn Statement (November 2015)	74	50	25	5	-10
Budget - excluding new policy measures (March 2016)	72	57	32	17	3
Budget - including new policy measures (March 2016)	72	56	39	21	-10

*Excluding borrowing of public sector banks. Negative number indicates a budget surplus

Sources: OBR

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Economic update: What does the new growth target mean for China?

Target range makes things a little easier for policymakers

At this year's National People's Congress, Chinese policymakers set a target range for GDP growth of between 6.5% and 7% for 2016 rather than a point specific target.

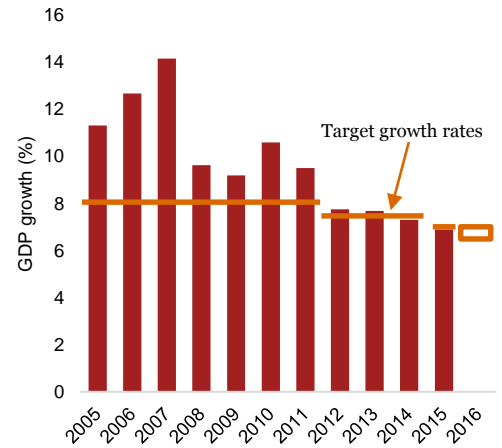
Setting a range makes things a little easier for policymakers as it provides some 'wiggle-room' in a country where the economy has shown signs of a gradual and, sometimes bumpy, slowdown in growth (see our [October 2015](#) edition). But fears of a hard-landing were somewhat allayed by the official fourth quarter GDP figures which showed growth of 6.8% coupled with a clearer communication plan deployed by the People's Bank of China (PBoC). This has increased market stability with the renminbi exchange rate reaching its strongest value against the dollar since the start of the year.

The growth-reform dilemma

In order to achieve this target, the government set out a number of initiatives to stimulate growth and embolden structural reform. These were headlined by the development target of creating at least ten million new urban jobs, tax cuts, and major investment packages of 800 billion yuan in railway construction and a further 1.65 trillion yuan in road construction, equivalent to around 3.3% of GDP.

To fund some of these measures, the target budget deficit for 2016 has been expanded from 2.4% to 3% of GDP. The government also plans to streamline administrative approvals and encourage innovation and entrepreneurship. Based on government plans for 2016, it suggests the priority is to maintain growth. In line with this, China has adopted a pro-active fiscal policy and a "flexible and adequate" monetary policy to spur economic activities, while still pushing for structural reform and a transition to consumption and services-led growth.

Fig 2: After exceeding targets for many years, growth rates have been below target for the last two in a row



Source: IMF

ECB announces more cheap loans but what impact will they have?

At the March ECB meeting, policymakers announced further expansionary measures to address below target inflation. These measures included interest rate cuts and an extension in the amount and coverage of eligible assets for its quantitative easing programme.

The announcement also included another round of targeted long-term refinancing operations (TLTROs) which will begin in June. Assuming there are no funds outstanding when the first operation takes place, these will provide Eurozone banks with up to €1.7 trillion of additional funding, equivalent to almost 60% of Eurosystem assets.

This measure is designed to increase lending to the real economy by fixing the borrowing rate at 0% until a banks' net lending exceeds a certain benchmark, following which they can borrow at the deposit rate i.e. -0.4%.

For banks with positive net lending the benchmark is zero, meaning they just need to continue with more of the same to benefit from the negative rate. But for banks with negative net lending in 2015, the benchmark is set equal to that amount. This means that those banks could qualify for negative borrowing rates simply by reducing the rate at which their net lending is falling.

Lending set to increase...

On the supply side, the TLTRO scheme is expected to increase the amount of credit available in the financial system and reduce the cost of borrowing. Easing credit conditions should stimulate the appetite for lending.

On the demand side, the ECB Banking Survey revealed that banks reported an increase in demand for loans from all different sizes of businesses in January 2016. Lower borrowing costs should help to maintain this momentum and lead to an increase in overall lending.

...but will it benefit businesses?

ECB survey data shows that around 10% of businesses in industry, trade and services identify access to finance as their most pressing problem. This is marginally higher for the construction sector. However, the proportion of firms for which this is their most pressing problem fell by almost 8 percentage points across all sectors between 2009 and the middle of 2015 (see Figure 3). This suggests the previous rounds of stimulative measures have had the desired effect.

Though not being the biggest problem for most businesses, Figure 4 shows that around 36% of firms still encounter some challenges when seeking finance. By providing banks with yet more additional funds to lend, TLTROs could help to reduce the number of businesses struggling to gain finance.

Fig 4: Over a third of businesses still face some challenges accessing finance

Sector	Access to finance (%)	
	Straightforward	Challenging
Trade	63	34
Industry	63	35
All sectors	62	36
Services	61	37
Construction	58	40

Note: Based on firms response to the pressingness of 'access to finance' as a problem on a scale of 1-10. Ratings of 1-5 defined as 'Straightforward'. Ratings of 6-10 defined as 'Challenging'. Excludes 'don't know' responses.

Source: PwC analysis, ECB data

This would make it easier for businesses to carry out their investment plans, which would have a positive impact on growth and inflation.

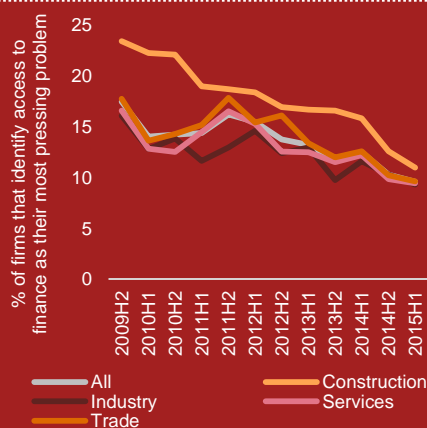
But that's not all...

Negative borrowing rates for banks would allow them to lend to customers at lower rates, while still maintaining enough of a margin. If this occurs, businesses could bring forward planned future investments in order to benefit from the cheaper finance available today.

In addition, the availability of cheap loans could make previously unaffordable investment plans affordable and encourage businesses to press ahead with them.

The ECB have put the measures in place to address low GDP growth and inflation. Whether the policy will work will depend on the reaction of the banks, and ultimately, of businesses.

Fig 3: Access to finance is not the biggest problem for most Eurozone businesses



Source: PwC analysis, ECB Survey on Access to Finance of Enterprises

The co-dependence of governments and the financial sector

Fig 5: Advanced economies have made more progress with implementing bank resolution reforms

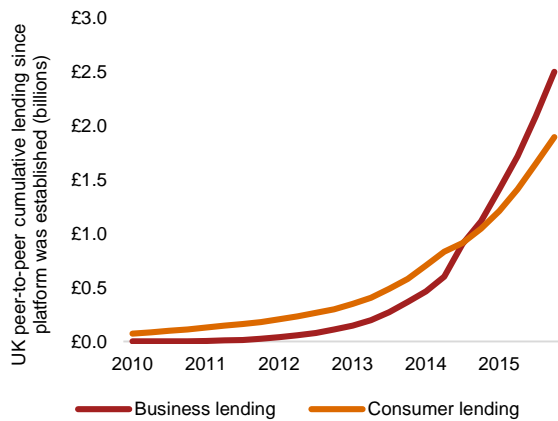
Countries	Overall	Availability of transfer / bail-in / temporary stay powers for banks	Recovery planning for systemic banks	Resolution planning for systemic banks
G7 economies				
Canada	●	●	●	●
France	●	●	●	●
Germany	●	●	●	●
Italy	●	●	●	●*
Japan	●	●	●	●
United Kingdom	●	●	●	●
United States	●	●	●	●
E7 economies				
Brazil	●	●	●	●
China	●	●	●*	●
India	●	●	●	●
Indonesia	●	●	●	●
Mexico	●	●	●	●
Russia	●	●	●	●
Turkey	●	●	●	●

● Implemented ● Partially implemented ● Not implemented

*Only applies to G-SIB(s) at present

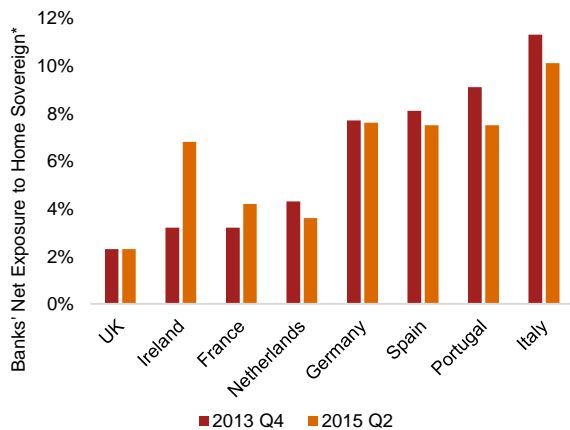
Source: Financial Stability Board

Fig 6: Peer-to-peer lending to businesses in the UK overtook lending to individuals in Q4 2014



Source: The Peer-to-Peer Finance Association

Fig 7: Banks' exposure to domestic sovereign bonds remains a vulnerability in some European economies



*Defined as net direct position in relation to their total assets
Sources: PwC analysis, ECB, EBA

The link between the financial sector and governments was apparent in 2008

Subdued growth in some emerging markets and low commodity prices have led to renewed interest in the link between governments and the financial sector. Recent financial crises have shown how strong this link has been, for example:

- In 2008, the banking crisis in Ireland morphed into a financial crisis after the authorities' decision to recapitalise banks directly and guarantee their liabilities. This helped push public debt levels from 24% of GDP in 2007 to 120% of GDP in 2012.
- On the other hand, private sector government debt holders had to accept losses during the second round of Greek bailout talks in 2012. This placed pressure on the banks who held over €30bn in domestic government bonds at the time.

For businesses this is relevant for two main reasons. First, banks remain a key source of credit, particularly in emerging markets. Second, economic research shows that financial crises can also amplify the depth and length of subsequent recessions, thus having a direct impact on business revenues.

This has also been an important issue on the global policy agenda as policymakers have tried to loosen these ties. But, how successful have they been?

But the G7 have led the way on bank reforms

Figure 5 shows that the G7 have made significant progress in insulating public finances from future banking failures. First, banks have raised capital: compared to 2010, banks' ratio of regulatory tier 1 capital to risk-weighted assets has increased in all of the G7 economies with the exception of Canada. Also, across the European Union (EU) for example, a common Banking Recovery and Resolution Directive (BRRD) was enforced at the beginning of this year. Unlike in the past, this now ensures that banks' shareholders and creditors pay their share of the costs of a bank failure through a bail-in mechanism. This has been complimented by other regulatory tools like stress tests which aim to forecast banks' balance sheets at times of severe but plausible events.

In contrast the E7 are lagging behind

For the E7, the pace of reform has been slower, partly because of the relatively smaller impact of the 2008 crisis. However, with emerging market risks rising (see our [March 2016](#) edition) and GDP growth slowing down in large economies like China, Brazil and Russia, insulating governments from banking failures remains an unresolved issue.

This is particularly relevant now as there are some tentative signs that financial sector risks are rising. According to the International Institute of Finance (IIF), nonperforming loans are on the rise in most emerging markets.¹ If these trends continue, then they could at an extreme trigger bank failures which, in the absence of resolution mechanisms, could have an impact on public finances.

Other sources of finance are growing in popularity

One possible implication of tighter banking regulation is that if banks become more prudent with their lending, financial activity may end up being shifted away from traditional banks. There are signs that this could already be underway as alternative financial channels have been growing in size. For example, the Financial Stability Board estimates that the assets of other financial intermediaries, a measure of the size of the shadow banking sector, in 20 economies and the Eurozone was around \$80 trillion in 2014, up from \$68 trillion in 2010.² In the UK for example, peer-to-peer lending has increased from £73 million in 2010 to £4.4 billion at the end of 2015 (see Figure 6) which represents a compound annual growth rate of 108%.

Less focus has been placed on the reverse channel

However, progress on insulating banks from weaknesses arising in government finances remains limited. Figure 7 shows that banks' exposure to home government debt was broadly similar in the middle of last year to what it was at the end of 2013. As well as this, the exposure of banks in Germany, Spain, Portugal and Italy is similar to the levels held by Greek banks during the bailout.

This is not surprising as in Europe home government debt is treated as a risk-free asset from a regulatory perspective, despite events during the Eurozone debt crisis showing that this is not always the case.

The next challenge is for policymakers around the globe to put in place measures that reduce banks' exposure to financially stressed governments. The Eurozone is at the forefront of this thinking with the European Systemic Risk Board having conducted some preliminary research into policy options. If this can be achieved, then the two-way link between governments and the financial sector will be weakened further. This would have positive impacts on financial stability at an individual economy and at a global level.

¹"EM Bank Lending Conditions Survey- 2015Q4", International Institute of Finance

²"Global Shadow Banking Monitoring Report 2015", Financial Stability Board

Projections: April 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	2.6	2.8	2.9	1.9	2.1	2.6	2.7
Global (PPP rates)	100%		3.1	3.2	3.4	3.4				
G7	32.0%	46.0%	1.8	1.9	1.8	1.9	0.2	0.8	1.8	1.8
E7	35.6%	25.4%	4.1	4.2	4.6	4.8	0.4	1.4	3.2	3.3
United States	15.9%	22.5%	2.4	2.3	2.3	2.3	0.1	1.0	2.1	2.0
China	16.6%	13.4%	6.8	6.5	6.0	5.7	1.5	1.8	1.8	2.8
Japan	4.4%	6.0%	0.5	1.0	0.8	0.8	0.8	0.4	1.4	1.5
United Kingdom	2.4%	3.8%	2.3	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	1.5	0.0	0.5	1.3	1.4
France	2.4%	3.7%	1.1	1.3	1.6	1.6	0.1	0.4	1.2	1.2
Germany	3.4%	5.0%	1.4	1.8	1.6	1.4	0.1	0.6	1.5	1.7
Greece	0.3%	0.3%	-0.3	-1.0	1.3	2.0	-1.1	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%	0.6	1.0	1.2	1.2	0.1	0.2	1.0	1.4
Netherlands	0.7%	1.1%	1.9	1.7	1.8	1.8	0.2	1.0	1.5	1.3
Portugal	0.3%	0.3%	1.5	1.5	1.4	1.2	0.5	0.8	1.4	1.6
Spain	1.4%	1.8%	3.2	2.8	2.3	2.0	-0.6	0.2	1.3	1.2
Poland	0.9%	0.7%	3.6	3.7	3.8	3.6	-0.9	-0.3	1.5	2.5
Russia	3.3%	2.4%	-3.8	-1.1	0.9	1.5	15.5	7.5	7.1	4.0
Turkey	1.4%	1.0%	3.4	3.4	3.5	3.5	7.7	8.5	7.5	7.0
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	2.6	2.7	3.1	0.7	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	-3.8	-0.0	3.0	9.0	9.0	6.5	5.0
Canada	1.5%	2.3%	1.2	1.2	1.6	2.2	1.1	1.4	1.8	2.0
Mexico	2.0%	1.7%	2.5	2.7	3.0	3.3	2.7	3.2	3.1	3.0
South Africa	0.7%	0.5%	1.3	0.8	1.8	2.5	4.6	5.8	5.5	5.3
Nigeria	1.0%	0.7%	2.7	3.3	3.8	4.5	9.0	10.5	10.0	8.5
Saudi Arabia	1.5%	1.0%	3.2	1.3	1.5	2.5	2.2	3.0	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	26-27 April
European Central Bank	0.0% (March 2016)	No rise until after March 2017	21 April
Bank of England	0.5% (March 2009)	No immediate rate rise likely	14 April



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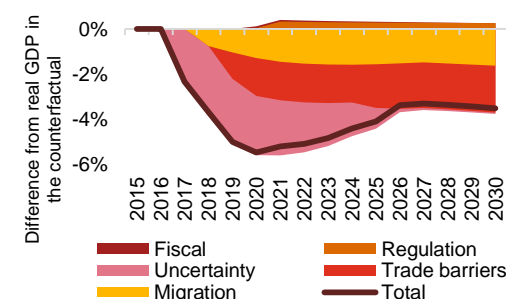
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Chart of the month

We estimate that the net longer term impact related to an EU exit could result in total UK GDP in 2030 being between 1.2% and 3.5% lower in our two exit scenarios than if the UK remains in the EU (around £25-65 billion, at 2015 values).

To read our full report, see our [website](#).

Chart of the month: The impact on UK GDP of a vote to leave the EU in the June referendum



Note: Chart represents impact assuming a WTO exit scenario
Sources: PwC analysis, Datastream, National Statistical Agencies

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