AllianceBernstein

Global Economic Outlook

Global Economic Research

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Overview

Global Economy – Recent business surveys show a change in global growth patterns, with improved growth in the developed economies and slower growth in emerging markets.

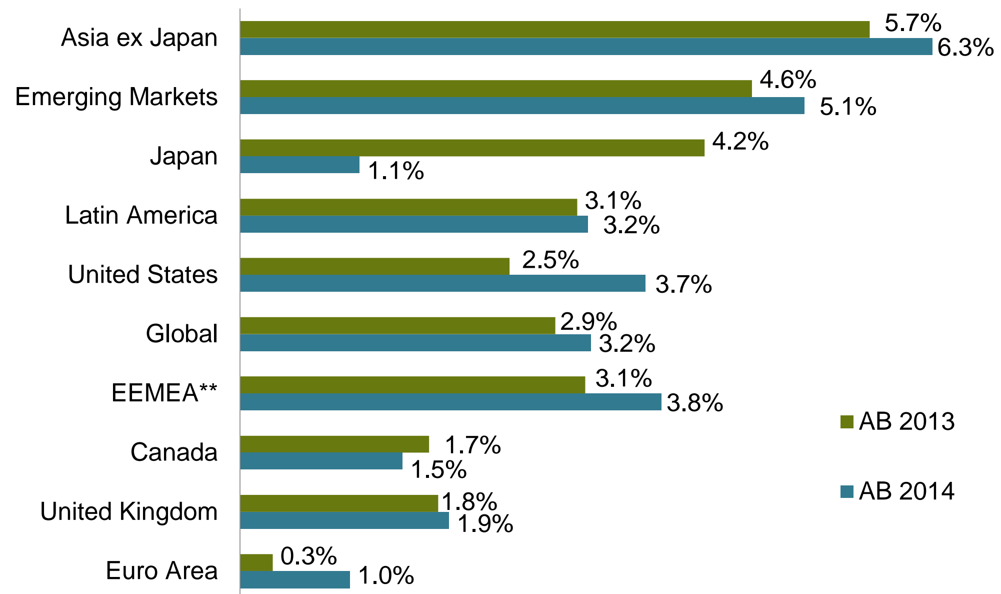
United States – US economic growth was lackluster in the first half, but we still expect second-half growth in the 3.0% to 3.5% range.

Europe – Recent data suggest that the recession is drawing to a close. In our view, the ECB is likely to keep policy on hold until the end of 2014 at the earliest.

Japan – Prime minister Abe's election victory has switched the focus towards the "third arrow" of Japan's reform agenda.

China – Beijing's emphasis on better reform and growth balance does not mean a policy U-turn towards reflation.

AllianceBernstein World Economic Growth Forecasts*



*4Q/4Q percentage change **Emerging Europe, Middle East and Africa
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Global Outlook

Major change in global growth patterns

Global economic growth remains modest, running at an annualized pace of about 2.5%, similar to trends of the past few months. Yet, recent business surveys point to a changing global growth pattern, with faster growth in the developed economies and a slowdown in the emerging economies. This is a sharp reversal from the growth outcomes that have been in place since the global growth cycle began in the summer of 2009.

Developed economies are gaining strength

In July, the global Manufacturing Purchasing Managers' Index rose one percentage point to 51.3, the best reading since March. In addition, the global non-manufacturing index also rose by 3.8 percentage points to 54.9, the highest reading since February 2012. In both surveys, strong gains in the developed economies were responsible for the overall improvement in business conditions.

Strong gain in new orders in developed economies

According to industry reports, the global manufacturing index for developed economies rose to nearly 53 in July, the highest reading in nearly three years, while the composite index for developing economies fell below the all-important threshold of 50 that separates growth from contraction. The composite manufacturing index was driven by strong gains in the US (up nearly five percentage points) and in Europe (a gain of 1.5 percentage points to above 50 for the first time since July 2011). A faster growth signal in the developed economies was also confirmed by a relatively strong increase in the new orders component, which rose nearly five points to 55, the highest reading since 2010.

Meanwhile, the aggregate index for manufacturing in the developing economies declined 0.6 percentage point to 49.4 in July, representing the lowest reading in over four years. The weakness in emerging markets was fairly broad, with countries in Asia feeling the brunt of the slowdown as they are directly and indirectly affected by weaker growth trends in China.

A similar country pattern appeared in the global nonmanufacturing survey: the US posted a gain of nearly four points to its best reading in 2013, Europe rose a little more than a point to its best reading in 18 months and the UK advanced slightly more than three points to record one of its highest readings on record.

Europe sees first upward revision to growth in a few years

Overall, the recent surveys indicate that we are in the early stages in a significant shift in the global growth cycle, with fresh leadership coming from the developed economies, particularly the US, Japan and even Europe, where projected growth has been revised up marginally for the first time in more than two years. And, while the growth trends in the emerging markets remain sluggish, the rebound in demand from the developed world should limit the scope of the slowdown in these economies, with a possible upturn in activity later in 2013 or early 2014.

US Outlook

Slower-than-expected growth in first half

The Bureau of Economic Analysis (BEA) reported that its preliminary estimate for the second quarter of 2013 showed annualized growth of 1.7% after a 1.1% advance in the first quarter. The first-quarter figure was cut sharply from BEA's previous estimate of 1.8% because of a relatively large downward revision to nonresidential structures investment. Apparently, concerns about an expiring tax credit for wind power, which is included in the power and communication segment of nonresidential investment, triggered a big boost in the fourth quarter of 2012 to

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17.6% annualized. In turn, this led to a corresponding sharp drop in the first quarter to –25.7%. Neither figure was reflected in the earlier GDP results.

Consumer spending trends remain mixed

The economy's performance in the second quarter was uneven, as a further contraction in the federal government sector dampened growth. Real consumer spending advanced 1.8%, following a 2.3% gain in the first quarter. Spending on goods, both durable and nondurables, remained relatively strong, increasing by 3.4% in the second quarter, following a 3.7% gain in the first quarter.

Meanwhile, spending on services rose by only 0.9% annualized, extending a very long string of anemic growth. Part of this reflects weakness in new housing construction, as the consumption of housing services is based on the number of occupied housing units. But very weak trends still exist in transportation, recreation and food services, too. Spending weakness in private services still seems inconsistent with the relatively strong gains in private sector service employment and hours worked. It will probably take another round of revisions in future years before we can settle this issue.

Housing rebound continues

Residential investment remained strong, advancing 13.4% annualized in the second quarter, the fourth consecutive quarter of double-digit gains. Even with the recent strong gains, the rebound in residential construction is far from over; we believe that there is huge pent-up demand for new housing, based on new household formation and the fact that that the sector's share of real GDP—at 3%—is half its historical average.

Business investment picked up in the second quarter, with an overall gain of 4.6%, driven by a 6.8% gain in nonresidential structures and a 4.1% gain in equipment and software. Spending on intellectual property, a new GDP component, rose 3.8%. Meanwhile, exports grew 5.4% in the second quarter, the strongest quarterly gain in nearly two years, and we think the final data will show an even stronger improvement, as commercial aircraft shipments appear to have been relatively strong in June, based on company reports.

Growth estimates for 2013 unchanged at 3.0% to 3.5%

On balance, some of the fog surrounding the US economy's performance in recent years has been lifted by the revised data, while inconsistencies between the product and income side of the accounts have also been diminished. These revisions serve as a reminder that GDP data for recent quarters are still subject to substantial revision. In addition, since BEA will not provide an official estimate on the income side of GDP for the second quarter until the end of August, we believe that the jury is still out on the pace of US economic growth this year, which we still project at 3.0% to 3.5%.

Europe Outlook

Recession draws to a close

After contracting for six consecutive quarters, and with the level of output still 3.3% below the cyclical peak in the first quarter of 2008, the euro-area recession is finally drawing to a close. That is certainly the message from hard data for the second quarter of 2013. Although June numbers have not yet been released, data for the three months to May show industrial production up 1.1%, retail sales up 0.2% and car registrations up 0.9%. Moreover, in June, euro-area unemployment posted its first monthly decline since April 2011. In light of these developments, it is not

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surprising that our monthly model for euro-area GDP is now pointing to positive growth.

Because our model is based on partial data, it may overstate the strength of growth in the second quarter. However, recent survey data also paint a brighter picture of the economy. In July, the composite Purchasing Managers' Index for manufacturing and services rose to 50.5 from 48.7 in June. This reading is the highest since the summer of 2011 and is consistent with 0.2% quarter-on-quarter GDP growth. The household sector has also become less downbeat. Consumer confidence fell sharply in the second half of last year but has improved in every month this year and is now back at its highest level since August 2011.

Recovery still likely to be modest

We should, of course, put this in perspective. Even if the economy breaks free from recession, growth is likely to be modest at best and it will take many quarters to recoup the output lost in recent years. Nonetheless, with fiscal policy being tightened less aggressively and the monetary transmission mechanism slowly starting to improve, we are hopeful that the recovery will prove sustainable. The major caveat is that it is imperative for the euro area to avoid any adverse shocks that could quickly derail the recovery.

ECB on hold until the end of 2014 at the earliest

Against this backdrop, we expect the European Central Bank (ECB) to keep monetary policy on hold until the end of 2014, at the earliest. That is certainly the message we took from the ECB's press conference at the beginning of August. Mario Draghi, the ECB's president, confirmed that the ECB expects interest rates to remain at or below current levels for an extended period and that this represents a bias to ease monetary policy further. But Draghi also noted the recent improvement in survey data and gave no indication that the ECB had actually considered cutting interest rates.

Importantly, the ECB was also relaxed about data showing a record €50 billion contraction in bank lending during the second quarter. Weak credit growth has been a constant source of concern for the ECB. But this month, credit was dismissed as a lagging indicator and poor outturns were blamed "first and foremost" on weak demand. In our view, the likelihood of the ECB taking any direct action to stimulate credit growth has diminished even further.

Barring signs of renewed economic weakness—which would undoubtedly provoke a policy response—we believe the ECB's main aim is to avoid a premature tightening of monetary policy via an increase in money-market interest rates. Indeed, the central bank said as much in its latest press statement: "Our monetary policy continues to be geared to maintaining the degree of monetary accommodation warranted by the outlook for price stability and promoting stable money market conditions."

Two key challenges

In this respect, the ECB faces two main challenges. The first of these is upward pressure on bond yields from developments elsewhere in the world—particularly the US, as the Federal Reserve begins to move toward its exit from quantitative easing. The second threat is upward pressure on money-market rates due to the contraction in the ECB's own balance sheet as banks repay surplus funds borrowed from the ECB at the December 2011 and February 2012 special Longer-term refinancing operations (LTROs).

So far, the ECB has countered these twin threats with the introduction of forward interest-rate guidance, an explicit easing bias and by stating that the rate hikes priced into markets for 2014 are "unwarranted." Still, many observers continue to fret about the contraction in the ECB's balance sheet—excess reserves are slowly, but remorselessly, falling to the €200 billion level previously identified as critical by the ECB.

In our view, these worries are misplaced. The ECB has made it very clear that it will not allow these developments to lead to a premature, market-driven tightening of monetary policy. And it clearly has the tools to achieve this aim—though any action would much more likely take the form of another liquidity injection (LTROs) rather than a reduction in policy interest rates.

Japan Outlook

Prime Minister Shinzo Abe's Liberal Democratic Party (LDP), together with coalition partner New Komeito, won 76 of the 121 upper house seats up for grabs in the July 21 election, exceeding pre-poll expectations. Combined with its majority in the lower house, the ruling coalition can now pass most legislation without any drawn-out parliamentary haggling with the opposition parties.

Election victory switches focus to the "Third Arrow"

This is an unambiguously positive outcome—close to a "Goldilocks" result—for Mr. Abe's economic policy. It's strong—a clear electoral mandate for him to continue down the reform path. But it is not too strong, falling short of the two-thirds majority that would be required for (and would likely lure Mr. Abe into) a controversial constitutional reform.

Note that this effectively marks the end of the first phase of Abenomics. The first six months or so of Mr. Abe's premiership was all about delivering a "big bang" of macro stimulus—both fiscal and monetary—resetting expectations and remaining politically popular. The need for political support ahead of the upper house election was partly why some of the more difficult reform measures, or the "Third Arrow" of Abenomics, were put on the back burner.

That approach has worked, giving the desired economic outcome—a weaker yen, a stronger equity market, 4% GDP growth and receding deflation—as well as the desired political outcome. That is, with parliamentary dominance and no need to go to an election for another three years, Mr. Abe clearly has the political scope to implement his vision without any explicit political hurdles.

But scope doesn't imply willingness. So this next phase will test Mr. Abe's desire to drive his agenda and his ability to make tough choices, overcome resistance from the old guard within his party and implement and execute those decisions.

All this against a backdrop where expectations are now significantly higher, and the policy challenges and decisions much more difficult. So, the next three to six months will be about tracking a myriad of policy details and judging whether they adds up to a substantial shift in fundamentals, and whether that shift generates the change in private sector behavior that is necessary for "success"—be it a capex recovery, wage increases, asset reallocation or a revival of the Japanese manufacturing industry.

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The bottom line is that we remain tentatively optimistic. Mr. Abe's policy agenda is clear enough. Despite the catchy "Three Arrows" moniker, the combination of monetary and fiscal stimulus (plus the promise of an eventual budgetary consolidation) and microeconomic reform is not particularly radical. Thus, with a virtual free hand in parliament for Mr. Abe now, it comes down to two questions: Can Mr. Abe deliver, and will it work?

Australia/New Zealand Outlook

We've long held a weaker-than-consensus view on the outlook for the Australian economy. History suggested that the adjustment to a peaking in the commodity cycle was likely to be a rocky one, and that's now becoming evident in the labor market, as the unemployment rate is drifting higher.

By late July, the Reserve Bank of Australia (RBA) looked set to respond via a 25 basis point cut in the cash rate. A relatively dovish speech late in the month by RBA governor Glenn Stevens effectively sealed the case, which revolves around four aspects.

RBA to continue to cut rates as non-mining recovery remains soft

First, the pickup in the non-mining economy remains relatively soft. The Manufacturing Purchasing Managers' Index, for example, plunged nearly eight points in July, and now sits close to its lowest level since the global financial crisis.

Second, inflation does not pose an obstacle to further monetary easing. Core consumer price inflation remains benign—toward the bottom of the RBA's 2%–3% target band. Producer prices also remain soft—up only 1.2% year over year—highlighting the limited pass-through effect of a weaker exchange rate.

Third, while the Australian dollar has fallen by 14% in trade-weighted terms, it still remains relatively elevated. With inflation low and uncertainty about the effectiveness of exchange-rate depreciation in boosting activity, the dollar's fall to date doesn't offer sufficient reason to hold back on further rate cuts.

And, lastly, the one area where the impact of rate cuts can be seen—a pickup in the established house market (prices and transactions)—is not seen as excessive. In the words of Stevens, it is still in the realm of "one of the expected and intended effects of monetary policy easing."

We continue to see this narrative holding for a while yet. A cut in August—if it materializes—is unlikely to be the last.

Canada Outlook

Consumer demand drove May GDP growth

Last week, Canada reported the monthly GDP growth rate for May, which was strongly driven by retail and wholesale trade. The surprise spurt in consumer demand puts the current run rate on second-quarter real GDP closer to 2%, annualized—somewhat above our forecast of 1.1% and the Bank of Canada's (BOC) estimate of 1%. But the gain in consumer demand does not look sustainable, given that payroll employment has shown no growth since the start of the year. With growth still heavily reliant on an already stretched Canadian consumer, the stronger-than-anticipated first half hasn't moved consensus estimates above 1.7% growth in 2013, which remains consistent with our expectations.

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Robust retail sales will be unsustainable without job growth

Certainly, May's retail sales numbers were robust, posting their biggest monthly increase in more than two years and altering the outlook for Canadian second-quarter growth. The robust reading showed that, despite weak income growth and lackluster gains in employment, Canadians were apparently continuing to spend. But the massive jump was helped by a pull-forward from April, during which unseasonably cold weather likely dampened spending. Furthermore, it is hard to see how consumer demand can remain so robust without a pickup in job growth soon.

Construction and manufacturing employment saw additional declines in May

According to the latest payroll employment report, the manufacturing and construction sectors shed a combined 33,000 jobs in April and May. Even though manufacturing eked out modest growth in output in May, the sector continues merely to muddle along. Also, while construction output was flat owing to the rebound in residential building following April's steep decline, nonresidential construction has continued to slow this month, the second consecutive month of output declines. May's GDP report, combined with recent employment trends, suggests that the "necessary rotation" toward investment-led growth that the BOC has called for is not quite underway.

May's energy slowdown likely to continue in June

In May, the robust growth in both retail and wholesale trade was partially offset by the steep decline in output from the energy sector. Oil and gas extraction shrank by more than 2% in May as petroleum and natural gas production both decreased. Output from the energy sector is much more volatile than that from the retail trade, but the divergence in growth between the sectors further underscores the Canadian economy's continued departure from the BOC's "plan" for a shrinking reliance on consumption to drive growth.

In June, floods in Alberta and a construction strike in Quebec probably exacerbated the industrial production and energy sector slowdowns experienced in May, thereby engendering a steep decline in overall output for June. Furthermore, if weather did play a significant role in May's strong retail sales, we should see a payback in retail-trade growth in June or July..

Emerging Markets Outlook

Slow growth is the main concern in the near term

Latin America: The overarching issue in the region continues to be the sluggish pace of economic growth observed in the major economies, prompted by weak external demand and the softer prices of some commodities. In some countries, the subdued external figures appear to have contaminated domestic demand somewhat. We still expect better economic performance across the region in the second half of 2013 relative to the first half, and a further improvement in 2014. However, the comparison against growth expectations from the beginning of the current year, shows significant downward revisions in most countries.

Brazil's fundamentals have deteriorated

Brazil is the regional economy where this phenomenon is most evident. Earlier this year, market expectations pointed to GDP growth of close to 4% this year and even higher in 2014. The latest Focus expectations survey conducted by the central bank, however, shows that market participants now expect the Brazilian economy to expand by only 2.2% this year. More importantly, only a mild improvement is forecast for 2014 at 2.6%, possibly signaling the market's belief that Brazil's potential growth rate has shifted downwards as a result of disappointing investment behavior in recent years. In addition, the fiscal position has suffered, as the government has maintained

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an expansionary fiscal policy to support growth. The deterioration in Brazil's fundamentals has resulted in a negative outlook on its sovereign credit rating by S&P, suggesting that the concerns may be more than merely cyclical. Given the proximity of the presidential elections, S&P might not alter the actual rating until after October 2014, but in the absence of much needed structural reforms, the rating seems to be on track for a downgrade next year. We believe that Brazil's investment grade status is not at risk for now, but there's a good chance that the country will be eventually placed at the lower end of the investment grade category.

Inflation has peaked, but tighter monetary policy ahead is likely

On the inflation front, we believe that the annual rate peaked in June and will gradually decrease during the second half of 2013, because of the phaseout of the food price shock and the sluggish demand. The sharp depreciation of the currency, on the other hand, poses a challenge and may prevent a more significant disinflation process later this year. We expect annual inflation to be below 6% by year-end, and near 5.5% in 2014. Without any significant fiscal tightening in the run-up to next year's election, the burden of the adjustment will be on monetary policy. As a result, we expect the central bank to hike the Selic (overnight) rate further towards more than 9% this year, despite the slow growth. Weaker fundamentals amid thinner capital flows have resulted in a weaker exchange rate. Our balance of payments projections suggest that foreign direct investment inflows will fall short of the current account deficit this year, fueling expectations of a weaker currency in the future. We now expect the Brazilian real to trade not stronger than 2.20/USD in the future.

Social unrest—a new regional phenomenon?

The other important novelty in Brazil has been the outbreak of generalized, and sometimes violent, protests across the country. What started as small demonstrations organized by minor grassroots groups quickly caught fire to become widespread protests against the low quality of public infrastructure, corruption and inequality. We believe that Brazil's protests may not be an isolated event but rather a phenomenon that deserves monitoring in the region. In recent months, different protests took place in Chile, Colombia and more recently Peru. Interestingly, economic performance in these countries in recent years has been solid by historical standards, and poverty indicators have improved significantly. The protests, however, indicate that faster growth may not be enough to fulfill the demands of a newly minted middle class that requests better services, security and a fair political system. In the near term, the protests represent a hurdle for adjustment policies, for instance the increase in public prices or the privatization of companies.

Mexico's growth has been disappointing

Economic activity has also been sluggish in Mexico. Industrial production has been flat on a year-on-year basis during the first five months of the year. The reasons behind the disappointing performance of the real economy are the stagnant export growth and the impact of fiscal consolidation measures announced last year that have prevented the implementation of a more expansive fiscal policy. After a temporary spike, mainly caused by supply shocks, inflation has converged towards within the target range. The currency has been very volatile in recent weeks, similarly to those of other emerging-market countries, averaging MXN12.7/USD since the initial "tapering" speech by US Federal Reserve chairman Bernanke in mid-May.

But structural reform agenda is in place

Unlike Brazil, expectations of deep structural changes in Mexico run high. Chief among them are a fiscal overhaul geared towards eliminating loopholes in the tax system and reducing the dependence of fiscal revenues on oil, and especially the deregulation of the hydrocarbons industry. The latter would open up the sector to

private participation, both private and foreign, as a way to increase investment and prompt production of oil and gas. The reforms were framed in the so-called Pacto Por Mexico, a multiparty accord signed last year by the ruling PRI and the opposition PAN and PRD parties. A deep energy reform requires changes to the constitution, which in turn can only be achieved via a legislative coalition, as no party holds a controlling qualified majority. The center-left PRD has already signaled its opposition to deregulating the sector. So it is up to the PRI and the PAN to push for the much-needed reform. Although some friction among parties has appeared on occasion—and even the survival of the Pacto itself has been in question—we remain constructive about the outlook for energy and fiscal reforms.

Energy reform is the biggest ticket

Last week, the PAN made its own energy reform plan public. The proposal is very ambitious, calling for hydrocarbons to remain the sole property of the republic, but allowing for private entities to participate in exploration, extraction and distribution, with a minimum 25% Mexican capital share in the allocation of oil blocks. A national energy commission would oversee concessions to private investors. The bill, which has the support of the vast majority of PAN lawmakers, is geared towards "maximizing the benefit of the country's oil and shale resources." In addition, the plan calls for the breakup of the monopoly of the CFE, the federal energy commission, in electricity generation and distribution, and authorizes the establishment of private operators. PAN sources also hinted that the proposal could result in the eventual "democratization" of Pemex, the Mexican state-owned oil company, which would involve a partial share float. The plan sets a high bar for the ruling PRI, as it appears to be at the higher end of expectations, especially regarding the partial privatization of Pemex, something that we believe to be unlikely for now. The PRI is expected to submit its own energy reform proposal to Congress, and we expect the plan to be roughly consistent with the PAN's ideas. Political noise ahead of a possible approval of the energy bill, however, cannot be ruled out, especially since the PAN is likely to seize the opportunity and use the endorsement of the energy plan as a bargaining chip to make progress in the area of political reform, for instance, by pushing for a second-round vote in presidential elections as well as changes that would allow for the reelection of public officials.

If the reform is approved, we would expect a significant increase in foreign direct investment to occur from next year, along with a positive impact on the Mexican peso and domestic interest rates. Under fairly conservative assumptions, the combined effect of the structural reforms already approved late last year (labor, telecommunications, education) plus energy and fiscal changes, could elevate Mexico's potential GDP growth rate by at least 100 basis points (b.p.) per year. In the near term, our expectation of good news on the reform front this year leads us to believe that the currency has upside potential during the second half of 2013.

India's economy faces intensified difficulties

Asia ex Japan: The Reserve Bank of India's (RBI) decision to tighten domestic liquidity in July was a surprise policy U-turn to support a faltering rupee. It was also a mistake, in our view. The move threatens to exacerbate India's economic difficulties and may prolong stagflation. We believe that an appropriate policy would be to allow exchange-rate adjustments (i.e., further depreciation of the currency) to rectify the trade imbalance, while maintaining an accommodative monetary policy to support growth and help sustain fiscal consolidation. Supply-side policies and structural reform, the circuit breakers for a stagflation cycle, are now at risk of being diluted as economic problems intensify and next year's general election draws closer. The

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muddled outlook makes the Indian rupee (INR) and local interest rates a no-go zone for investors, in our view. Accordingly, we have lowered our GDP forecast for India in 2013 by 50 b.p. to 4.7% and for 2014 by 120 b.p. to 5.2%. This represents a prolonged period of below-trend growth on the back of poor policy coordination.

China's policy shift to focus on better growth/reform balance…

By contrast, China's Premier Li Keqiang's latest statement on economic policy has signaled a change in focus to achieve a better balance between economic restructuring and growth. Mr. Li's call for the bottom line of GDP growth at 7% has reduced the market's hard landing worry and lifted investors' confidence about a possible rebound in GDP later in the year. We think, however, that Mr. Li's statement did not imply a policy U-turn in China but, rather, it suggested that Beijing would increase efforts to curb the slowdown in the growth momentum. However, Beijing's options are limited, as there aren't many readily available policies to boost growth as was the case during the global financial crisis in 2009–2010.

…does not imply a policy U-turn toward reflation

For one, the central bank will need to maintain a relatively tight monetary policy in order to control financial risk in the system as a continued deleveraging effort. Moreover, the government may, at best, fast-track investment approvals of several "approved" sectors—such as infrastructure, green energy and technological upgrading—under the current five-year plan to provide a floor to GDP. The major headwind will remain on the external side given the continued sluggish export performance not just in China but in many of its regional peers. In addition, without a major relaxation of Beijing's current tight housing policy, China's investment and consumption growth are unlikely to regain momentum meaningfully in view of the new regime's determination to crack down on corruption, which will basically have the opposite effect. Overall, we still expect China's quarterly GDP growth to ease to around 7% year on year in the second half of 2013 from 7.5% in the second quarter.

Activity and survey data in EEMEA point to a tentative growth recovery…

Emerging Europe, Middle East and Africa: After the sharp economic slowdown during the past 12–18 months, the EEMEA region's economies should begin to recover in the second half of this year. But how quickly growth will re-accelerate to a new cruising speed and what that new cruising speed will be remain highly uncertain. For one, high-frequency activity data have been mixed of late with industrial production momentum accelerating in central Europe, Turkey and South Africa, but falling back into negative territory in Russia. Meanwhile, the latest purchasing manager indices in manufacturing paint a similar split picture for the near-term outlook: factory output is seen expanding in Poland, the Czech Republic and South Africa, but contracting once again in the region's two largest economies—Russia and Turkey. Overall, the region's industrial output continues to move sideways and the forward-looking surveys hover around a no-growth mark.

…but growth potential is now markedly lower than before the financial crisis

In any case, when growth finally reaccelerates, we do not expect its pace to be stronger than about two-thirds of what it we saw during the five-year period leading to the 2008–2009 financial crisis. This is because we do not expect a repeat of the region-wide credit boom or the global commodity price boom (benefiting Russia and South Africa) and expect direct investment inflows from core Europe to remain relatively subdued.

Barring commodity price shock, inflation outlook remains benign

Meanwhile, on the inflation front, the outlook remains very benign. In most EEMEA countries, inflation is currently either well below the central bank targets (namely in central Europe), just hovering inside the target range (in South Africa), or is expected to fall inside the target range by the end of the year (in Russia, Romania, and—fingers crossed—Turkey). We expect inflation in central Europe to bounce back from

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the current multiyear lows over the next 12 months. However, barring an exogenous commodity price shock, we don't expect inflation to rise materially above the central banks' target for the monetary policy horizon.

All this combined points to extended monetary accommodation

A combination of a rather tepid and uncertain growth outlook and a very benign inflation path has three major implications for the region. First, it means that in several EEMEA countries, central banks have still room to ease monetary policy, especially in the base-case scenario where short-term interest rates in the advanced economies remain anchored at current very low levels for some time. Second, it means that most central banks in the region will be able to keep their policy accommodative for much longer—at the very least until the second half of next year. And, third, it means that EEMEA currencies will struggle to appreciate in value and are likely to remain very vulnerable to the cross-border capital flow reversals that we've seen in recent months. Critically, EEMEA currencies had failed to appreciate much, even last year when portfolio inflows into their local markets were robust—something we do not expect to continue in the world of US Fed tapering.

Further rate cuts still expected in Russia, Romania and Hungary

One simple gauge which central banks have room to ease are the current levels of real ex-ante policy interest rates, i.e., nominal policy rates deflated by the inflation rate expected in the next 12 months. According to this metric, further cuts would be justified in Romania, Hungary, Poland and Russia where—in contrast with the rest of the region as well as most advanced economies—real policy rates are still positive. Taking into account the current individual countries' growth and inflation dynamics, we are currently forecasting 75 basis points of further rate cuts this year in Romania and Russia, and an additional 50 basis points in Hungary before the year-end. In Poland, the central bank (including the dovish MPC members) has already declared an end of the easing cycle, so further cuts there would require a significant deterioration in the growth outlook rather than a recovery.

The major risk to the expected policy-rate cuts (in Russia, Romania and Hungary) and expected policy-rate stability (in the rest of the region) is a potential replay of the large emerging-market risk sell-off we had seen in May and June this year. The countries whose currencies will be most vulnerable in such a scenario are those that have the largest external financing needs. One simple gauge of this vulnerability is the size of the country's basic external balance as a share of GDP, i.e., the current account deficit minus the stable sources of financing such as net FDI inflows and (for the EEMEA's EU member countries) inflows of EU convergence and cohesion funds. Turkey and South Africa rank as the most exposed to a further currency sell-off should capital inflows stop or reverse outright. In contrast, the countries of Central Europe (especially Hungary) and Russia are running basic external surpluses so they should be somewhat less exposed, although not immune if nonresident portfolio investors decide to exit their local-bond and equity markets. In most of the major countries in the region, nonresident investors now hold 30% or more of the local government bonds.

…especially in South Africa…

In South Africa, the rand has already adjusted quite significantly in real effective terms. It depreciated by almost 15% since the end of 2011 while the other major EEMEA currencies appreciated by 3%–6% during the same period. Nevertheless, much of the positive benefit of a weaker exchange rate on the size of the current account deficit may be offset by an expected increase in capital goods imports as the government and state-owned agencies step up infrastructure spending.

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…and Turkey, where further depreciation pressure on the lira is the major upside risk to our interest-rate forecast

In Turkey, the exchange rate may still have to adjust a bit more given the country's current account deficit and a dearth of external financing, but the Central Bank of the Republic of Turkey (CBRT) does not see much room for allowing further currency adjustment given a difficult inflation outlook. Further depreciation pressure on the lira therefore poses the most significant upside risk to the policy rate in the entire region. At the monetary policy committee meeting last month, the CBRT prepared the ground for further (potentially quite dramatic) tightening of short-term liquidity to defend the lira by hiking the lending rate which defines the upper end of the effective policy-rate corridor. While the CBRT seems averse to outright rate hikes (the repo rate is still at 4.50%), it has taken a firm decision to move away from defending the lira with its (relatively scarce) foreign exchange reserves. Instead, it is deploying an interest-rate defense under the CBRT's rather unorthodox flexible monetary policy framework.

Broad political inclusion in Egypt should remain a top priority

Frontier Markets: After the removal of Egyptian President Morsy, the military and its appointed interim government continue to face protests from opposition groups, namely the Muslim Brotherhood. We remain concerned that such protests, already resulting in a number of deaths, will impede any kind of economic or political reform agenda. The Muslim Brotherhood may face crackdowns, but they remain a popular political party with well entrenched networks and, if elections were held today, would remain one of the most successful with the electorate. Therefore, if the military is unable to include them in the reform process, the government will lack the broad and representative coalition it needs to turn around the Egyptian economy.

Moroccan government is reforming Islamic-led coalition in run-up to subsidy reform

Meanwhile in Morocco, the Istiqlal party, the junior party in the Islamic-majority coalition government, resigned citing concerns over the implementation of subsidy reform due to take place this August after Ramadan. The resignation leaves the ruling Justice and Development Party (PJD) in search of a replacement or else it must face early elections. We believe the king will prefer the first option and the subsidy reform agenda will continue, as most of the legislation has been tied to a recently renewed IMF credit line. Some have suggested that the recent blow to political Islam in Egypt has emboldened opponents across the region, but we still believe that country-specific factors are likely to win out over broader movements, for now.

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AllianceBernstein Global Economic Forecast

Aug-13

	Real Growth (%)				Inflation (%)				Official Rates[1] (%)		Long Rates[1] (%)	
	4Q/4Q		Calendar		4Q/4Q		Calendar		EOP	EOP	EOP	EOP
	2013F	2014F	2013F	2014F	2013F	2014F	2013F	2014F	2013F	2014F	2013F	2014F
Global	2.9	3.2	2.3	3.2	2.5	2.7	2.3	2.7	2.13	2.29	3.36	3.68
(PPP Weighted)	(2.8)	(3.7)	(3.0)	(3.7)	(2.7)	(2.7)	(3.0)	(2.6)				
Industrial Countries	1.9	2.2	1.1	2.2	1.6	2.0	1.4	2.0	0.42	0.56	2.15	2.58
Emerging Countries	4.6	5.1	4.5	5.1	4.1	4.2	4.2	4.2	5.54	5.73	5.83	5.94
United States	2.5	3.7	1.7	3.5	2.1	2.4	1.6	2.4	0.13	0.50	2.75	3.50
Canada	1.7	1.5	1.5	1.6	1.5	2.6	1.1	2.2	1.00	1.25	2.75	3.25
Europe	0.6	1.2	-0.1	1.1	1.4	1.3	1.6	1.4	0.55	0.58	1.85	2.10
Euro Area	0.3	1.0	-0.5	0.9	1.3	1.2	1.5	1.3	0.50	0.50	1.75	2.00
United Kingdom	1.8	1.9	1.1	1.9	2.3	1.9	2.6	2.0	0.50	0.50	2.25	2.50
Sweden	1.4	2.2	1.1	1.9	0.6	1.5	0.1	1.3	1.00	1.50	2.00	2.25
Norway	2.5	2.9	2.3	2.7	1.7	1.8	1.7	1.8	1.50	2.00	2.50	2.75
Japan	4.2	1.1	2.3	2.2	0.6	2.7	-0.1	2.4	0.10	0.10	0.90	1.00
Australia	1.9	1.8	2.1	1.8	2.0	1.7	2.2	1.9	2.25	1.75	3.50	3.75
New Zealand	1.9	4.4	2.5	2.6	1.4	2.3	0.9	2.0	2.50	3.50	3.90	4.25
Asia ex Japan	5.7	6.3	5.9	6.2	2.9	3.2	2.9	3.2	5.34	5.43	4.52	4.44
China[2]	7.0	7.6	7.3	7.4	2.5	2.6	2.4	2.7	6.00	6.00	3.90	3.80
Hong Kong[3]	3.5	3.1	3.2	3.8	2.7	3.7	3.4	3.3	0.50	1.00	2.35	2.80
India[4]	4.4	5.9	4.7	5.2	4.2	5.6	5.1	5.2	7.50	7.50	8.50	8.00
Indonesia[5]	5.9	5.4	5.8	5.6	7.4	4.8	6.4	5.6	6.50	6.25	6.80	6.50
Korea[6]	3.1	2.7	2.4	2.8	1.3	2.1	1.2	2.0	2.25	2.75	3.30	3.60
Thailand[7]	3.5	4.0	4.3	5.5	2.4	3.9	2.5	3.5	2.25	2.75	3.60	3.80
Latin America	3.1	3.2	2.6	3.2	6.2	6.5	6.2	6.3	7.09	7.22	8.46	8.82
Argentina	3.0	2.1	3.2	2.0								
Brazil	2.8	2.5	2.3	2.7	5.8	5.4	6.0	5.6	9.50	9.50	10.50	11.00
Chile	4.1	4.5	4.1	4.5	2.9	3.0	2.3	2.9	4.50	5.00	5.40	5.70
Colombia	4.5	4.5	3.8	4.5	2.7	3.0	2.6	3.0	3.25	3.75	6.70	7.00
Mexico	3.1	4.2	2.6	4.1	3.6	3.5	3.6	3.5	4.00	4.25	5.70	5.80
EEMEA	3.1	3.8	2.4	3.7	5.3	5.3	5.8	5.3	4.37	4.98	7.23	7.76
Hungary	1.1	1.7	0.3	1.5	2.2	3.3	2.1	3.2	3.50	4.25	6.60	7.50
Poland	1.7	2.9	1.0	2.6	0.9	2.4	0.9	2.1	2.50	3.00	4.10	4.50
Russia[8]	3.0	3.7	2.4	3.8	5.9	5.6	6.7	5.9	4.75	5.25	7.35	8.00
South Africa	2.5	3.4	2.1	3.3	5.4	5.8	5.7	5.6	5.00	5.50	8.00	8.50
Turkey[9]	5.0	5.4	3.8	5.0	7.3	6.5	7.4	6.2	4.50	5.50	8.75	9.00

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

6) Korea: Overnight call rate and 10-year government bond yield
7) Thailand: 1-day repo rate and 10-year bond yield
8) Russia: Longest fixed-rate government bond until April 11, 2011; 10-year bond thereafter.
Official rates: CBR's O/N fixed deposit rate until Oct 2011, then 1-day repo rate
9) Turkey: Since Oct 2011, the official policy rate no longer accurately reflects the central bank's monetary policy stance.
Note: Real growth aggregates represent 27 country forecasts, not all of which are shown.
Note: Blanks in Argentina are due to the distorted domestic financial system so we don't forecast.