

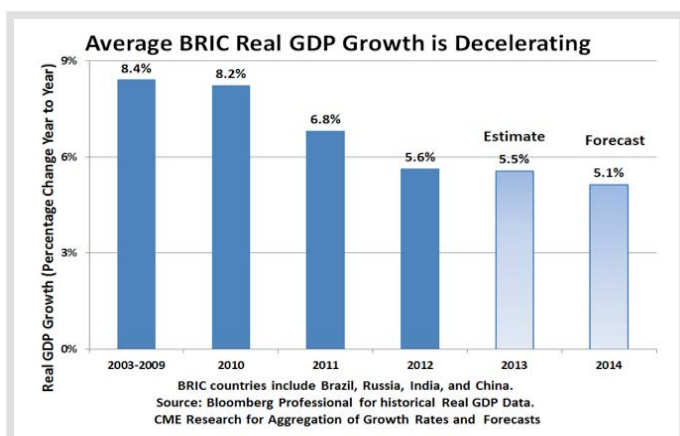
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DECEMBER 9, 2013

Decelerating BRICs face Structural Challenges

The emerging market countries' share of world GDP growth has increased dramatically from 37% in 2000 to just under 50% in 2012. More recently, though, growth has slowed in the emerging market world. The BRIC economies' (i.e., Brazil, Russia, India, and China) size-weighted real GDP growth has fallen from 8.2% in 2010 to 5.5% in 2013. In 2014, weighted growth for the BRICs is again projected to continue its incremental deceleration to 5.1%.

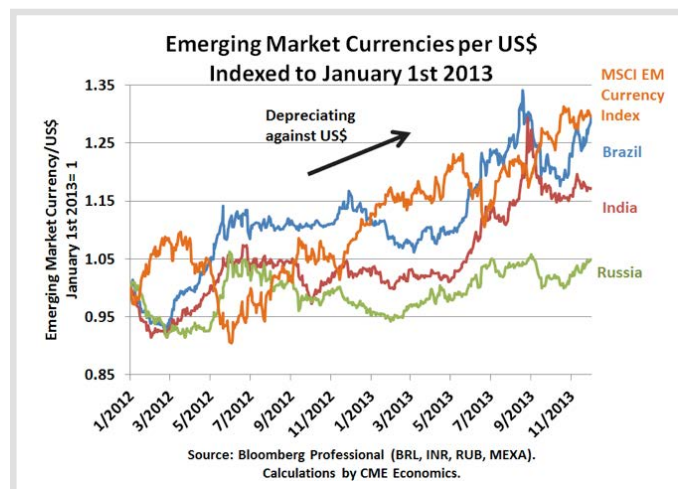
In the first decade of the new millennium, some analysts were so impressed by the growth in emerging market countries that they saw the potential for a decoupling from the mature industrial economies. In this line of reasoning, emerging market countries could be their own engines of growth. What many analysts failed to understand was the important role played by economic growth in the major industrial countries in creating the conditions for the break-out growth in the emerging market economies. That is, the robust growth of the US and Europe during the 2002-2006 period is not always given appropriate credit for its substantial contribution toward encouraging a decade of superior economic growth in the emerging market countries.



Presently, five years after the financial panic of September 2008, one of the major long-term challenges for emerging market countries now coming into focus is the adjustment

process to slower economic growth in the developed and aging economies. As the developed countries cope with their debt overhangs, demographic challenges, and lower long-run potential growth rates, the emerging market countries are reducing their growth expectations as well, while facing some critical structural challenges.

Moreover, there have been complications for emerging market countries from currency and equity market volatility, in part as a consequence of the near-zero short-term rates in the US, Europe, and Japan, as these countries fight the specter of potential deflation. For example, the severe depreciation of emerging market currencies in 2013, which started early in the year and picked up traction, had the appearance of a "contagion" episode. There were multiple factors in play, including Federal Reserve "Taper Talk" – or indications that the Fed might curtail Quantitative Easing. Other fears were important, too. Geopolitical concerns, from disruptions in Brazil, Turkey, and Egypt, to civil war in Syria, all were potential contributors to a change in sentiment by market participants leading to risk reductions in emerging market exposures and asset allocation shifts to mature industrial country equity markets, which were being supported by their low interest rate policies and central bank bond purchase programs. The risk reductions and asset allocation shifts prompted wide-spread currency depreciation and equity downturns in the emerging market world.



Thus, emerging market countries in general and the BRIC nations specifically have to cope with powerful global influences from the mature industrial world, even as they work through their own very different economic and political challenges. For the purposes of this report, we take as the backdrop some key assumptions that the mature industrial economies will continue to perform at less than their perceived potential growth and will continue to maintain near-zero short-term interest rates. For example, even with the likely tapering of quantitative easing in the US, the Federal Reserve has been clear to guide markets that its very low target federal funds rate policy will remain in place for many years to come. Against this backdrop, 5% average real GDP growth for 2014 in the emerging market world may be viewed as a respectable performance, even if it represents a deceleration from the faster growth of the previous decade.

What the global influences and the averages obscure, however, is just how different the economies of the BRIC countries really are, and equally, how different are the structural challenges and the policy choices they face. Brazil is coping with a rising middle class demanding improved government services. Russia faces growth constraints due to its dependence on energy exports. India's current account deficit is greatly exacerbated by its massive energy and food subsidy programs. China is in the midst of orchestrating a transition from an infra-structure building growth model to a more domestic-demand oriented approach to economic growth. To break down the current economic situation and policy issues within each of the BRIC countries, we have adopted a question and answer format for this report. We will start with Brazil, and move through Russia, India, and China, attempting to provide some prospective answers for key questions facing these economies that go well beyond the global influences.

I. Brazil: The Challenges of a Rising Middle Class

Q: How are expectations impacted by the rise of the middle class in Brazil?

A: Brazil has sustained a significant increase in the standard of living for its citizens. GDP per capita increased 231% from 2005 to 2013. There is the caveat, however, that the economic growth experienced by many Brazilian citizens has been partly

financed by an increased use of credit which brings with it greater financial risks for the economy as well as the prospects of improved lifestyles. With the rise in income and access to credit, numerous Brazilians have experienced a shift in expectations. Brazilian citizens appear to want more from their government – especially in terms of basic public services commonly associated with improved standards of living.

The crux of the middle-class shift that has occurred has been the rise of the so-called “C” class – a lower-middle class defined by individuals who earn between US\$1800 to US\$6000 per year. The increase in this demographic has been substantial; representing just 21% of the population in 2005, it currently represents 54% of the population. This rise of the middle class is a great opportunity for companies in Brazil (and arguably companies abroad as well) to provide a new range of products and services, generating jobs and economic growth. This has already started with the availability of lower priced versions of traditionally higher-end goods and services – including hairstyling and chocolate.

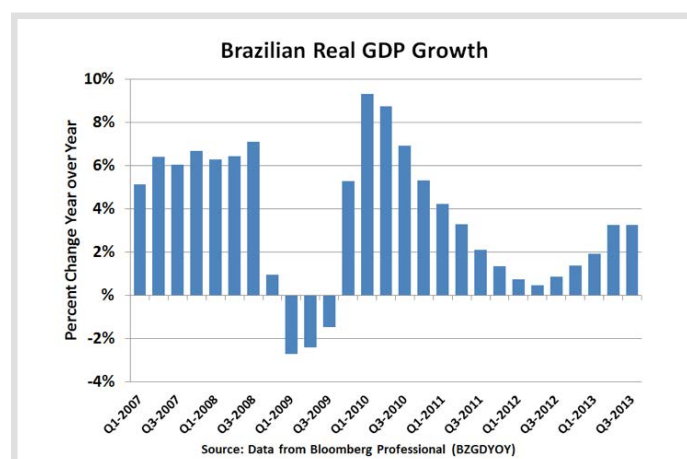
Q: What are the implications for government provided public services?

A: Deficiencies in the government's provision of basic services have been especially highlighted against the backdrop of massive spending by the government for the World Cup in 2014 and Olympics in 2016. Quality of life issues are at the core of the protests – health care, public safety, education and transportation. While improving and reforming these services are structural issues which are difficult to change immediately, middle-class protests this past summer in over 100 Brazilian cities have given a voice to the issues.

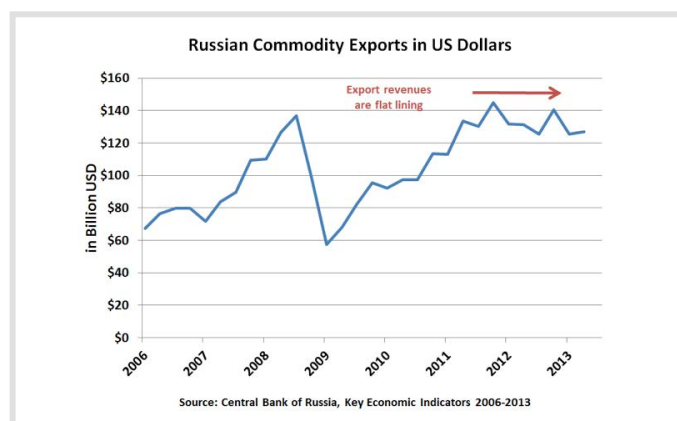
Some concrete examples of lacking social services include a healthcare system with a shortage of doctors, and a justice system and police force which are considered by some to favor the wealthier classes. Furthermore, education in Brazil has both quality and quantity issues – with education reform cited as being highly needed. The protests have put increasing pressure on the government for social reforms at a time when the budget is constrained by the push for international recognition surrounding the upcoming sporting events Brazil will host, and then further complicated by the deceleration of economic growth and currency turbulence.

Q: What is the economic outlook for 2014?

A: Economic conditions are not expected to pick-up soon, with growth in 2014 forecasted at a moderate 3%, while inflation is expected to remain relatively steady at 5.5% – 6%. The continued inflationary pressure within Brazil means it will be increasingly difficult for the Brazilian government to stoke growth through interest rate cuts.



A further issue affecting future energy receipts to the Russian government is the potential restructuring of long term natural gas contracts. The current stagnation of government revenue will be exacerbated if a structural change occurs where Russian gas prices are no longer tied to Brent oil prices as is currently the case. Since late 2011, Gazprom has given US\$3 billion in gas price adjustments to European customers who have demanded rebates over long-term pricing tied to Brent crude oil that they deemed as unfair. A further US\$1 billion in payouts is expected to be paid by Gazprom in 2014. The net result is a flat-lining of exports and budget constraints on the government.



II. Russia: The Pitfalls of a Dependency on Energy Exports

Q: Just how reliant is the Russian economy on its oil and gas industries?

A: The advantages of vast energy supplies come with an Achilles' heel for the Russian economy. As it stands, energy exports are 70% of Russia's total exports. Energy taxes and export duties on oil and gas are the largest source of tax income for the Russian government accounting for 60% of revenues by official accounts, and closer to 80% by independent and industry estimates. Hence, from a fiscal perspective, the Russian government's high dependence on increasing oil output and elevated Brent crude oil prices to finance government receipts makes it vulnerable to stagnation of energy exports in US dollar terms.

Q: What does Russia's entry into the World Trade Organization mean for the Russian Economy?

A: Russia's entry into the World Trade Organization (WTO) has been 18 years in the making. Regardless – Russia's admission into the WTO in July of 2012 has been disappointing in not being a driver of growth as anticipated. In theory Russia's entry was meant to be a catalyst to diversify and modernize the Russian economy. Proposed benefits had been to attract foreign investment more easily, and over the long-term move towards a more diverse economy less reliant on energy exports. The key wording here is "long-term". An increase in competition and openness to trade may eventually be beneficial for Russia, but structural adjustments are unlikely to support real GDP growth in the near term.

Russian Q3-2013 year-over-year GDP growth was 1.2%, while Russia's 2013 growth rate is estimated to be only slightly higher at 1.8%. This is much slower than the initial 5% growth projections made at the beginning of the year by the Russian Central Bank. Annual real GDP growth for 2014 is expected to incrementally increase to 2%. As well, Russia's inflation rate, which is currently at 6.3%, may increase to 7% in 2014. This inflation will likely be the result of unavoidable price hikes on many goods which are controlled by the Russian government, which is looking in every corner for new revenue sources.

III. India: Land of Subsidies

Q: What is the magnitude of subsidies provided by the Indian government? And to what degree are the subsidies affecting government finances?

A: The magnitude and continued growth of subsidies in India are concerning for the government's fiscal health. Oil subsidies in particular are one of the culprits of a widening current account deficit. Currently, India imports a staggering 80% of its oil which is then heavily subsidized for its citizens. The oil refining and marketing companies import crude oil at global market rates. The companies are then required to sell 3 key products – Kerosene, Diesel and Liquefied Propane Gas (LPG) – at significantly subsidized rates. The marketing and refining companies then receive subsidy payments from the Indian government to compensate them for their losses. Also, gas or oil bought by the refining companies from state-run oil producers is purchased at a significant discount. To put the magnitude of the subsidy cost into perspective – note that at the end of India's 2013 fiscal year, total subsidy cost was 1.6 trillion rupees (i.e., US\$26.6 billion at 60 Rupees per US dollar) or 1.9% of India's GDP. This has increased from 2005 when the total cost was 0.6% of GDP.

Moreover, the issue of oil subsidies has been intensified by the decline in the rupee, as global oil contracts are priced in US dollars. This past summer, using a creative FX intervention plan, the Reserve Bank of India announced it would be selling US dollars to the largest state run oil companies. And while some oil reform subsidies are occurring – recently, a small

increase in the price of subsidized diesel was passed, the pace is not deemed fast enough to slow the growth of the widening current account deficit and assuage investor worries about government spending.

Energy is not the only large subsidy program. In addition, a new large-scale food subsidy program, the Food Security Bill was passed in September 2013. With an estimated cost of US\$21 billion, the program will subsidize rice, wheat and grains for two thirds of the population. This is occurring at a time when market participants are doubting whether the Indian government can get its spending, subsidy costs and current account deficit under control.

Q: What are the implications of India's affinity for large amounts of gold?

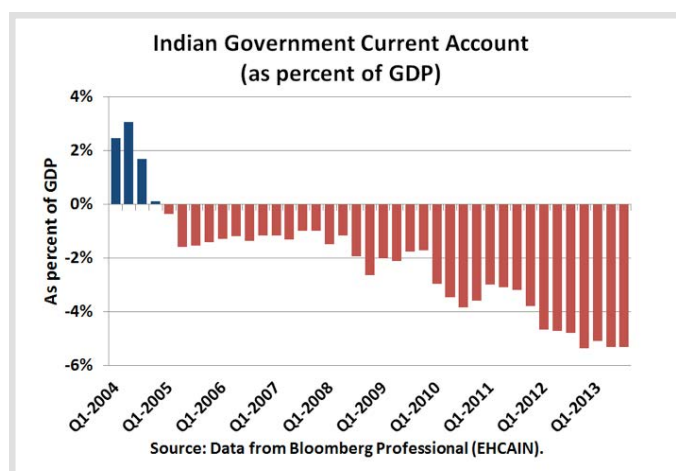
A: Beside energy and food subsidies, another contributing factor to the current account deficit is India's insatiable appetite for gold. India is the world's top importer of gold (followed closely by China), importing a quarter of total global demand. Indian gold imports stand at US\$16.5 billion per quarter. India's demand for gold is a function of its deeply-rooted traditional and religious uses, as well as its role as a saving vehicle – 40% of Indians do not have a bank account. The Indian government and the Reserve Bank of India have an acute awareness of the issue and have begun to address it. Since the beginning of 2012 the Indian government has raised gold import taxes from 2% to 15%. Meanwhile, the Reserve Bank of India has mandated that 20% of gold imported must be turned around and exported. Nevertheless, Indian affinity for gold is not easily curbed, and a black market of gold imports has arisen. The most unique way of smuggling the precious metal into the country has been in true Willy Wonka fashion: through gold-filled chocolate bars.

Q: What is the outlook for the current account deficit based on the economic conditions in India?

A: The Indian government current account deficit as a percent of GDP has been getting larger, presently at -5.8%. When countries restrict capital flows, then typically a growing current account deficit works to depreciate its currency, which in turn leads to inflationary pressures. On the capital account side,

India is highly dependent on Foreign Direct Investment (FDI). This dependency can lead to instability in the currency, as witnessed in the summer. FDI flow can be temperamental with regards to market participant's preferences and appetite for risk, especially regarding the government's attitude towards foreign ownership of businesses operating inside India. Shorter-term capital flows fill the gap when FDI slows, but only at the price of a lower rupee.

Projections are for the current account deficit to decline slightly and hover at 5.5% of GDP moving forward. The Indian government has made it clear that getting the current account deficit under control is a priority. As well, import taxes and regulations put in place to curb gold demand have seen moderate success – tracked purchases of gold for a recent Indian festival holiday were down 50% from last year. However, downside risks to the current account deficit include the introduction of new subsidy programs, and the seeming inability to substantially modify oil subsidies. Also, being a re-election year in India suggests government spending will be slightly higher than last year. Working on the other side of the current account, it is not clear that Indian exports will rise given the global outlook or that international investors will want increased exposure to Indian assets.



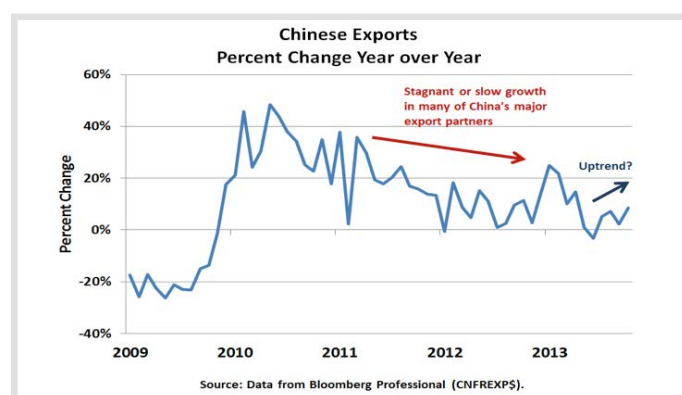
A longer-term potential upside to India's economic conditions and overhaul of worrisome domestic policies is Raghuram Rajan, the new Head of the Reserve Bank of India, who has pledged wide-spread reform to the banking sector within India and sweeping changes to enhance competitiveness within the Indian economy. Only time will tell if the rhetoric will be made into actionable conclusions with meaningful results. As well, it seems likely that any progress by the Reserve Bank will need the Indian government to be working in tandem in order to address fiscal spending and issues not under the jurisdiction of the Reserve Bank.

IV. China: From Infra-Structure Spending to Domestically-Driven Growth

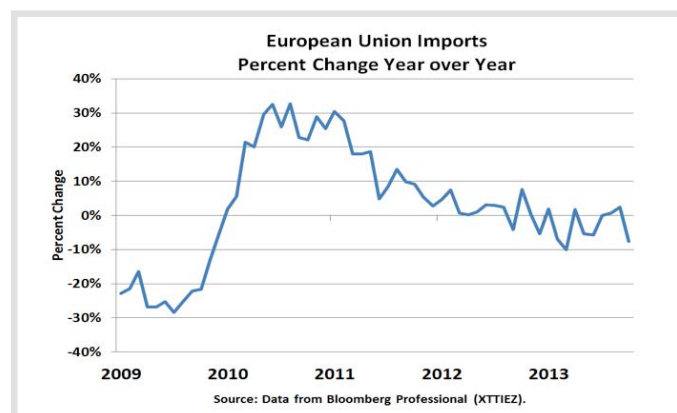
- Q: Why is China's new leadership shifting from an infra-structure spending growth model to a more domestically-driven approach to future economic growth?**
- A:** The previous economic growth model in China was dominated by large-scale infrastructure building with the state playing a key role in many aspects of the economy. As the Chinese economy has grown and modernized, there has been a natural evolution towards diminishing economic benefits from additional large scale, state-directed infrastructure projects. Hence, China has started to experience a slow deceleration of economic growth as a natural result of the success of its modernization program. Recognizing that the economy was entering a new phase, China's new leadership has identified and started to embrace the potential benefits of shifting from an infrastructure- and investment-based economy to a model of domestically-driven consumption growth. The next phase of growth in China will likely be fueled by a more flexible system for the allocation of scarce resources, from commodities to financial capital, potentially providing great benefit for consumers and businesses. Enhancing economic growth prospects through these market mechanisms is an idea the Chinese government now seems to recognize and appreciate.

Q: What are the factors working against China's economic transition?

A: The answer, unfortunately, is timing. China's aim to transition to a more consumption-based economy from an infrastructure- and investment-based economy is occurring at a time of lackluster global economic growth. The combination of steady, but sub-potential growth in the US, a stagnant Europe, and decelerating growth in many emerging market countries is working against China's goal. These less-than-ideal global growth conditions are slowing China's export growth. The trend of Chinese exports year-over-year has been on a decline since Q1-2010. There has been a slight uptick in exports since Q2-2013; however, it is too soon to determine if this will be a sustained uptrend.



Highlighting unfavorable global trade dynamics for China is Europe – China's largest trading partner. Europe has had declining imports overall. European imports on a sustained decline suggest Europe will not be a source of export capacity for China or any of the emerging markets moving forward.



Q: How are financial modernization and reforms progressing in China?

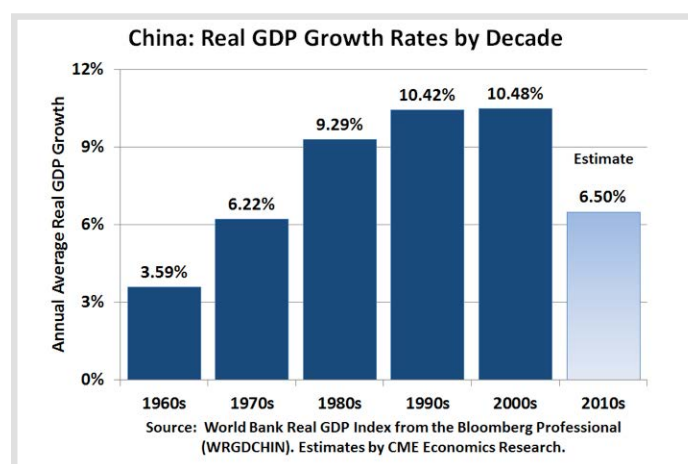
A: As discussed earlier, China is moving towards financial market modernization and increased integration with world markets. The pace is slow. China would like to utilize financial innovation to spur growth. While China did loosen control of certain interest rates – including commercial rates and those on discounted bills this past summer – there are many improvements which can be implemented. Examples include utilizing asset securitization as a method to make better use of bank credit, removing restrictions and caps on residential mortgage rates, and most requested, liberating the deposit rates which banks can pay. Currently, there exists a ceiling on the rates banks can pay depositors. This has effectively guaranteed profits for Chinese banks, and simultaneously depressed interest income for depositors.

An example highlighting the slow pace of financial modernization is the recent re-introduction of the Chinese Government 5-year bond futures. The futures were closed for trading in 1995, and 18 years later have been re-introduced, but with significant restrictions. Major players including banks and insurers are currently not allowed to trade. While, certain firms, including mutual funds, can trade only for hedging purposes. As well, margin requirements have been set higher than the legal minimum and after draft regulation was revised, the limit of holdings was revised downwards by 20% — a disappointment to many market participants. Meaningful trading volume of these government bond futures is not likely to occur without portfolio and speculative activity.

In summary, China is experiencing a structural economic slowdown, and current economic conditions might suggest that the timing is perfect to reap some of the growth benefits of financial modernization. The Communist Party has made a bold announcement recently to embrace reforms which let “markets” play a greater role in the Chinese economy. The party's statements implying vast economic reforms were met with relief (and hope) by many market participants.

Q: What is the growth outlook for China?

A: Chinese third quarter year over year GDP growth stands at 7.8%. While this may seem high relative to developed economies, it reflects a marked slowdown from the real GDP growth experienced only two years ago, which was above 9.5%. Furthermore, China's target growth rate has been lowered to 7% year over year. For 2014, our view is that GDP growth will fall slightly and be in the range of 6.5% -7%. Inflation which is at 3.1% annually will likely remain relatively steady in 2014, as no additional inflationary pressures within China are foreseen to arise.



separate reasons. First, less than robust growth in the older, industrial countries (i.e., Japan, Europe, the US) since the 2008 financial panic is providing a significant drag on the ability of emerging market countries to grow their exports. Second, the rising tide of the strong growth period (2003-2010) lifted all boats, but the ebbing tide has exposed serious, although quite different, structural challenges in each of the BRIC nations. In addition to slowing economic growth, the structural issues outlined above have raised risk flags for global investors, as evidenced by emerging market currencies and equities coming under intense pressure in 2013.

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V. Market Implications Merge Individual Challenges and Global Influences

The country-specific considerations outlined above show a very wide breadth in type of structural challenges faced by the different BRIC economies. Potential solutions for many of these challenges will likely take strong political will and decisiveness – not always traits many governments (emerging market or otherwise) possess. The factor in common to all of these issues, however divergent they appear, is that these structural challenges are all working to constrain current (and potentially, future) economic growth in the four largest emerging market economies.

In summary, the emerging market economies, led by the large BRIC nations are seeing their economic growth decelerate from the superior pace which they had become accustomed in the previous decade. We have noted two

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