The recovery phase: Are we there yet?

At a glance...

CEOs are confident about advanced economies' outlook

A key question for 2014 is whether the recovery in advanced economies is more than just hype.

In our view, backed by our Global CEO Survey, the shift in sentiment in favour of advanced economies is broadly justified based on our assessment of macroeconomic indicators and a more certain policy outlook in the US.

Fundamentals are improving

At face value, output levels still remain below trend for most advanced economies. However, most fundamentals are improving:

- **External** balance sheets are now under better control. Greece, for example, is headed for its first ever current account surplus since joining the Eurozone;
- On the **financial** side, asset prices continue to grow broadly in line with trend rates suggesting fears about markets over-heating may be overstated. In the US, in the third quarter of 2013, house prices grew by 1.5% quarter-on quarter compared to a long-term rate of 1.3%; and
- On the **domestic** front, ample spare capacity in the economy suggests output can increase without having an adverse impact on inflation, leaving plenty of room for central banks to hold interest rates at historic lows for a while longer. In the UK, for example, inflation hit its target rate of 2.0% in December. In fact in some cases deflation seems to be the bigger risk.

US economy on a roll

One of the major advanced economies, the US recovery seems the most secure. The financial sector has restructured and the household debt to GDP ratio is at more manageable levels. Also, the outlook for fiscal and monetary policy looks more predictable than in 2013.

Eurozone mixed with a strong Germany and weak periphery

The Eurozone recovery is a tale of two halves. The peripheral economies are more reliant on external demand as their main source of economic growth, while the public sector remains weak and there is a risk of reform fatigue.

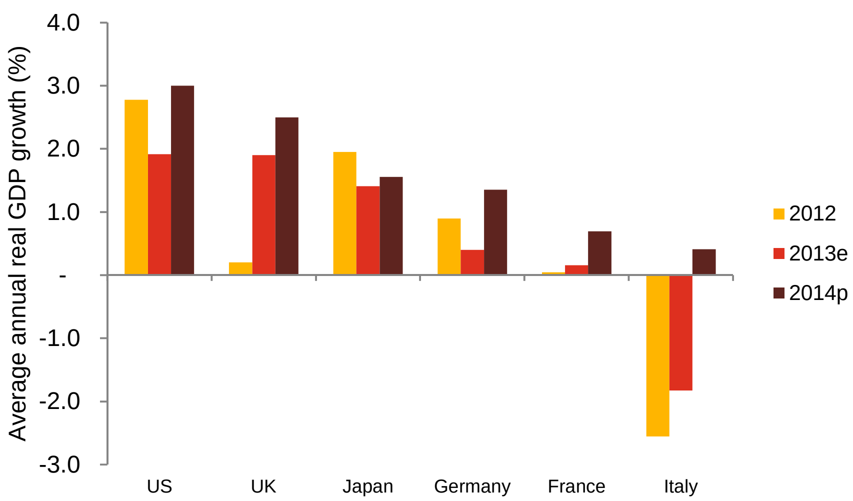
In contrast Germany and other Northern European economies are projected to grow faster than the periphery. We expect this to be fuelled by less aggressive public sector consolidation (in relation to 2013) which will help support domestic demand, and robust external demand.

Winter Olympics: US top, Russia rising

Building on our previous modelling work on the Summer Olympics, we've predicted the medal tallies for the Sochi Winter Olympics by identifying the relationship between socio-economic (and weather related!) metrics and previous medal success.

We expect the US to top the medal table with Russia moving up strongly due to the host country advantage.

Fig 1: GDP levels remain below trend for most advanced economies, but growth rates are picking up, which will help close the gap



Source: PwC projections, Thomson Datastream

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Economic update: Lower inflation is bad news for the periphery

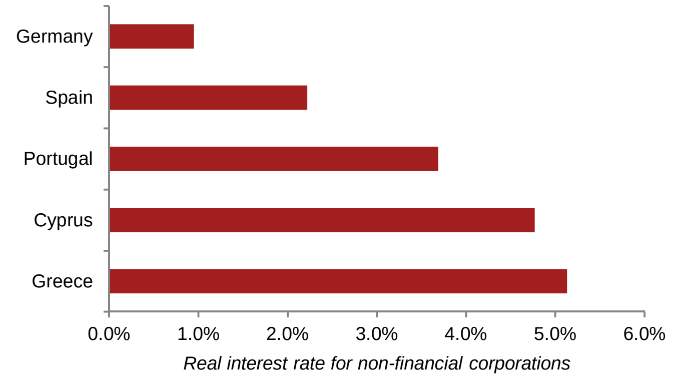
The latest data shows that inflation in the Eurozone has dropped to 0.8% on a year-on-year basis, which is significantly lower than the European Central Bank's (ECB) target of "below 2 %". This, coupled with a weak recovery in some peripheral economies, raises the possibility of deflation taking hold. So what would be the implications of this, and what does it mean for the Eurozone's recovery?

One side-effect is consumers postponing spending as they wait for prices to come down in the future. This is more relevant for peripheral economies which are already experiencing a significant contraction in domestic demand. A short-term decrease in consumption could exacerbate this trend and increase their reliance on external demand as the main source of economic growth.

A second implication of negative inflation is that it pushes up real, inflation adjusted, interest rates. Businesses in the periphery are already under pressure as they pay higher nominal interest rates compared to their competitors in the core. Higher real interest rates (see Figure 2), could deter them from taking part in longer term investment projects altogether.

The analysis above shows that businesses in the periphery continue to be under severe stress even though economic growth is turning more positive.

Fig 2: High real interest rates are a burden on the peripheral economies



We have estimated the real interest by deflating the average interest rate incurred by non-financial corporations on a loan (with a 1-5 year duration) by the projected five year average inflation rates.

Source: PwC analysis, IMF, ECB

Predictions for Winter Olympics

As the 2014 Sochi Winter Olympics draws near, there is growing interest in the likely medal tallies of different countries. In our 2012 Summer Olympic medals paper, we accurately predicted the top four medal winning countries. The question is; can we do it again for the Winter Olympics? Our analysis is based on econometric modelling, where we test the historic relationship between a range of socio-economic metrics and medal success to estimate future medal success.

Russia press home their host advantage

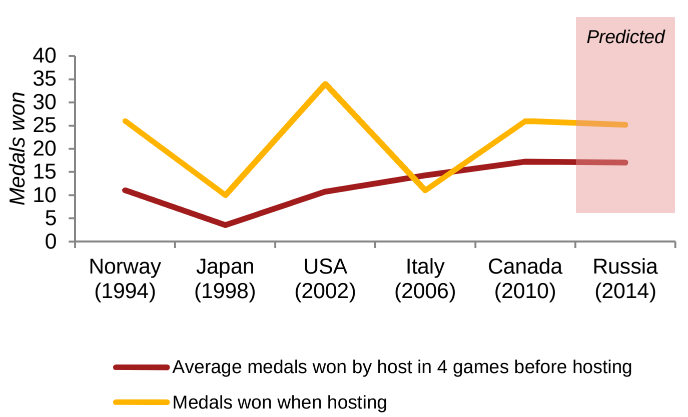
Our model identified a strong positive impact on expected share of total medals from hosting the Winter Olympics, which is demonstrated in Figure 3. Russia are projected to make full use of this advantage at Sochi with a estimated haul of 25 medals, 10 more than their total in 2010.

Table 1: Predicted medals for Sochi 2014

	Medal rank	2014 medals estimate	2010 medals	Change	GDP rank (2013)
US	*1*	**35**	37	-2	*1*
Germany	*2*	**26**	30	-4	*5*
Russia	*3*	**25**	15	+10	*6*
Canada	*4*	**23**	26	-3	*13*
Austria	*5*	**22**	16	+6	*37*
Norway	*6*	**21**	23	-2	*46*
China	*7*	**15**	11	+4	*2*
Switzerland	*=8*	**10**	9	+1	*36*
Sweden	*=8*	**10**	11	-1	*34*
UK	*=21*	**2**	1	+1	*8*

We used regression analysis to produce the results in Table 1, employing a Tobit model to estimate medal share for the 28 countries which have won at least one medal in the last three Winter Olympics. The variables used were total GDP, ski resorts per head, level of snow coverage, medal shares in the previous two Winter Olympics, and dummies for countries with a "tradition" of winter sports and for host countries.

Fig 3: Home advantage in the Winter Olympics



The Economy matters – But so does the climate

The modelling results showed that the size of the economy is significant in determining success at the Winter Olympics, with total GDP appearing as a significant variable. However, a large economy is not sufficient on its own for a strong performance – our model also indicated that the climate is an important factor. Snow coverage and the number of ski resorts per head have a significant and positive impact on medal shares.

Larger, developed countries with the right climate dominate the top of our projected medals table, with the top three places taken by the US, Germany and Russia. However, Norway and Austria demonstrate that a smaller economy is not a barrier to success, with a greater estimated medal haul than countries such as China and France.

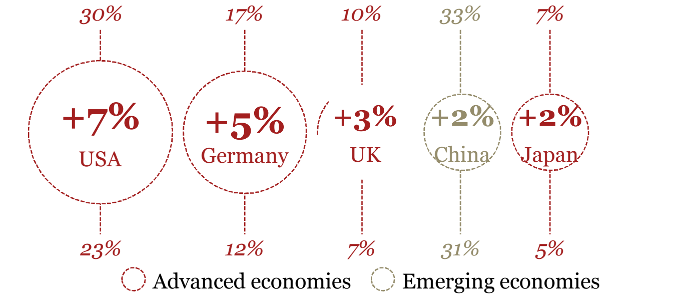
While this is a light-hearted analysis it makes an important point of how organisations can use economic techniques to help make better business decisions. The purpose of our model is not to forecast medal totals with complete accuracy, but to increase the predictive power of medal projections over and above using historic medal results alone. The model allows us to make better, more confident and more informed forecasts. Businesses can use similar techniques to do the same.

Growth: Fact or fiction?

Fig 4: CEOs are turning back to certain advanced economies for growth

Q.: Which three countries, excluding the country in which you are based, do you consider most important for your overall growth prospects over the next 12 months?

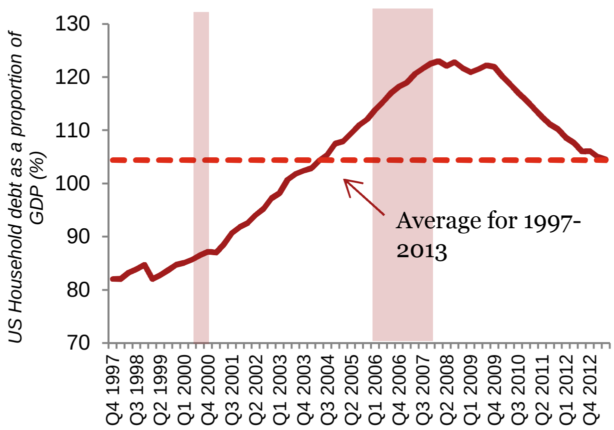
% of CEOs naming country, 2014



% of CEOs naming country, 2013

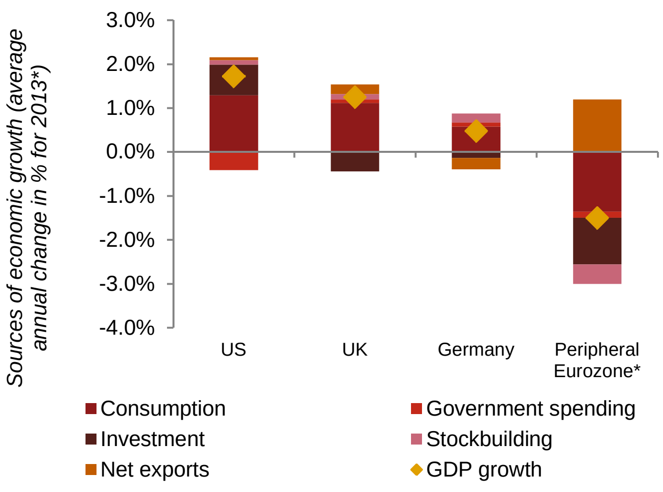
Source: [PwC 17th Annual Global CEO Survey]

Fig 5: US household debt as a proportion of GDP



Shaded area indicates recession
Source: PwC analysis, Thomson Datastream

Fig 6: Breakdown of sources of economic growth



* The above is based on projected Q4 figures. Peripheral Eurozone is made up Ireland, Italy, Portugal and Spain . We have weighed the expenditure categories using their GDP levels.

Source: PwC analysis, Thomson Datastream

CEOs see rosy outlook for advanced economies

One of the central messages coming out of Davos last month was the clear shift in CEO sentiment in favour of advanced economies. This, in turn, was driven by the improving growth outlook in advanced economies. Our Global CEO survey, which was launched at Davos, shows that the shift was strongest in the US, closely followed by Germany and the UK (see Figure 4).

However, in the past five years we've seen hopes of a sustained economic recovery dashed a couple of times. So, a key question for 2014 is whether the outlook for advanced economies will live up to expectations.

US: Don't stop me now

In our view, the US outlook seems the most secure out of the major advanced economies. This is driven by two main factors: households have paid down their debt to more manageable levels (see Figure 5) which has encouraged consumers to spend more; and the financial sector has restructured.

In the medium-term the outlook for the US economy remains bright. As economic growth strengthens, spare capacity will gradually diminish. This, could spark an investment spree by US cash-rich firms, which could help create more jobs in the future with positive knock-on effects on the rest of the economy. US economic output already stands 6% higher compared to Q4 2007 , which is the second best performance out of the G7 (Canada has grown by around 7%).

Peripheral Europe: Still fragile

For peripheral Europe, the outlook is better than last year. In our main scenario, we project that economic growth will return to the peripheral economies in 2014. However modest headwinds remain for the business, households and financial sector.

Figure 6 shows that net trade was the only component of GDP that grew positively last year. Given the weak state of the private sector and ongoing public sector consolidation, we expect that the economy will continue to rely on foreign demand as its main source of growth.

Households in the periphery also carry a relatively high level of debt (see Figure 1) and will face similar pressures where unemployment levels remain high. Unlike the US, where financial sector restructuring is largely complete and credit growth has swung into positive territory, we expect European banks to face potential capital shortfalls of around € 280 billion[1] as the European Central Bank completes its Comprehensive Assessment and other regulatory measures take effect.

Core Europe: More positive outlook

For core Europe, however, the outlook is more positive. We project Germany to grow by 1.4% per annum in 2014 on the back of strong export growth. Most German businesses have strengths in key areas. On the supply side, they have access to relatively cheap credit (see our analysis in Figure 2) and skilled labour. On the demand side, its world-class automotive, chemicals and engineering industries are well linked into overseas growth markets, most of which are nurturing rapidly expanding middle-income classes.

Despite the uneven growth pattern across the Eurozone, the overall outlook for 2014 is much better than last year. In our main scenario – where we assume structural reforms continue unabated– we project Eurozone GDP will expand by 0.8% in 2014.

A solid recovery is also developing in the UK with an easing of the two significant headwinds to growth: high inflation and the Eurozone crisis, have eased[2]. We will be discussing prospects for the UK economy in much more detail in our next *UK Economic Outlook* which will be released in March.

[1] "De-leverage take 2: Making a virtue of necessity", PwC

2. 'UK economic recovery- as good as it gets?' PwC Economics in Business blog

Projections: February 2014

	Share of 2012 world GDP		Real GDP growth				Inflation			
	PPP*	MER*	2013e	2014p	2015p	2016-2020p	2013e	2014p	2015p	2016-2020p
Global (market exchange rates)		100%	2.5	3.2	3.3	3.2	4.7	5.0	5.6	4.7
Global (PPP rates)	100%		2.9	3.6	3.7	3.7				
United States	19.5%	22.5%	1.9	3.0	3.0	2.4	1.5	1.8	1.9	1.9
China	14.7%	11.4%	7.7	7.5	7.2	7.0	2.7	2.5	2.7	3.4
Japan	5.5%	8.3%	1.4	1.6	1.1	1.2	0.3	2.0	1.7	1.5
United Kingdom	2.8%	3.4%	1.9	2.5	2.4	2.4	2.6	2.1	2.1	2.0
Eurozone	13.5%	16.9%	-0.5	0.8	1.2	1.5	1.4	1.3	1.5	1.9
France	2.7%	3.6%	0.1	0.7	1.2	1.6	1.0	1.2	1.6	2.0
Germany	3.8%	4.7%	0.4	1.4	1.5	1.5	1.6	1.7	1.8	2.0
Greece	0.3%	0.3%	-3.8	0.2	1.8	2.5	-0.9	-0.6	0.1	1.0
Ireland	0.2%	0.3%	0.1	2.1	1.8	2.7	0.5	1.4	1.2	1.7
Italy	2.2%	2.8%	-1.8	0.4	1.0	0.8	1.3	1.1	1.3	1.7
Netherlands	0.8%	1.1%	-1.1	0.3	1.0	1.6	2.6	1.4	1.7	2.1
Portugal	0.3%	0.3%	-1.4	0.9	1.2	1.8	0.4	0.7	1.2	1.5
Spain	1.7%	1.8%	-1.3	0.6	0.9	1.7	1.5	0.9	1.2	1.7
Poland	1.0%	0.7%	1.2	1.9	2.4	3.9	1.2	1.9	2.4	2.5
Russia	3.0%	2.8%	1.9	2.1	3.5	3.8	6.8	6.6	5.6	5.6
Turkey	1.3%	1.1%	3.6	3.8	4.2	4.5	7.5	6.7	6.4	4.8
Australia	1.2%	2.1%	2.4	2.7	3.0	3.1	2.2	2.3	2.5	2.7
India	5.7%	2.6%	4.8	5.5	6.3	6.5	6.3	5.0	5.6	6.0
Indonesia	1.4%	1.2%	5.7	5.4	6.0	6.3	7.0	7.2	6.4	5.1
South Korea	1.9%	1.6%	2.7	3.1	4.0	3.8	1.2	1.8	2.9	2.9
Argentina	0.9%	0.7%	5.2	2.0	2.1	3.3	10.5	11.2	13.3	9.7
Brazil	2.8%	3.1%	2.2	2.7	3.1	4.0	6.2	5.8	5.6	4.8
Canada	1.8%	2.5%	1.6	2.3	2.5	2.2	0.9	1.5	1.9	2.1
Mexico	2.2%	1.6%	1.2	3.0	3.4	3.6	3.8	3.8	3.9	3.6
South Africa	0.7%	0.5%	1.9	2.8	3.2	3.8	5.7	5.3	5.0	4.8
Saudi Arabia	1.1%	1.0%	3.8	4.4	4.2	4.3	3.5	3.4	3.5	4.0

Sources: *PwC analysis, National statistical authorities, Thomson Datastream and IMF. All inflation indicators relate to the CPI, with the exception of the Indian indicator which refers to the WPI. 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.*

**PPP refers to Purchasing Power Parity and MER refers to market exchange rates.*

Interest rate outlook of major economies

	Current rate (Last change)	Expectation	Next meeting
Federal Reserve	0-0.25% (December 2008)	QE tapering to continue during 2014	18/19 March
European Central Bank	0.25% (November 2013)	On hold for now	6 February
Bank of England	0.5% (March 2009)	On hold for now	6 February

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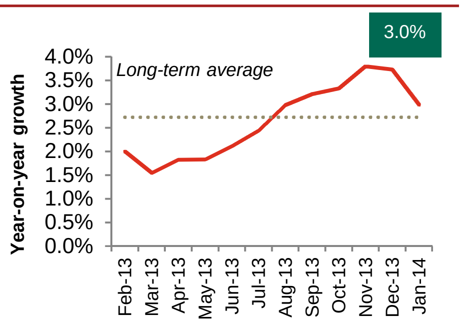
PwC's Global Consumer Index – January 2014

Global consumer spending weakened in January, but remained above the long-term growth rate. This is consistent with the slowdown experienced in some emerging countries.

Global equity market activity also weakened recently which has contributed to the decline in the index.



*The GCI is a monthly updated index providing an early steer on consumer spending and growth prospects in the world's 20 largest economies. For more information, please visit **www.pwc.co.uk/globalconsumerindex***

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