CURRENT ECONOMICS
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Every month, Current Economics reviews the research produced by top international economists from the world's leading firms, selecting a sample of the best available for publication. Coverage includes analysis of topical issues, the economic outlook for a selection of countries and, periodically, the outlook for exchange rates and interest rates. As a benchmark for comparison with the views of individual researchers, a table of the latest consensus forecasts for growth, inflation and current account balances is presented on the back page.

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Assistant Editor: Robert Hunt
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Articles Featured

Asia's investment growth has slowed significantly over the past decade, with last year's figure for the region as a whole coming in below the 3% mark, a far cry from the double digit growth which was experienced not too long ago. This can be partly explained by rising incomes and falling savings rates, but David Carbon warns that if the trend is not reversed, incomes and employment are likely to suffer as a result. In this article, he argues that the real problem is Asia's current account surpluses and advocates a shift to current account deficits in order to foster greater domestic investment. However, the author notes that mindsets will have to change for this to occur.

The Russian economy endured a mixed start to 2015 following an annual expansion in GDP of 0.6% last year. A less severe contraction in Q1 GDP growth helped to lift the mood but this quickly changed following signs of weak private consumption data between January-April, although investment looked better during this period. Based on latest available data, the Economics Ministry updated its 2015 GDP forecast at the end of May, and is predicting a 2.8% contraction. Authors, Evgeny Gavrilenkov, Anton Stroutchenevski, Natalia Suseeva and Sergei Konygin examine the viability of the ministry's forecast and outline the measurement difficulties faced by forcasters. They point out that it is better to focus on tipping points in the economy and not on exact numbers, and assess how ruble dynamics will impact on the economy.

Consumer confidence in Argentina has gradually improved in recent months ahead of October's upcoming presidential elections. However, the country still faces fast-rising price pressures and the likelihood of a GDP contraction in 2015. Commenting on the current situation, Mauro Roca believes that annual inflation will pick up pace again, and that current policies are failing to address significant imbalances in the economy, thus unlikely to bring about long-term macroeconomic stability. He points out how increased liquidity expansion, coupled with a misaligned currency, have led to increases in inflation expectations for 2016. Whoever wins the presidential election faces significant macroeconomic challenges to overcome.

The New Zealand economy began the year strongly, as booming housing and construction activity, along with low interest rates, sizeable population increases as a result of high levels of immigration, led analysts to anticipate that this year's GDP growth would come in just below the 2014 figure of 3.3%, a fairly healthy growth rate by advanced economies' standards. In this article, Dominick Stephens, Michael Gordon, Felix Delbrück and Satish Ranchhod describe the economy as being 'two-speed', explaining that while robust domestic demand is buoying growth, at the same time the country's external sector is continuing to face strong global headwinds, including soft global demand and a strong NZ$, as well as falling commodity prices, which will take a large amount of income out of the economy.

Following the European bond sell-off last month, the question remains as to whether central banks will be able to maintain low rates in Europe and the Far East going forward. In this article, Patrick Legland, Daniel Fermon, Laure Fauchet, Takuji Aida and Kiyoko Katahira point out that low inflation should mean the European Central Bank will continue with its Public Sector Purchase Programme until at least September of next year. They then move on to contrast the situation in Japan with the European case. The authors point out that in spite of the similarities which exist between the two regions, vast differences are evident in their respective labour markets.

Asia – Arresting the Great Investment Slowdown

David Carbon, DBS Bank, Singapore

Asia's investment growth has slowed to a crawl. After averaging 15% per year for decades, real investment growth in the Asia-10 has slowed from an 11-odd percent pace in 2008, to 6.5%, on average, in 2009/10, 5% in 2012, 4% in 2013 and below 3% in 2014. The drop isn't just about China, where many would say a slowdown is overdue. These figures are simple averages of the Asia-10, so tiny Singapore counts just as much as the massive mainland.

Savings and investment have been key to the growth equation in Asia since 1950 as indeed they are everywhere. Higher incomes tomorrow can only come from sacrificed consumption today. With few exceptions, the more you save, the faster you grow. So far, Asia's GDP growth hasn't suffered much. In simple average terms (again to avoid heavily biasing the picture with China), growth has run between 4.5%-4.75% for the past four years.[1] But it won't stay there if investment doesn't stabilize soon. Output, incomes and employment will all take a hit. How do you arrest Asia's great investment slowdown? How do you turn it around?

Of Structures and Cycles

Alas, a big part of the answer is, you don't. As discussed below, much of the great investment slowdown is 'structural' – owing to the steady rise in incomes over the past few decades. To this extent (but no further), slower investment is good news, not bad.

It's no surprise then that Hong Kong, Korea and Taiwan – Asia's three highest income countries after Singapore – have experienced the most marked slowing in investment (charts 4-7, page 5). China and India, at the lower end of the income spectrum, haven't experienced much if any slowdown in trend investment growth. Most would agree this makes sense for India, where per-capita income is Asia's lowest at US$1,700 (chart 8, page 6). But even after years of fast growth, China's income remains low by Asian standards at US$7,600 and, from this perspective, the recent 'slowdown' could prove to be more cyclical than structural. In the event, it hasn't been especially large to begin with (chart 7, page 5).

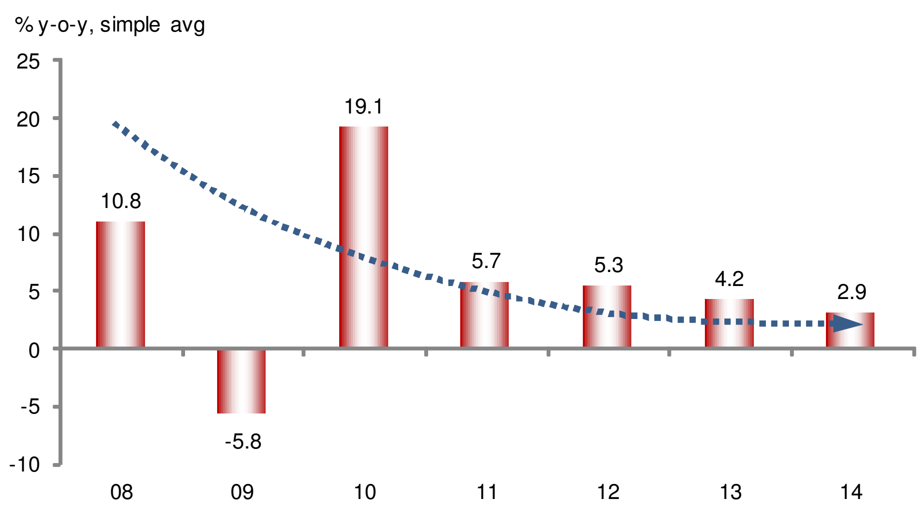
Why Does Investment Slow?

Why does investment slow when incomes go up? The main reason is people save less / consume more. And at the end of the day saving and investment are one and the same. It doesn't start out that way of course. At very low incomes, the opposite is true. At very low incomes most economies are agrarian based and most of what gets produced, by necessity, gets consumed. But if you can scrimp and save a bit, the surplus can be invested in better seeds or capital equipment – productivity and incomes jump sharply. This allows more saving and more investment. A virtuous circle ensues.

But as incomes continue to rise, two things happen. The returns from more machinery or fertilizer, say, grow smaller. The second 'tractor' doesn't bring the same bang as the first; the third even less, and so on. All countries find it increasingly difficult to lift productivity the higher it already is. This is the technical, supply-side of the equation: returns to saving fall.

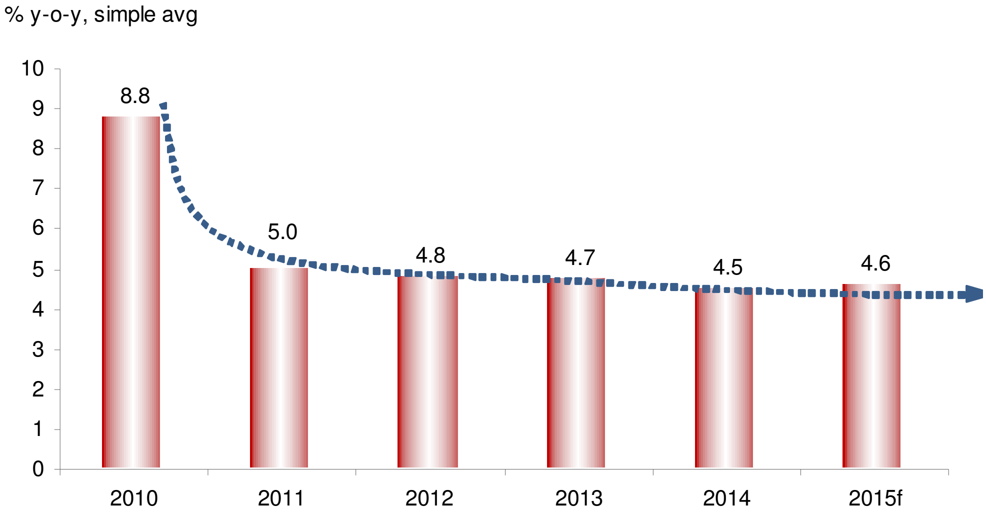
The second thing that happens is on the softer, demand side: people themselves change. As incomes go up, most want to enjoy the fruits of their labor. Another dollar in the bank becomes less attractive than a new dress, a night on

Chart 1: Asia 10 – Real Investment Growth



Source: CEIC Data, Bloomberg, DBS Group Research

Chart 2: Asia 10 – GDP Growth (Simple Average)



Source: CEIC Data, Bloomberg, DBS Group Research

the town, a trip to Spain. Falling returns from saving and a rising preference for consumption join hands and bring a reduction in savings as a proportion of income.[2] Less savings means less investment.

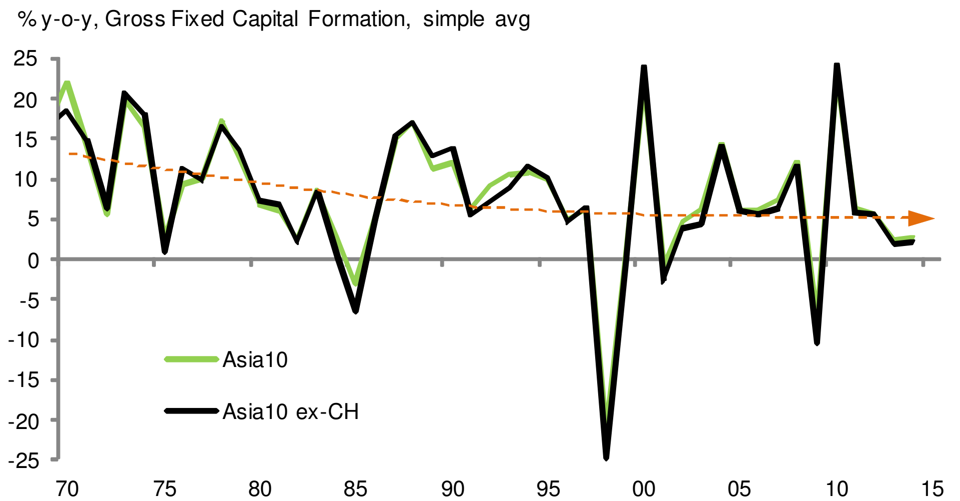
U-shaped savings rates are seen virtually everywhere, eventually.[3] Hong Kong's saving rate (chart 9, page 6) peaked when incomes hit US$20,000 in today's prices. The same is true for the US and Japan (charts 11 and 12, page 7). Malaysia's saving rate (chart 10, page 6) turned south when incomes reached a much lower US$8000 per person – thankfully the rate itself remains a very high 35% of GDP. The same occurred in Thailand.

Over-Investment? Or Poor Investment?
The experiences of China and Singapore are interesting and instructive (chart 13, page 7). China is often accused of 'over-investing' – it saves too much and consumes too little, or so it is said. Saving and investment close to 50% of GDP can only lead to the kind of debt trouble that China seems to be in today. A greater consumption share in GDP 'is needed'.

But is it really? Singapore saves and invests just as much as China – and it's done so for 30 years – but nobody accuses Singapore of macro mismanagement. On the contrary, Singapore rightfully receives kudos all the time for its growth record. What gives? Why is Singapore a hero; China a reprobate?

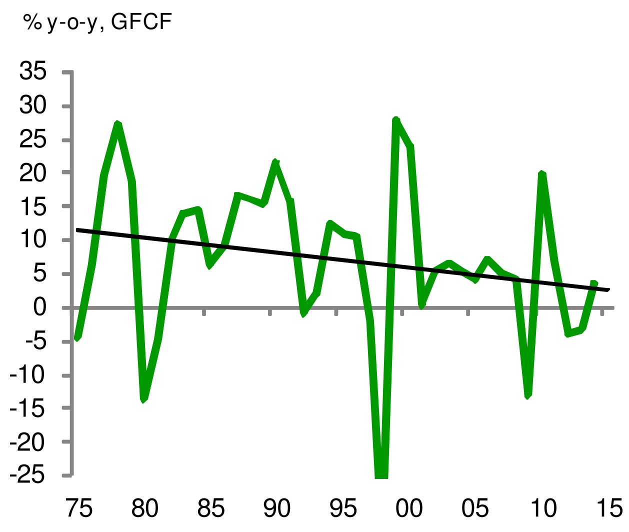
Whatever it is, it has nothing to do with 'over-investment'. Fifty percent of GDP is fifty percent of GDP whether it's China's or Singapore's. China may have invested poorly, as most countries do from time to time. But that's different. Even China's infamous 'ghost towns' – built but not yet occupied cities – are, at worst, an example of poor investment, not over-investment. Any technocrat could have used the money spent on the ghost town to build

Chart 3: Asia 10 – Real Investment Growth



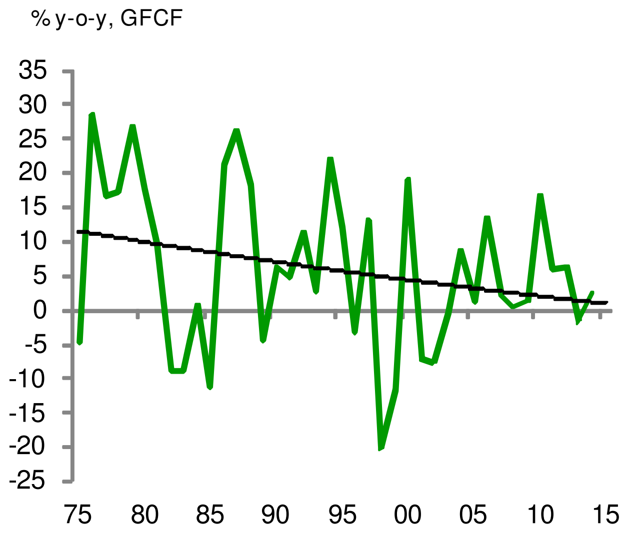
Source: CEIC Data, Bloomberg, DBS Group Research

Chart 4: Korea – Real Investment Growth



Source: CEIC Data, Bloomberg, DBS Group Research

Chart 5: Hong Kong – Real Investment Growth



Source: CEIC Data, Bloomberg, DBS Group Research

something more immediately beneficial to society and have been praised for his efforts. Which isn't to say that 'immediately beneficial' is the most important criteria to judge investments by. A 7% growth rate, like China's, means a lot of things that look strange today look less so tomorrow. Singapore's 4th and 5th terminals at Changi airport come to mind.

Four quick points: First, roads always go nowhere when you build them. It's what happens later that counts. Second, over-investment from a national / macro perspective isn't a well-defined term; it's nigh impossible to induce. If poor investment is the worry, call it poor investment.

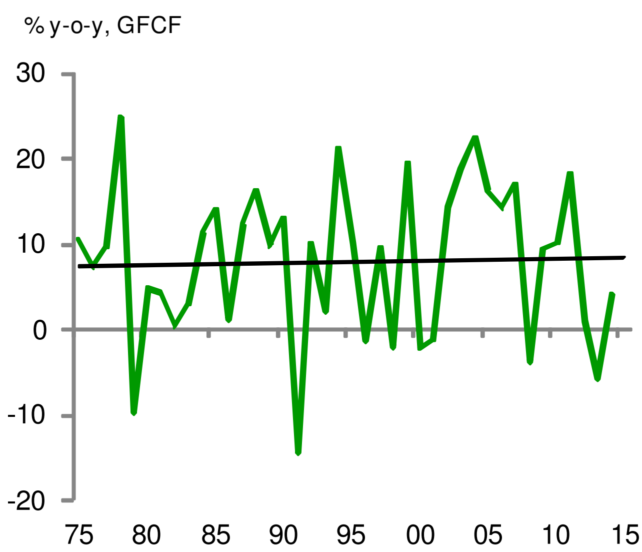
Third, a high consumption share in GDP is not something to strive for, as if having one provides some sort of macro benefit, like 'sustainability'. Singapore has sustained a saving / investment ratio of 50% of GDP for decades and has little to show for it but one of the highest incomes in the world. Falling savings rates tend to occur as incomes go up. But the process isn't set in stone and when it occurs it occurs naturally. Most importantly, there's nothing good or bad about it. If a country prefers to work 12 hours a day and save half of it for a better life tomorrow, wonderful. If a country prefers a lower 'income' in return for cleaner air and more time at the beach, wonderful too. Consumption, saving and investment shares in GDP are choices, not exam grades.

Finally, judging by relative income levels, Singapore's experience and China's vast undeveloped inland areas, it could well take another 50 years before China's investment rate starts to fall. And the country could well be better off for it than were it to pursue greater consumption today.

Arresting the Slide in Investment

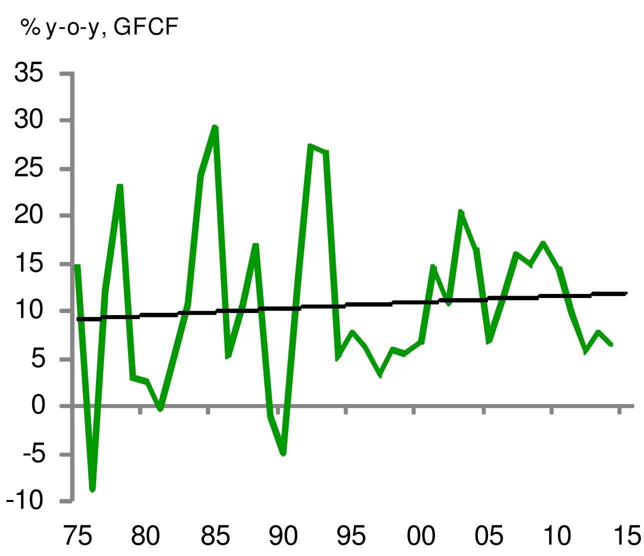
For most Asian countries, including China and Singapore, the issue isn't how to guard against 'over-investment', it's

Chart 6: India – Real Investment Growth



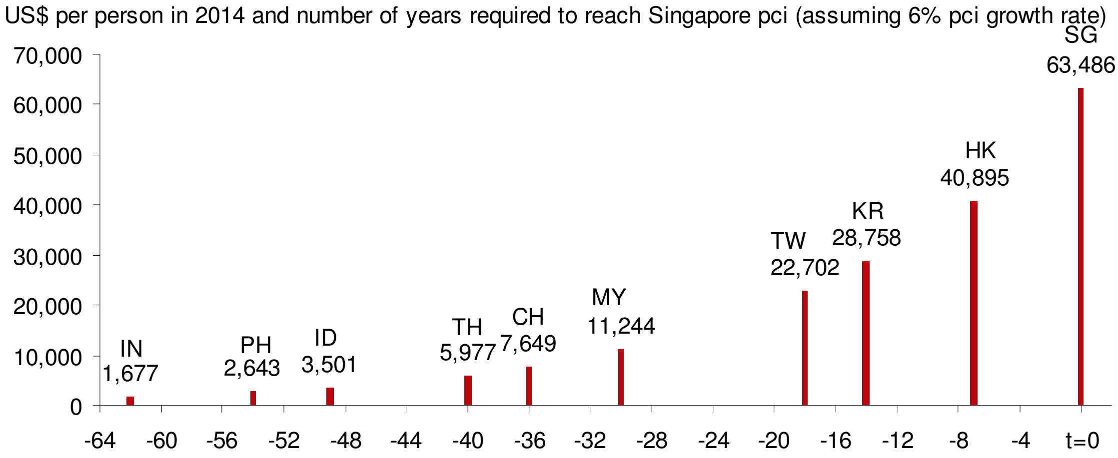
Source: CEIC Data, Bloomberg, DBS Group Research

Chart 7: China – Real Investment Growth



Source: CEIC Data, Bloomberg, DBS Group Research

Chart 8: Asia – Per Capita GDP Timeline



Source: CEIC Data, Bloomberg, DBS Group Research

how do you arrest its slide of the past few years? Asia-10 growth in real fixed capital formation has fallen below 3% per year (chart 1, page 3) and that simply won't sustain the kind of GDP growth needed to raise incomes and employ growing populations.

Enter China's new Asian Infrastructure Investment Bank (AIIB) – might that turn the tide? Unfortunately no, and not because Japan and the US remain petulantly reluctant to join. The AIIB aims to raise US$100bn for regional investment projects, which simply isn't a large amount of money. In 2014, Asia-10 gross fixed capital formation amounted to US$6,700bn. If the AIIB raised and then dispersed all US$100bn of its funds over the next three years – a highly unlikely event – it could finance an additional 0.4% of Asia-10 investment over and above what is already likely to occur on that time frame. That's better than nothing but not by much. The AIIB's significance is more political than economic.[4]

Asia's Current Account Surpluses Have to Go

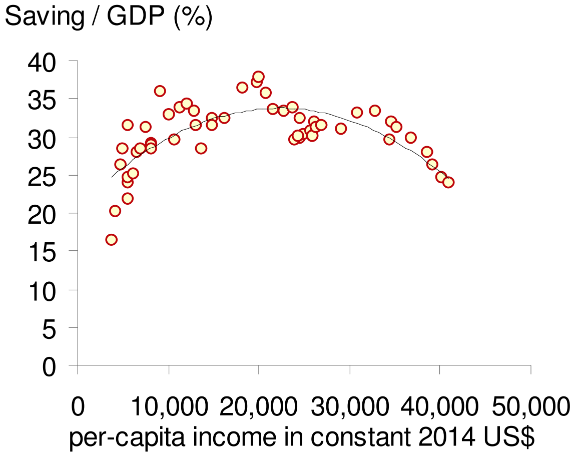
There's a bigger reason why the AIIB is unlikely to lift investment in Asia: all the Asia-10 countries, save for India and Indonesia, are running current account surpluses and have been for the past 18 years. Why does that make the AIIB irrelevant? Because if you're running C/A surpluses, you're lending to the rest of the world. You don't need to borrow funds from the AIIB if you're a lender yourself. You don't need to borrow funds from *anyone* if you're a lender yourself.

But if Asia has been lending to the rest of the world for the past 18 years, it's immediately clear how to raise investment at home: stop lending and start borrowing. Stop running C/A surpluses and start running C/A deficits. Stop investing in US Treasuries and start investing domestically, where the income-lifting capital equipment and infrastructure is needed.

Run current account deficits? Sounds pretty heretical. To most, it is. Foreign investors wouldn't like it. Rating agencies wouldn't like it. Local officials wouldn't like it. It's unanimous.

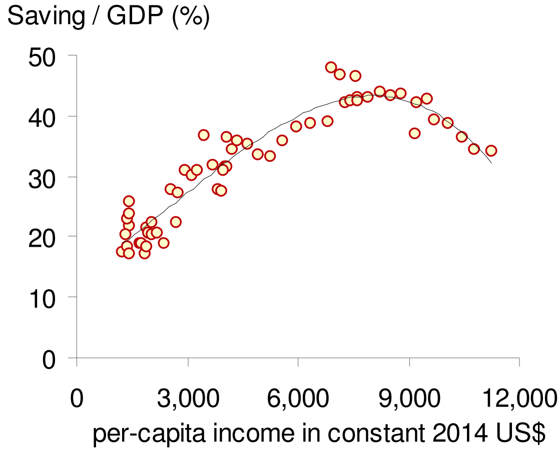
And unanimously wrong. Running deficits in Asia isn't heretical. It's Finance 101. It's the way things are supposed to be. Higher income / capital abundant countries are supposed to lend to lower income / capital scarce

Chart 9: Hong Kong – Saving / GDP and Per-Capita Income



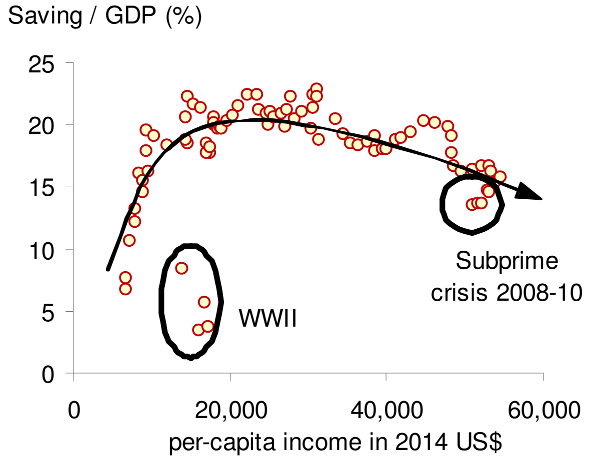
Source: CEIC Data, Bloomberg, DBS Group Research

Chart 10: Malaysia – Saving / GDP and Per-Capita Income



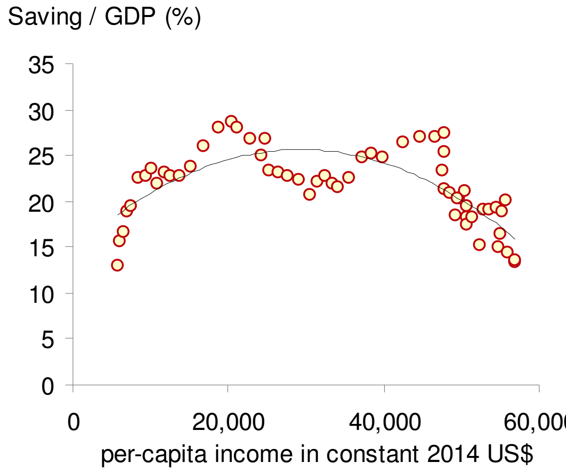
Source: CEIC Data, Bloomberg, DBS Group Research

Chart 11: US – Saving / GDP and Income (1929-2014)



Source: CEIC Data, Bloomberg, DBS Group Research

Chart 12: Japan – Saving / GDP and Income (1929-2014)



Source: CEIC Data, Bloomberg, DBS Group Research

countries, not vice-versa. The foreign lender earns a higher return than he can at home; the local borrower can invest more than his own savings will allow. And – most importantly – everyone's incomes go up more than they otherwise would. It's a handshaking deal that benefits both sides of the borrower/lender equation. Why rating agencies, officials and Boston fund managers see heresy in this is anyone's guess but for the sake of higher incomes of everyone involved, mindsets need to change. Emerging economies are supposed to be borrowers, not lenders.

But what kind of money are we talking about here? Would moving from surplus to deficit really make much of a difference to Asia's investment equation? Yes it would – a very large difference. On average, Asia-10 countries have run C/A surpluses to the tune of 6% of GDP every year since 1998. That means they have lent 6% of their income to foreign countries every year for the past 17 years. They could have been investing that much at home instead.

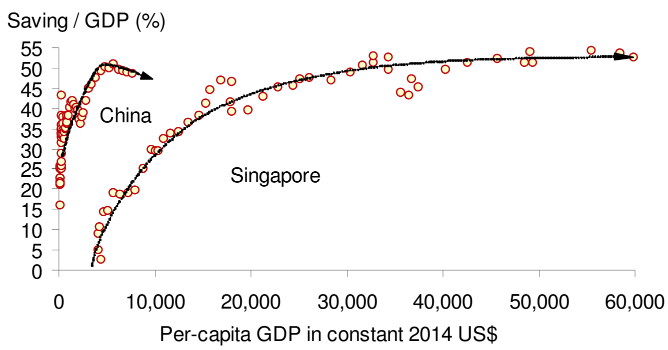
And that's without any red ink. If they ran deficits of 2%-3% of GDP, domestic investment could be 8%-9% of GDP higher than it currently is. That's a boatload of investment dollars that could be improving Asia's infrastructure, lifting Asia's growth rates and lifting Asian incomes. To be sure, the 2%-3% deficit represents borrowing and returns on those funds go to the foreigner. But the 2%-3% rise in the capital stock each year lifts labor productivity and wages too, and that portion stays at home. Again, it's a handshaking deal.

Asia-Vu?

Too much borrowing is dangerous of course. After all, the reason deficits are anathema to foreign investors, public officials and ratings agencies alike is because too much borrowing led to the Asian financial crisis of 1997/98. But that was 17 years ago and deficits back then were 10% of GDP in some countries for a good many years. It's time to let go.

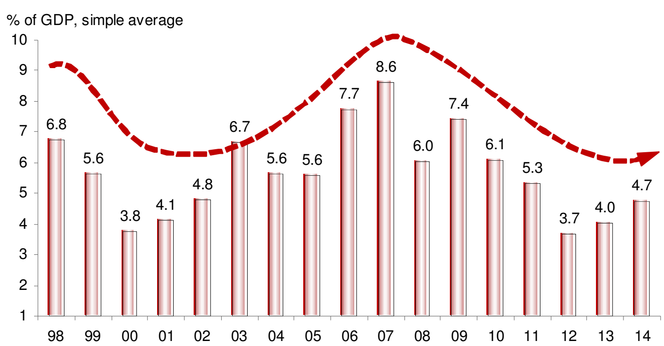
Who would benefit in Asia by a swing to deficit? Everyone, save, as mentioned, for India and Indonesia, where deficits of 2%-3% of GDP are already being run. Malaysia would benefit greatly, as domestic investment has fallen sharply and it runs a current account surplus of 5%-6% of GDP. Korea and Taiwan run surpluses of 6% and 12% of GDP respectively and few would argue that those economies couldn't use some more local investment.

Chart 13: China and Singapore – Saving / GDP and Per-Capita Income



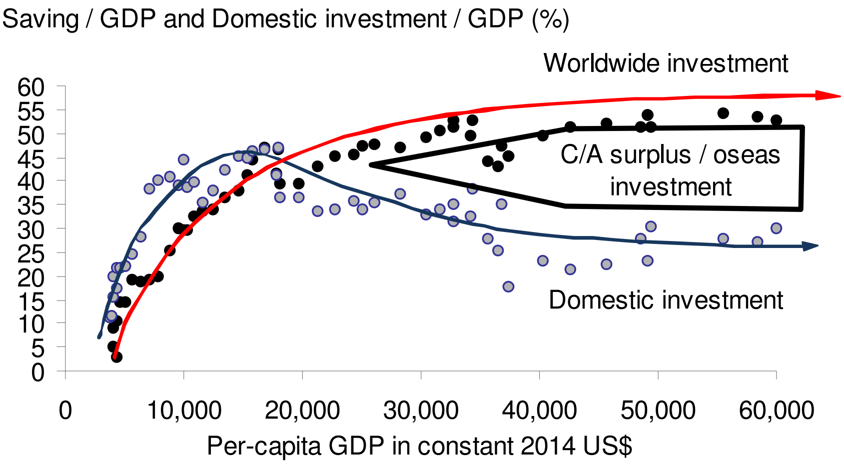
Source: CEIC Data, Bloomberg, DBS Group Research

Chart 14: Asia 10 – Current Account Surplus



Source: CEIC Data, Bloomberg, DBS Group Research

Chart 15: Singapore – Saving and Domestic Investment Shares in GDP and Per-Capita Income



Source: CEIC Data, Bloomberg, DBS Group Research

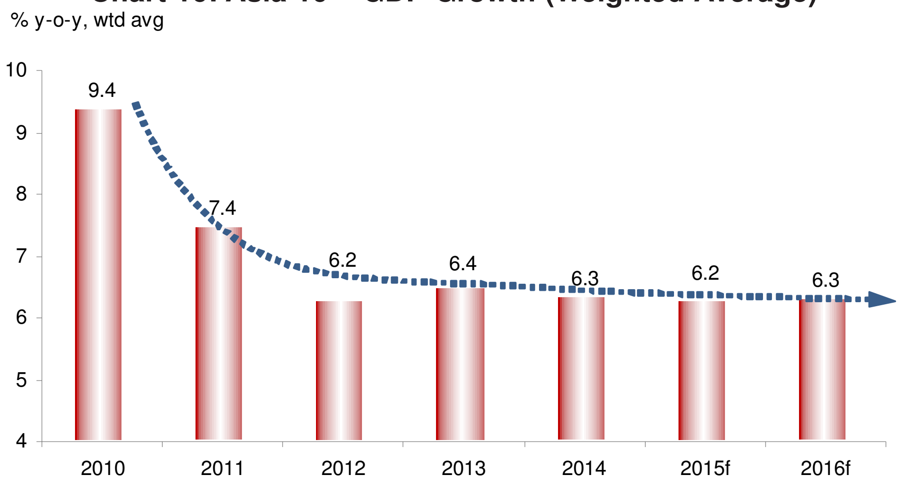
Singapore might benefit more than most (chart 15, page 8). It is grappling with below-normal GDP and productivity growth and has been attempting to raise both with a significant restructuring exercise that is now entering its fifth year. Results have been mixed. Singapore is a high income country and so, by the logic outlined above, ought to be lending abroad. But its current account surplus was 19% of GDP in 2014 and has averaged 20% of GDP since 2010! With productivity growth negative in 2014, it's hard to argue that some of that 19% of GDP current account surplus couldn't be spent on domestic investment instead of overseas investment, helping raise domestic productivity and incomes in the process.

A Brighter Future

Asia's incomes continue to rise and slower investment is a natural part of that process. But investment growth has slowed to below 3% per year and that won't sustain the GDP growth that Asia is accustomed to and needs to keep incomes rising and populations employed. Current account surpluses are standing in the way of greater domestic investment in all Asian countries save for Indonesia and India. A swing to modest 2%-3% of GDP deficits could lift investment in the region by 8-9 percentage points of GDP – a huge amount.

But mindsets have to change for this to occur. Officials, ratings agencies and fund managers all need to let go of 1997. Everybody wins when capital abundant investors lend to capital scare borrowers. Everyone loses when the opposite occurs, as it is today. Periodic crises shouldn't mean you throw the baby out with the bath water. Until the much-needed mindset shift occurs, no amount of funding from an AIIB or other institution will succeed in lifting domestic investment in the region. Some say you can't squeeze blood from a turnip. It's just as hard to shovel water into a fire hydrant.

Chart 16: Asia 10 – GDP Growth (Weighted Average)



Source: CEIC Data, Bloomberg, DBS Group Research

Notes:

[1] *Weighted average growth has also remained stable for the past four years at about a 6.25% growth rate (chart 16, above). The lion's share of China's slowdown came in 2011.*

[2] *Demographics may also play a role. As individuals age, they begin to work less and ultimately dis-save. If a country overall is aging, savings rates will tend to fall.*

[3] *See also: "Asia: U-shaped Consumption Paths and Non-Discretionary Spending", 17 Jan14.*

[4] *Nor is China's US$50bn AIIB commitment particularly significant. In today's dollars, China's trade surplus of the past five years amounts to about US$1,250bn, most of which has been invested in US Treasuries and German Bunds. Shifting US$50bn of that into regional infrastructure is plainly less momentous than it sounds.*

Russia: Dangerous Appreciation of the Ruble

Evgeny Gavrilenkov, Anton Stroutchenevski, Natalia Suseeva and Sergei Konygin, Sberbank, Moscow

Forecasts for 2015, % change (unless stated otherwise)	Gross Domestic Product	Gross Fixed Investment	Consumer Prices (Dec/Dec)	Current Account Balance (US$bn)
Sberbank	-1.5	-8.0	12.5	50.0
Consensus[1]	-3.5	-9.2	12.1	53.9

[1]Source: Eastern Europe Consensus Forecasts, June 2015.

The Russian economy demonstrated mixed results in the first few months of 2015. Negative sentiment prevailed on the back of a weak ruble, and consensus expectations pointed to a deep contraction in the economy. However, after the State Statistics Service reported that y-o-y GDP declined by just 1.9% in 1Q15, many forecasters upgraded their 2015 growth outlook. Nevertheless, the mood changed again after 4m15 (Jan-Apr period) statistics were released a few days later, showing that the numbers in certain areas (such as retail and real income data) fared worse than those from 1Q15.

Statistics can be fairly unreliable and are subject to change during turbulent times, meaning they should be taken with a grain of salt. Statisticians often cannot properly capture what is happening in the economy amid intensive structural changes, and therefore historical time series are often revised once more detailed data is collected.

Reported investment statistics looked better in 4m15 than 1Q15, unlike private consumption data (such as the aforementioned retail and real income results). Investment declined 3.7% and 4.8% (y-o-y) in 4m15, respectively. It was reported previously that investments dropped around 6% y-o-y in 1Q15, but the revised data suggests that the contraction was less severe, around 3.5% (y-o-y), which is a significant revision. This also occurred with investment statistics in 2013 and 2014. In 2013, the figures were changed from negative to positive, while in 2014, they were revised from -3% to about -2%, indicating a less severe contraction. We suspect that more 2014 revisions are forthcoming, not only to investment statistics but to other data as well.

Policymakers and investors are challenged by the fact that they have to make decisions on the basis of data that is currently available. Given this, it is unsurprising that the Economics Ministry updated its medium-term outlook at the end of May, suggesting that 2015 GDP will decline by 2.8%, while investment in production capacity will drop more than 10.7%. This implies that for the rest of the year, investment will plummet by well over 10% (y-o-y) each month, creating a shock to the economy. The ministry also expects gross investment to plunge 24.5% this year. It predicts that the economy will grow by 2.3% next year and investment in production capacity to rise by 3.1%; however, the latter figure is still a cause for concern due to the low-base effect if we assume that investment drops in 2H15 as significantly as the ministry forecasts.

The ministry's growth outlook does not take into account all elements of GDP, but it will be reconstructed based on official statistics. It is important to note that the ministry does not show the base year prices used in its calculations. Official growth statistics for 2014 and for previous years use 2008 as a base year. However, the ministry omitted the statistical discrepancy and explicit references to inventory change, which is a crucial part of gross

Table 1: GDP Structure and Real Growth, 2014-16

	State Statistics Service data		Economics Ministry data			
	Structure, 2014, in 2008 prices	Structure, 2014, in 2014 prices	Structure, 2014	Real growth, 2014	Real growth, 2015E	Real growth, 2016E
GDP	**100.0%**	**100.0%**	**100.0%**	**0.6%**	**-2.8%**	**2.3%**
Total consumption	**73.6%**	**73.2%**	72.7%	0.9%	-5.3%	0.7%
Household consumption	56.0%	53.3%	52.9%	1.3%	-6.5%	1.3%
Government consumption	17.3%	19.5%	19.4%	-0.1%	-2.0%	-1.0%
Non-profit institutions serving households	0.4%	0.4%	–	–	–	–
Total investments	**19.6%**	**20.3%**	**20.2%**	**-7.3%**	**-24.5%**	**19.9%**
Fixed capital investments	21.9%	20.6%	20.5%	-2.0%	-10.7%	3.1%
Changes in inventory	-2.3%	-0.3%	–	–	–	–
Net exports	**9.1%**	**7.2%**	**7.1%**	**29.8%**	**84.5%**	**-19.1%**
Exports	31.9%	30.0%	29.8%	-0.1%	-0.9%	2.8%
Imports	22.8%	22.9%	22.7%	-7.9%	-25.3%	10.2%
Discrepancy	-1.9%	-0.7%	–	–	–	–

Source: State Statistics Service, Economics Ministry

Table 2: GDP, 2013-15

	State Statistics Service data			Economics Ministry data		
	Structure, 2013	in R bln, 2014	Structure, 2014	in R bln, 2015E	Real growth, 2015E	Structure, 2015E
GDP	**100.0%**	**71,406**	**100.0%**	**69,408**	**-2.8%**	**100.0%**
Total consumption	**72.5%**	**52,252**	**73.2%**	49,500	**-5.3%**	**71.3%**
Household consumption	52.4%	38,037	53.3%	35,565	-6.5%	51.2%
Government consumption	19.7%	13,932	19.5%	13,654	-2.0%	19.7%
Non-profit institutions serving households	0.4%	282	0.4%	282	0.0%	0.4%
Total investments	**22.8%**	**14,520**	**20.3%**	**10,963**	**-24.5%**	**15.8%**
Fixed capital investments	21.8%	14,706	20.6%	13,133	-10.7%	18.9%
Changes in inventory	1.0%	-186	-0.3%	-2,170	1,064.9%	-3.1%
Net exports	**5.9%**	**5,106**	**7.2%**	**9,045**	**77.1%**	**13.0%**
Exports	28.6%	21,437	30.0%	21,244	-0.9%	30.6%
Imports	22.7%	16,331	22.9%	12,200	-25.3%	17.6%
Discrepancy	-1.2%	-471	-0.7%	-100	-78.8%	-0.1%

Source: State Statistics Service, Economics Ministry, Sberbank CIB Investment Research

investment. As such, we reconstructed these figures. Meanwhile, it appears that the ministry forecasts growth for 2015 and beyond using 2014, instead of 2008, as the base year; its reported 2014 structure corresponds to the nominal GDP structure published by the State Statistics Service, excluding the statistical error that the ministry omits. This omission is more acceptable using 2014 prices than 2008 prices, as it is less significant.

Our calculations show that in order to come up with a 2.8% GDP contraction forecast for this year, assuming a 24.5% drop in gross investment and a 10.7% fall in fixed investment, inventory change for the year would stand at -3.1% of GDP. We do not challenge the other elements of GDP, such as consumption and net exports, and ignore the statistical error.

This 3.1% of GDP contraction in inventories looks too severe, as inventories already declined last year, according to official statistics. Inventories had posted comparable growth in 2008 after which they contracted 3.1% in nominal terms (over 4.0% in real terms, using 2008 fixed prices) in 2009.

If we assume that investment in production capacity contracts less than the ministry expects – say, around 6% – then a sensitivity analysis shows that inventories should decline by almost 4% this year, which is even less reasonable. If we assume that inventories cannot contract this year – because they decreased last year – and we use the Economics Ministry data for the remainder of our calculations, then GDP growth would be flat. This illustrates that forecasters are still in the dark about the 2015 growth outlook due to inconsistent statistics: whether the economy contracts by 3% or posts zero growth is statistically indistinguishable.

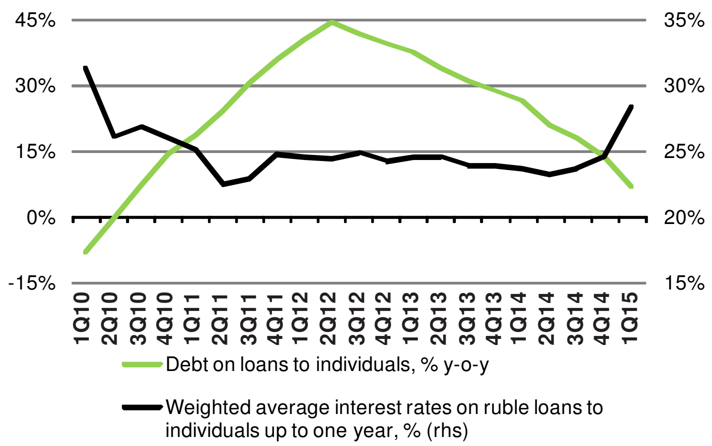
The current crisis looks different from that of 2009, which means that not all comparisons with that year are relevant. Though the statistical data currently available is limited

Table 3: Economic Performance in 2009 and 2015, y-o-y

	2009	4m15
Final consumption	**-4.9%**	**–**
Retail	-5.1%	-7.5%
Paid services	-2.5%	-0.9%
Gross investment	**-41.0%**	**–**
Investment in production capacity	-14.5%	-3.7%
Net export	**56.6%**	**–**
Export, real	-4.7%	–
Import, real	-30.4%	–
GDP	**-7.8%**	**-1.9%***
Freight transportation	-10.2%	-1.6%
Industry	-9.3%	-1.5%
Agriculture	1.4%	3.5%
Construction	-21.1%	-4.8%
Export, nominal	-36.4%	-27.6%*
Import, nominal	-36.4%	-37.3%*

** data as of 3m15*
Source: State Statistics Service

Chart 1: Consumer Credit and Interest Rates on Ruble Loans



Source: CBR

(just select figures for 4m15 and an aggregate GDP contraction of 1.9% in 1Q15), it is still clear that the decline in investment this year is not as sharp as it was in 2009. Consumption, however, will likely dip more this year, even though consumer services did not fall as much as they did in 2009. Production appears to have been much stronger in 4m15. Overall, given the available monthly statistics, GDP contraction of 1.9% in 1Q15 appears to be compatible with the monthly data.

Meanwhile, simple calculations show that after a 1.9% (y-o-y) fall in GDP in 1Q15, in order to realize 2.8% GDP contraction for the full year, each of the remaining three quarters this year would have to post a decline in GDP of around 3% (y-o-y). This is possible in theory but perhaps too pessimistic given the ongoing disinflation and expected improvement in the retail market.

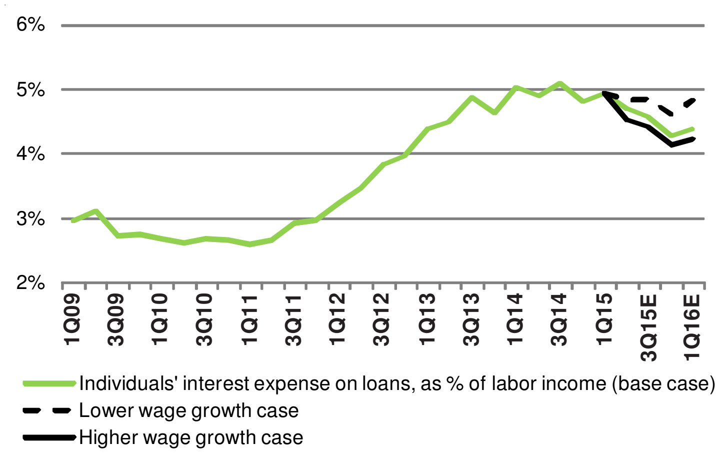
Given the aforementioned measurement difficulties, particularly in gross investments, it is better to concentrate not on exact numbers, but on tipping points, i.e. when the current negative trend can be broken (if at all). Russia's growth began decelerating a few years ago as individuals struggled to repay expensive retail loans, which had previously inflated domestic demand and buoyed production. As consumer debt started to shrink m-o-m (though not y-o-y yet due to the base effect), demand declined, restraining economic growth.

As of end March 2015, car loan debt declined 10% (y-o-y), consumer loan growth decelerated to 1% (y-o-y) and mortgage loan debt increased 27% (y-o-y). We expect overall individual debt to fall 1% (y-o-y) this year on the back of decreasing consumer loan debt, which comprises about 60% of overall individual debt.

Interest expenses on retail loans have been growing faster than nominal wages over the past four years. This has resulted in a higher share of income spent on covering interest expenses and a lower share on other spending and savings. Last year, the former stabilized at 5% of labor income amid muted wage growth and consumer deleveraging.

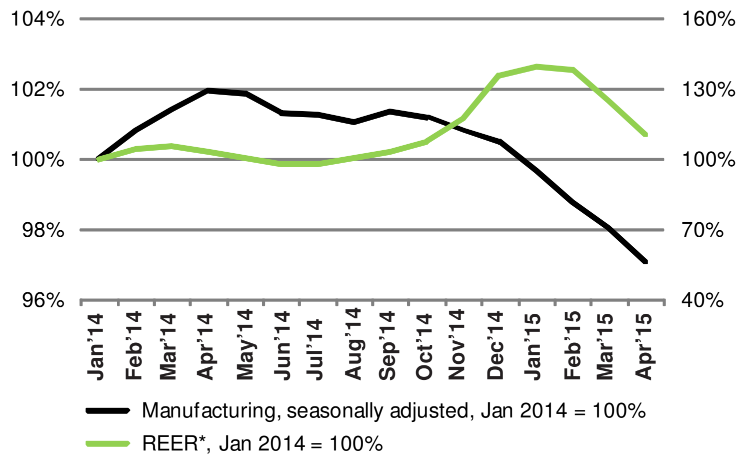
We have estimated three scenarios for the share of interest expense in labor income, assuming that individual loan

Chart 2: Individual Interest Expense on Loans, As % of Labor Income



Source: CBR, State Statistics Service, Sberbank CIB Investment Research

Chart 3: Manufacturing Growth Vs Ruble Appreciation



**REER down means appreciation*
Source: State Statistics Service, CBR, Sberbank CIB Investment Research

debt declines overall and interest rates gradually lower this year. In our base case scenario, we expect nominal wage growth of around 6% (y-o-y) this year; in the lower wage case, 0% (y-o-y); and in the higher wage case, 10% (y-o-y). In the base case and higher wage case scenarios, the share of interest expense in labor income falls to 4.3% and 4.2%, respectively, at the end of this year, which would free up resources to support consumer demand. In the lower wage case scenario, interest expense remains close to 5% of labor income, which implies no increase in disposable income.

In all scenarios, 2Q15 is the tipping point – if inflation decelerates rapidly and interest rates drop significantly, then expenditures on servicing consumer debt could approach 4% of labor income by year end. This is where it was in early 2013, when consumer demand rose and contributed to economic growth. As such, the Russian economy could start 2016 off on a positive note, which appears to be in line with Economics Ministry forecasts. Disinflation and stability on money markets are crucial factors for this scenario to materialize.

The currency market and exchange rate dynamics are other important factors. The Russian ruble weakened from about 48-49 against the dollar to well above 53 – a 10% shift – within just a few days. Furthermore, on June 4, it reached 55 (a 13% shift). This correlated to the dollar's appreciation against other currencies as well as the fall in oil prices, but it was influenced by other elements as well. The ruble was artificially (though not necessarily intentionally) inflated by regulators as they provided over US$38bn in FX refinancing to banks by end 1Q15, which far exceeded the 1Q15 current account surplus. This oversupply of FX on the market in recent months meant that the ruble could do nothing but appreciate. In 2014 and 1H13, when the Central Bank of Russia (CBR) provided financing against non-market collateral, aggressively supplying banks with ruble liquidity, the ruble weakened. When ruble refinancing was replaced with FX refinancing, the ruble strengthened. As such, the currency was neither fully floating nor in equilibrium in either 2014, when the CBR directly intervened on the FX market until the currency band was abolished, or currently, while the CBR is still extending FX refinancing. The currency's recent weakening could be associated with the CBR's abolition of long-term FX refinancing as of June 1.

Given that the CBR has continued to influence the FX market one way or another, it has become virtually impossible to determine the fundamental or equilibrium value of the ruble. In our research, we assume that as long as the economy grows at a reasonable rate, then the currency will hold its fundamental value. This is not a hard-and-fast rule, but an assumption supported by Russia's considerable immunity to various macroeconomic imbalances, including a budget deficit and external debt that is difficult to service, even with a current account surplus. A weak enough currency, which could enable a country to produce competitive goods and services, thus contributing to economic growth, can offset the well-known problem of low quality of institutions and inconsistent economic policy.

Economic performance deteriorated in April, following the ruble's appreciation in March and April. This deterioration was rooted in several causes. As wage growth slowed and Russians struggled to pay off their expensive consumer debt, consumption fell under pressure. In addition, export-oriented manufacturing sectors such as metals, fertilizers and more suffered from deteriorated dynamics as the ruble appreciated. The too-strong ruble negatively impacted economic growth and budget revenues. Therefore, the currency's recent weakening is healthy.

If the CBR stops directly influencing the exchange rate, as it currently promises, then the ruble should continue to weaken by year end, assuming all else equal. This would be a healthy development, and we would not be surprised to see the currency above 60 to the dollar as foreign debt repayments gradually rise by year end. That said, we are not changing our 2015-16 outlook at this stage. The weaker the ruble is by year end, the lower the exchange rate volatility will be in the future, and the better economic performance we can expect in 2016. If the ruble stays in the range of 50-55 to the dollar, we can expect to see zero economic growth or even negative next year.

Argentina: Short-Term Gain, Medium-Term Pain

Mauro Roca, Goldman Sachs, New York

Forecasts for 2015, % change (unless stated otherwise)	Gross Domestic Product	Final Consumption	'True' Rate of Inflation (Dec/Dec)	Current Account Balance (US$bn)
Goldman Sachs	-1.7	na	30.6	na
Consensus[1]	0.1	0.3	27.8	-8.7

[1]Source: Latin American Consensus Forecasts, June 2015.

Introduction

With only a few months left until Argentina's presidential elections, the current policy mix is delivering positive dividends for the administration. Consumer confidence has been steadily increasing during the past few months and has reached a three-year high. Moreover, this measure is just short of the all-time peak reached at the beginning of 2007, when the economy was growing at a high rate that was supported by surpluses in both the fiscal and external accounts and annual inflation was just beginning to rise into double digits (Exhibit 1, below).

The improved consumer outlook is also consistent with recent polls showing that there has been a noticeable recovery in President Cristina Fernandez de Kirchner's approval ratings, and that a majority of the population favors some continuity of current policies and gradualism in the application of the inevitable corrections.[1] It is clear that these factors could play an important role in the incoming presidential elections.

Remarkably, a mild improvement in macroeconomic dynamics has been enough to boost consumer confidence even when the economy is still immersed in stagflation. After all, annual inflation is still running at elevated levels; economic activity continues to contract on a yearly basis; and exchange rate pressures still show there is a delicate balance of payments situation.

But this temporary reprieve, as important as it may be from a political perspective, is likely to have some lagged economic consequences as it has been achieved at the cost of increasing macroeconomic imbalances. Driven by a growing fiscal deficit, the expansion of monetary aggregates is continuously accelerating. External accounts continue to deteriorate amid increasing currency overvaluation and tightening exchange rate controls. The maintenance of generous public subsidies intensifies relative price distortions.

Above all, the current policy mix cannot be sustained for long due to its intrinsic inconsistencies. The disproportionate increase in liquidity amid rising currency misalignment and relative price distortions threatens the medium-term inflation outlook, regardless of the policies adopted by the new administration. In our view, rather than continue decelerating, inflation is poised to resume an increasing trend. In this context, we maintain our year-end inflation forecast at an above-consensus 30.6% y-o-y (as measured by the City of Buenos Aires)[2] and raise our 2016 estimate to 35.7% y-o-y (up from 32.5% y-o-y).

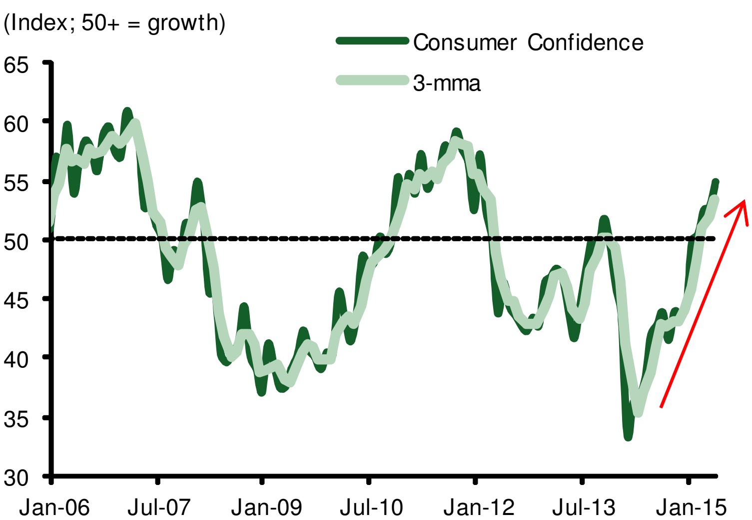
Inflation Approaching its Short-Term Floor

The recovery in consumer confidence is to a great extent explained by the stabilization of the exchange rate and the associated improvement in the inflation outlook.

After peaking at the end of 2014, annual inflation has been progressively decelerating since the turn of the year. According to the National Institute of Statistics (INDEC), consumer inflation declined to 15.8% y-o-y in April from 23.9% in December of 2014 (Exhibit 2, page 14).

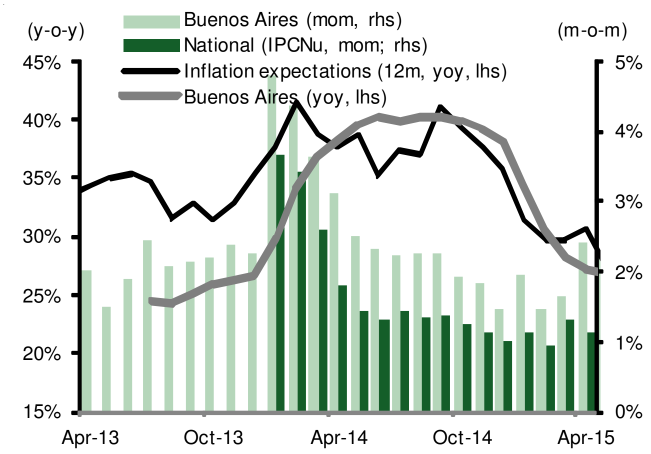
While it is known that there is a significant divergence between INDEC's and alternative inflation measures, the evolution of different price indices has broadly captured similar inflation dynamics. For instance, according to the Statistical Institute of the City of Buenos Aires, inflation

Exhibit 1: Robust Recovery of Consumer Confidence



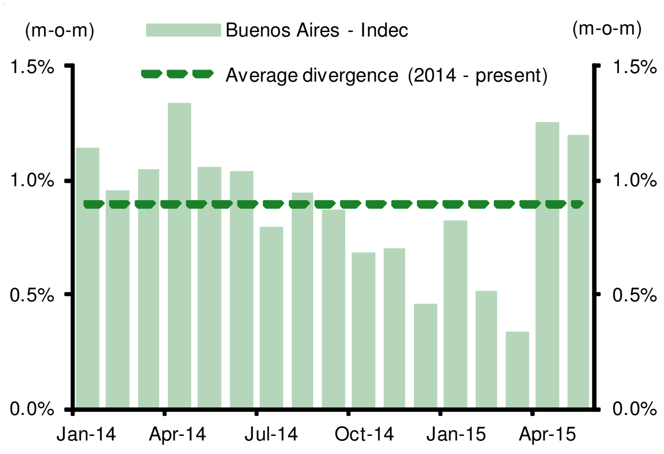
Source: Universidad Torcuato di Tella

Exhibit 2: Inflation Soon to Stop Falling



Source: INDEC, Statistical Institute of Buenos Aires; Di Tella University

Exhibit 3: Persistent Divergence of Inflation Measures



Source: INDEC, Statistical Institute City of Buenos Aires

has continuously decelerated, to 27.1% y-o-y in April from a peak of 40.3% y-o-y reached in September 2014 (Exhibits 2 and 3, above).

But regardless of statistical discrepancies, we believe annual inflation may be approaching its short-term floor. Moreover, we estimate it will progressively increase to 30.6% by year-end, as the base effects that helped to reduce it during 1Q15 will continue to weaken. Furthermore, inflation persistence – better captured by monthly figures – is poised to remain elevated due to an unrelenting monetization of a growing fiscal deficit amid tightening financial limits on further Central Bank sterilization. Amid this increase in domestic liquidity, a potential (and usual) dollarization of portfolios in the months leading to the presidential election poses another important risk to the short-term inflation outlook.

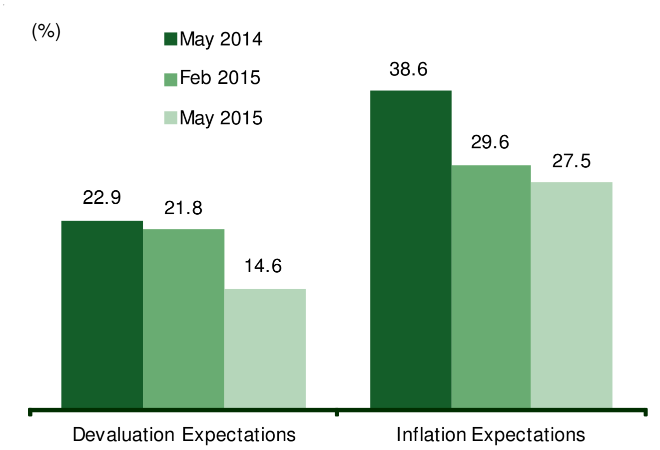
Above all, the current unsustainable policy mix is very likely to have some lasting and lagged effects on inflation that will probably materialize with significant vigor at the beginning of the next administration. The exchange rate's probable loss of effectiveness as a nominal anchor in a context of excess liquidity and required normalization of some key relative prices could bring higher inflationary pressures. In all, we consider that the inconsistency of the current policy strategy seals its own fate.

Policy Inconsistency Prevents Sustainability

The current policy mix aims chiefly at bringing some stability ahead of the presidential elections rather than correcting the large macroeconomic imbalances. Moreover, this very short-term policy approach is worsening those imbalances and, ultimately, increasing the magnitude of the economic adjustment that would be necessary to correct them. In a nutshell, the policy strategy is based primarily on management of the exchange rate and fiscal instruments to (try to) improve the short-term inflation-activity trade-off, while adopting a series of exchange rate controls and short-term financing to cope with the tightening restrictions on the balance of payments.

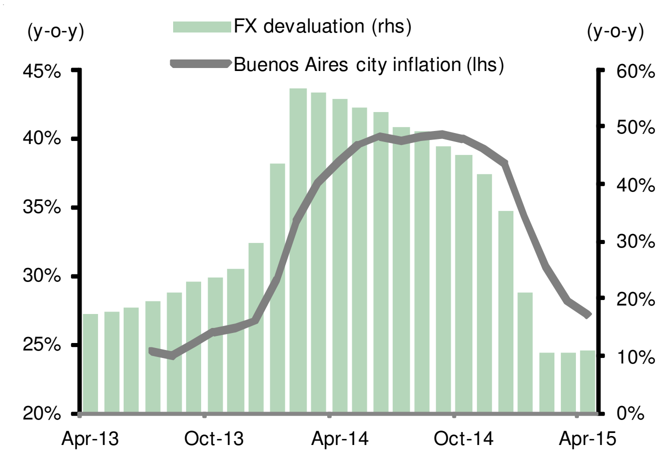
As a result, the exchange rate has taken on the role of the main nominal anchor. By managing a low depreciation drift, the Central Bank has been able to reduce both exchange rate and depreciation expectations (Exhibit 4, below).

Exhibit 4: Inflation and Devaluation Expectations Moderate



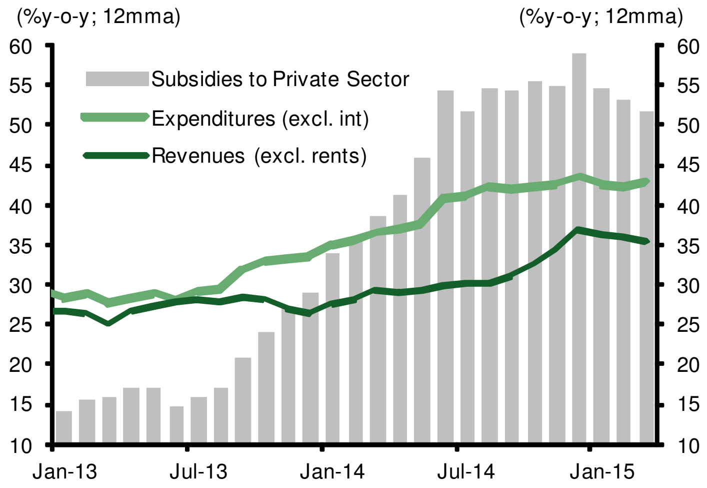
Source: Haver Analytics, Di Tella University

Exhibit 5: Exchange Rate Impact on Inflation



Source: INDEC; Statistical Institute City of Buenos Aires; Di Tella University

Exhibit 6: Elevated Growth of Fiscal Expenditures



Source: Ministry of Economics and Finance

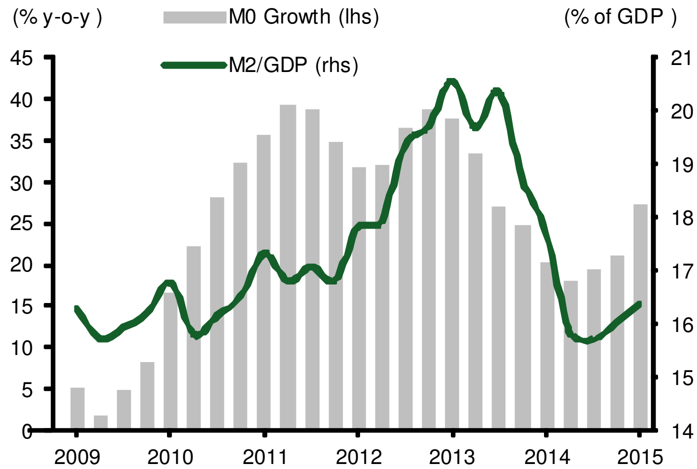
Ultimately, and helped by increasing economic slack, the resulting stability of the nominal exchange rate has also played a crucial role in diminishing realized inflation (Exhibit 5, page 14).

Another important pillar of the perceived stabilization of macroeconomic conditions is the use of fiscal instruments to support consumption and economic activity ahead of the presidential elections. Apart from existing economic subsidies directed at supporting transportation and energy demand, the government has recently launched a series of programs to finance consumption of both durable and non-durable goods. As a result, public expenditures continue to increase well beyond genuine fiscal revenues, ultimately worsening the fiscal stance of the central government (Exhibit 6, above). In fact, we estimate that the fiscal deficit will rise to a sizable 6.3% of GDP by the end of the year, from 5.3% of GDP in 2014.[3]

The financing of the ever larger fiscal deficit intensifies the policy inconsistency. Facing limited access to international financing due to lingering problems with its external debt, the government has been relying almost exclusively on the Central Bank to finance the gap in the fiscal accounts. In fact, this fiscal dominance has lately been the main factor underlying the monetary base's expansion, particularly after the Central Bank is finding it increasingly difficult to continue sterilizing this fiscally induced monetary injection due to the large stock of its own short-term debt (70% of the monetary base, Exhibits 7 and 8, below and page 16). Without even considering any further sterilization, the Central Bank would have to issue the close to 8% of GDP of new debt before the end of the current presidential mandate just to service (that is, roll over) its existing debt (Exhibit 9, page 16).[4]

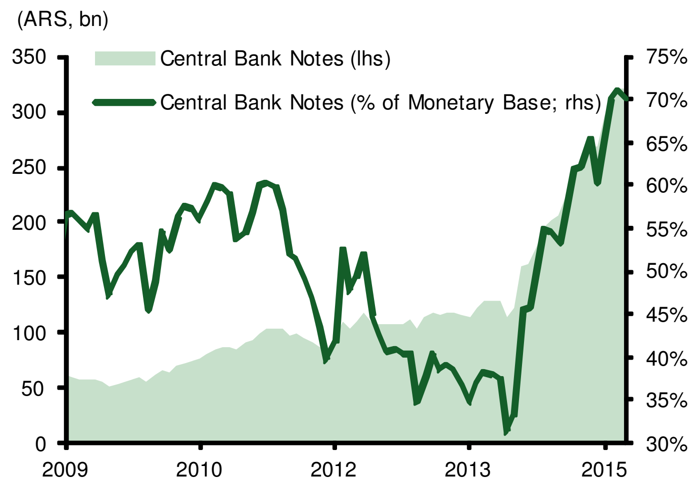
The reduced sterilization is already being reflected in a faster pace of growth of monetary aggregates. After a period of relative monetary restraint during 1H14 – when monetary aggregates were contracting in real terms – the rate of growth of the monetary base has gradually increased from less than 20% y-o-y in 3Q14 to more than 30% during the first two weeks of May. As a result, the rate of growth of liquidity (measured by M2) has also jumped from less than 25% y-o-y to more than 35% y-o-y during the same period. It is just a matter of time before this increased

Exhibit 7: Restrain No More



Source: BCRA, Goldman Sachs Global Investment Research

Exhibit 8: Rising Stock of Central Bank Notes (LEBACs)



Source: Central Bank of Argentina

liquidity boosts inflation pressures and, ultimately, exchange rate overvaluation.

The use of the exchange rate as a nominal anchor is far from novel in a country that has historically failed to implement a solid monetary policy framework. From past experience, however, it has also become evident that unless this temporary resource is accompanied by consistent fiscal and monetary policies, potential short-term gains usually lead to larger long-term costs. Given the magnitude of the macroeconomic imbalances and the evident inconsistency of the current policy framework, this time will probably not be very different.

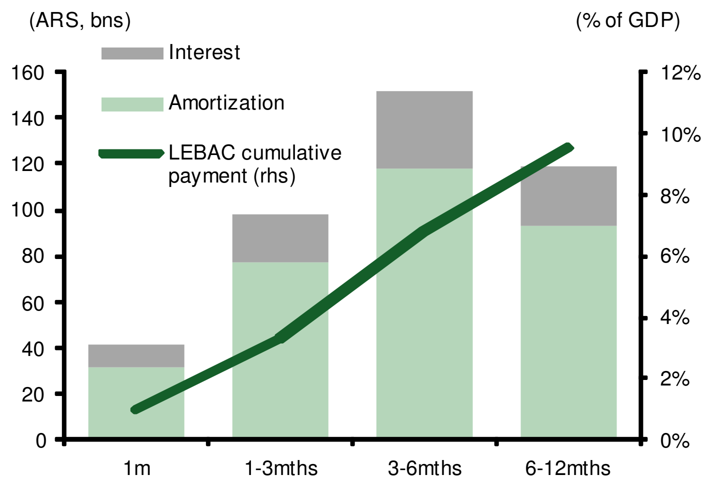
Dissecting the Dynamic Effects of the Current Policy Mix

To better illustrate the inconsistency, or the undesired consequences of the current policy mix, we perform an econometric estimation of resulting macroeconomic dynamics. As analyzing (identifying) the macroeconomic effects of different policy decisions in emerging countries is usually difficult due to the reduced availably or reliability of macroeconomic data, we make a brief digression on our methodology.

Basically, we estimate a structural vector autoregression (VAR) of a Neo-Keynesian macroeconomic model for an small open economy in which economic activity, inflation, monetary aggregates (M2) and the exchange rate are endogenously and dynamically determined across periods. But to circumvent the credibility issues affecting Argentina's official GDP and inflation series, as a first step we use factor analysis to construct indicators of economic activity and price variation for a large series of relevant high-frequency estimators. In a second step, we replace the GDP and inflation series by these factors in the VAR estimation to perform a factor-augmented vector autoregressive model (FAVAR), first introduced by Bernanke *et al*. (2004).[5] As explained by those authors, this methodology allows the exploitation of larger information sets to properly identify the policy transmission mechanism.

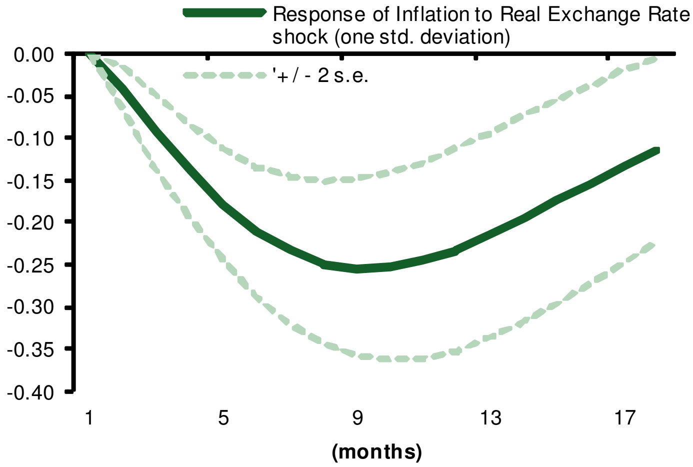
The results of our estimation show that overvaluation of the currency – a necessary consequence of using the exchange rate as a nominal anchor – is particularly effective in reducing inflation but at the cost of depressing economic activity. A strengthening of the real exchange rate has a deflationary effect that peaks after 2-3 quarters before

Exhibit 9: Maturity Profile of LEBACs



Source: Central Bank of Argentina

Exhibit 10: Response of Inflation to Real Exchange Rate Shock



Source: Goldman Sachs Global Investment Research

gradually fading (Exhibit 10, above). In addition, through its negative effect on competitiveness, it has a negative, but somewhat lagged, impact on economic activity (Exhibit 11, below).

On the other hand, higher growth in monetary aggregates – resulting from fiscal dominance – might have a mild and transitory positive impact on economic activity but above all, introduces persistent inflationary pressures (Exhibit 12, page 18). In turn, and due primarily to these inflationary effects, it also strengthens the real exchange rate (Exhibit 13, page 18), further reducing economic competitiveness.

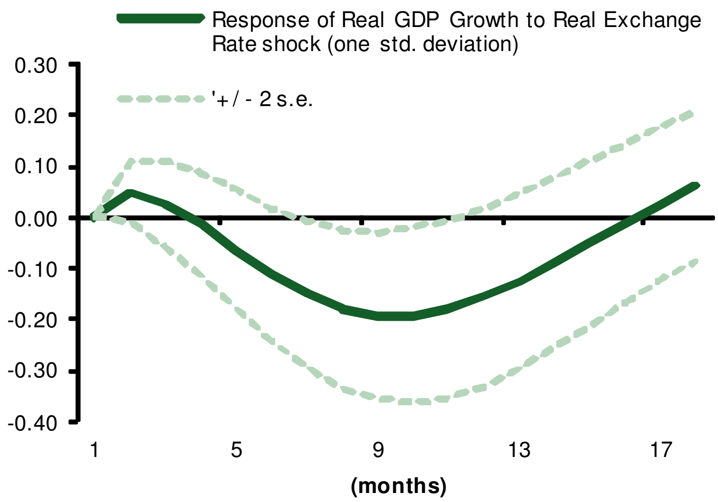
Our results also provide some explanation why the chosen strategy could have some positive short-term impact on inflation but at the cost of exacerbating medium-term inflationary pressures. According to our estimations the deflationary effect on the strengthening of the exchange rate is initially relatively larger than the inflationary impact of the monetary impulse. While a 1% increase in the real effective exchange rate reduces (the factor of) inflation by 0.6% after two quarters, a 1% increase in liquidity (M2) increases (the factor of) inflation by less than 0.2% during that same period.[6]

But since the effects of the monetary impulse are considerably more persistent that those of the exchange rate shock, at some point the former prevail. A 1% increase in liquidity still has a positive impact on (the factor of inflation) of 0.9% after 7 quarters when the effects of the exchange rate on inflation are already fading.

Hence, the existing policy strategy of using the exchange rate as the main instrument to control inflation while subordinating monetary policy to a lax fiscal stance to support economic activity may have some short-lived positive impact on inflation (or expectations) but eventually leads to the intensification of, or, in the best case, the perpetuation of the current stagflation scenario. Long-term pain will probably be more important than any short-lived short-term gain.

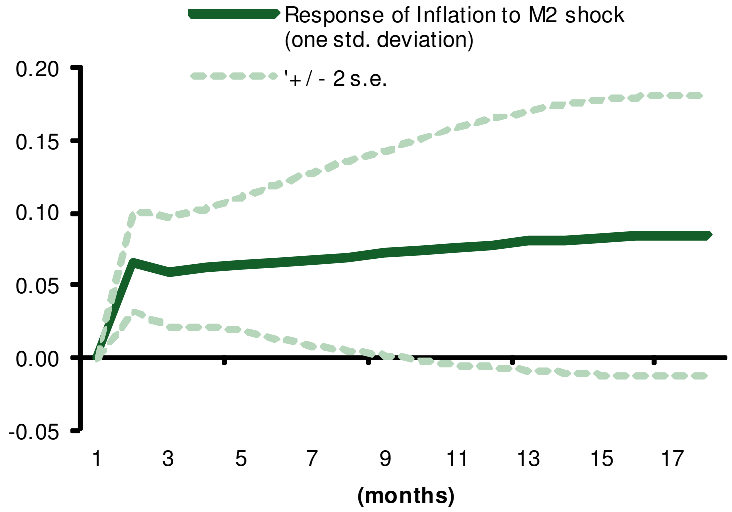
An additional problem is that the reliance on the exchange rate as a nominal anchor rapidly decreases its effective-

Exhibit 11: Response of Economic Activity to Real Exchange Rate Shock



Source: Goldman Sachs Global Investment Research

Exhibit 12: Response of Inflation to Monetary Shock



Source: Goldman Sachs Global Investment Research

ness as agents understands that this policy strategy cannot be maintained for long and at some point the currency misalignment would have to be corrected.

As a result, the maintenance of this strategy continuously deteriorate the short-term activity-inflation trade-off (that is, further inflation deceleration will have a rising cost in terms of economic activity, even if the proper monetary instruments were to be eventually used to that objective).

Its recent relative success in (at least superficially) stabilizing financial conditions is, in our view, based on two ephemeral factors. First, the temporary recovery in gross international reserves, thanks to short-term bilateral financing (China swap) and tightening exchange rate controls, has helped to deter expectations of a balance of payment crisis (even when the quality of those reserves has continued to deteriorate). Second, and probably more importantly, the proximity to the presidential elections (October 25) and the widespread belief that the next administration will implement the necessary correctives are helping to anchor medium-term expectations. As these ephemeral factors disappear, inflation and exchange rate dynamics may considerably change at the onset of the next administration (or after the elections if the perception of a timely correction begins to wane).

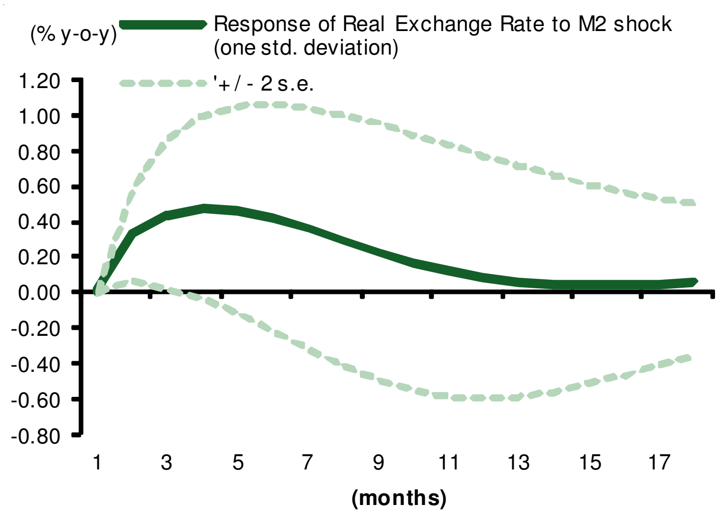
Political Uncertainty Still Elevated

According to polls, there are three leading candidates in the presidential race: Governor of the Province of Buenos Aires Daniel Scioli (FPV), National Deputy Sergio Massa (FR), and Mayor of the City of Buenos Aires Mauricio Macri (PRO).

While Mr. Scioli and Mr. Massa are running under different party labels, they both belong to the broad Peronist movement. Mr. Scioli was vice president under President Nestor Kirchner (2003-2007), and Mr. Massa was Chief of the Cabinet of Ministers under President Cristina Fernandez de Kirchner (2009-2011). In contrast, Mr. Macri, who has not had close political ties with the current administration, recently struck a national alliance with the traditional UCR party, the perennial antagonist of Peronism.

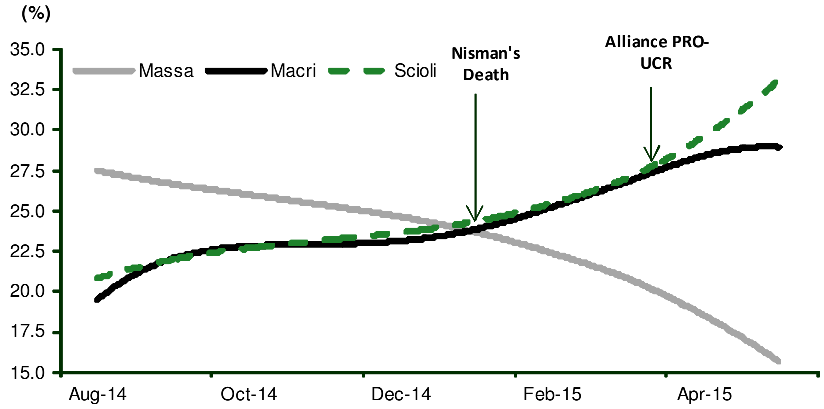
The diverging political stances of the leading candidates have naturally resulted in an increasing polarization of the elections around the issue of “continuity vs. change.” Mr. Scioli is viewed as better suited to capture the vote of that

Exhibit 13: Response of Real Exchange Rate to Monetary Shock



Source: Goldman Sachs Global Investment Research

Exhibit 14: Evolution of Intentions to Vote For President



Note: Poll of Polls constructed using results from six mayor pollsters. "Nisman's Death" refers to the apparent suicide in January 2015 of Alberto Nisman, one day before he was due to present in Congress new evidence on an alleged cover-up by the government of the 1994 bombing of a Jewish community center in Buenos Aires
Source: Goldman Sachs Global Investment Research

large part of the population that either supports the continuation of the current policy framework or at most, would accept a gradual implementation of the necessary corrections. In contrast, Mr. Macri is running under the premise of swift and far-reaching change to most policies implemented under the Kirchners' administration during the last 12 years. Lastly, Mr. Massa, who has recently adopted "exact change" as the central slogan of his campaign, is aiming to attract that part of the electorate swinging between these two extremes.

The latest polls already reflect this growing polarization. Helped by the perceived stabilization of macroeconomic conditions, Mr. Scioli's campaign has recently gained significant momentum, allowing him to open a small lead over Mr. Macri (Exhibit 14, above). At the other extreme, intentions to vote for Mr. Massa – not long ago seen as the leading candidate – are fading rapidly as he struggles to position himself in the middle.

Pace of Adjustment Would Be Dictated by the Challenging Macroeconomic Backdrop

In economic terms, and even when none of the leading candidates has explicitly presented his proposal, the perception is that Mr. Scioli would favor a gradualist approach, trying to correct some of the largest distortions while preserving the prevailing financial stability, whereas Mr. Macri would adopt a more aggressive policy stance.

But due to the delicate macroeconomic backdrop that the next administration will inevitable inherit, following any extreme approach entails serious risks. Excessive gradualism would perpetuate the currency overvaluation and exchange rate controls. Additionally, repressed inflation would increasingly feed inflationary expectations. Ultimately, excessive gradualism would prolong the stagflation while increasing the risks of an abrupt and disorderly correction.

On the other hand, a policy of shock risks generating a painful overshooting in key macroeconomic variables. Due to significant currency misalignment and repressed demand for hard currency,[7], a rapid lifting of exchange rate controls would probably trigger a sharp devaluation of the Argentine Peso. Needless to say, in a context of elevated liquidity, removing the sole nominal anchor could be highly inflationary. Similarly, a rapid readjustment of energy tariffs – something that would be required to reduce the fiscal deficit – could have a major impact on inflation.

As a consequence, we think that prevailing economic conditions – instead of political preferences between "gradualism" and "shock" – will ultimately dictate the pace of economic adjustment. The next administration will have to strike an elusive balance between showing solid and continuous steps in the right direction and avoiding further nominal and financial instability that could ultimately derail the reform process. In this regard, it will be crucial to adopt a proper sequencing of politically palatable economic measures.

But regardless of the policies chosen, the current policy mix already sets an elevated floor for inflation at the onset of the new administration. The disproportionate increase in liquidity amid rising currency misalignment and relative price distortions threatens the medium-term inflation outlook. In particular, due to the recent acceleration in the rate of growth of monetary aggregates, and expectations it will be maintained during most of the current electoral year amid risks of instability of the demand for money, we increase our 2016 inflation forecast to 35.7% y-o-y (up from 32.5% y-o-y).

Notes:

[1] *See "Argentina: A first look into the presidential election; brace for gradual change," EM Macro Daily, May 13, 2015.*
[2] *According to the latest Latin American Consensus Forecast, the inflation consensus forecast for 2015 is 27.8%.*
[3] *See "Argentina: Fiscal deficit continues to widen," May 29, 2015.*
[4] *See "Argentina: Are there any limits to fiscal deficit monetization?," EM Macro Daily, April 24, 2014.*
[5] *Bernake, Ben S., Jean Boivin, and Piotr Eliasz. "Measuring the effects of monetary policy: a factor-augmented vector autoregressive (FAVAR) approach." No. 10220. National Bureau of Economic Research, 2004.*
[6] *Note that the factor of inflation is inherently adimensional. It is not correct to interpret that a given variation in the factor immediately corresponds to a similar variation on consumer inflation. But it is valid to assess the relative impact of both shocks to inflation.*
[7] *See "Argentina: Economic Repression Intensifies Transition Challenges," Latin America Economic Analyst, April 2, 2015.*

New Zealand: Build Me Up – Growth Driven by Robust Construction Activity

Dominick Stephens, Michael Gordon, Felix Delbrück and Satish Ranchhod, Westpac, Wellington

Forecasts for 2015, % change (unless stated otherwise)	Gross Domestic Product	Private Consumption	Consumer Prices	Current Account Balance (NZ$bn)
Westpac	3.0	4.4	0.2	-11.6
Consensus[1]	2.9	3.6	0.6	-11.3

[1]Source: Asia Pacific Consensus Forecasts, June 2015.

It's been a solid start to the year for the New Zealand economy. Over the past few months we've seen continuing strength in the housing market and construction, as well as strong gains in retail spending. These conditions, along with low interest rates, surging immigration, and low inflation have seen demand in the economy growing at a robust pace. This strength is even more impressive given the headwinds in the external sector, including falls in global dairy prices and the elevated NZ$.

We're expecting that the economy will remain solid over the next couple of years, and are forecasting GDP to grow by around 3% in both 2015 and 2016. However, underlying this robust aggregate outlook, it's likely that New Zealand will continue to be a 'two-speed' economy. Strength is expected to remain underpinned by domestic demand in the main urban centres. At the same time, conditions in rural regions and among some exporters will be more challenging.

While the outlook for the next few years is robust, many of the current drivers of growth will fade over time. Notably, the peak in the Canterbury rebuild is rapidly approaching. In addition, the current strength in net immigration will start to dissipate when job markets offshore eventually improve. As this occurs, economic growth will slow from 2017.

Normally when New Zealand experiences a period of strong demand, increases in inflation and the resultant increases in interest rates spoil the party. But not this time. The outlook for inflation over the next few years looks likely to be so well contained that we now see no need for further Official Cash Rate (OCR) hikes in the current economic cycle. Nevertheless, we do expect the RBNZ to implement new mortgage restrictions targeting property investors.

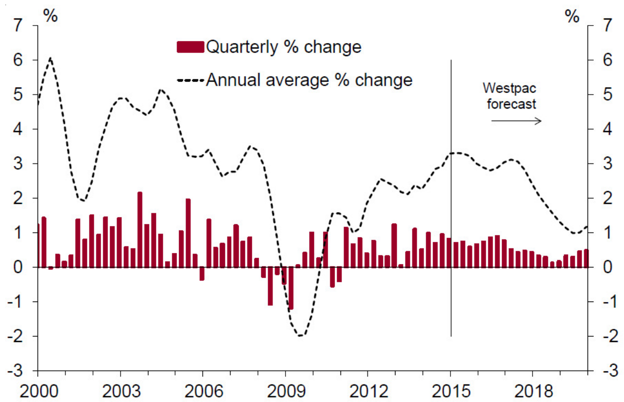
Hammers and Nails

The key driver of New Zealand's current economic upturn has been a strong increase in construction activity. Building levels were up a whopping 23% over the past year, with much of this related to ongoing reconstruction work in Canterbury.

The rebuild is now well advanced, with the Earthquake Commission's home repair program more than 95% complete. And while building levels in Canterbury are expected to remain elevated for some time yet, the peak in the rebuild is clearly in sight. We are already seeing signs that the upward trend in residential building activity has stalled, with new dwelling consent issuance down around 25% over the first three months of the year. We expect total reconstruction activity (which also includes commercial and infrastructure projects) will peak in early 2016, and then start easing back from 2017.[1]

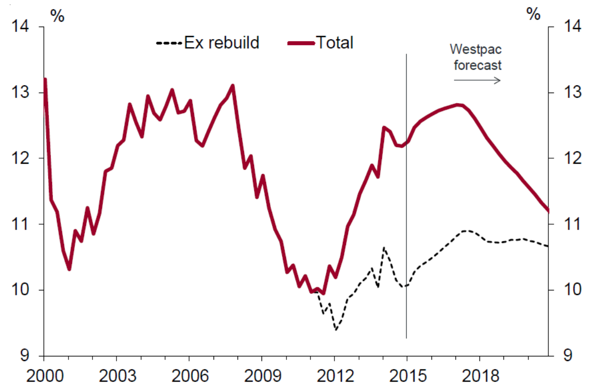
Strength in construction isn't just a Canterbury story, however. Construction activity in Auckland has also been increasing, supported by strong population growth, low building in recent years, and (as discussed below) strong economic incentives. Consents for new dwellings in Auckland have lifted by 20% over the past year. Nevertheless,

Figure 1: New Zealand GDP Growth



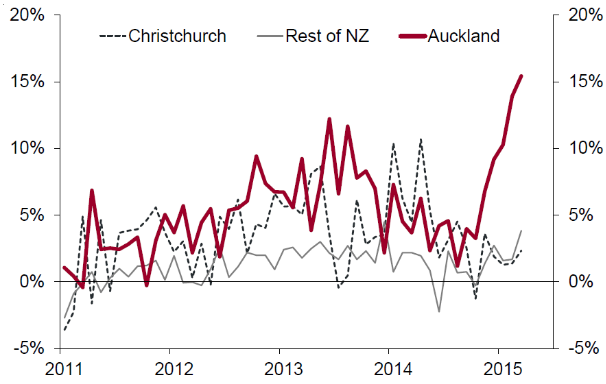
Source: Statistics NZ, Westpac

Figure 2: Construction Spending (Share of GDP)



Source: Statistics NZ, Westpac

Figure 3: House Prices, Change Over Six Months



Source: REINZ

building levels in Auckland are still below what's needed to keep up with its surging population growth. We expect residential construction in Auckland will remain strong over the next few years, with increases in commercial and infrastructure spending also expected.

As construction levels have increased, capacity pressures in the sector have started to emerge. These pressures mainly relate to the availability of labour, with increasing numbers of firms highlighting difficulties finding suitable staff. This is pushing up construction wages and costs. It's also providing some brake on the pace of construction activity, especially in Auckland.

"That" Housing Market

Auckland's housing market is on fire. REINZ data suggest that house prices have risen by 16% over the past six months alone. And while it's not unusual for there to be regional divergencies in prices, Auckland's current degree of out-performance is striking.

A number of possible reasons for the strength in Auckland house prices have been suggested. But while these may explain some of the increases we've seen recently, they certainly don't explain the whole picture. For instance, the notion that house prices are rising because of strong population growth and a legacy of underbuilding conveniently ignores the fact that rents in Auckland are rising at the paltry pace of 2.6% per annum – rents would be rising faster if a shortage of accommodation was the key issue. Similarly, construction costs aren't the issue – building costs in Auckland were up 5.9% over the past year, and only make up a proportion of the total cost of a property. Neither are low interest rates the main driver – other parts of New Zealand face the same interest rates but sport very different housing markets. Finally, labelling the Auckland housing market a "bubble" or blaming foreign speculators actually explains nothing – why has the bubble or foreign speculation not emerged in Wellington or Oamaru?

We think that there may be another factor at play: the perceived value of the land in Auckland is rising because housing supply regulations are being liberalised.

At first glance, this idea sounds counterintuitive, but it is actually quite simple. In line with the global trend towards greater centralisation of economic activity, Statistics NZ projections indicate Auckland's population is set to grow by around 740,000 people over the coming thirty years (an increase of close to 50%). This is expected to create unprecedented demand for dwellings located within striking distance of a major Auckland centre of employment, most notably the Central Business District. At present, much of the relevant area is occupied by single dwellings on relatively large plots of land. In the past, zoning restrictions and building regulations made it difficult or expensive to intensify the use of that land. But recent regulatory changes are opening an easier and cheaper path to intensification. And consequently the value of the land has gone up.

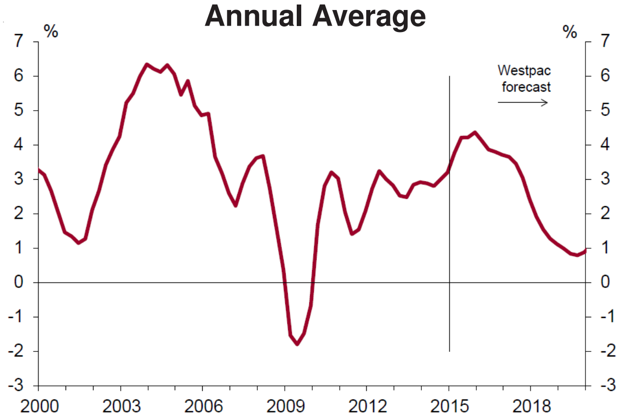
What this means is that the value of today's house-plus-land packages is shooting up. If all goes to plan over time land will be subdivided and the swathe of more affordable housing that Auckland needs will be built. But if a young couple wants to buy into today's market, they first have to outbid a developer or speculator who understands the concepts we have outlined.

The latest data gives no hint of Auckland house prices slowing their upward march, and we have upgraded our forecast of nationwide house price inflation this year to 10%. With low inflation keeping OCR hikes off the table, the RBNZ is instead likely to dip into its macro-prudential tool kit to lean against housing market pressures. We expect that some form of lending restriction will be introduced in the second half of this year targeting residential property investors. However, while such restrictions may take some of the steam out of the housing market, we don't think house price inflation will materially slow until the economy turns.

Sizzling

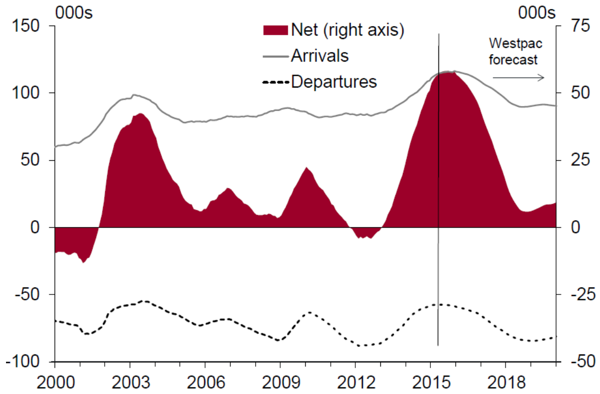
It's not just housing and construction activity that has been strong. Domestic demand more generally has been picking up. Notably, household spending has been charging ahead in recent months, and we now expect that spending growth

Figure 4: Household Consumption Growth, Annual Average



Source: Statistics NZ, Westpac

Figure 5: Annual Net Immigration



Source: Statistics NZ, Westpac

over 2015 and 2016 will be the strongest we've seen in close to a decade.

Contributing to the robust outlook for consumption spending have been solid gains in real labour earnings. The proportion of New Zealanders in employment has been trending higher in recent years. In addition, although nominal wage growth has been moderate, adjusting for changes in purchasing power, households' earnings have actually been growing at a firm pace. In fact, real wage growth in the year to March was the highest it's been over a decade. Households' purchasing power has received a particularly large boost from lingering strength in the NZ$, which has dampened prices for a range of goods.

Adding to the strength in household spending have been the gains in household wealth associated with rising house prices. In addition, many households are benefiting from current low borrowing rates.

Surging population growth has been another driver of consumer spending. New Zealand's strong relative economic performance and labour market conditions have seen net immigration climb to 56,000 people in the year to March – 30% higher than the peak of early-2000s migration boom.

We've been upbeat on the outlook for net immigration for some time, and it's now looking likely that immigration levels will stay high for longer than we had previously assumed. While conditions in New Zealand have strengthened, the global economy is still experiencing a gradual recovery. Importantly, the outlook for Australia (the main destination for New Zealanders travelling abroad) is looking softer than previously assumed. As a result, we now expect that net immigration will remain firm through to 2016, before turning down as growth in New Zealand slows and labour market conditions offshore gradually improve.

There are two important headwinds for the household sector - continuing restraint in government spending, and (as discussed below) flagging export earnings. We expect that the latter will shave around 0.7 percentage points off consumer spending over the coming year. However, the drag from these two factors is materially smaller than the positive impact of the factors mentioned above. Consequently, we still expect consumption spending to grow at a rapid pace over the coming years.

From Dry to Damp

The drought conditions that were weighing on the outlook at the time of our previous quarterly update have proven less severe than feared. Nevertheless, the external sector is continuing to face a number of significant headwinds.

Falling prices for some of our key commodity exports, particularly dairy, will drain a significant chunk of income out of the economy. Our forecasts assume that around half of this loss in export earnings will pass through to lower spending, resulting in a significant drag on growth. Our research indicates that the reduction in export earnings will have a particularly large impact on plant and machinery investment spending. Retail spending in rural communities may also be affected. However, history suggests that the overall sensitivity of consumer spending to export incomes is actually quite low. In addition, the spending power of all households is receiving a significant boost from the high NZ$.

Exporters outside of the dairy sector have also been facing a number of headwinds, including lingering softness in global demand. But despite such headwinds, export levels have actually held up. We have been surprised by the resilience of manufactured exports in the face of the high NZ$/AU$ and weakness in the Australian economy. This may be because a significant proportion of New Zealand exports to Australia relate to the construction sector, which has actually been faring better than other parts of the Australian economy. In addition, increasing Chinese visitor numbers and reviving Northern Hemisphere visitors have helped to boost tourism earnings. Meanwhile, a lift in foreign students numbers has boosted education exports.

Notes:

[1] *See "Focus on the Canterbury Rebuild", Available here: http://www.westpac.co.nz/assets/Business/Economic-Updates/2015/Bulletins-2015/Focus-on-the-Canterbury-rebuild-April-2015.pdf*

Can Central Banks Keep Rates Low in Europe and Japan?

Patrick Legland, Daniel Fermon, Laure Fauchet, Takuji Aida and Kiyoko Katahira, Société Générale, Paris/London/Tokyo

The European bond sell-off in May is likely to have run its course, as ECB QE will remain a major force, while inflation should stay low despite the recovery.

Mostly a Technical Correction: After reaching a historical low of 5bp mid-April, the 10y Bund yield rebounded c.60bp, dragging down other bond markets in its wake. According to our Rates strategists, the recent sell-off of global bonds was mainly driven by technicals, such as the reversal of QE frontrunning, crowded positions, and extreme rate levels. VaR limits have been hit and triggered bond sales, amplifying volatility. While the Bund and OAT moves have been dramatic, higher-yielding Treasuries and Gilts have proved more resilient. This differentiation suggests the sell-off was a necessary adjustment from extreme valuations in core euro bonds, rather than the beginning of a sustained global bond bear market.

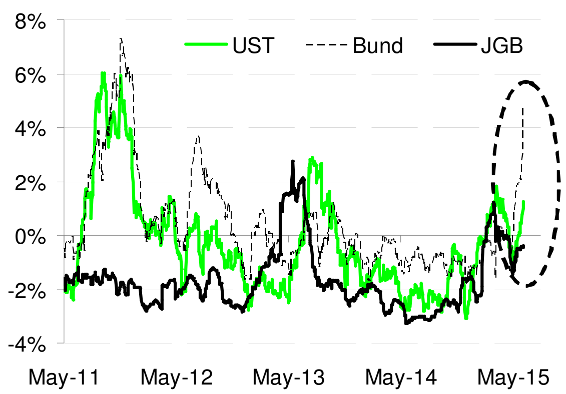
Improving Eurozone Macroeconomic Conditions Can Partly Explain the Sell-Off: Since the beginning of the year, the eurozone economy has gained momentum (+0.4% growth in Q1 q-o-q). The recovery has mainly been driven by household spending, buoyed by stronger purchasing power (owing to low inflation and lower oil prices), better employment expectations, and a slower pace of fiscal consolidation. The ECB's QE also improved financial conditions and weakened the euro. But, medium term, growth should moderate, as temporary positive factors (like lower oil prices) could fade. Our economists also expect net exports and capex to be disappointing engines of growth. Further progress on structural reforms is therefore needed for a sustainable recovery to take hold.

Inflation Not Yet a Threat For Eurozone Bonds: At the start of the Fed's QE phases, interest rates generally went up as inflations expectations increased. Inflation expectations have also increased somewhat in the eurozone. But, with unemployment still high in most of the region, we remain sceptical of any acceleration in inflation expectations (although the oil price remains a risk factor). In fact, our Rates strategists highlight that the sell-off was mostly due to an increase in real rates. With growth expected to remain modest due to structural headwinds, and unemployment still high, eurozone inflation should remain low (around 1.4% between 2016 and 2019).

ECB QE Just Started, and Purchases Will Reinforce Large Supply/Demand Imbalances. As the recovery in Europe remains fragile and inflation should stay below 2% for the coming years, the ECB should continue its Public Sector Purchase Programme (PSPP) until at least September 2016. So far, the ECB has only completed c.10% of the purchase programme. Asset purchases from the ECB are reducing net supply, while there is already a shortage in safe euro assets. According to our Rates strategists, the changing structure of cash flows may soon bring support to the long end of the EUR curve, even if the ECB alters the rhythm of its purchases (see chart 3, page 24). The real EUR 5-30y curve is now positive again. Any further steepening would incentivise insurers and pension funds to step in again at these higher rate levels.

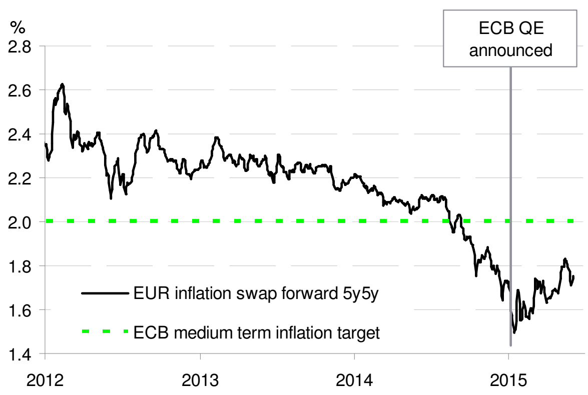
Carry Trades in Peripheral Countries Remain Attractive: Spain and Italy enjoy a cyclical recovery and growth should support a further decline in their sovereign yields.

Figure 1: 10y Sov. Yield Realised Volatility – Deviation From Long-Term Average



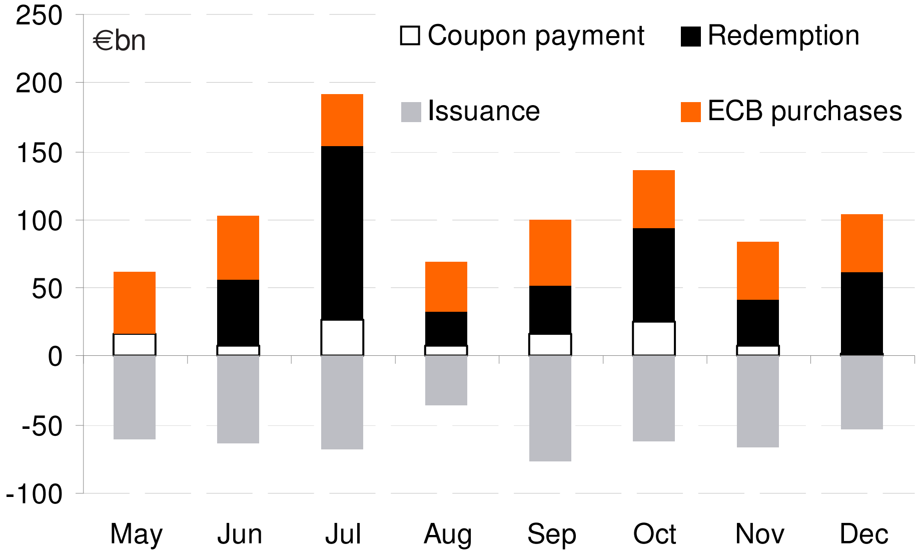
Source: SG Cross Asset Research/Thematics, Datastream. Based on 30-day rolling volatility. Long term average calculated from 1989

Figure 2: Inflation Expectations Reversing...But Still Slow



Source: SG Cross Asset Research/Thematics, Bloomberg

Figure 3: EUR Sovereign Net Cash Flows to Turn Far More Supportive in June and July



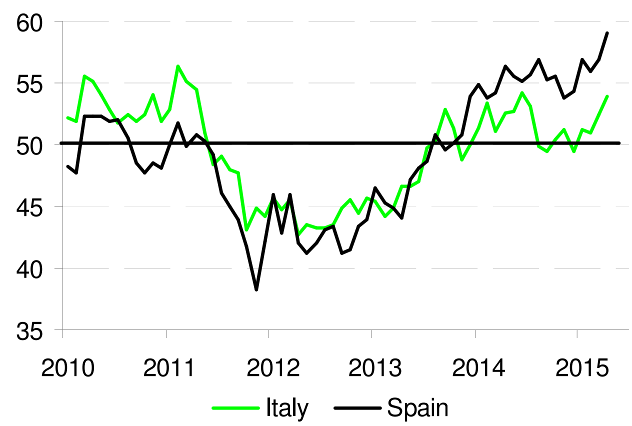
Source: SG Cross Asset Research/Rates

With no significant inflation threat, the PSPP remains a major anchor for EGB yields. Peripheral spreads have widened following the sell-off but remained resilient faced with the Greek situation. Our Rates strategists expect higher yielding EGBs to retrace a good deal of their recent sell-off. We favour Spanish and Italian 10-year bonds, which provide an attractive pick-up with yields near 2%.

Japan 10-Year Bonds at a Crossroads?

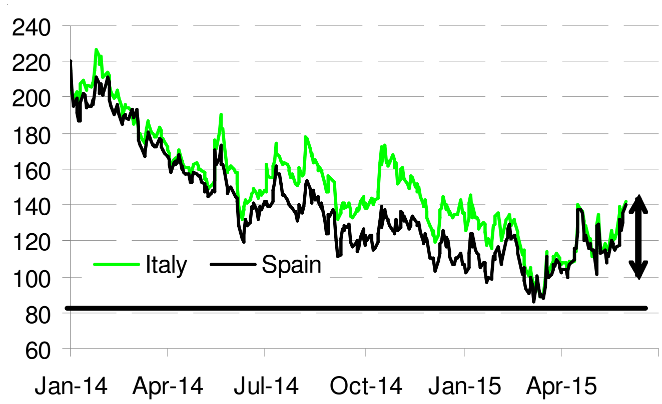
Despite the similarities between the eurozone and Japan, there are some notable differences in the labour situation that are worth highlighting. Japan's wages are expected to rise. With tighter labour market conditions (in part due to demographics), we expect stronger wage expansion in the future, as labour shortages are starting to impact companies that want to retain their employees. The ratio of new jobs relative to applicants has reached a 20-year high, while the unemployment rate is at a historical low favouring future wage growth. Real earnings have stopped declining, and the number of people in employment has increased by one million in the past twelve months. Moreover, as a result of strong pressure by the government on companies to increase wages (to compensate for the corporate tax cut), more companies are implementing base wage increases.

Figure 4: Composite PMIs Show Recovery Gaining Traction



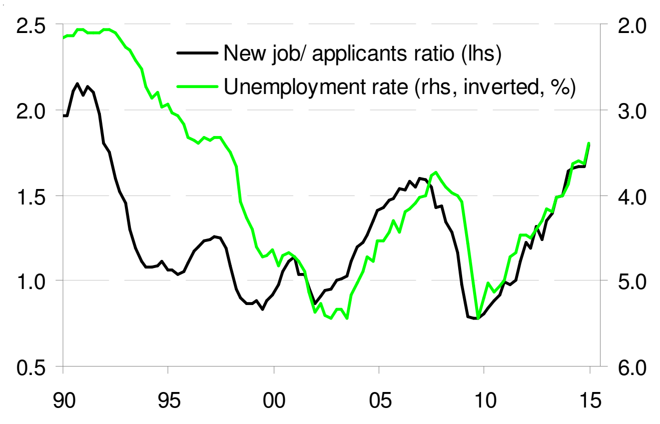
Source: SG Cross Asset Research/Thematics, Datastream

Figure 5: 10y Peripheral Spreads Tightening Potential



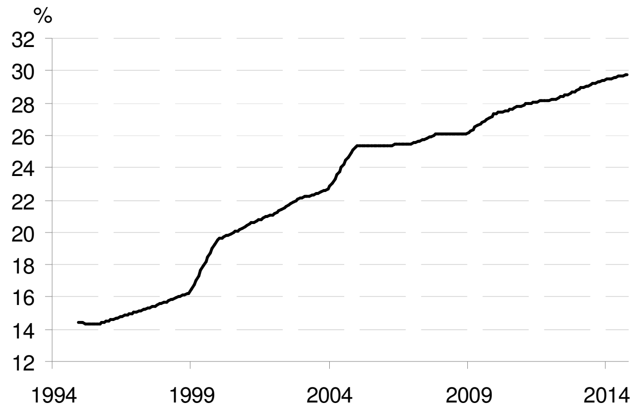
Source: SG Cross Asset Research/Thematics, Datastream

Figure 6: Tighter Labour Market Conditions



Source: SG Cross Asset Research/Thematics, Bloomberg

Figure 7: Share of Part-Time Workers in Total Employees



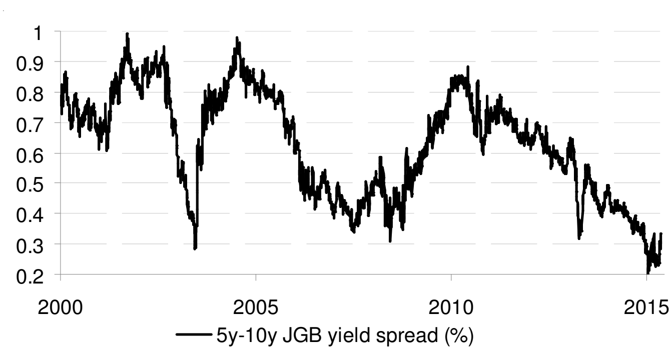
Source: SG Cross Asset Research/Thematics, Bloomberg, Ministry of Health, Labour and Welfare

In the FY 15 annual spring wage talks, major companies accepted a base wage hike of about 2.5% (including annual wage hikes). Our economists therefore expect aggregate wages to expand strongly in fiscal year 2015, supported by stronger corporate profits. But, structural reforms will be key to reducing the dual nature of the labour market which is hindering wage growth and labour productivity. Indeed, 30% of employees are part-time workers.

Successful Reflation of the Economy Would Eventually Drive Rates Higher: So far, inflation expectations have increased slightly, mostly as a result of QQE and yen depreciation, but the latter may only have a temporary impact on inflation expectations. To achieve a sustained rise in prices to the 2% target, further structural reforms, especially in terms of stimulating corporate activity and expanding aggregate wages, are necessary. If Abenomics succeed in pushing Japan out of deflation, the BoJ may not be able to keep the 10-year at such low levels, despite massive easing. However, we expect reflation will be a medium-term improvement and prefer to position for a likely increase in monetary easing in H2 2015. (For investors looking to benefit from higher yields, our rates strategists suggest zero-cost optional trades, which would not lose money if JGB rates do not increase).

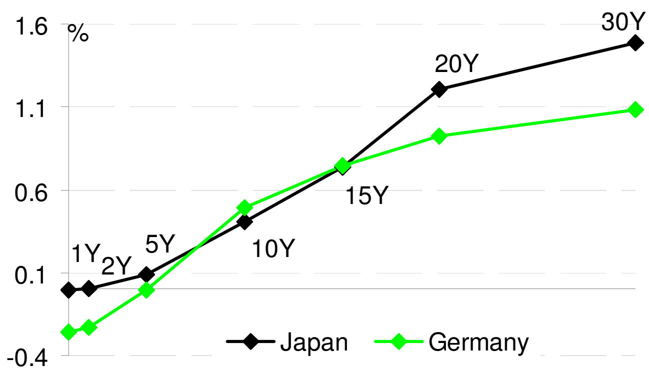
Still Good Reasons to Fear the "Widow Trade": The growing domination of the BoJ on the Japanese bond market remains a risk for shorting bonds. The BoJ is on its way to owning c.50% of all JGB outstanding by 2017 according to our Rates strategists. Despite sharp and repeated sell-offs, the 10-year bond has continued to rally

Figure 8: 5-10y JGB Yield Spread at Historical Low (%)



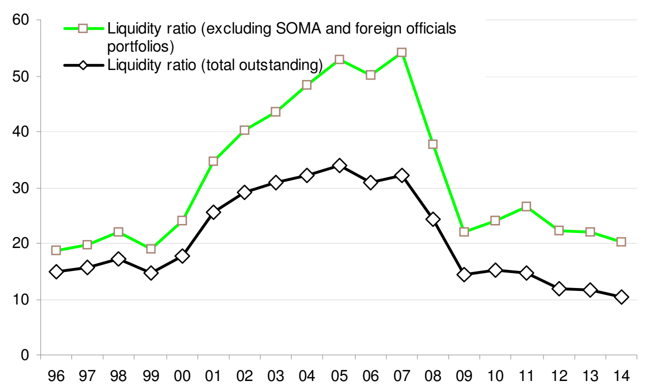
Source: SG Asset Research/Thematics, Datastream

Figure 9: Japanese Vs German Yield Curves – The Japanese Curve Has Potential to Flatten



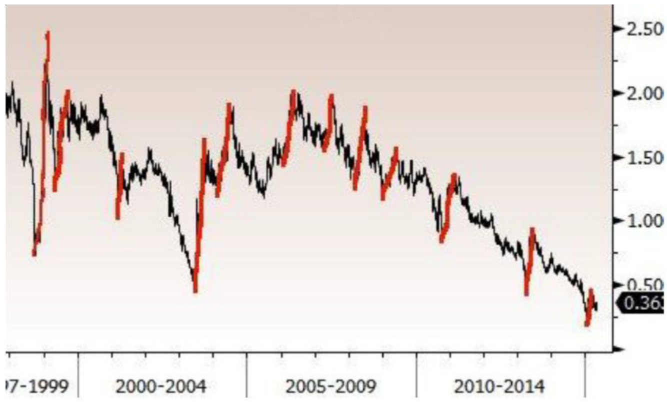
Source: SG Asset Research/Thematics, Bloomberg. As of 01/06/2015

Figure 10: Treasury Liquidity Ratio



Source; SG Cross Asset Research/Cross Asset Quant – SIFMA, New-York Fed. The liquidity ratio is defined as the annual volume traded by the US primary dealers, divided by the US Treasuries total outstanding amount.

Figure 11: Repeated Sharp Sell-Offs in 10y JGB



Source: SG Cross Asset Research/Rates

inexorably under the pressure of BoJ asset purchases. Given the current low inflation rate, we expect the BoJ to announce additional easing measures in H2 2015 to avoid falling back into deflation. Like after the announcement of QQE2 in October 2014, the very long-end of the JGB curve would most likely benefit from additional BoJ easing. Moreover, we note that the term premium in the 10y JGB sector is depressed relative to 20y+ maturities, with 2-10y or 5-10y slopes being low compared to the level of rates, contrary to 10-20y or 10-30y. Further easing could thus lead to a flattening of the JGB 10-30y curve, which remains steep compared to other markets in the 10-30y segment.

Liquidity Decline: A Factor of Volatility in Global Bond Markets

A Structural Decline in Liquidity… Since 2008, liquidity conditions deteriorated markedly in sovereign markets. This results in part from the changes in the structure of financial markets, including the impact of tougher regulations for banks and institutional investors, and the growing share of mutual funds. One measure of liquidity, the "liquidity ratio", declined sharply in major bond markets, including the US. For instance, the liquidity ratio of US Treasuries (measured as the annual volume traded by US primary dealers, divided by total outstanding amounts of US Treasuries) declined sharply (see chart below from our Quant analysts). Moreover, liquidity in bond futures has also declined.

...Reinforced by Unconventional Monetary Policy: As a result of central bank asset purchases, the liquidity of these markets has been further impaired (via a reduction in net supply and the implementation of one-way trades). For example, a study from the BoJ shows that liquidity in the JGB market has been declining since autumn 2014 (when the BoJ stepped up its QQE).

Lack of Liquidity to Amplify Future Volatility Spikes: Shallow market depth could cause sharper volatility spikes in the future, echoing the Japanese bond crash in 2013 and the flash crash on USTs last autumn.

Recommendations For the Next 12 Months

- According to our rates strategists the bond sell-off has little basis in terms of macro conditions or flow, but rather is technical. We expect peripheral bond yields to largely retrace their moves into the summer and favour long positions in Spanish and Italian 10- year bonds (in asset swap terms).
- In Japan, we expect the 10-20y or 10-30y curve to flatten as the long end should benefit from further purchases under QQE2 by the BoJ, most likely in October 2015, while the 10-year term premium is low compared to longer maturities.

Risks to Consider

- Spanish general elections in December 2015 could increase volatility on peripheral bonds.
- Stronger growth and inflation in the US could hurt peripheral bonds.
- Much stronger Japanese growth, leading to a bear-steepening of the yield curve.
- Lack of liquidity and dislocations, in particular in the JGB market.

CALENDAR OF FORTHCOMING EVENTS

Date	The Americas	Europe/Middle East/ Africa	Asia/Pacific
July 2015		**EU** - Luxembourg Presidency Begins **Burundi** - Presidential Election (15)	
August 2015	**Mexico** - President's State of the Nation Address **Haiti** - Parliamentary Elections (first round) (8)	**Denmark** - 2016 Budget Proposals	**Japan** - 2015/16 Budget Proposals
September 2015	**Guatemala** - Presidential and Parliamentary Elections (13)	**Netherlands** - 2016 Budget Proposals	
October 2015	**IMF/World Bank** - Annual Meeting **Canada** - Parliamentary Election (19) **Argentina** - Presidential Election (25) **Haiti** - Parliamentary Elections (second round) (25)	**Germany, France** and **Italy** - 2016 Budget Proposals **Burkino Faso** - Presidential and Parliamentary Elections (11) **Switzerland** - Legislative Election (18)	**APEC** - Annual Meeting **Australia** - Treasury Mid-Year Economic and Fiscal Outlook
November 2015	**Mexico** - 2016 Budget		
December 2015			**Philippines** - 2016 Budget
January 2016	**USA** - President's State of the Union Address	**EU** - Netherlands Presidency Begins	
February 2016	**USA** - Budget Proposals **Canada** - 2016/17 Budget Proposals	**EU** - 2016/17 Budget **Germany** - Cabinet's Annual Economic Report **Iran** - Legislative Election (26)	**India** and **Singapore** - 2016/17 Budget
March 2016		**United Kingdom** - 2016/17 Budget Proposals	**China** and **Hong Kong** - Annual Budget Meeting
April 2016			
May 2016	**Dominican Republic** - Presidential and Parliamentary Elections (15)		**Pakistan** - 2016/17 Budget Proposals
June 2016			

CONSENSUS FORECASTS: WORLD ECONOMIC ACTIVITY

June Survey	Real GDP % increase			Consumer Prices % increase			Current Account Balance, US$bn		
	2014	2015	2016	2014	2015	2016	2014	2015	2016
Belgium	1.0	**1.2**	**1.5**	0.3	**0.3**	**1.6**	9.8	**5.3**	**4.8**
Canada	2.4	**1.6**	**2.2**	1.9	**1.1**	**2.1**	-37.6	**-51.5**	**-38.5**
France	0.2	**1.2**	**1.6**	0.5	**0.2**	**1.2**	-28.0	**-19.3**	**-18.0**
Germany	1.6	**1.9**	**2.0**	0.9	**0.5**	**1.7**	292	**256**	**245**
Italy	-0.4	**0.7**	**1.2**	0.2	**0.2**	**0.9**	41.1	**44.0**	**45.1**
Japan	-0.1	**1.0**	**1.7**	2.7	**0.7**	**1.0**	24.7	**117.6**	**109.8**
Netherlands	0.9	**1.9**	**1.7**	1.0	**0.5**	**1.3**	89.7	**75.4**	**70.4**
Norway	2.2	**1.4**	**1.9**	2.0	**1.9**	**2.0**	42.3	**29.3**	**33.9**
Spain	1.4	**2.9**	**2.6**	-0.2	**-0.3**	**1.2**	11.3	**7.5**	**6.6**
Sweden	2.3	**2.7**	**2.9**	-0.2	**0.2**	**1.4**	35.7	**27.8**	**27.7**
Switzerland	2.0	**0.7**	**1.2**	0.0	**-1.1**	**-0.1**	49.5	**50.8**	**48.6**
United Kingdom	2.8	**2.4**	**2.5**	1.5	**0.3**	**1.6**	-161.4	**-127.0**	**-116.4**
United States	2.4	**2.2**	**2.8**	1.6	**0.2**	**2.1**	-411	**-456**	**-497**
North America[1]	2.4	**2.1**	**2.7**	1.6	**0.3**	**2.1**	-448.6	**-507.4**	**-535.7**
Western Europe[2]	1.3	**1.7**	**1.9**	0.7	**0.3**	**1.3**	420.0	**385.9**	**377.7**
European Union[2]	1.3	**1.8**	**2.0**	0.6	**0.3**	**1.4**	328.3	**308.3**	**292.4**
Euro zone[2]	0.9	**1.5**	**1.8**	0.4	**0.2**	**1.3**	313.0	**263.0**	**247.7**
Asia Pacific[3]	4.6	**4.7**	**4.9**	2.7	**1.7**	**2.2**	404.7	**635.8**	**602.0**
Eastern Europe[4]	1.6	**-0.2**	**2.0**	7.4	**8.8**	**5.9**	9.1	**5.8**	**4.4**
Latin America[5]	1.2	**0.3**	**1.9**	11.3	**14.5**	**12.0**	-176.4	**-173.4**	**-161.8**
Other Countries[6]	3.6	**2.6**	**3.4**	5.1	**5.2**	**5.6**	66.7	**-48.9**	**-18.5**
Total	2.7	**2.5**	**3.1**	3.0	**2.6**	**3.1**			

*[1] USA and Canada. [2] The Euro zone aggregate is taken from our panel's latest forecasts; Euro zone current account data and forecasts are based on extra-euro zone data, i.e. they are compiled from an aggregate of the Euro zone member states' transactions only with nonresidents of the Euro zone. The European Union data includes the Euro zone countries plus Denmark, Sweden and the United Kingdom as well as May 2004 entrants the Czech Republic, Estonia, Hungary, Lithuania, Poland, Slovakia and Slovenia, plus Romania and Bulgaria who entered in January 2007 (data taken from Eastern Europe Consensus Forecasts). Western Europe comprises the Euro zone plus Denmark, Sweden and the United Kingdom, along with Norway and Switzerland. [3] Survey results for Japan plus fifteen other countries taken from **Asia Pacific Consensus Forecasts**. [4] Twenty-seven countries including eleven European Union countries taken from the latest issue of **Eastern Europe Consensus Forecasts.** [5] Eighteen countries taken from the latest issue of **Latin American Consensus Forecasts** (Inflation figures are on a December/December basis). [6] Egypt, Israel, Nigeria, Saudi Arabia and South Africa. Regional totals, as well as the grand total for GDP growth and inflation, are weighted averages calculated using **2013 GDP weights**, converted at average 2013 exchange rates. Current account forecasts have in some cases been converted from local currency to US$ using consensus exchange rate forecasts for the purposes of comparison.*

Sources: Consensus Forecasts, June 2015; Asia Pacific Consensus Forecasts, June 2015; Latin American Consensus Forecasts, June 2015; Eastern Europe Consensus Forecasts, June 2015
