Euler Hermes Economic Research

# Economic Insight

# 2016-17: Tectonic shifts and risk of local tremors

October 18, 2016


Daniela Ordóñez, Economist
daniela.ordonez@eulerhermes.com

Ana Boata, Europe Economist
ana.boata@eulerhermes.com

Stéphane Colliac, Senior Economist
stephane.colliac@eulerhermes.com

Mahamoud Islam, Asia Economist
mahamoud.islam@eulerhermes.com

Ludovic Subran, Chief economist
ludovic.subran@eulerhermes.com


## Executive summary


- Global growth will decelerate to +2.4% in 2016, down from +2.7% in 2015. It could edge up to +2.8% in 2017, if regional tectonic plates continue to show resilience: improved growth in the US, and Europe, and stabilizing emerging markets.
- Earthquakes could come from: (i) a nudged policy stance in post-elections US; (ii) an unbalanced rebalancing in China; (iii) more political risk in Europe; as well as (iv) a disappointing come back of emerging markets after two years of belt-tightening.
- Three global tickets to watch: (i) Bankruptcies will rise by +1% in 2016 and +2% in 2017 with a higher cost overall; (ii) trade will disappoint (+3.1% only in 2017), still missing -USD1970bn in value terms compared to 2014; and (iii) last, commodities could surprise us once again.


### Imperceptible and slow movements at the surface, yet profound and risky paradigm shifts

2016 has been hectic. The year began with the Chinese stock market crash, followed by plummeting oil prices at USD25/bbl. The impeachment in Brazil, the Brexit vote, the failed military coup in Turkey as well as the growing uncertainty around the U.S elections outcome reminded companies that political risk is not a thig of the past.

Yet, the world has been resilient – to all appearances. These shocks have caused more angst than real pain. Global growth will decelerate to +2.4% in 2016, down from +2.7% in 2015. But there will be no collapse. Growth should then edge up to +2.8% in 2017 (seventh year below +3%), driven up by improved growth in the US and stabilizing emerging markets.

While headline numbers look uneventful, pressure points might come from a lot of places. When regional tectonic plates move and interact, frictions and structural shifts (faults) may translate into global consequences with long-lasting impact. Earthquake alerts and potential eruptions (caused by a fast-flowing monetary magma) are among the risks we identify for 2017.

### Be prepared for earthquake alerts from key regional plates

**Plate #1: The United States** - Everything is on hold ahead of the presidential elections scheduled

Figure 1
Real GDP growth (%)

| | *Weight** | 2014 | 2015 | 2016 | 2017 |
|---|---|---|---|---|---|
| **Global GDP growth** | *100* | **2.7** | **2.7** | **2.4** | **2.8** |
| United States | 22 | 2.4 | 2.6 | 1.7 | 2.2 |
| Brazil | 3 | 0.1 | -3.9 | -3.5 | 0.6 |
| United Kingdom | 4 | 3.1 | 2.2 | 1.6 | 0.7 |
| ***Eurozone*** | **17** | ***1.1*** | ***1.9*** | ***1.6*** | ***1.6*** |
| Germany | 5 | 1.6 | 1.5 | 1.8 | 1.7 |
| France | 4 | 0.7 | 1.2 | 1.5 | 1.5 |
| Italy | 3 | -0.3 | 0.6 | 0.8 | 0.9 |
| Spain | 2 | 1.4 | 3.2 | 2.8 | 2.1 |
| Netherlands | 1 | 1.4 | 2.0 | 1.6 | 1.7 |
| **Central and Eastern Europe** | **6** | **1.5** | **-0.1** | **1.4** | **2.2** |
| Russia | 3 | 0.7 | -3.7 | -0.9 | 1.0 |
| Turkey | 1 | 3.0 | 4.0 | 3.0 | 3.2 |
| **Asia** | **29** | **4.8** | **4.9** | **4.7** | **4.8** |
| China | 13 | 7.3 | 6.9 | 6.5 | 6.4 |
| Japan | 6 | -0.1 | 0.6 | 0.7 | 1.0 |
| India | 2 | 7.2 | 7.6 | 7.3 | 7.5 |
| **Middle East** | 4 | **2.6** | **2.7** | **2.3** | **3.4** |
| Saudi Arabia | 1 | 3.6 | 3.4 | 1.5 | 3.0 |
| **Africa** | **3** | **3.6** | **2.9** | **1.4** | **2.4** |
| South Africa | 0 | 1.6 | 1.3 | 0.5 | 1.5 |

** Weights in global GDP at market price, 2014*

*Source: Euler Hermes*


EULER HERMES
Our knowledge serving your success

A company of Allianz

for November. Consumers and companies are on a 'wait-and-see' mode. The Fed postponed the rate hike to December. US economic growth should reach +1.7% this year, before crawling up to +2.2% in 2017, as households' consumption and private investment may pick up after the elections.

The plate will indeed be nudged by policy-makers. We expect the Fed to raise rates by +0.25pp in Dec-16 and twice more in 2017 but markets have priced that in and spillovers will be limited (including on the mortgage market; see Figure 2). Outside of the US, we also expect limited impact this time. As for the fiscal policy, both candidates have announced a stimulus package to boost growth and revitalize ageing infrastructures, hence our slightly upbeat forecast.

**Plate #2: China** – Supportive economic policies will keep growth in a decent range while rebalancing (Figure 3 highlights winners and losers): +6.5% in 2016 and +6.4% in 2017. Fiscal policy will take the lead with higher investment to directly boost demand growth. Monetary policy will be accommodative (maximum one rate cut) as deflationary pressures and elevated financial risks recede. Yet, high corporate debt level, notably for State Owned Enterprises (SOEs), rising non-performing loans, and surging credit growth continue to be a problem. The RMB could depreciate by -2.5% against the USD, after -5% in 2016 and will continue to be volatile (reserve currency, Shenzhen-Hong Kong connection, OBOR ambition).

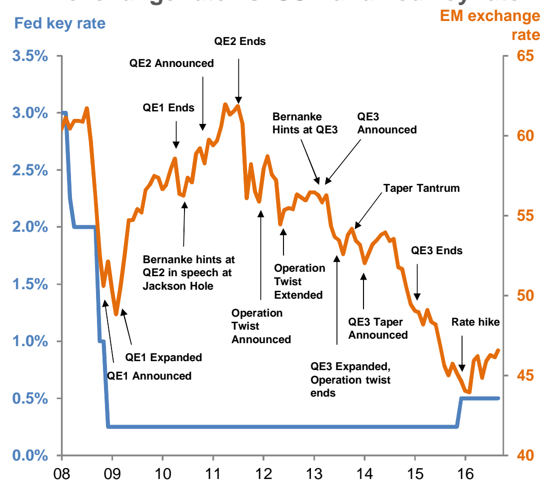
Looking forward, China should be kept in check. Tremors will be felt as confidence and capital flows depend on forward-visibility given by policy makers. For companies, bankruptcies will continue to increase, especially as zombie SOEs are let go. China will contribute less to global trade and yet grow its influence through abundant foreign direct investments. The question is, though, who is left to finance growth *in* China?

**Plate #3: Europe** - Growth will be stable at +1.6% in 2017 thanks to improved policy-mix. The ECB's QE program will continue to provide easy financing, which helps the construction sector *inter alia*. The Juncker Plan was doubled to reach EUR630bn by 2022, of which EUR116bn have already been disbursed. If the latter is fully implemented, it may boost the EU's annual GDP growth by +0.5pp by 2022, and double investment growth to +5%. Most countries are also encouraging a more conducive business backdrop (tax cuts e.g.) to fuel private investment growth spurred by higher consumption.

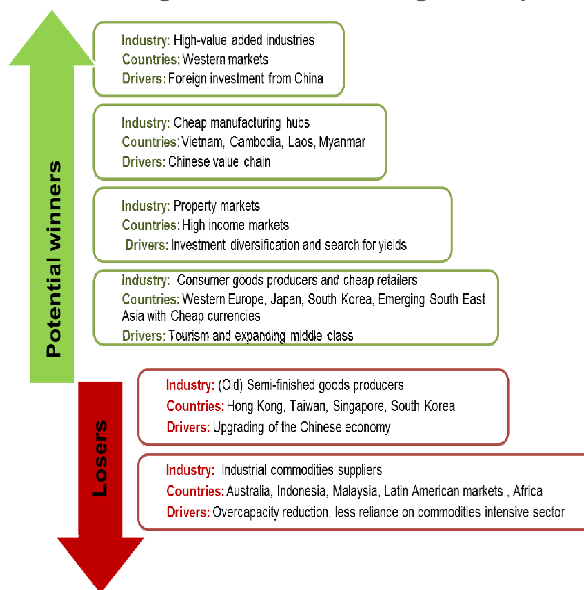
In a year from now, the face(s) of Europe may have entirely changed. Powerful political shifts are expected (Figure 4): referendum in Italy, elections in France, Germany and the Netherlands, risk of new elections in Spain. If one adds, tensions at the borders from the Brexit negotiation with the UK to nationalism in Poland and Hungary to the migrant crisis in Greece and Turkey, 2017 looks like a year of potential upheavals, with known impacts on the private sector.

**Plate #4: Emerging markets** - After years of intense quakes, emerging economies will regain some momentum (from +3.8% in 2016 for GDP growth, to +4.4% in 2017). Brazil and Russia will exit recession after three years of economic crisis.

**Figure 2**
**EM exchange rate vs. USD and Fed key rate**

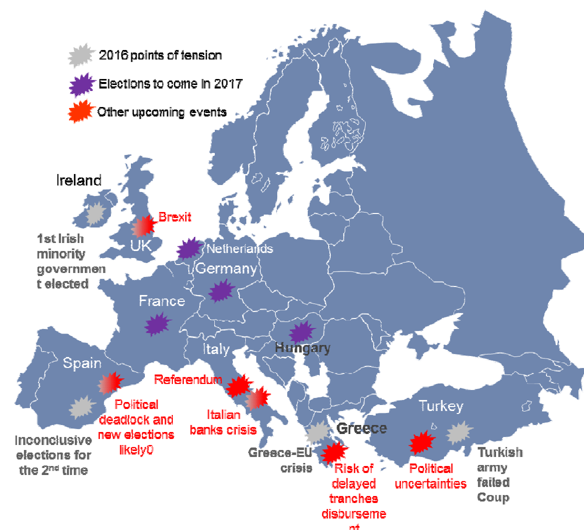



**Figures 3**
**China's growth normalization: global impact**




Source: Euler Hermes

**Figure 4**
**Mapping uncertainties in Europe**




Source: Euler Hermes

Activity will pick up in South Africa, Saudi Arabia and the UAE, after recording in 2016 the slowest growth pace since the financial crisis (Figure 5).

Emerging markets are back but selectivity is on. The drop in commodity prices, confidence shocks, public finances profligacy, and exchange rate depreciations have paved the way to more fragility in some countries. Nigeria (-0.4% in 2017, after -2.5%) and Venezuela (-5.7% after -10%), will both remain in recession next year. A growing number of countries turned to the IMF to avoid Balance of Payment crisis (Ukraine, Jordan, Serbia, Sri Lanka, Tunisia, and Kyrgyzstan e.g.). New candidates for IMF financial assistance are numerous as liquidity strains remain in frontier markets: Papua Guinea, Mongolia, Egypt or Belarus, are only some examples.

## One major friction and two widening faults

**The insolvency friction** stems from disappointing global growth. For the first time since 2009, insolvencies will increase by +1% worldwide this year. This trend should accelerate slightly next year (+2% in 2017; see Figure 6), driven up by bankruptcies in emerging markets. Brazil (+15%), Singapore (+15%) and China (+10%) will be the flop 3 when it comes to getting paid.

Although Eurozone countries will benefit from an ongoing decline, corporate insolvencies will surge by +8% in the UK as Brexit negotiations weigh on the private sector. The US will see a +5% rise in bankruptcies: the energy sector purge may be abating but not over.

The cost of insolvencies is increasing: in H1-16, 1 out of 5 firms that went bankrupt had a turnover above EUR1bn, compared to 1 out of 8 in H1-2015. The cumulated turnover of insolvent big companies reached EUR44bn in H1-15, against EUR28bn a year before. A domino effect is possible.

**The commodity fault** will keep oil prices low for a long time as oversupply is not receding, and demand does not catch up. We forecast average crude oil price of USD44/bbl in 2016 and 51/bbl in 2017. Though neutral for global growth, this price range will continue to cause divergence between net-exporters and net-importers.

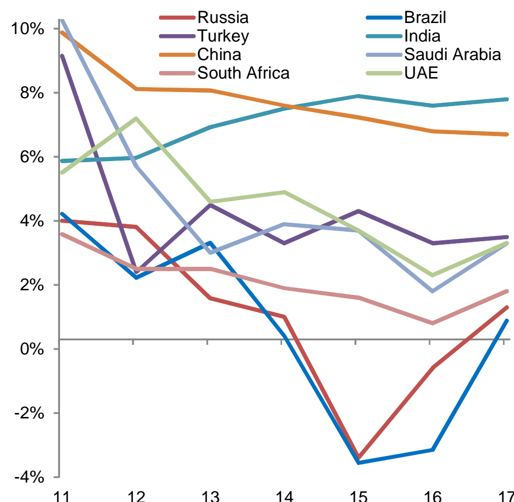
For the latter, the oil dividend is behind but low oil prices will keep helping consumption without a proper confidence boost (Figure 7). From commodity exporters, the stabilization will be welcome after two years of monetary and fiscal adjustments that restrained growth.

**The trade fault** seems too big to bridge, at least for now. In volume terms, trade is expected to grow by +2.1% in 2016 and +3.1% in 2017, far below the pre-crisis average of +7%.

In value terms, the trend may be even more alarming: -2.9% in 2016, after -10.4% in 2015. It is expected to rise by +5.7% in 2017 on the back of conservative reflation assumptions. Yet, the world would still miss -USD1970bn compared to 2014. This gaping hole of exchange goods and services equals the GDP of Italy.

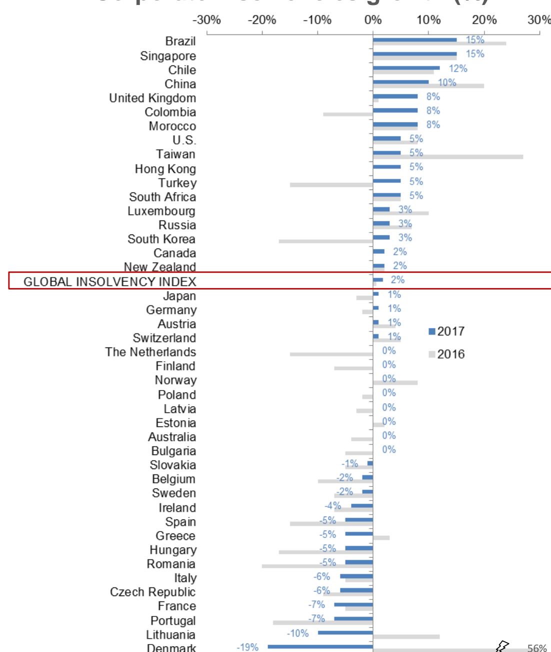
In the medium-run, momentum will still be difficult to achieve as servitization (and non-tradeable-oriented stimuli), financial fragmentation (rapid

**Figure 5**
**Real GDP growth (%)**



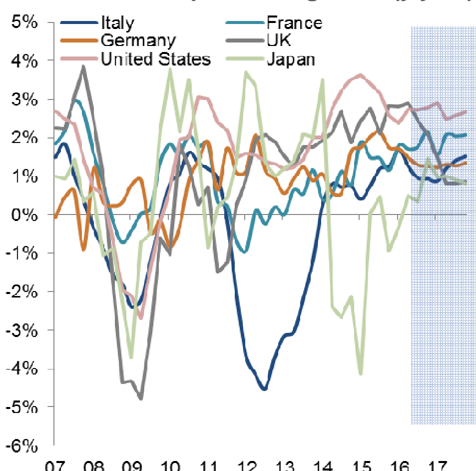

*Sources: National sources, Euler Hermes*

**Figure 6**
**Corporate insolvencies growth (%)**




*Source: Euler Hermes*

**Figure 7**
**Private consumption real growth (y/y, %)**




*Sources: HIS, Euler Hermes*

capital flight, hard credit conditions in emerging markets) and protectionism (+1800 new measures since 2014) are on the rise.

## Money magma: Playing with fire

Below the regional plates, the real risk lies in the absence of plausible price signals in the real economy, in spite of abundant global liquidity. As major Central Banks continue to be accommodative, only less disinflation in producer prices comes as a good news for stronger nominal demand ahead.

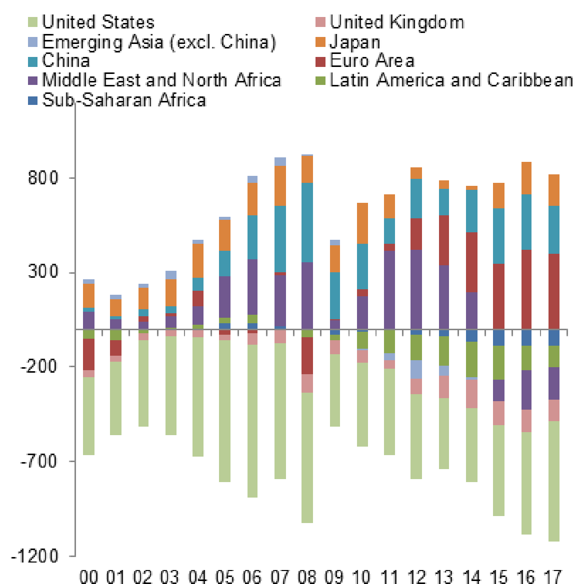
The global saving glut remains a challenge as imbalances remain (Figure 8). Precautionary savings is at unprecedented levels while leverage is cheap: USD7trn of cash remains trapped on companies' balance sheets without strong return-on-investment looming head. The money magma will continue to flow rapidly below the regional plates, generating volatility and risks of volcano eruptions.

**Volcano #1: Crowding-out effect**. Public debt purchases by Central banks are drying-up the sovereign bonds market, pointing to, if needs be, some market distortions, including ultra-low interest rates. The ECB has reached its target of monthly asset purchases (EUR60bn initially, later increased to EUR80bn) only three times since the launch of the program in March 2015. Scope and duration of quantitative easing will be announced but as low interest rates for longer will force agents to do the splits. Net-consumers are favored over net-savers, the business cycle over the financial cycle. Redistribution effects are overall positive but nudges to financial pure players should not be disregarded.

**Volcano #2: Emerging markets still lack financing**. While liquidity is abundant in the US, Europe, China and Japan, credit crunches mushroom in the emerging world. Portfolio inflows are recovering but remain below their long-term average. This has not translated into better credit conditions locally (figure 9). For companies, financing growth and investment is a challenge. The CAPEX of emerging markets is subdued.

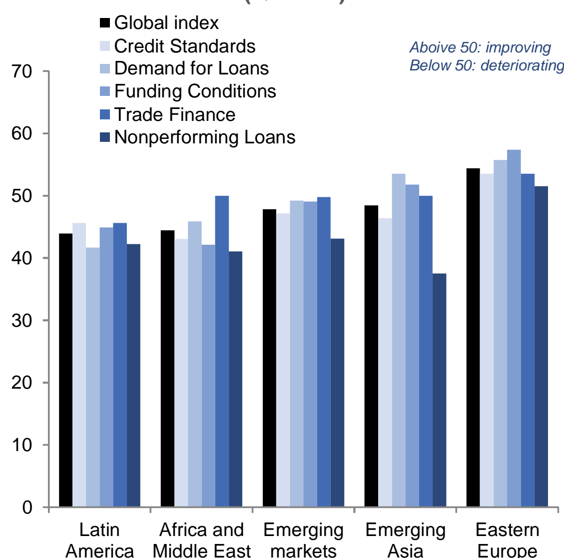
**Volcano #3: Bubbles?** Some stock markets (Brazil, Russia, US Tech) have over-performed, sometimes way and beyond what fundamentals suggest. Safe-haven currencies (JPY, CHF, DNK) continue to show strong valuations, despite monetary easing by Central Banks. Finally, real-estate markets are picking up fast: prices in Canada (Vancouver), Australia (Sidney), Sweden, New Zealand or Norway have risen sharply. Deflating such bubbles should be on policy-makers' to-do to avoid panic and/or welfare costs.

**Figure 8**
**Current account balance (USD bn)**




*Sources: IMF-WEO, Euler Hermes*

**Figure 9**
**Emerging Markets Bank Lending Survey (Q2-2016)**




*Sources: IIF, Euler Hermes*

DISCLAIMER
These assessments are, as always, subject to the disclaimer provided below.
This material is published by Euler Hermes SA, a Company of Allianz, for information purposes only and should not be regarded as providing any specific advice. Recipients should make their own independent evaluation of this information and no action should be taken, solely relying on it. This material should not be reproduced or disclosed without our consent. It is not intended for distribution in any jurisdiction in which this would be prohibited. Whilst this information is believed to be reliable, it has not been independently verified by Euler Hermes and Euler Hermes makes no representation or warranty (express or implied) of any kind, as regards the accuracy or completeness of this information, nor does it accept any responsibility or liability for any loss or damage arising in any way from any use made of or reliance placed on, this information. Unless otherwise stated, any views, forecasts, or estimates are solely those of the Euler Hermes Economics Department, as of this date and are subject to change without notice. Euler Hermes SA is authorised and regulated by the Financial Markets Authority of France.
© Copyright 2016 Euler Hermes. All rights reserved.



**Contact Euler Hermes Economic Research Team**
research@eulerhermes.com

**Publication Director**
**Ludovic Subran, Chief Economist**
ludovic.subran@eulerhermes.com