Financialisation: The $9 trillion opportunity and what to do with it

At a glance…

Strong and credible financial markets are a prerequisite for sustainable growth in any market economy. The deepening of financial markets, or "financialisation", has been a significant feature in advanced economies for the past few decades. For example, G7 domestic credit grew from 100% of GDP to 160% in less than 25 years. But there is more to come.

A $9 trillion opportunity is up for grabs

We think that the next wave of financialisation will take place in the E7 as the shift in global economic power continues to move from the West to the East. Figure 1 demonstrates that all of the E7 except China have relatively low levels of credit compared to the size of their economies.

The scale of the opportunity on offer is unprecedented. If E7 credit to GDP ratios were to converge to the average of the G7, this would imply additional lending of around $9 trillion (calculated in 2012 US dollars), which is broadly equivalent to the entire annual output of China.

But this comes with risks…

The pace of development of financial markets matters. If too fast, then this could destabilise the public and private sectors as experienced in countries like Indonesia, Korea and Thailand at the time of the Asian crisis of 1997-98, or the US and Europe in the run up to the global financial crisis.

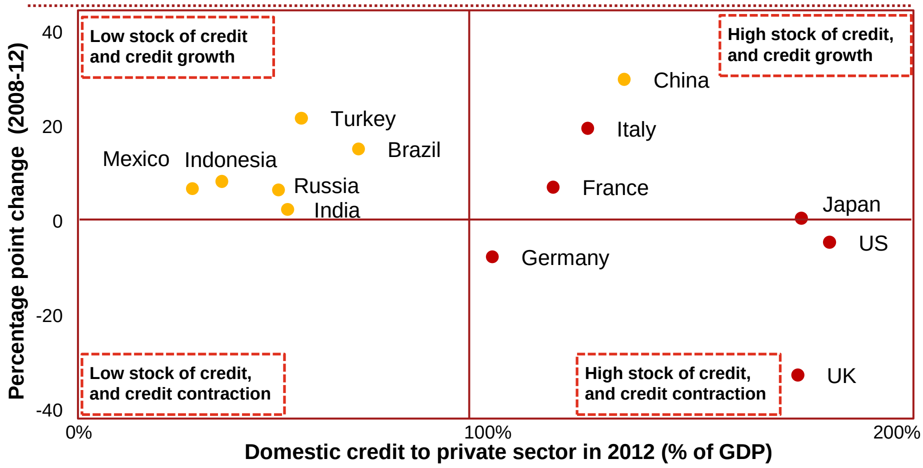
This creates a real challenge for regulators in the E7, who need to 'mature' as quickly as the financial sectors around them. At a macro level, this requires a stronger, more effective and transparent governance framework and an appropriate monetary policy. Alongside this a more tailored approach could be adopted for either specific asset classes (e.g. property lending) or the non-official (or 'shadow') sector by developing and establishing a specific set of instruments for intervention in these particular markets. China is already faced with these challenges as credit has been growing at a very rapid rate since 2008, raising fears of a credit-fuelled property bubble.

US economy regains lost jobs from financial crisis

In April, the US passed a critical threshold as employment exceeded its pre-crisis level for the first time.

In the Eurozone, however, the story is different. Although Germany has created more than 2 million jobs since early 2008, the rest of the bloc lost 6.7 million jobs over the same period.

Fig 1: The majority of E7 economies have low levels of credit relative to their economy



E7 economies are labelled in yellow. We have not included Canada in the diagram due to unavailability of comparative data

Sources: PwC analysis, World Bank, OECD

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Economic update: US employment figures back to former glory while Germany continues to fly solo

GDP has been recovering at a modest pace in most advanced economies. But is this momentum pulling through to the employment numbers? Employment figures are an important metric for businesses to monitor as they correlate strongly with household consumption which, in turn, is a key driver of company revenues.

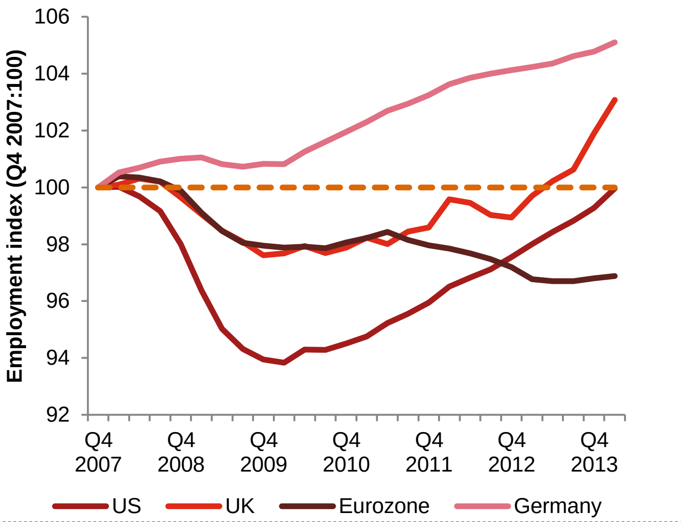
US has more jobs now than before the crisis

Figure 2 shows that the US recovery reached a key milestone in April as the economy managed to regain all of the jobs lost since the fourth quarter of 2008. We expect this picture to continue to improve as US GDP grows at around 2-3% per annum in 2014-15.

Germany flying solo

In the Eurozone, the employment picture remained mixed. Germany sits at one end of the spectrum having created more than 2 million jobs. At the other end are other Eurozone countries where around 6.7 million jobs have been lost, mostly driven by the peripheral nations. Greece, for example, has lost around 1.1 million jobs since the onset of the crisis. This pattern suggests that, for every (net) job created in Germany since the crisis began, around 3.2 jobs have been lost in the rest of the Eurozone.

Fig 2: Germany's labour market seems disconnected from the rest of the Eurozone



Sources: National statistical agencies, PwC analysis

ECB action – what does it all mean?

Inflation has been dropping in the Eurozone for some time now. The latest estimate is for Eurozone annual inflation of 0.5% in May, down from 0.7% in April.

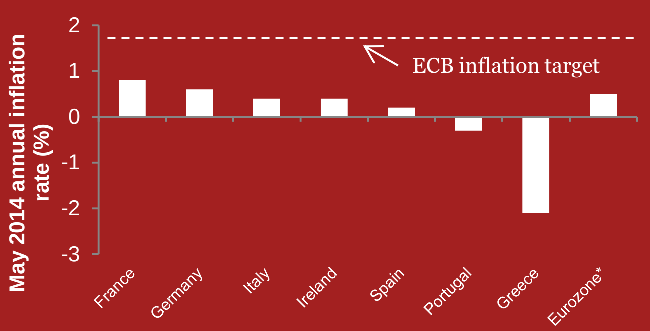
At its June monetary policy meeting, the European Central Bank (ECB) introduced a negative deposit rate. This represented a break with "conventional" monetary policy thinking, which held that the so called zero bound provided a floor for policy rates.

So what exactly did Mario Draghi announce?

1. A cut in the main refinancing rate from 0.25% to 0.15%
2. A cut in the rate the ECB pays on commercial bank deposits from zero to -0.1%
3. Introduction of "Targeted Longer-Term Refinancing Operations" (TLTROs)

These TLTROs are designed to allow banks to borrow at very low rates, with the aim of stimulating lending to the real economy. Banks will be able to borrow based on their existing lending to the Eurozone non-financial private sector, but will be expected to meet certain benchmarks for lending.

Fig 3: Eurozone inflation is now considerably short of the ECB target of below, but close to, 2%



Source: Eurostat **provisional estimate*

The three key channels to the real economy

- **Exchange rate** – The euro is likely to weaken making Eurozone exports more competitive in global markets. This could boost stuttering growth, while making imports more expensive and so pushing up inflation.
- **Bank lending** – A negative deposit rate should encourage commercial banks to withdraw their reserves from the ECB and lend to the real economy where they could potentially get greater returns. This trend could be further supported by the provision of up to €400bn of cheap ECB loans (via TLTROs), which is roughly equivalent to the combined economic output of Ireland and Greece.
- **Confidence** – These measures are a clear indication of the ECB's commitment to avoid price deflation by using extra-ordinary tools, like negative interest rates, to support growth. Draghi, who has steered market expectations effectively in the past, has attempted a similar move by stating *"Are we finished? The answer is no, we aren't finished here".*

Is it going to work?

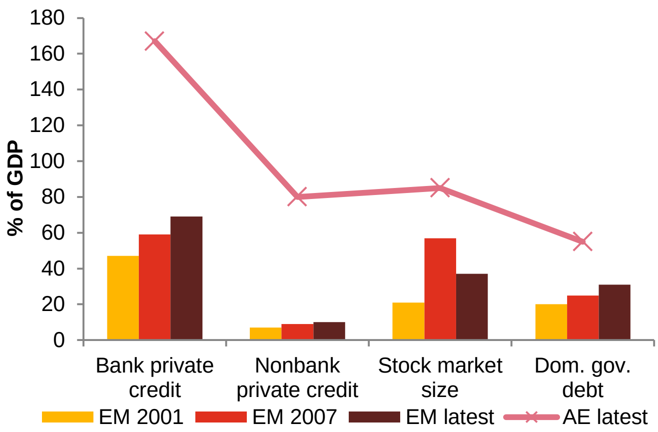
The euro has weakened slightly since the announcement, but the longer term impact remains unclear. Some inflation may be imported in the short term, which will reduce real consumer spending power, but exporters may take longer to feel a positive effect.

The newly announced TLTRO loans will be extremely cheap finance i.e. charged at the main refinancing operations rate plus 0.1 percentage points (or 0.25% based on today's rates) for 4 years. This is expected to allow banks to lend to the real economy even though GDP growth rates remain slow by historical standards.

We think the effects of Draghi's policies will become clearer once the Asset Quality Reviews (AQRs) of the large Eurozone banks are completed towards the end of the year. Investors, markets and the regulator should then have a clear view on the capacity of commercial banks to lend more.

Growing pains: How fast is too fast for financialisation?

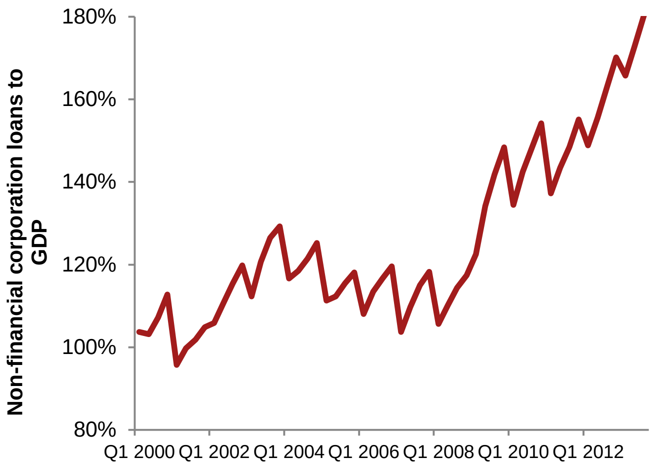
Fig 4:Emerging economy financial markets still have some way to go to match advanced economies



In this chart, we have used the IMF's definition of emerging and advanced economies. EM = emerging market, AE = advanced economy

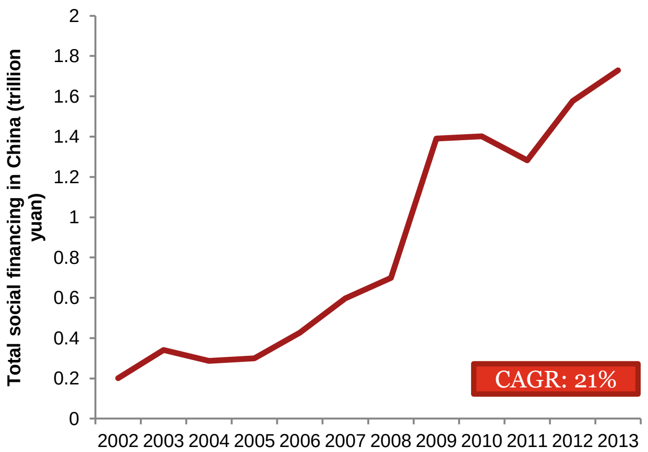
Sources: PwC analysis, IMF

Fig 5: China has seen rapid growth in corporate credit since 2008



Sources: PwC analysis, BIS, NBS

Fig 6: Social financing in China has been growing at double digit rates



Source: Thomson Datastream

Financial markets are growing in emerging markets

One of the most important global economic trends over the past few decades has been the deepening of financial markets, or "financialisation". The two key hallmarks of this have been the increasing amounts of leverage in the private sector (both for companies and households) and the increasing importance, size and sophistication of the financial sector. In the G7, for example, domestic credit as a proportion of the economy has increased from around 100% of GDP to 160% in less than 25 years (although this became excessive in the run up to the 2007-8 crisis).

Emerging markets still have some way to catch up to reach financialisation levels similar to those in the advanced economies (see Figure 4). However, global megatrends, like the shift in economic power from the West to the East and rapid urbanisation, coupled with better technology, have set in motion a process of convergence in credit ratios between the E7 and G7, although this still has a considerable way to go. The size of the potential increase is huge. If E7 credit to GDP ratios were to converge to the average of the G7, it would imply additional lending of around $ 9 trillion (calculated in 2012 US dollars).

In China, credit has been rising even faster than in parts of the Eurozone before the crisis

The biggest and most visible example of a rapidly financialising emerging market is China (see Figure 5). Some sources estimate that total credit in China has approximately doubled since the financial crisis hit as the government there has sought to boost China's domestic investment. Specifically, the boom in credit extended to the corporate sector has been even greater than that seen in the peripheral Eurozone countries prior to the financial crisis.

There are serious risks associated with overly rapid financialisation

Growing financial markets can facilitate the transfer of capital to productive areas of the economy. However, if the speed of market development or the breadth of different financial markets is too great, the risks of destabilising "boom and bust" cycles increase.

At the same time, spillovers into less regulated "shadow banking" sectors can lead to markets which are hard to monitor and regulate effectively. The rapid growth of "shadow bank" property lending in China is a good example of this. Figure 6 shows the sharp upward trend in "social financing" in China, which is a broader measure of credit that includes non-official sources of lending. This has been growing at around 21% per annum, which is significantly faster than nominal GDP growth. If not managed and monitored properly, these spillovers could affect the real economy by potentially amplifying credit-fuelled booms and busts.

What can be done about these risks?

As financialisation takes hold, regulators need to adjust and develop regulations that reflect the changes in the financial system. At a macroeconomic level, this involves a strong financial governance framework and appropriate monetary policy. Alongside this, certain more dynamic and faster growing markets may require more tailored approaches. Macro-prudential regulation, for example, allows for more targeted intervention in specific asset classes (e.g. property market lending or share trading) without affecting the wider real economy too badly.

Projections: July 2014

	Share of 2012 world GDP		Real GDP growth				Inflation			
	PPP*	MER*	2013e	2014p	2015p	2016-2020p	2013	2014p	2015p	2016-2020p
Global (market exchange rates)		100%	2.4	2.8	3.2	3.2	4.8	5.2	5.6	4.6
Global (PPP rates)	100%		2.9	3.3	3.7	3.6				
United States	19.5%	22.5%	1.9	2.3	3.0	2.4	1.5	1.8	2.2	1.9
China	14.7%	11.4%	7.6	7.4	7.3	7.0	2.6	2.5	2.6	3.4
Japan	5.5%	8.3%	1.5	1.5	1.5	1.2	0.4	2.1	2.1	1.5
United Kingdom	2.8%	3.4%	1.7	3.0	2.6	2.4	2.6	1.7	1.9	2.0
Eurozone	13.5%	16.9%	-0.5	1.0	1.4	1.5	1.4	0.9	1.2	1.5
France	2.7%	3.6%	0.1	0.9	1.1	1.7	1.0	1.1	1.2	1.5
Germany	3.8%	4.7%	0.5	2.0	1.9	1.3	1.6	1.2	1.4	1.7
Greece	0.3%	0.3%	-3.9	0.3	2.1	3.0	-0.9	-0.4	0.1	1.3
Ireland	0.2%	0.3%	-0.3	1.7	2.5	2.5	0.5	0.2	1.2	1.5
Italy	2.2%	2.8%	-1.8	0.1	0.9	1.0	1.3	0.7	1.0	1.4
Netherlands	0.8%	1.1%	-0.8	0.2	1.5	2.0	2.6	0.8	1.2	1.4
Portugal	0.3%	0.3%	-1.0	0.1	1.4	1.8	0.4	0.5	1.1	1.5
Spain	1.7%	1.8%	-1.2	0.9	1.3	1.5	1.5	0.3	0.8	1.0
Poland	1.0%	0.7%	1.5	2.7	3.2	3.5	1.2	0.6	2.2	2.5
Russia	3.0%	2.8%	1.2	0.5	1.5	2.5	6.8	6.7	5.8	5.0
Turkey	1.3%	1.1%	4.0	2.4	3.8	4.5	7.5	8.0	6.7	4.8
Australia	1.2%	2.1%	2.4	2.6	2.2	3.1	2.2	2.8	2.6	2.7
India	5.7%	2.6%	4.6	5.3	6.6	6.5	6.3	5.6	6.1	6.0
Indonesia	1.4%	1.2%	5.8	5.4	5.8	6.3	7.0	6.2	5.3	5.1
South Korea	1.9%	1.6%	3.0	3.5	3.7	3.8	1.3	2.3	3.0	2.9
Argentina	0.9%	0.7%	5.0	0.7	1.8	3.3	10.6	11.9	13.3	9.7
Brazil	2.8%	3.1%	2.3	1.8	2.5	4.0	6.2	6.6	5.7	4.8
Canada	1.8%	2.5%	1.8	2.2	2.5	2.2	0.9	1.7	1.8	2.1
Mexico	2.2%	1.6%	1.3	2.6	3.7	3.6	3.8	3.9	3.7	3.6
South Africa	0.7%	0.5%	1.9	1.8	2.5	3.8	5.8	6.1	5.5	4.8
Saudi Arabia	1.1%	1.0%	4.0	4.1	4.3	4.3	3.5	3.1	3.5	4.0

Sources: *PwC analysis, National statistical authorities, Thomson Datastream and IMF. All inflation indicators relate to the Consumer Price Index (CPI), with the exception of the Indian indicator which refers to the Wholesale Price Index (WPI). Argentinian inflation figures are based on the old price index which measure CPI in Greater Buenos Aires. A new index the "National and urban Consumer Price Index" (NuCPI) has now been released by INDEC the Argentinian statistical agency. We will monitor this new price index and will base our projection on this once we have several months of data available. 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	0-0.25% (December 2008)	QE tapering to continue during 2014	3 July
European Central Bank	0.15% (June2014)	On hold following easing in June	3 July
Bank of England	0.5% (March 2009)	On hold for now	10 July

Richard Boxshall
T: +44 (0) 20 7213 2079
E: richard.boxshall@uk.pwc.com

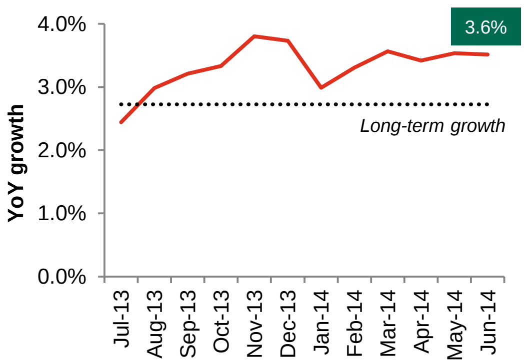
William Zimmern
T: +44 (0) 20 7212 2750
E: william.zimmern@uk.pwc.com

Barret Kupelian
T: + 44 (0) 20 7213 1579
E: barret.g.kupelian@uk.pwc.com

PwC's Global Consumer Index

Global consumer spending continues to maintain its momentum, growing at 3.6% this month.

Industrial production in the G20 economies has picked up, and the improvement in consumer and business confidence continues to support consumption.



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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