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# Mexico's energy reform, India's election shocker, Turkey's current account, and monetary policy tightening in China.

By Jan Dehn

Mexico passed the energy reform with overwhelming support, while the outcome of local elections in India gives rise to optimism about reforms after the general election next year. Turkey's current account is on track for material improvement, while China's authorities continue to steadily prepare their economy for tighter financial conditions. We also provide an update of the state of deleveraging in the US and review industrial production in Europe and the state of play in Japan.

| Emerging Markets | Index level/ yield | Spread over UST | 1 week change |
|---|---|---|---|
| MSCI EM | 988 | | -2.41% |
| MSCI FM | 584 | | -0.15% |
| GBI-GD | 6.74% | | -0.03% |
| ELMI+ | 4.08% | | -0.33% |
| EMBI GD | 5.88% | 299 bps | 0.60% |
| EMBI GD IG | 4.97% | 206 bps | 0.50% |
| EMBI GD HY | 9.37% | 673 bps | 0.80% |
| CEMBI BD | 5.65% | 326 bps | 0.14% |
| CEMBI BD HG | 4.81% | 240 bps | 0.16% |
| CEMBI BD HY | 7.57% | 521 bps | 0.13% |

| Global backdrop | Index level/yield/ FX rate/price | 1 week change |
|---|---|---|
| S&P 500 | 1,775 | -1.79% |
| VIX Index | 15.76 | 16.83% |
| 5 year UST | 1.52% | 4 bps |
| 10 year UST | 2.85% | 1 bps |
| 10 year Bund | 1.83% | -1 bps |
| EURUSD | 1.3784 | 0.44% |
| USDJPY | 103.01 | -0.23% |
| Brent | $109 | 0.31% |
| Copper | $335 | 1.06% |
| Gold | $1230 | -0.31% |

## Emerging Markets

**Mexico:** Mexico's Senate and Lower House overwhelmingly approved an extremely important energy reform, which introduces private participation in oil production in Mexico. The bill still requires ratification in half of Mexico's state legislatures, but this is unlikely to pose problems. The next steps are secondary legislation and regulations, then FDI flows can begin, and then a couple of years later we expect to see material increases in oil and gas production. The energy reform is the culmination of an 18 month frenzy of reforms, which is likely to materially raise Mexico's productivity and trend growth rate.

**India:** Some 15% of India's electorate went to the polls last week to vote in four separate state assembly elections. The outcome was a politically important shift in voter sentiment away from the ruling Congress Party towards the opposition BJP party. The significance of this result is clear: If replicated in the 2014 general election the business friendly BJP party could be returned to power. Depending on the size of BJP's mandate, such an outcome would likely usher in a phase of economic reforms. Following a period of material overheating in the last couple of years India this year took corrective measures through changes to the exchange rate as well as monetary and fiscal policy tightening. These adjustments are on-going. We believe they have already sown the seeds of a gentle cyclical upswing, which should raise India's growth rate from a 5% handle this year to more than 6.5% next year. However, India's trend growth rate will only rise if India resumes structural reforms. Hence the significance of last week's election outcome.

Meanwhile, high frequency data releases from India over the past week were mixed. Inflation was higher than expected due to food prices, but food price inflation should subside gradually over the coming months. Industrial production was also weak, falling 1.8% yoy in October. This data release contradicts last week's PMI release, which was strong. Finally, India's external rebalancing continues apace. The trade deficit in November declined to USD 9.2bn from USD 10.6bn in October. Declining imports were the main reason for the better than expected result.

**Turkey:** Turkey's current account deficit continued to narrow. Fresh data from October shows the current account deficit narrowing to USD 2.9bn versus USD 3.0bn expected. This keeps Turkey's external balances on track for significant improvement this year and next. The deficit has already narrowed from 8.8% of GDP in Q2 2012 to 7.7% in Q2 of 2013. Among the small group of Emerging Markets countries with macroeoconomic

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adjustment challenges, Turkey has opted to adjust by weakening the currency in preference to raising interest rates. The transmission mechanism of adjustment runs via business confidence. A weaker Turkish Lira tends to reduce demand for investment and consumption among very 'exchange rate aware' firms and households. Arguably, a more efficient way to reduce domestic demand would be via conventional rate hikes, but rate hikes would pose a risk to the property sector and could be construed as politically risky ahead of local elections in March. While inefficient, we think Turkey's unorthodox adjustment process will work, albeit slowly. Third quarter GDP data released last week showed that Turkey's economy expanded by 4.4% yoy versus 4.2% yoy expected. At the margin, domestic demand growth is contributing less to growth, consistent with the central bank's strategy.

China: China's monetary authorities continue to slowly scale back the pace of total social financing. In November, the growth rate of total social financing declined slightly to 18.5% yoy from 18.6% yoy in October. The percentage pace of lending has come off from the low 20s in early 2013. Broad money growth (M2) also slowed to 14.2% yoy from 14.3% yoy in October. Given the recent pickup in economic activity in China the gradual slowing of money growth is gently putting upwards pressure on interest rates. In order to ensure that corporates and households can manage under these tighter financial conditions the Chinese government recently launched further supply-side reforms. No other country on the planet is reforming as aggressively as China – and no other country is likely to be as prepared for tomorrow's world of tighter financial conditions than China. A slew of macroeconomic data released over the past week suggest that China's growth is steady and healthy: Industrial production and retail sales were marginally stronger than expected, while fixed asset investment fell marginally short of expectations

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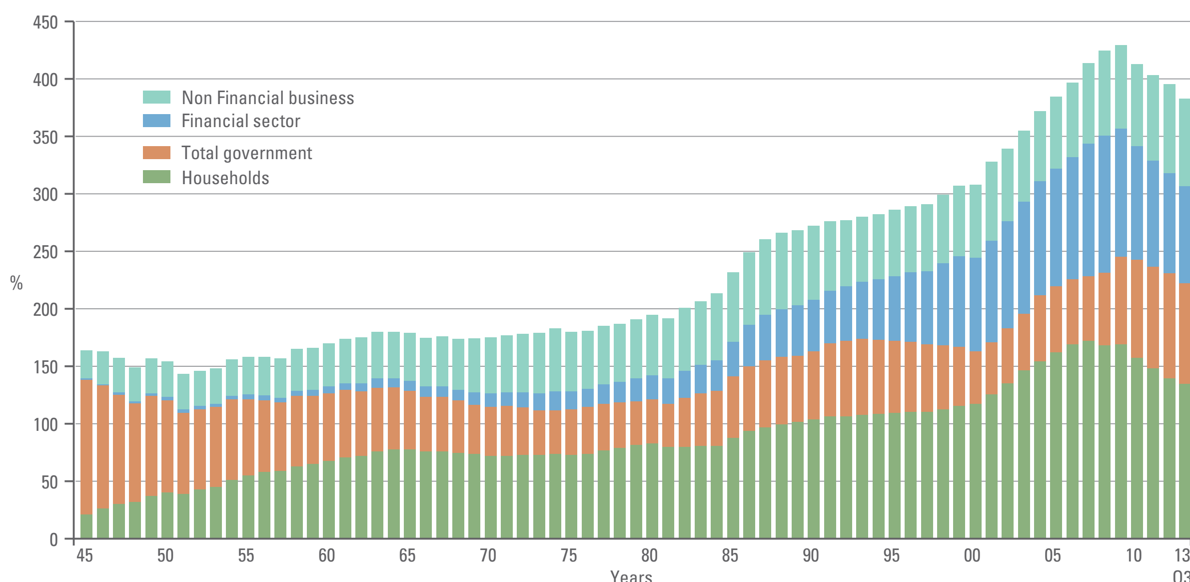
In our opinion, the balance sheets of US institutions are among the most important macroeconomic variables in the world. Since US banks were recapitalised early and US firms are cashed up, ready to invest what is still missing in the recovery is a robust consumption and investment response. We think the still sluggish consumption and investment response in the current business cycle is due to still heavy deleveraging.

Last week the US Federal Reserve released Q3 Flow of Funds data for all sectors of the US economy in Q3. This data provides an up-to-date picture of the debt profile of the US economy.

The good news is that the total debt stock as a share of GDP in the US declined from 392% of GDP at the end of 2012 to 383% of GDP by Q3 2013. This does not include some 300% of GDP in unfunded healthcare and other social liabilities. Nominal GDP was up 4% over the period, while total outstanding debt increased by 1.6%. The decline in debt to GDP illustrates the importance of nominal GDP growth – either via faster real GDP growth or via inflation – in restoring the US economy to healthy debt levels.

A breakdown of the outstanding debt by sector shows that corporate debt rose sharply (up 4.9%), mortgage debt declined (-0.7%), Federal government debt rose sharply (up 3.3%), and state and local government debt declined modestly (-0.9%).

Fig 1: **Total US debt, by sector (% of GDP)**




Source: Federal Reserve.

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The not-so-good news is that corporates probably borrowed to buy back stock, not to invest, because investment rates remain subdued. Also, the pace of household deleveraging has almost slowed to a halt. US households currently have debts equivalent to 103.8% of their income, down from 104.3% in Q2 and 105.6% of income in Q3 2012. While the household debt ratio is therefore well off its peak of 130% in 2008 we think there is still work to do. Academic studies of past banking and real estate crises show that households can be expected to deleverage back to pre-bubble levels, which would mean 90% debt to income. On the current pace, this means US households will not be done until H2 2016.

The US Congress managed to achieve a compromise deal, which avoids a late-year budget crisis, but at the expense of more fiscal spending in 2014. The deal increases net spending by USD 23bn (less than 0.2% of GDP) next year. The deal does not encompass an extension of the debt ceiling, which Congress will have to revisit in February next year.

Former Israeli central bank governor Stanley Fischer is being considered for the post of Vice Chairman of the Federal Reserve, according to press reports. One of Fischer's publicly stated views is that he does not believe in forward guidance unlike Janet Yellen, who is due to take over the Chairperson position early next year. As such, this story introduces further uncertainty into the market ahead of the Fed's next attempt at scaling back QE. The sell-off in the long end of the US treasury curve this summer shows that the market assigned zero credibility to Bernanke's verbal guidance on rates. The biggest challenge facing the Fed as it moves towards a second attempt to taper is precisely how it can prevent the long end of the US treasury market from selling off. After all the Fed has very limited capacity to 'twist' and the market will naturally want to see bond prices fall when USD 85bn of demand (the Fed's monthly purchases) disappear from the market.

Industrial production (IP) in Europe tumbled in November, down 3.6% on an annualised rate. This follows a return to positive growth in Europe in Q2 (0.3% qoq sa), but then a very tepid pace of expansion in Q3 (0.1% qoq sa). Our view is that Europe's growth is likely to continue to be very modest due to the region's inability to resolve legacy issues in the banking system, excessive debt levels across the region, and insufficient appetite for deeper structural reform. On the other hand, the resulting slow growth will keep inflation low and hence ensure that policy rates stay low.

In a somewhat negative development as far as chances of meaningful structural reform in Japan are concerned the approval rating for Prime Minister Shinzo Abe's administration in Japan declined 10.3% to 47.6%, according to a poll by Kyodo. Abe's administration unleashed a ferocious stimulus program earlier this year in order to win a majority in July's senate elections, but it has so far not used its political capital to address Japan's underlying structural problems. The government says it will refocus on economics early next year, but the reform challenge is enormous and with polls heading in the wrong direction the risk that the government opts for further stimulus while shying away from genuine reform is increasing.

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