September 2016

Global Economy Watch

Global services exports have been growing strongly, but will this continue?

Dear readers,

In the UK, uncertainty remains prevalent following the Brexit vote. However, the national accounts data for the second quarter of 2016 were stronger than expected. In light of this, we have revised up our main scenario projections for UK GDP growth to 1.8% in 2016 (from 1.6%) and to 0.7% in 2017 (from 0.6%). These projections also reflect that fact that the early official data for July have held up reasonably well, notably for retail sales, but it is still too early to make a judgement on the impact of the referendum on the economy in Q3. We will update our projections in more detail in the November edition of our UK Economic Outlook report.

One consequence of the UK's vote to leave the EU is that global trade has found itself under the spotlight. It is likely to be some years before we get clarity around the trade terms that will exist between the UK and the EU. However, following Brexit, we expect the UK government to pursue trade deals with leading EU and non-EU economies. Given the UK's relative strength in services, policymakers are likely to place a particular emphasis on liberalising services trade. Over the last ten years, global services exports grew at an annual average rate of around 6.5% and now stand at about $5 trillion. If the UK is able to secure trade deals with the US and fast growing emerging economies like China and India that make it easier to export and import services, and if an agreement can be reached on the Trade in Services Agreement (TiSA - a global agreement involving 23 WTO members including the EU), then there could be even faster global and UK services export growth still to come.

Focusing on the EU, if the Brexit vote results in the UK losing some of its access to the Single Market, then there may be opportunities for the Central and Eastern European (CEE) economies to attract foreign direct investment (FDI) from the UK. On average, the CEE economies have outperformed the wider EU at attracting foreign investment due, in part, to their low labour costs and relatively fast labour productivity growth. The challenge for policymakers in these economies now is to improve their business environment. If they can do this, then the CEE economies could continue to be among the EU's star performers in the years to come.

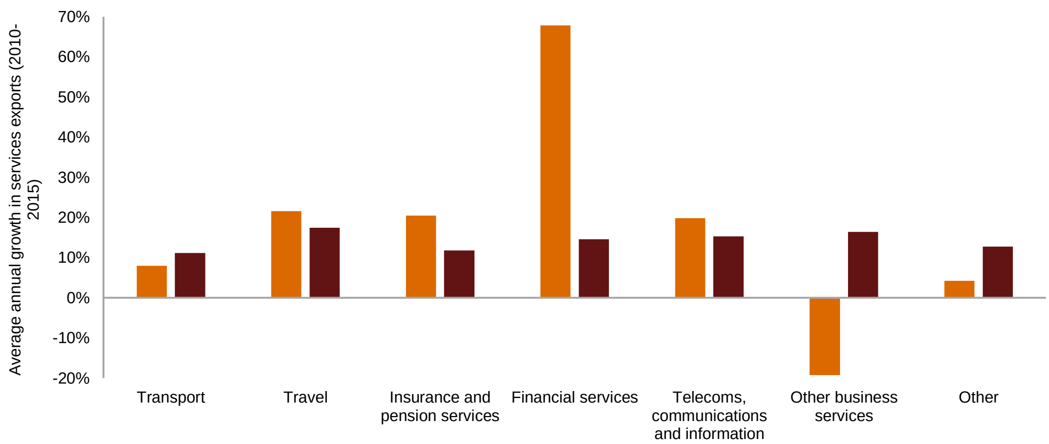
Turning to the US, average monthly job creation to date in 2016 (186,000) has been slightly below our prediction from the start of the year of around 200,000, but the job creation data for June and July were more impressive. If this continues, we would expect the Fed to raise interest rates before the end of the year.

Kind regards

Richard Boxshall

PwC | Senior Economist

Fig 1: On average, the value of exports has been growing in most services categories in China and India



Sources: PwC analysis, UNCTAD, IMF

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Economic update: No room for complacency on the US labour market

Average US jobs growth slightly below our projection so far in 2016

In the January 2016 edition of Global Economy Watch, we estimated that the US would continue to create an average of around 200,000 jobs per month in 2016. So far in 2016, the US economy has added an average of around 186,000 jobs each month (see Figure 2), slightly below our projection but not too bad.

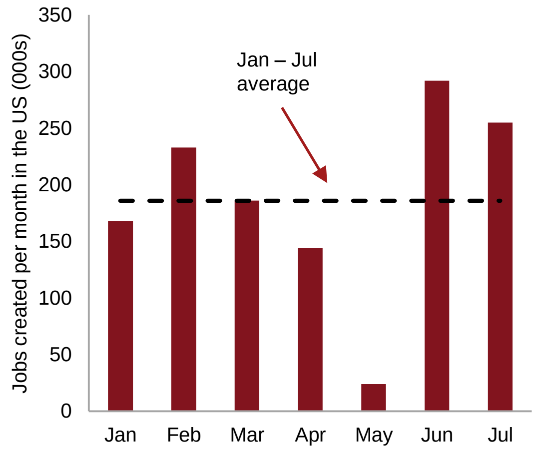
Reducing labour market slack could bring big benefits

However, despite continued job creation, spare capacity still exists in the US labour market. The civilian labour force participation rate has averaged around 62.8% this year, considerably lower than a decade ago when the average participation rate was 66.2%. Involuntary part-time employment also remains high at close to 6 million, though this is now on a downward trajectory.

Eliminating this labour market slack would reap considerable benefits. For example, if the participation rate were to return to around 66%, and assuming the unemployment rate remained at current levels (4.9%), then US employment could increase by around 8 million. But achieving this would take time and specific policy measures to tempt people of working age back into the labour force.

For policymakers, this slack is a signal that the labour market is still in recovery mode. But it is going in the right direction. Job creation in June and July was impressive and continued tightening of the labour market should begin to push up real wages, and eventually tempt people back into the labour force. It would probably also prompt the Fed to raise interest rates before the end of the year.

Fig 2: The US economy added more than half a million jobs in June and July combined



Source: US BLS

Focus on: The Central and Eastern European (CEE) economies – an emerging market success story

CEE economies outperforming the wider EU

Last year, the Central and Eastern European (CEE) EU economies – the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia – grew at a GDP-weighted average rate of 3.5% per annum. This was considerably faster than most other EU economies including Germany, France, Italy and the UK.

This strong growth is a continuation of historical trends. Since joining the EU in 2004, the CEE economies have grown at a GDP-weighted annual average rate of 3.2%, compared to average growth of just 1.2% per annum across the EU-28.

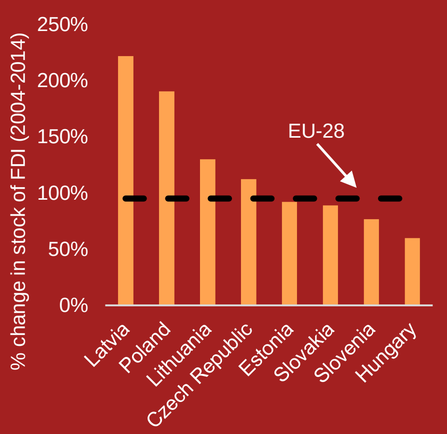
What makes the CEE economies an attractive destination for FDI?

The CEE economies have also succeeded in attracting foreign investment. On average, the stock of foreign direct investment (FDI) in these eight economies in 2014 was around 120% higher than in 2004. Over the same period, the stock of FDI across the EU-28 increased by 95% (see Figure 3). Manufacturing businesses in particular have been attracted to the CEE region with several large automotive and electronic companies investing and expanding their presence in these economies.

A number of economic conditions have made the CEE economies attractive to investors:

- **Low labour costs**: the average hourly cost of labour in the CEE economies was €9.50 in 2015, significantly below the average level for the EU as a whole (€25).
- **Fast growth in labour productivity**: between 2004 and 2015, labour productivity in the CEE economies grew by an average (across years and countries) of 2.8% per annum, compared to just 0.9% across the EU.

Fig 3: Of the CEE economies, Latvia has experienced the largest increase in FDI



Sources: PwC analysis, UNCTAD

- **Access to the EU Single Market:** the CEE countries can offer investors full access to the Single Market with tariff-free trade and a large pool of potential consumers and workers.

Looking forward, however, will these CEE economies continue to be a relatively attractive destination for FDI?

Opportunities for further FDI exist…

Economic growth is expected to remain relatively strong in the CEE region. For example in Poland, the largest CEE economy, we project that real GDP will grow by around 3.5% per annum on average in the short and medium-term.

Continued economic growth would be expected to gradually drive up labour costs, and this could have an adverse impact on the region's FDI attractiveness. However, it would take years for this to really have a material impact. If labour costs were to continue to grow at their 2004-2015 compound annual growth rate in every CEE economy, it would take 11 years before labour costs in one of these economies (Estonia) reached the current level for the EU as a whole. And EU average labour costs will also have risen over this period, even if not so fast, so the CEE's cost advantage is likely to have narrowed but not disappeared by 2030.

The CEE economies could also stand to benefit from the UK's vote to leave the EU. If the UK loses some of its access to the Single Market, then some UK businesses may decide to establish a presence in the CEE economies.

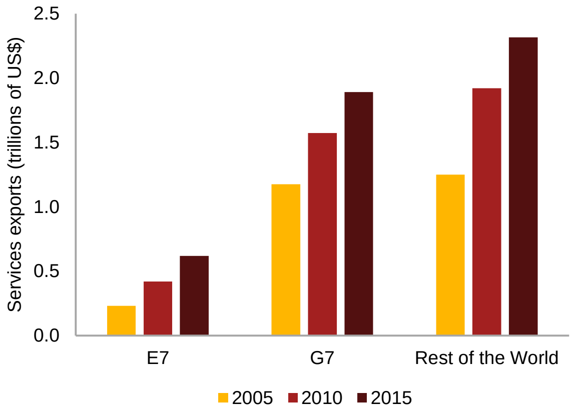
…but becoming more business friendly would make the CEE economies even more attractive

For all the CEE economies' benefits, they do still face some challenges, particularly related to their business environment. Excessive bureaucracy and red tape may discourage some foreign companies from investing, despite the attractive investment proposition on offer. In the World Bank's 2016 'Ease of Doing Business' Index, the CEE economies rank between 16th and 42nd out of 189 countries. While relatively high in global terms, these economies still lag behind many other European economies such as Denmark, which ranks 3rd and the UK, which ranks 6th.

The CEE economies have been among the EU's star performers over the past decade. If their policymakers engage with businesses, foreign and domestic, and make the necessary improvements to their business environment, then this could continue in the years to come.

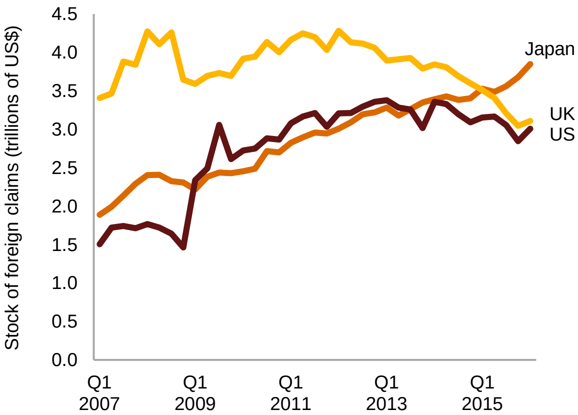
What is the outlook for global services trade?

Fig 4: The G7 and E7 combined make up just over half of global services exports



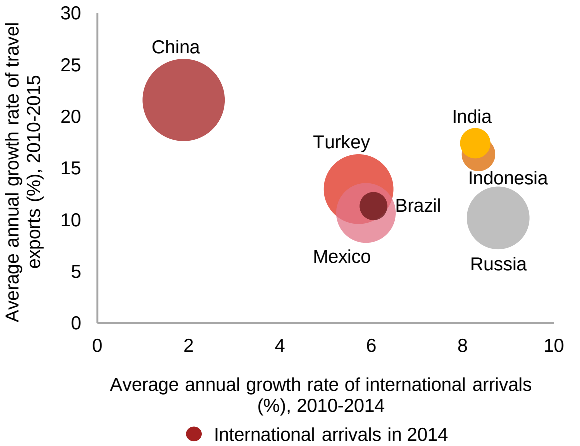
Sources: PwC analysis, UNCTAD

Fig 5: Japan's cross-border loans in Q1 2016 were more than double their value in Q1 2007



Source: BIS

Fig 6: India is enjoying relatively fast growth in tourism spending and number of international visitors



Sources: PwC analysis, UNCTAD, IMF, World Bank

Brexit vote puts trade back on the agenda

Global trade has been under the spotlight over the past few months. In particular, the Brexit vote has prompted uncertainty around the future trade terms between the UK and the EU, which will have an impact on businesses throughout the UK, Europe and perhaps further afield. The UK has a particular strength in services, and it is widely expected that UK policymakers will seek to put services at the heart of future trade deals. But how have global services exports been performing in recent years?

Over the last decade, global services exports grew at an annual average rate of around 6.5%. This was higher than the growth rate of nominal global GDP and global goods exports and has pushed the value of services exports around the world to around $5 trillion.

So, which economies are the top performers in services? To answer this question, we looked at the value of services exports across the G7 and E7 economies since 2010. Our analysis was conducted in nominal terms and in national currencies to exclude the impact of the strong US dollar skewing the 2014 and 2015 estimates.

Japan experienced the highest growth in services exports in the G7…

The G7 economies contribute just under 40% of global services exports (see Figure 4), with the US ranking as the world's largest exporter. But between 2010 and 2015, Japan enjoyed the highest growth in services exports (10.4%) amongst the G7, ahead of France (7.7%) and Germany (6.0%). However, the value of Japanese services exports remains some way behind compared to that in the US and the UK.

Japan has also enjoyed relatively strong growth in the value of financial services (FS) exports, which averaged around 23% per annum. Low domestic yields have encouraged local banks to offer loans abroad at competitive rates, whereas in other Western economies, the low growth environment and risk aversion by banks has constrained lending activity. As a result, Japan overtook the UK as the largest provider of cross-border loans in 2015 (see Figure 5). Loose monetary policy in Japan, coupled with a likely US interest rate increase later this year and continued uncertainty regarding Brexit in the UK, mean that its recent success in exporting financial services looks set to continue.

…but it's in the E7 that the fastest growth has occurred

Since 2010, the average annual growth rate of services exports has been above 10% in every E7 economy. China is unsurprisingly the largest services exporter in the E7 and has enjoyed average annual services exports growth of 14.3% since 2010, but India (15.2%) and Turkey (15.2%) have been the top performers among the E7. Focusing on the two largest emerging economies – China and India – some interesting sector stories begin to emerge (see Figure 1).

In China, financial services has been the strongest performing services exports category when measured in annual average growth terms. While FS exports only comprise 1% of total service exports, the contribution of the FS sector to the Chinese economy is increasing. In 2010, the financial intermediation industry made up around 6.2% of Chinese GDP, but this rose to around 9.2% in the first half of 2016. The increasing prominence of the Chinese renminbi in global markets (as symbolised by its inclusion in the IMF's Special Drawing Rights basket), coupled with a growing FS sector, suggest that financial services will have an important part to play as the Chinese economy continues to rebalance.

In India, travel exports (or tourism spending) grew at a faster rate than overall services exports. Figure 6 shows that India does not currently attract as many visitors as some of its E7 peers, but it does occupy a sweet spot with relatively fast growth in both the number of international arrivals and tourism spending. The government has also taken steps to support the tourism sector, for example by introducing and expanding the e-tourist visa scheme to cover 150 countries. As this sector develops, there will be opportunities for both domestic and international businesses, with 100% FDI permitted in the tourism sector and several large travel-related companies already having a presence in India.

So, what next for global services trade?

Talks are ongoing on the Trade in Services Agreement (TiSA), a global agreement involving 23 World Trade Organisation (WTO) members, including the EU. Striking a deal around these negotiations would provide the necessary push to global services exports.

For the UK, the government will almost certainly seek to agree trade deals with fast growing emerging markets, and these will likely place a particular emphasis on services. Global services trade has been growing strongly, but there could be even faster growth still to come.

Projections: September 2016

	Share of 2015 world GDP		Real GDP growth				Inflation			
	PPP	MER	2015	2016p	2017p	2018-2022p	2015	2016p	2017p	2018-2022p
Global (Market Exchange Rates)		100%	3.0	2.4	2.8	3.0	1.7	2.1	2.6	2.7
Global (PPP rates)	100%		3.4	2.9	3.4	3.4				
G7	31.5%	46.6%	1.9	1.4	1.7	1.9	0.2	0.8	1.8	1.8
E7	36.1%	25.8%	4.8	4.6	5.2	5.0	0.4	1.4	3.3	3.3
United States	15.8%	24.5%	2.6	1.5	2.2	2.3	0.1	1.2	2.2	2.0
China	17.1%	15.0%	7.1	6.5	6.5	5.7	1.5	1.8	1.8	2.8
Japan	4.3%	5.6%	0.6	0.6	0.5	0.8	0.8	0.1	1.3	1.5
United Kingdom	2.4%	3.9%	2.2	1.8	0.7	2.1	0.0	0.6	1.8	2.1
Eurozone	11.9%	15.8%	2.0	1.6	1.5	1.5	0.0	0.2	1.3	1.4
France	2.3%	3.3%	1.2	1.4	1.5	1.6	0.1	0.3	1.2	1.2
Germany	3.4%	4.6%	1.4	1.6	1.4	1.4	0.1	0.3	1.5	1.7
Greece	0.3%	0.3%	-0.3	-1.3	0.3	1.5	-1.1	-0.3	0.5	1.3
Ireland	0.2%	0.3%	26.3	4.2	3.3	2.5	0.0	0.8	1.8	1.7
Italy	1.9%	2.5%	0.6	0.9	1.0	1.2	0.1	0.2	1.1	1.4
Netherlands	0.7%	1.0%	2.0	1.6	1.6	1.8	0.2	0.8	1.5	1.3
Portugal	0.3%	0.3%	1.5	1.3	1.3	1.2	0.5	0.7	0.9	1.5
Spain	1.4%	1.6%	3.2	2.6	2.3	2.0	-0.6	-0.4	1.3	1.2
Poland	0.9%	0.6%	3.6	3.5	3.4	3.5	-0.9	-0.3	1.0	2.4
Russia	3.3%	1.8%	-3.7	-1.7	1.0	1.5	15.5	7.3	6.8	4.0
Turkey	1.4%	1.0%	4.0	3.2	3.5	3.5	7.7	8.3	7.5	7.0
Australia	1.0%	1.7%	2.5	2.6	2.8	2.7	1.5	1.8	2.5	2.5
India	7.0%	2.9%	7.1	7.7	7.7	6.5	4.9	4.1	4.3	5.0
Indonesia	2.5%	1.2%	4.8	4.8	5.2	5.4	6.5	5.7	6.1	5.1
South Korea	1.6%	1.9%	2.6	2.7	2.6	3.3	0.7	1.0	1.6	3.3
Argentina	0.9%	0.8%	2.4	-0.8	2.1	2.5	17.0	25.0	25.0	20.0
Brazil	2.8%	2.4%	-3.8	-3.8	0.0	3.0	9.0	9.0	6.5	5.0
Canada	1.4%	2.1%	1.1	1.3	1.9	2.2	1.1	1.6	1.9	2.0
Mexico	2.0%	1.6%	2.5	2.1	2.7	3.3	2.7	2.7	3.1	3.0
South Africa	0.6%	0.4%	1.3	0.3	1.0	2.0	4.6	6.0	5.5	5.5
Nigeria	1.0%	0.7%	2.7	0.0	1.5	3.5	9.0	14.5	13.5	11.0
Saudi Arabia	1.5%	0.9%	3.5	1.0	1.5	2.5	2.2	4.0	3.2	2.5

Sources: *PwC analysis, National statistical authorities, Datastream and IMF. All inflation indicators relate to the Consumer Price Index (CPI). Argentina has declared a national statistical emergency, and as such, inflation data releases have been suspended. Therefore our inflation projections are based on the latest available data from 2015. Also note that the tables above form our main scenario projections and are therefore subject to considerable uncertainties. We recommend that our clients look at a range of alternative scenarios.*

Interest rate outlook of major economies

	Current rate (Last change)	Expectation	Next meeting
Federal Reserve	0.25-0.5% (December 2015)	Rate rise delayed until December 2016 or later	20-21 September
European Central Bank	0.0% (March 2016)	No rate rise for the foreseeable future	20 October
Bank of England	0.25% (August 2016)	Further small rate cut possible later this year	15 September

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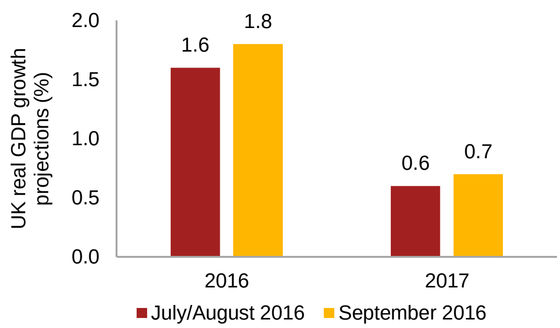
Chart of the month

Following the release of the UK's Q2 2016 national accounts data, we have marginally revised up our main scenario projections for real GDP growth in 2016 from 1.6% to 1.8%, reflecting the stronger than expected Q2 growth.

We continue to expect a slowdown in the UK economy in 2017, but are now projecting growth of around 0.7%.

Chart of the month: We have marginally revised up our real GDP growth projections for the UK



Source: PwC analysis

We help you understand how big economic, demographic, social, and environmental changes affect your organisation by setting out scenarios that identify growth opportunities and risks on a global, regional, national and local level. We help make strategic and tactical operational, pricing and investment decisions to support business value creation. We work together with you to achieve sustainable growth. Do get in contact with one of the team if you would like to discuss any of these topics.