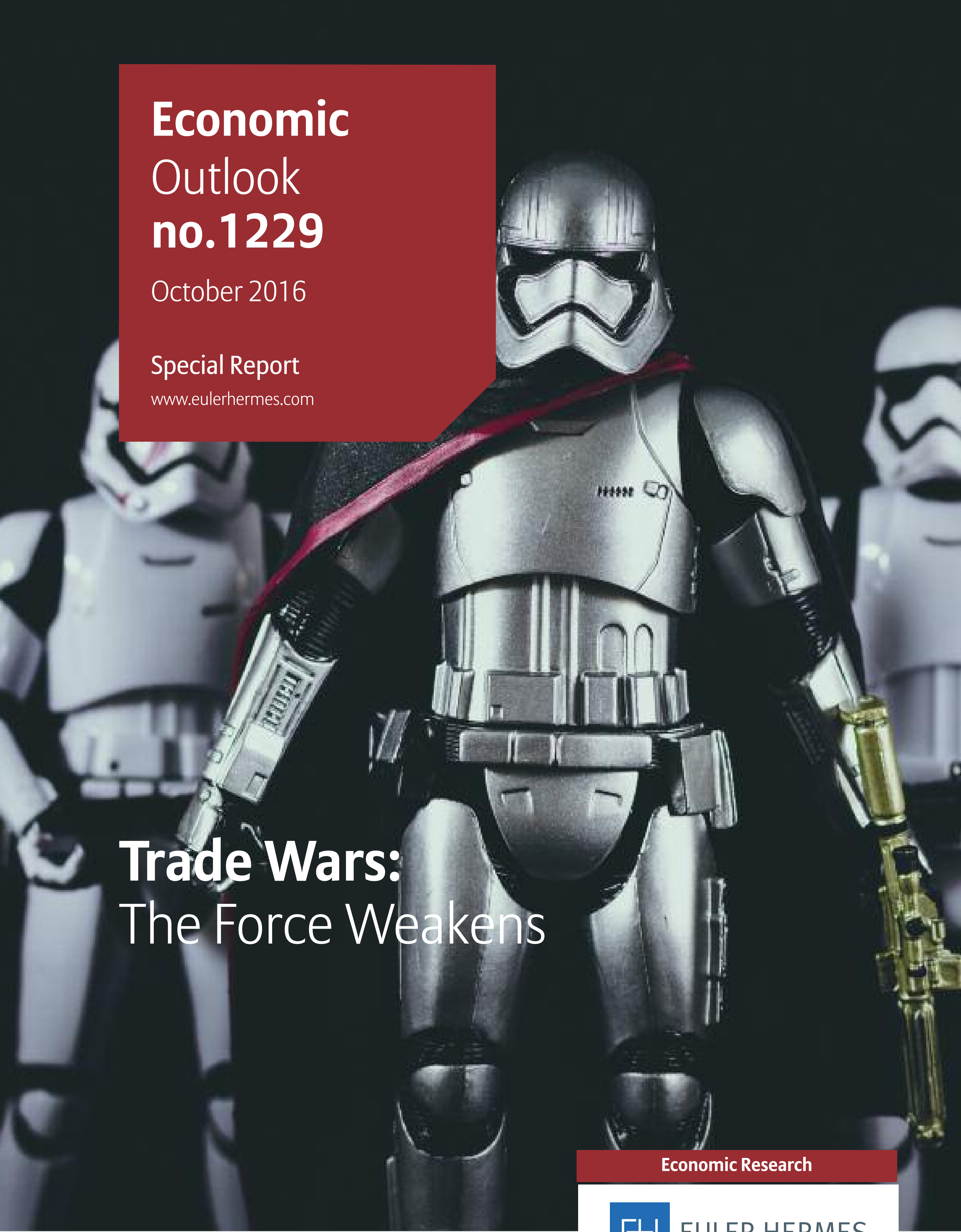

Economic Outlook no.1229

October 2016

Special Report

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Trade Wars: The Force Weakens

Economic Research

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Special Report

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EDITORIAL

"Judge me by my size, do you?"

LUDOVIC SUBRAN

In The *Empire Strikes Back*, Luke Skywalker is tasked with raising his X-wing from the swamp but he complains that it is too big, which frustrates Yoda — size matters not when it comes to the Force and to life. It is certainly one of the most memorable quotes from the Emperor's "little green friend." Yoda is an icon and his nuggets of wisdom (often in his backwards speak) do resonate with all of us, including economists.

While resilient (so far), the global economy is experiencing a succession of little (and not so little) crises from Brexit to the end of the BRICS armor, which can break the compass of many companies, especially those who still want to try their luck abroad. Trade, as a consequence, has been seriously disappointing over the past couple of years (deceleration of China, the US and the recessions in major emerging markets, the commodity counter shock, lack of forward visibility). More importantly, it appears that trade will never grow the same again, staying below the +4% growth mark in volume per annum. Why? Because of three major transformations: first, consumers all over the world demand more services (and experience) than goods; second, trade financing has become more complex and costly (longer delays of payments, currency risk, uneven credit conditions); and third, political risk and protectionism are on the rise (700+ protectionist measures per year).

So now what? Is it the end of globalization? Certainly not. Does it mean we need to rethink globalization? Yes, we do. Once a panacea, and the very objective (for survival) or many mercantilist countries (China, Germany, Canada) and companies, it looks like the recipe for globalization will have to evolve to be more inclusive, trust-based and handled differently by policy-makers and CEOs alike. The public and private sectors have indeed had a hard time adapting to the new trade paradigm. Hence the relative fiasco of mega trade deals (TTIP between Europe and the U.S. for instance).

At this point you may wonder why a Yoda quote in the title, right? In fact, what looks like impediments to global trade could actually become opportunities for smaller — and more agile — countries and companies in their quest to go global. Like a canoe in high tide, a younger company or a smaller (but grittier) country can succeed better under turbulence than the Titanic can. Examples range from Singapore and Dubai to Israel and Morocco. First, the digitalization and *servitization* of trade enables companies to immediately become multinationals (micro ones though) and not be limited to their catchment area or by very costly physical operations. Second, the fast-moving liquidity, which spurs cross-border M&A deals, enables companies to become international by acquiring others, thereby expanding their influence, their brand, their footprint. This happened even without a proper manufacturing base. Last, the defiance between countries will help rediscover regional blocks and allies, and align interests. This is particularly important for smaller countries and companies to grow their influence abroad, slowly but surely.

In the end, this report also is a reminder for every company out there to commit itself to trading safely, win or lose. Or as Yoda said it: "Do. Or do not. There is no try [for trade]."

The “**Trade**” Force Weakens

MAHAMOUD ISLAM, DANIELA ORDOÑEZ AND LUDOVIC SUBRAN

1• Global trade growth weakens to +2.1% in 2016 in volume. In 2017, it would grow by a modest +3.1%. In value terms, global trade will contract by -2.9% this year. Between 2014 and 2016, the world has lost -USD3129bn in exchanged goods and services, an amount close to the GDP of Germany. Demand shocks, the super slump in commodities prices, currency war, and *domesticalization* (lesser dependence on trade) explain this disappointing performance. Importers such as China will only see +USD41bn of additional imports over 2016-17. At the same time, the battle intensified between exporters. Germany is expected to post +USD75bn of additional exports in 2016-17.

2• In the medium-term, growth in the volume of world trade is expected to stay below +4% annually. There are three reasons behind this. First, structural shifts in global demand as the US and China have retreated for good, and (non-tradeable) services have grown faster than before in most countries. Second, financial fragmentation makes trade and debt financing (in USD) very complicated and competitive devaluation have failed. And last, the private sector has been startled by rising political risks and growing protectionisms measures (+352 in H1 2016).

3• Companies will have to find new alternatives to expand their business. First, they could rely on services and digitalization. Our Enabling Digitalization Index (EDI) shows that Germany, the Netherlands and Sweden are best placed to benefit from this transformation. Second, companies can rely on foreign investments to grow and internationalize differently. Cross-border M&A deals amounted to USD1.6tn last year. Chinese companies have embarked on a shopping spree. Last, in the wake of disappointing mega trade deals, rediscovering regional blocks appear as a necessary move.

+2.1%
Global trade growth in volume in 2016

“Growth, I am NOT your father anymore”– Trade Vader

Global trade of goods and services is disappointing. It is expected to slow down to +2.1% in 2016 (from +3% in 2015).
Global trade volume growth has increased at a limited pace over the past four years, twice slower than the pre-crisis average (+7%). In fact, sluggishness has pushed the trade growth rate closer to the GDP growth rate, and in 2016 it might even dip below the headline figure (estimated at +2.4% in 2016). Other institutions, such as the World Trade Organization, have raised concerns: they forecast +1.7% of trade growth (goods only) in 2016.
In value terms, the trend is alarming. Global trade is set to decrease further this year (-2.9% in 2016, after -10.4% in 2015). Between 2014 and 2016, the cumulated loss would amount to -USD3129bn, which is almost the equivalent of Germany’s GDP.

There are four reasons – all of them largely intertwined – which explain the particularly disappointing trade momentum in both volume and value terms, in the short run:

▶ **First, subdued demand**. GDP growth has been below +3% for six consecutive years as import-intensive consumption and investments, especially from the emerging world, have been missing in action. China, in particular, has reined in its import bill;

▶ **Second, the commodities super slump**. Global energy exports, for instance, are expected to fall by an estimated -USD518bn this year, before a timid recovery in 2017 (+USD280bn). Ferrous and non-ferrous commodity trade will also contract further this year, by -USD58bn;

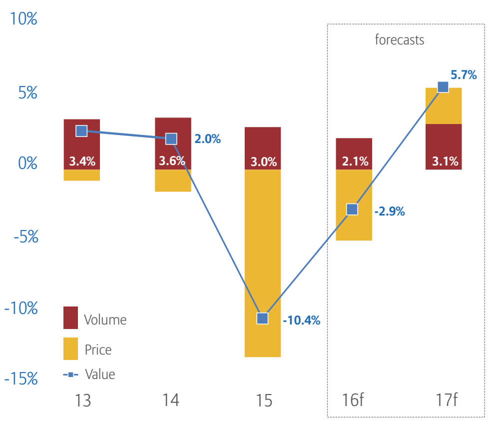
▶ **Third, a currency war**. The appreciation of the USD following the Fed rate hike, and the need to tighten the belt for commodity exporters and for China, have caused an unprecedented lose-lose race for depreciations. Currency depreciation against the USD is likely to stay the course in 2016. Currency depreciations shaved up to -USD960bn off global trade in 2016. Note that the problem is that few economies will regain competitiveness from these depreciations (no J-curve effect in sight);

▶ **Fourth, *domesticalization*.** In addition to a clear trend of value creation stemming from services (reaching 70% of GDP worldwide in 2017; it was 66% in 2007). Recent stimuli (oil dividend, tax cuts and subsidies, accommodative monetary policies) have translated into a higher consumption of non-tradable goods and services (care and leisure, real estate, financial services to name a few). As a reminder, services exports only represent 7% of total GDP.

In 2017, global demand growth is expected to increase moderately (+2.8% for global GDP), with momentum in both advanced economies and emerging markets (Brazil and Russia to exit recession e.g.); in particular, net commodity exporters should regain some purchasing power as prices gradually increase. Depreciation will ease from 2017 onwards as major economies also move to a firmer footing with an active stimulus. Last, some reflation should spread across most manufactured goods as producer prices stop declining. All in all, global trade in volume would increase by +3.1%, and by +5.7% in value. Yet, the world would still miss -USD1970bn compared to 2014, which is worth the GDP of Italy.

▶

Chart 1 Global trade growth

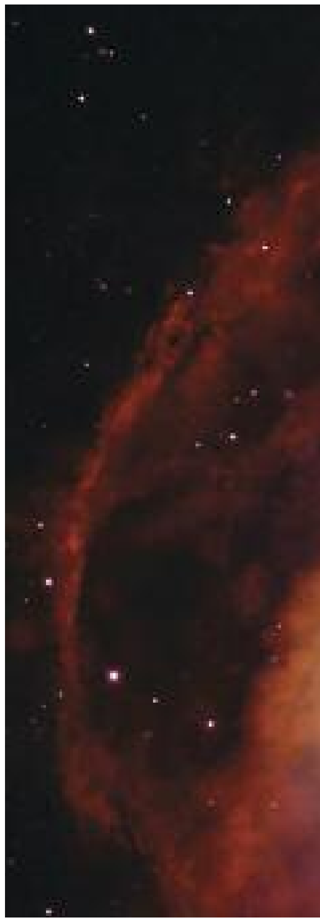


Sources: IHS, Euler Hermes

ZOOM

The Commodities **Menace**

Global energy exports will decrease in 2016 by **-USD518bn**



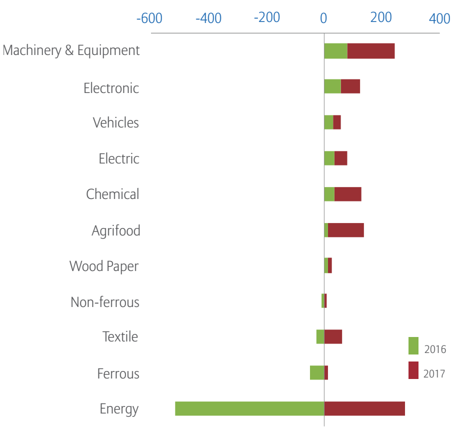
Unsurprisingly, it is the primary (commodities) sector which has been shaping the contraction in the value of global trade. Producers of primary industrial commodities will probably post another bad year, dragged down by lower prices. Stabilizing prices will not necessarily help recover the lost pricing power in 2016.

Energy (-USD518bn in trade value this year) and ferrous (-USD58bn) epitomize the bigger risk around the low-for-longer commodity countershock: (i) the inability to survive as debt levels were already high in the sector; and (ii) the transmission of deflationary pressures downstream (machinery and equipment sector e.g.). As a result, producers of low value-added goods, without pricing power (drop in commodity prices and currency depreciations for emerging markets) will face additional pressure.

The agri-food industry is likely to thrive with a modest improvement (+USD15bn in 2016). Yet downside risks weigh on the outlook, with a strong decline in prices (-18% in 2015) and weak demand outlook for large emerging markets such as China, Russia, and Brazil.

Sectors with more value-added content will prove resilient, benefitting from less sensitivity to prices. Exports of electronics and electrical industries will rise by +USD58 and +USD37bn, respectively, benefitting from higher private consumption in advanced economies and an expanding list of products included in the Information Technology Agreement (ITA). Vehicle exports will post growth of +USD29bn. Outsourcing production in competitive manufacturing hubs closer to the end user (as in from Japan to Mexico for US consumers) allows costs to be kept at a lower range and boost exports through regional sales. Machinery and equipment exports will post decent growth thanks to better pricing power (USD80bn). ■

Chart 2 Sector gains for goods exports



Sources: IHS, Chelem, Euler Hermes

Few (Galactic) import Empires and not much striking back

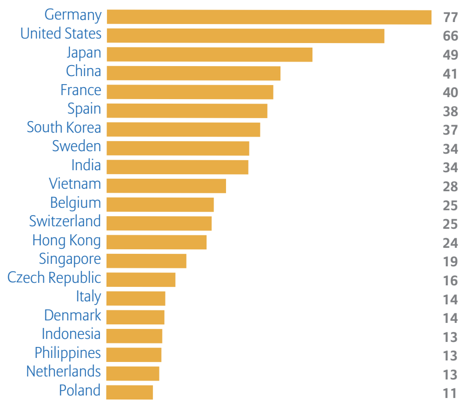
The first reason of this trade slow motion is sluggish demand. When ranking countries by additional import needs, GDP growth, size, and currency explain an unusual top 5: Germany (+USD77bn), the US (+USD66bn), Japan (+USD49bn), China (+USD41bn) and France (+USD40bn). While Germany tops the countries to look at to find export opportunities, China is only the 4th country on par with France when it comes to additional imports over 2016-2017. China stopped being the world largest outlet more than a year ago, pushing down massively global trade figures. Europe became the region of the world to go to for most exporters countries continue to rely on imported goods and services for consumption and investments.

We decided to cluster imports Empires in four categories using the types of atmospheres in the Star Wars Galaxy. From Type I, where levels of oxygen, nitrogen, and hydrogen are appropriate and the air is breathable by the majority of species to Type IV where the environment suit is required. To define these types of importers we used: (i) real imports growth to measure the strength of the demand effect; and (ii) imports gains in nominal terms (USD) to reflect size and currency effects. Global trade growth average was used as the cutoff for real imports growth (+2.6% p.a. over 2016-17); the average additional import needs (+USD10bn) was used for nominal import gains over 2016-17.

▶ **Type I**. Eurozone countries will perform above the global average in 2016-2017 with fair real imports increasing and significant nominal gains in USD terms (+USD248bn from 2015 to 2017). This growth will be underpinned by improvements in private consumption and investment. Some emerging markets will also see a gradual pick-up in demand. In ASEAN, particularly Indonesia, Philippines and Vietnam, demand will strengthen because of rising incomes and favorable demographics. In India, an improved investment cycle will be associated with imports of capital goods.

▶ **Type II**. Large (trading) economies such as the US (+USD66bn) and China (+USD41bn)

Chart 3 Additional imports needs by country
(cumulated change 2016-2017 in USDbn)



Sources: Chelem, Euler Hermes

will see a mixed performance with sizeable gains but below-trend real import growth. In both countries, a more service-oriented growth and more autonomous manufacturing sectors – i.e. less dependent on foreign suppliers for commodities for the US; of intermediate goods for China – will translate into moderate import growth.

▶ **Type III**. Some countries will perform well but gains will be small. These include countries related to the Eurozone economic cycle (including Slovakia, Portugal, Turkey, Morocco and Côte d'Ivoire), and countries combining positive growth prospects and strong business environment (Israel, Peru).

▶ **Type IV**. Commodity- rich countries will post lower import growth in USD terms as currency depreciation (for Australia, Canada, and Chile) leads to higher imports costs but also because of demand contraction (for Brazil, Russia and Nigeria). Countries with weak fundamentals (twin deficits, political stress), like Turkey, will record lower USD-denominated imports due to both currency pressures and weak demand growth. The United Kingdom will see lower growth as Brexit concerns translate to lower investment growth, while imports deteriorated with GBP depreciation. ▶

Chart 4 Global trade – Import drivers

Sources: IHS, Euler Hermes

The Return of the European (export) *Jedis*

Since most importers post decelerating demand, exporting has become harder and requires mastery. We have therefore established a typology of countries based on export performance corresponding to the four Jedi ranks. This new world order uses real exports growth average over 2016-2017 and cumulated gains in global market share over the same period.

▶ **First, *Jedi Masters* are highly experienced and demonstrate a great understanding of the Trade Force.** They combine strong growth of real exports (above global average) with a rise in market share. This includes core Eurozone countries and countries in the same value chain (such as Romania and Poland). These will benefit from a combination of cheaper currency, eased financing conditions and greater demand growth in their main partners (namely European Union members). This elite category also includes countries with strong competitive advantages (Vietnam, Philippines, Morocco and Kenya), thanks to cheaper labor costs, and strategic positioning in regional value chains (low-cost manufacturing hubs).

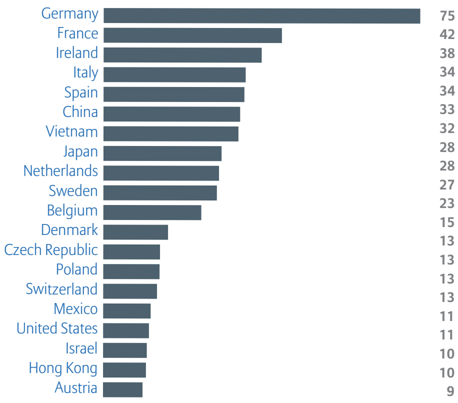
▶ **Second, the *Jedi Knights* are able to increase market shares despite lower volume growth.** These markets are experienced in trade and specialized in high-value-added products, which makes them relatively less sensitive to price shocks. Their safe-haven status means their currencies are a bit overvalued. Yet, domestic companies benefit from very accommodative policies and thus are able to remain competitive in the global environment. These markets will have a hard time this year but market conditions would become less restrictive gradually next year with further monetary easing from their Central Banks. This should result in cheaper currencies and looser financing conditions. For example, Denmark, Switzerland, and Japan have already shifted policy rates into negative territory to alleviate currency pressures.

▶ **Third, the *Padawans* (or *Jedi Apprentices*) are countries with strong potential.** They will record strong growth in real exports but lose market share due to strong price pressures. In China, for instance, weaker RMB will provide some boost to volume growth, but (i) deteriorated price competitiveness due to rising wages and strong appreciation of the currency; and (ii) limited demand growth overseas will translate into reduced exports in USD (+USD33bn cumulated over 2016-2017) and a loss of market share (-0.15pp over the same period). Countries with a strong market share (e.g. Saudi Arabia, Australia, and South Africa) and countries with a more diversified export base (Canada, Mexico) may enjoy strong growth in volume terms but market shares will probably decline without a price boost. For manufacturing hubs (e.g. Turkey and Thailand), weaker currencies will lead to lower USD-denominated exports but boost volume growth.

▶ **Fourth, the *Younglings* (or *Jedi Initiates*) refer to markets that are not able to benefit from the Force.** Exports growth is subdued, and negative price pressures prevail. This includes: (i) countries highly dependent on Chinese demand (primary industrial commodities and Asian intermediate goods suppliers); (ii) exporters suffering from monetary tightening or strong currency (United States) and (iii) markets that are affected by political deadlocks (Russia).

Even though *Master Yoda* thought that "*A Jedi uses the Force for knowledge and defense, never for attack*", in practice, some countries have demonstrated they can use the lightsaber better than others. According to our estimates, when ranking countries by the cumulated export gains over 2016-2017, the top 5 are Germany (+USD77bn), France (+USD42bn), Ireland (+USD38bn), Italy (+USD34bn) and Spain (+USD34bn). China only comes in sixth position with +USD33bn of additional exports expected in 2016 and 2017, closely followed by Vietnam and Japan. The return of the European *Jedis* is obvious.

Chart 6 Exports gains
(cumulated change 2016-2017)



Sources: IHS, Euler Hermes

Chart 5 Growth in real exports of goods and services and change in global market shares

Sources: IHS, Euler Hermes

Rogue trade: Why will it **never be** the same **again**?

Unfortunately, there is little hope that trade recovers fully to pre-crisis tempo, even post 2017. Some of the reasons behind the short-term slump resemble structural breaks, which could explain why trade will never be the same again. Three warning lights pop-up on the dashboard of the trade spaceship: shifts in demand, financial balkanization (USD financing shortage and ineffective currency wars) and political risks (protectionism).

Demand Stormtroopers

Global demand is struggling to find a solid footing as cyclical shocks become more frequent. 2015 marked the fourth consecutive year in which GDP growth has been below the +3% threshold. This situation will last until 2017 at least. More importantly, it seems that looking ahead the alignment of stars (US, Europe, China and emerging markets all growing full speed at the same time) will not happen anytime soon. This is one of the unexpected consequences of the global financial crisis, seven years on.
China and the US have been retreating from their role as global trade engines:
1• China is going through a transition. Firstly, it pivots from growth led by investment and exports (manufacturing) to growth led by consumption and services. At the same time, it shifts from producing low value-added goods to high-tech products. Then there is the move to a more sustainable growth, which is less resource and credit-intensive.
2• In the US, the energy revolution has paved the way for two structural changes. The first one is the decrease of energy imports as the US became autarkic. The second one is the competitiveness improvement for downstream industries due to lower input costs. We estimate that a 1pp decrease in real import demand growth from the US could shave up to 0.2pp of global trade growth.

Several local shocks threaten the future of trade. They are more frequent and have more negative spillovers on neighbor countries. One example is Brexit since the UK is one of the world top importers. This was a low blow for Europe at a time when the recovery also emanated from stronger intra-regional trade.
On top of country-specific demand loopholes, two major changes may explain why trade may never exceed +4% of annual growth in volume ever again.
The first change is the shortening of global value chains. The second is the growing share of (non-tradeable) services in value-added creation. For the first one, lower investment growth (often more import-intensive than consumption) translates into lower import growth. In addition, vertical integration of large economies affects global supply chains. This is the case for China in its quest to absorb first tier suppliers from Taiwan for instance, or multinationals which decide to compact value chain or re-shore when competitiveness is restored to gain quality. Import substitution has played a growing role in regional blocs.
As for the second change, it is not news that the share of services in value-added creation has been growing steadily over the past ten years. Yet, since the crisis, this trend has accelerated on the back of: (i) recent fiscal and monetary stimuli which supported domestic services in particular (financial, real estate, leisure); and (ii) the economic renaissance coming from the digital and tech revolutions whereby people have replaced basic materials and capital goods as inputs.


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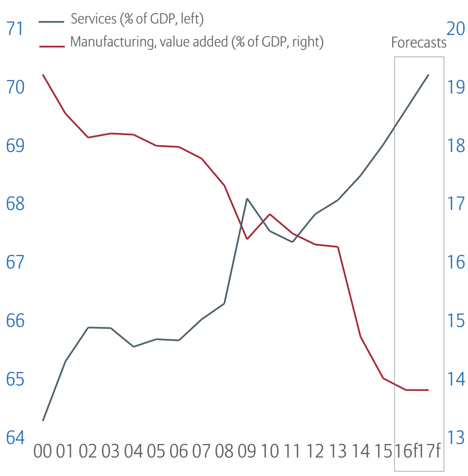
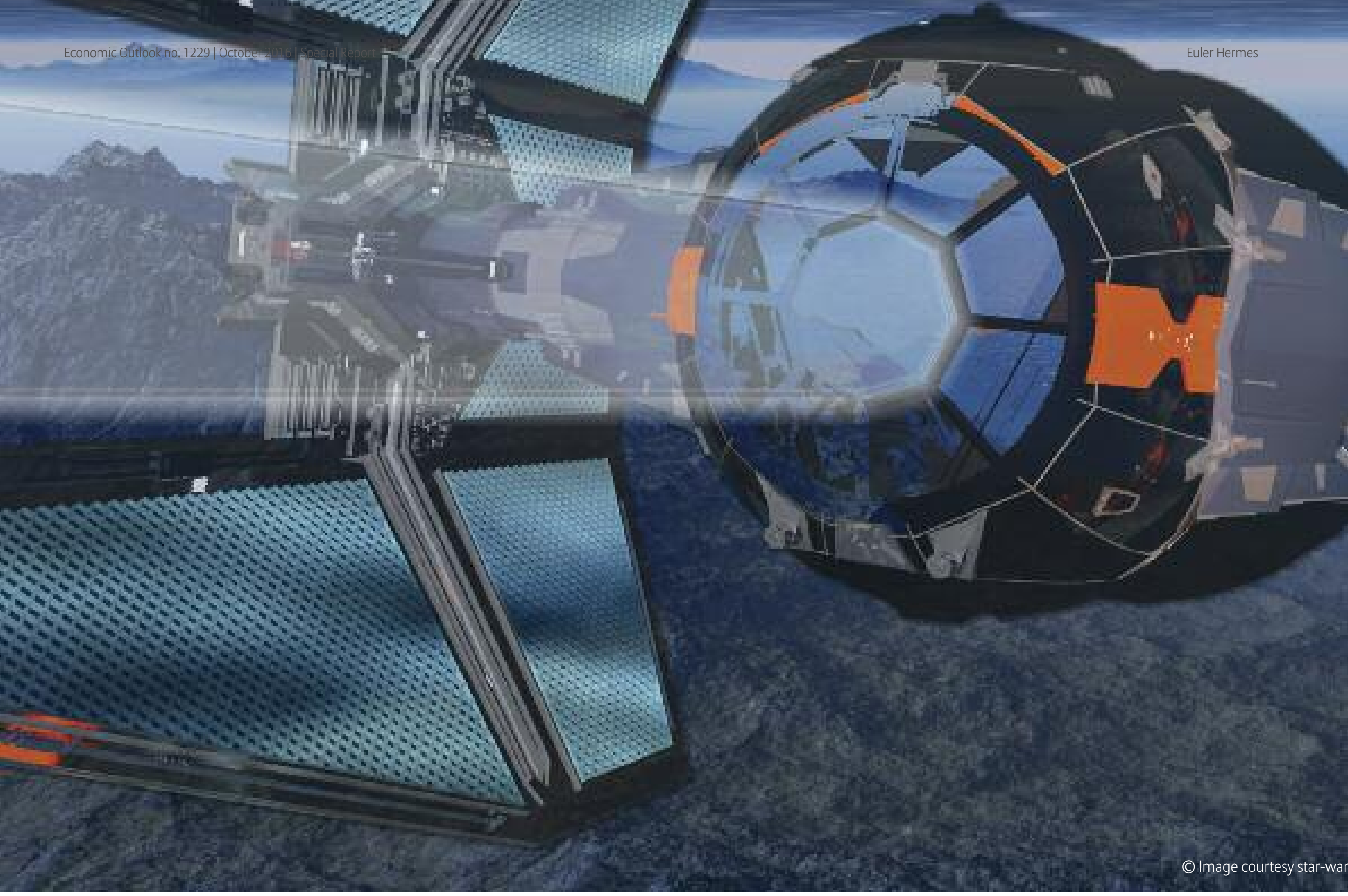
Chart 7 Services and manufacturing value-added
(as a percentage of GDP)



Sources: IHS, Euler Hermes

1pp
decrease in real import demand growth from China could shave up to **0.3pp** of global trade growth



© Image courtesy star-war

Death Star: Financial balkanization

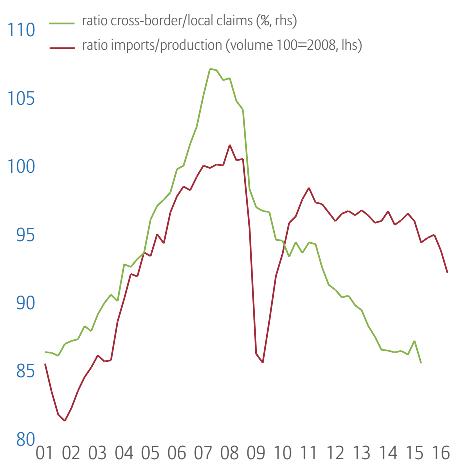
Financial globalization has been one of the main drivers behind the acceleration of trade globalization, and the financial crisis one of the main catalysts of the global trade collapse in 2009. Looking forward, it seems that one of the key reasons for subdued trade in the medium-run will be financial fragmentation. Shortage of USD financing, currency carnage, and capital controls are symptoms of segregated financial basins. Global governance has failed to deliver a quick fix to further balkanization of the financial flows.

A dollar drought

Dollar debt and trade grew hand-in-hand until 2014, as high commodity prices and low-interest rates led some commodity exporters to add production capacity (e.g. +USD800bn were added to their debt stockpile between 2006 and 2014 only for the oil sector according to the BIS). Since cash flows were denominated in dollars and were rising, they were used as implicit collateral allowing more dollar debt issuance. Further tightening by the Federal Reserve of the US and low for longer commodity prices have caused rising mismatches between dollar liabilities and dollar assets at the country, sector and company level, creating an urge for deleveraging and inhibiting trade flows in so doing. In addition, when an economy loses access to the international capital market, corporates have to redeem their debt instead of refinancing it and often cut investments, which leads to fewer imports of capital goods. When Central Banks lack foreign exchange reserves (unwillingness to share, sudden stops or simply fixed exchange rates), this downward spiral is accelerated and the probability of liquidity squeeze is increasing in the banking sector – especially when domestic credit is not crunching yet – making banks less supportive.

Disruptions in financial flows can also help explain the shortage. The ring-fencing of the world financial system is structural, a legacy from the Great Recession (2008-09) when European banks lost their leadership in the intermediation of global USD financing and never recovered it. As a result, cross-border bank flows have been re-oriented and banks got regionalized, especially for trade financing.

Chart 8 Import content of production index* and ratio of international-to-national bank liabilities



* import/production
Sources: BIS, CPB, Euler Hermes

The world is now divided into several sets of regional banks/peers. When a leading country in a region is losing steam (e.g. Brazil), banks effectively reduce their supply of financing for trade locally (e.g. in Latin America). Last but not least, new rounds of capital controls have been put in place around the world, especially in emerging markets, to avoid capital flight.

Currency carnage has failed to boost trade globally

The recent wave of currency depreciations around the world may have nudged global trade for good – and mostly negatively. Most countries, especially commodity exporters, were forced to depreciate (and raise interest rates) due to capital outflows, causing imports to contract (and trade balance to improve because of belt-tightening). A decrease in the value of currency can be useful for countries with improved financing conditions and for non-primary industrial commodity producers. For such economies, cheaper currencies may translate into better price competitiveness, which would lead to an increase in export volumes. In the end, while many currencies depreciated, this did not lead to export growth (J-curve effect) and only non-commodity exporters with a marked improvement in financing conditions usually succeeded in expanding their trade balance. Colombia, Russia, Brazil, Chile, Peru, Indonesia are as many examples of countries without a proper rebound post-currency depreciations. Among large economies, the Eurozone and Japan would benefit the most as a positive feedback loop took place between exports and GDP growth. In China, a cheaper RMB will provide some momentum. Yet mixed financing conditions for exporting companies – lower cost of domestic credit, but high debt, higher cost of external funding – will act as a drag. ▶

Chart 9 Real export growth versus growth in real effective exchange rate
(between 2013 and 2015)

Sources: IHS, Euler Hermes

May the force be with us: Political risk, protectionism, and defiance

Multiple political hotspots around the globe will continue to weigh on confidence, driving countries and multinationals to take a “wait and see” position. Some simply shore up defenses and close up to the world. From soured relations (and sanctions) between the West and Russia, to the risks of conflict in the Middle East to rising discontent in Brazil and South Africa, investors and companies have been overwhelmed with bad news coming from the political sphere. If one adds uncertain processes (elections, mega trade partnerships, Brexit), this has comforted a standstill weighing on trade prospects. Businesses can sustain populism and policy mistakes but could go belly up if their assets are confiscated or expropriated.

More importantly, protectionism could become more frequent and disrupt the business climate. In 2014, 792 protectionist measures were adopted. In 2015, there were 705 new ones; and in H1 2016, 352 on top. For a country like Russia, this adds up to 202 measures since 2014. In this flop 5 for open trade, India (158), the US (126), Brazil (107) and Indonesia (94) follow.

From the itemized list, one can observe that protectionism is becoming more diverse:

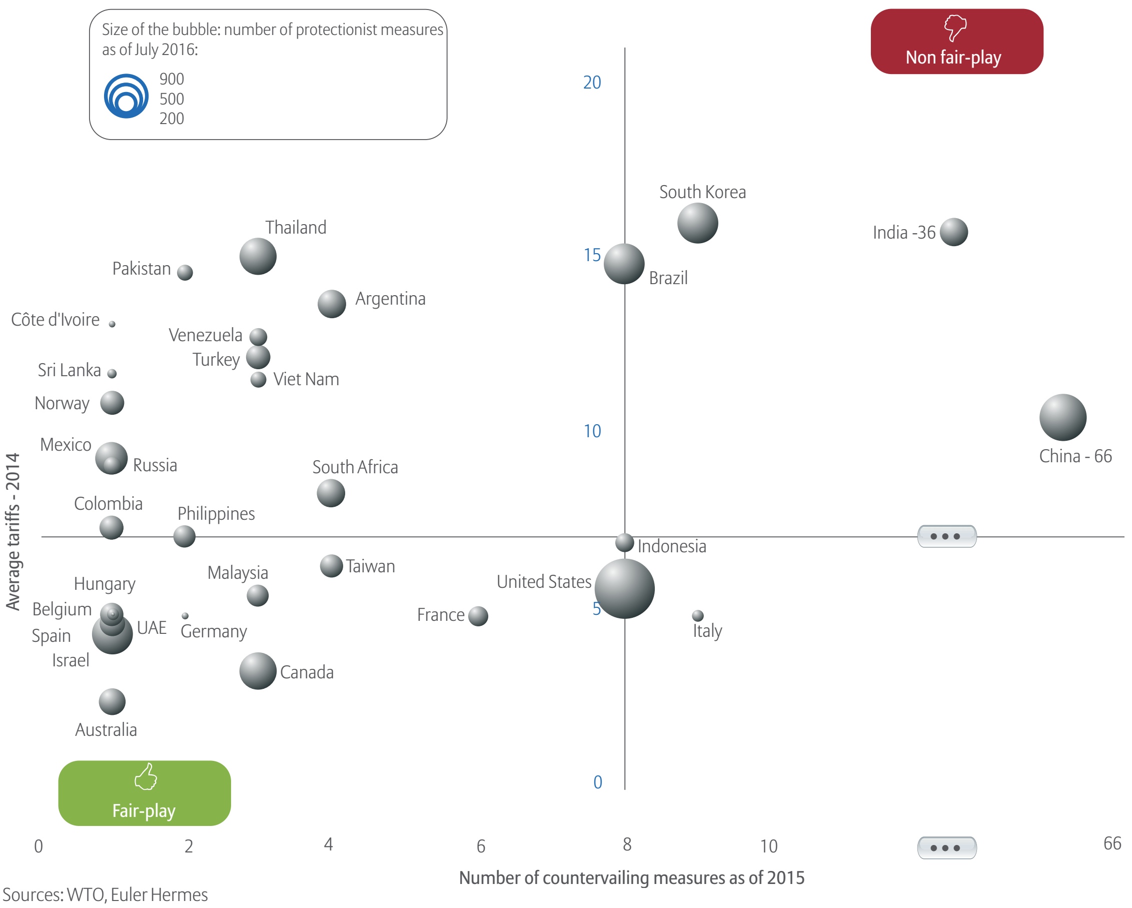
1• Classic: Trade barriers such as high tariffs and quotas. India (15.6% tariff on average) Brazil (14.7%), Argentina (13.6%) or Turkey (12%) are known for resorting to tariffs. Standards and norms are also a very known way to protect domestic production;

2• Almost classic (and growing): Protectionism is rampant in services as governments tamper with licenses and the regulatory framework. Courier services and broadcasting are closed for foreign investment in China. In India, only Indian nationals can obtain full licenses for legal services. In Brazil, air transport is almost closed for foreign investors with equity participation limited at 20% of voting capital. When ranking countries for trade restrictiveness: Indonesia, China, India, Russia and Brazil come first. Number six is Canada which shows that even if Canada has signed a plethora of bilateral trade agreements, services can be a touchier subject;

3• Less classic (but very used): Supportive measures can also come into play and are notably used by OECD countries (public banks, export promotion agencies, direct subsidies). The UK runs an extensive support network for enterprises. Its agency had a budget of EUR368mn, with specific sector and geographic priorities. China, probably the most aggressive player, has developed various programs to develop clusters, providing companies with cash bonuses, discount services, and preferential tax rates. The United States often supports exporters indirectly through tax cuts.

To get an idea of the landscape, we charted average tariffs and the number of countervailing measures as reported to the World Trade Organization (WTO), highlighting fair, unfair and lame players when it comes to open trade.

Chart 10 Protectionism at a glance



Sources: WTO, Euler Hermes

In the first half of 2016, **352 new protectionist measures** were adopted worldwide

The **sequel** trilogy: **Which internationalization strategies**?

With global trade below trend, companies will have to find alternative strategies to internationalize. Mirroring the three impediments to trade (demand shift, financial fragmentation and political risk), we believe there are three solutions for companies (and policy makers alike): digitize and focus on services even more, use investment flows to conquer the world (and repatriate dividends later), and work on the backdrop, including second generation trade partnerships.

New Hope: *Servitization* and digitalization

To quote Master Yoda once more: "Do. Or do not. There is no try.". It is the same with *servitization* and digitalization. Companies have to adapt fast and those who can use these trends will be better placed to go global.

New force #1: *Servitization*

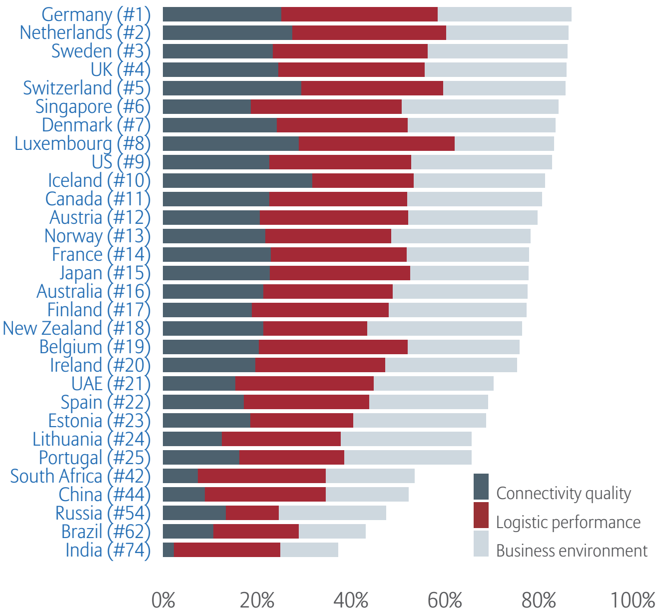
Trade in services has been less disrupted compared to trade in goods. In 2015, services exports as reported in the balance of payments accounted for 6.7% of global GDP (stable from 2014), while goods exports decreased to 22% (from 24%). Though in 2016, we expect a decrease worth -USD140bn, it reflects the sharp decline in transport services which account for 18% of total service exports due to the lower performance of marine transports. Note that in the first half of 2016, the Baltic Dry Index is still 50% below the average of 2014. Yet apart from this sub-sector, we expect a positive increase of +USD40bn in traded services. In 2017, trade in services will post an increase of +USD268bn.

Structurally, the higher consumption of services in large emerging markets like China, the dedicated stimuli in advanced economies, and the value-creation from user experience and new care models are changing the internationalization landscape. In China, for instance, services went above the 50% mark in GDP in 2015 (from 48.1% in 2014), the rise of the middle class is set to be accompanied with larger services imports. More importantly, companies are adapting fast through *servitization* that is the delivery of a service component as an added value, when providing products. From the automotive industry diversifying into financial services to the telecom operators administering after-sales service for virtually any company to the transformative impact of the internet of things (IoT), *servitization* of business has been on the rise. Equipping younger companies with *servitization* techniques early on in their internationalization is a good way to make sure that they will continue to innovate.

New Force #2: Digitalization

Another buzz word, digitalization, actually means something for the future of trade. Data is a new commodity and data flows are growing very rapidly, and are immune to the globalization slowdown. According to McKinsey, the amount of cross-border flows of data has grown 45 times since 2005 that is +4000% in 10 years, leading to 211 terabits of data flowing each second. ►

Chart 11 Euler Hermes Enabling Digitalization Index
(Ranking out of 135 countries)



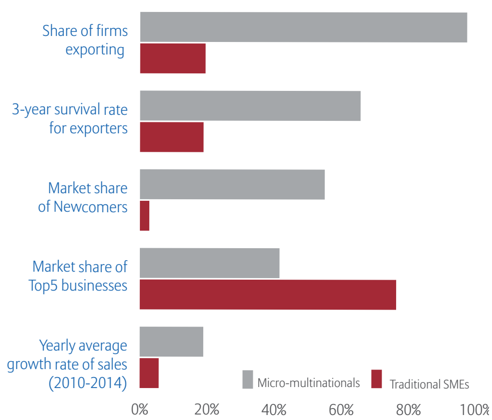
Sources: World Bank, Euler Hermes calculations

Digitalization contributes to **9.4%** of the annual global economic output **3.6%** is due exclusively to cross-border transactions

The big data bang is expected to continue, multiplying by x6.6 by 2020. Companies have to continue to tap into this infinite driver for openness, the same way the finance sector did earlier on. We estimate that digitalization of business activities contributes to 9.4% of the annual global economic output, of which 3.6% is due exclusively to cross-border transactions. We expect this contribution to increase rapidly in coming years and reach 16.6% of global economic output in 2020 (7.4% for cross-border transactions).

We built a proprietary weighted index to illustrate countries' ability to provide the necessary environment for effective internationalization of companies in the digitalization era: the Enabling Digitalization Index (EH EDI). 135 countries were included in the analysis. The index includes: (i) the quality of connectivity assessed by the number of secure servers, the ratio of internet users, and the ratio of telephone lines available to population; the World Bank's (ii) Logistic Performance Index; and (iii) Doing Business Index. Germany, the Netherlands, and Sweden lead the ranking. The UK, Singapore and the US rank in the top 10 countries best positioned to foster the international development of enterprises through digital. No emerging markets made it to the Top 20. None of the BRICS rank in the top 40 and China ranks 44th.The digital divide lingers.

Chart 12 Micro-multinationals and SMEs Which fares better?



Sources: eBay, Euler Hermes

ZOOM

Attack of the (micro-multinationals) **Clones**

While most companies are suffering from the structural slowdown in global trade, others have proven being adapting better: the micro-multinationals. These are companies, often small, and young, which decided to leverage technology (and notably the internet), to develop market activities worldwide, directly. Using eBay Marketplace data, we found the following:

✓ **Fact #1: Micro-multinationals export more** – While only on average only 20% of traditional SMEs export, 97% of the micro-multinationals embrace the adventure of exporting.

✓ **Fact #2: Micro-multinationals survive better in the exporting field** – The three-year survival rate is just 19% of traditional SMEs, while 66% of micro-multinationals continue to export after three years.

✓ **Fact #3: Micro-multinationals grow faster** – Exports on eBay platform increased by nearly 19% on average per year between 2010 and 2014, while exports of traditional SMEs only grew by 6%.

✓ **Fact #4: Better opportunities for newcomers** – Newcomer businesses in the eBay Marketplace are able to capture 55% of the export market in just one year, whereas, globally, new traditional SMEs enterprises make up only 3% of the traditional export market.

✓ **Fact #5: The value of export is better distributed among the population (better Gini coefficient)** – Among traditional SMEs, the top 5% of exporters account for 76% of the export market. This is not the case of SMEs using the eBay marketplace where the top 5 micro-multinationals only account for 44% of the exports on the eBay platform. ■

USD1.6tn
worth of cross-border M&A deals in 2015

The Revenge of Investment: Closing in on consumers

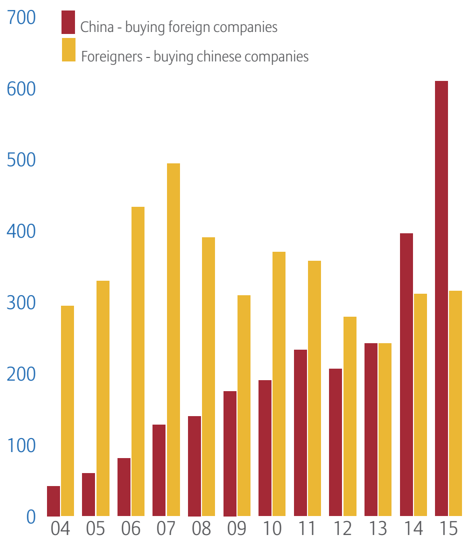
Companies may want to focus on increasing sales and investment earnings from overseas markets selling directly to the end-buyers, instead of export revenues.

In 2015, global net foreign direct investment inflows increased by +22% (after -20% in 2014). This was supported to a large extent by a rise in investment directed to the Eurozone and the US. In emerging markets, the trend was mixed. Key large economies were deemed less attractive as demand contracted (Brazil and Russia) or economic growth showed signs of weaknesses (China). On the contrary, accelerating economies continued to perform relatively well. India and Vietnam are two clear examples.

The vehicles for Foreign Direct Investments (FDI) were mostly cross-border Mergers and Acquisitions (M&A). Buyers splashed out USD4tn on M&A deals in 2015, including minority investments. This marks the highest amount ever, surpassing the previous record set in 2007. Cross-border deals contributed to this dynamic. In 2015, these grew +18% compared with +13% for M&A deals in total, reaching USD 1.6tn. Consumer-related activities such as pharmaceuticals and agrifood were the most targeted sectors, representing 1 out of 4 cross-border deals. European corporates are increasingly targeted by foreign acquisitions both from the US and Asia, notably Chinese and Japanese firms. These deals are boosted by a weak Euro (compared to the USD), abundant liquidity, and cheap debt.

China is becoming a key global player. Acquisitions by Chinese corporates have peaked at USD596bn in 2015, almost a fifth of which were cross-border deals. Companies from China were particularly active in the technology & communication and consumer sectors, close to 45% of their acquisitions abroad. The trend is aligned with the economic model adjustment initiated by the government. China is seeking not only returns but also advanced technology.

Chart 13 Number of M&A deals initiated on Chinese companies or by Chinese companies



Sources: Bloomberg, Euler Hermes

Though we expect a more modest increase this year, there are three reasons to believe FDIs flows will offset (partially) disappointing trade:

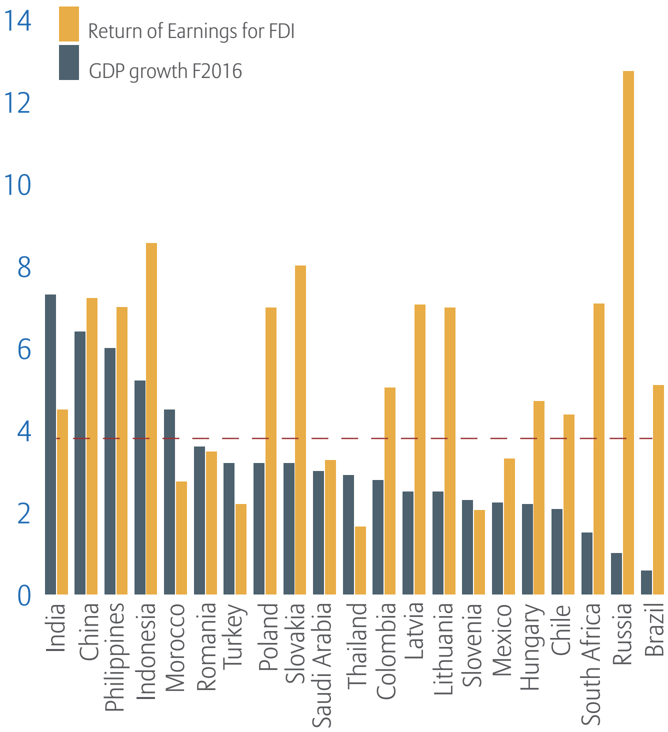
► **First, households' consumption** accounted for 59% GDP in 2015, up from 58.3% GDP in 2014. Companies will need to get closer to their customer to understand their needs better (and be hedged against currency volatility).

► **Second, cash-rich companies in Japan or the US** (with appreciating currencies) could choose to invest in countries where assets are cheaper.

► **Third, improving profits (+5.8% 4q/4q in Q2 2016 in the Eurozone)**, poor returns on investment in some countries (Japan, Taiwan, and South Korea) and excess savings (China) are looking for safe havens where demand will eventually come, more certainly abroad, for both protection and promotion reasons.

To find out destination countries for investment, the outlook and business climate matter. This is why FDIs have returned to Europe and are continuing to flow in Vietnam or Morocco. A solid financial system, a hard currency, a strong regulatory framework, good payment behavior between companies, low taxation, and a sizeable domestic market are all among key determinants for FDI inflows, as per the literature. To go one step further, we decided to rank emerging markets by GDP growth in 2016 and map the estimated return of earnings (RoE) for FDI (Income paid on FDI over FDI inward stock) using a 3.8% (average growth) cutoff. Asian markets and particularly the Asian giants – China, India and ASEAN – lead the pack as they offer both high growth and high returns. These are followed by countries with strong growth and fairly decent returns in North Africa (Morocco) and Eastern Europe (Turkey, Romania, Poland, Slovakia). The latter present improved growth prospects thanks to the Eurozone's recovery and provide solid returns.

Chart 14 GDP growth and Return of Earnings for FDI
(Income paid on FDI over FDI inward stock)



Sources: IHS, Euler Hermes

+5.8%
4q/4q
profits growth
in Q2 2016
in the Eurozone

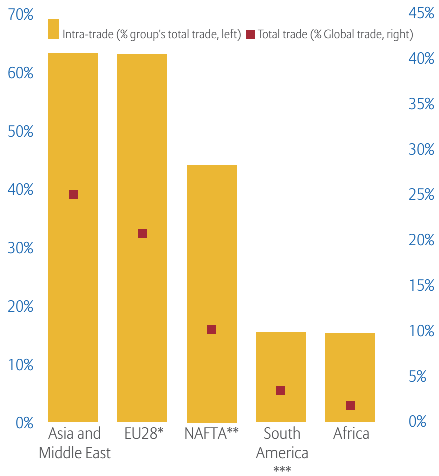
The Return of the Blocks, with or without Free Trade Agreements

Although global trade integration paused, global trade organization is still region-centric. Three regional blocks, the European Union (32% of global trade flows), Asia and Middle-East (39%) and North America (16%) account for 87% of global trade. Intra-trade represents more than half of the European Union and Asia's trade flows, it is 44% for North America. Rediscovering regional epicenters (for Latin America, Eastern Europe, ASEAN or the Europe-Middle East-Africa region) and the power of gravity will be essential to find the critical mass and yet trade safely.

In the meantime, horizontal trade agreements seem to have lost momentum. In the early 1990's a slew of free-trade agreements and treaties – from Maastricht to NAFTA – seemed to take the world by storm. A generation later, mega Free Trade Agreements (FTA's) are at a critical crossroads as the benefits of globalization, once acknowledged for all (cheaper prices, new jobs, innovation) seem to only benefit a few while the middle class fears job destruction. Meanwhile, SMEs do not seem to be able to benefit from bigger but more complex playgrounds. Both US-led mega trade deals seem to be stalling. The Trans-Pacific Partnership (TPP), which connects Pacific nations from the US to South-East Asia, or the Transatlantic Trade and Investment Partnership (TTIP), which links the EU and the US, could have replaced global trade governance in the longer-run.

Mega-scale agreements aim at fostering trade and investment integration but also at an alignment of business practices. Yet, without an accompanying social compact (safety nets, transition subsidies) and more transparency, the man on the street seem to oppose such deals on both sides of the Ocean, in spite of immense benefits.

Chart 15 Intra-trade and trade per region



*European Union
** North American Free Trade Agreement
*** and Central America

Sources: UNCTAD, Euler Hermes

What does the future hold? Certainly a different set of alliances. We believe that three blocks have yet to be reorganized: the Americas, with a new role for the US, the EMEA region, with the Eurozone at its center, and Asia led by both Japan and China. These very instinctive and geographical regions hold secrets to their coherence: their size, the structure of their value chains, and their relative financial independence. In each block, the epicenter, once a colonial super power has to revisit its influence through better co-development. Though consumer demand, know-how, and hard currency will certainly continue to come from these epicenters, it is important to start reinventing equitable trade basins to avoid massive failures.

We have three blocks:

1• The vertical basin – Europe has to consolidate its east and its south. In the South, selectivity and cautiousness will be vital for companies as the outlook for the Middle East is still risky. However, the advantage of backwardness of African countries (including Côte d'Ivoire, Ethiopia, Kenya, and Tanzania) offer unprecedented options for developing economic ties beyond commodities. Manufacturing, innovation, and leapfrogging consumers are important trends in the region. Some hubs (Morocco, Côte d'Ivoire, Kenya) and future super powers (Nigeria e.g.) need to be revisited, especially when it comes to financing growth.

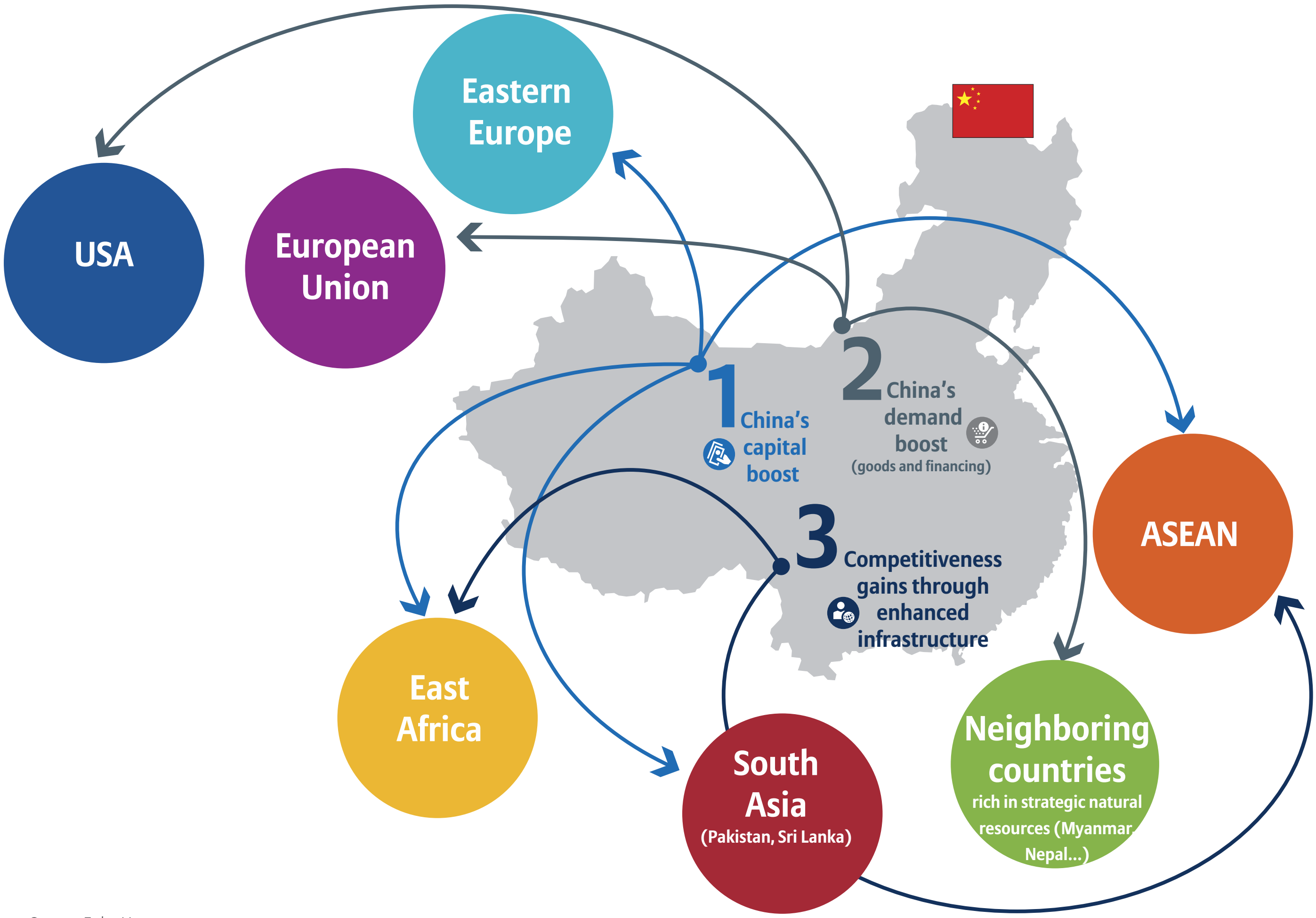
2• Instead of TaPPing into cross-ocean trades, the US should provide ammunition to the wider American trade basin to be strengthened. The disappointing Brazilian outlook and the difficult return of Argentina have halted trade momentum in South America. The Pacific Alliance coun-

USD1.6tn
the total firepower of the One Belt One Road project

Chart 16 Five OBORtunities for China

Source: Euler Hermes

Chart 17 Who could win outside of China?



Source: Euler Hermes

tries and Mercosur countries have yet to find their complementarities but all thrive on dollar terms. Better innovation sharing and mobility (including of human capital) will be key in re-developing the partnership and providing a platform for regional mega companies.

While mega trade deals take more time to be delivered, each individual country is revising its own trade policy. One concept that recently emerged is called progressive trade policy. A progressive trade policy aims at being relevant, transparent, inclusive and value-based. It is supposed to avoid any type of dumping, care for redistribution in benefits and help create value along the way. Canada and the EU are at the forefront of such policy-making. Yet many countries still struggle to find the right balance between offense and defense. The best example is China.

3• Last, China decided to launch its own mega trade deal called the **One Belt One Road initiative**. Its strategic goals include connectivity and cooperation on a vast scale by reinforcing trading routes from Asia to Africa, Middle East, and Western Europe. In practice it is a much more regional initiative, aiming at realigning the Asian Tigers. Outside of China, the impact would be felt through a capital boost in ASEAN, South Asia (Pakistan, Sri Lanka) and East Africa. It would go through a gradual increase in demand from China for strategic natural resources (e.g. Myanmar for natural gas, Mongolia for copper). Another channel would the rise in competitiveness as infrastructure for trade improves (Cambodia, Myanmar, Laos and Vietnam, East African markets). Some projects have already started. For example, in ASEAN, the Malaysia-China Kuantan Industrial Park project is ongoing with an investment of about USD3.4bn. In South Asia, the China-Pakistan Economic Corridor project is in progress. So far, the total firepower of the OBOR project, when incorporating the funds of the Asian Infrastructure Investment Bank, the Chinese silk Fund, BRIC New Development Bank, the promises of both Chinese development bank and China's sovereign wealth funds, is worth at least USD1.6tn.■

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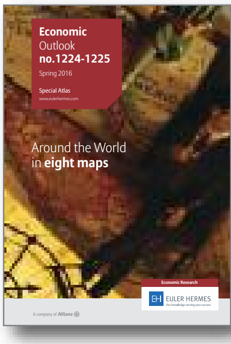

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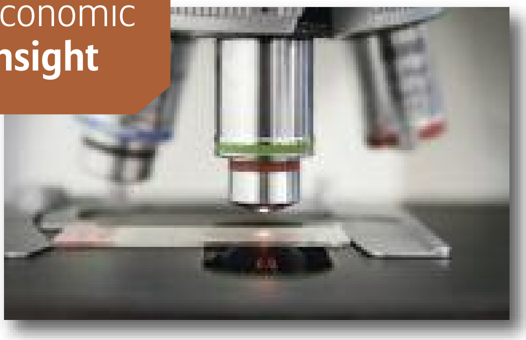

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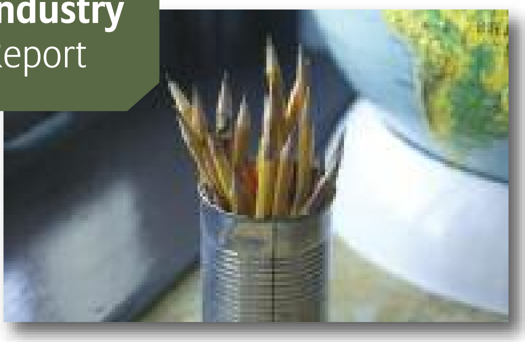

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