Euler Hermes Economic Research

Economic Insight

Why is global growth a FLOP(s)?

April 13, 2016

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Executive summary

- It looks like we are stuck in a **multi-low-speed world:** global growth is expected to slow down marginally to +2.5% in 2016, after +2.6% last year. Advanced economies will grow moderately (+1.8% in 2016) while emerging markets need more time to bottom-out (+3.6%, a new record low since 2009). As a result, 70% of global GDP will be slowing down or in recession and our Global Insolvency Index is expected to increase by +2% in both 2016 and 2017, the first rise since 2009.
- Why is global growth disappointing? Because of the **FLOP(s),** these bottlenecks which asphyxiate growth: subdued trade and investment **Flows** – and antsy capital ones; segregated **Liquidity** with horns of plenty and drought-prone asset classes; low for longer **Oil** and commodity prices triggering unwanted second-round effects; hesitant and uncoordinated **Public Policies**; and possible downside **Surprises**.

Multi-low-speed world, almost under control

The start of the year has been stormy and volatile. Markets were unnerved by suspicious symptoms of a global economic downturn: the slowdown in China, the renewed fall in oil (and commodity) prices and the rise of the dollar. Yet the falls in equity prices have been driven by the energy and banking sectors pressured by the counter oil shock and the interest rates environment.

In the real economy, there is one major reason to worry: the return of credit risk. CDS premiums on investment grade corporate bonds have increased across regions since Q4 2015. This reality already trickled down to the risk of non-payment: our Global Insolvency Index is expected to increase by +2% in both 2016 and 2017, the first rise since 2009. Double digit growth in insolvencies will be registered in Asia and Latin America. At the same time, the US's rebound is explained by the tightening financing conditions and contracting manufacturing sector. Business insolvencies in Europe will continue to moderate further, but only slightly, while levels remain considerably above 2007 levels.

Overall, we remain in a **multi-low-speed world** where global growth is expected to slow down marginally to +2.5% in **2016,** after +2.6% last year (see Figure 1).

Figure 1: Euler Hermes GDP growth forecasts

	*Weights**	2014	2015	2016	2017
Global GDP growth	*100*	**2.7**	**2.6**	**2.5**	**2.8**
United States	22	2.4	2.4	2.1	2.0
Brazil	3	0.1	-3.9	-3.5	0.3
United Kingdom	4	2.9	2.2	1.9	1.8
Eurozone	**18**	***0.9***	***1.5***	***1.6***	***1.7***
Germany	5	1.6	1.4	1.7	1.8
France	4	0.2	1.1	1.3	1.5
Italy	3	-0.3	0.6	1.0	1.2
Spain	2	1.4	3.2	2.6	2.1
Central and Eastern Europe	6	**1.5**	**0.0**	**1.3**	**2.2**
Russia	3	0.7	-3.7	-0.9	1.0
Turkey	1	3.0	4.0	3.3	3.5
Asia	**29**	**4.8**	**4.8**	**4.7**	**4.7**
China	13	7.3	6.9	6.5	6.4
Japan	7	-0.1	0.5	1.0	0.6
India	2	7.2	7.5	7.6	7.8
Middle East	4	**2.8**	**2.7**	**2.3**	**3.5**
Saudi Arabia	1	3.6	3.4	1.5	3.0
Africa	3	**3.5**	**2.7**	**2.8**	**3.6**
South Africa	0	1.5	1.3	1.0	1.5

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

Sources: IHS, Euler Hermes' forecasts

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Advanced economies remain in a moderate growth mode (+1.8% in 2016). Emerging markets need more time to bottom-out: Euler Hermes forecasts a slight slowdown to +3.6%, a new record low since 2009. Overall, more than 70% of world economy will slow down or be in recession in 2016 (see Figure 2). China, the US, the UK, Turkey, and Saudi Arabia will disappoint this year.

The US and the UK are indeed ending their recovery cycle. China will tiptoe around the 6.5% mark, a new regime. Brazil, Russia and Argentina will remain in negative territory. The risk landscape in emerging markets started to derail two years ago and does not seem over yet. As a consequence we had several downgrades in our short-term country risk ratings for emerging markets: Brazil was downgraded twice (from Low to Medium risk in Q3 2014 and to Sensitive in Q3 2015); China was downgraded from Low to Medium risk in Q3 2015; South Africa, Chile, and Colombia moved from Low to Medium risk in Q4 2015 (see Country Risk Map).

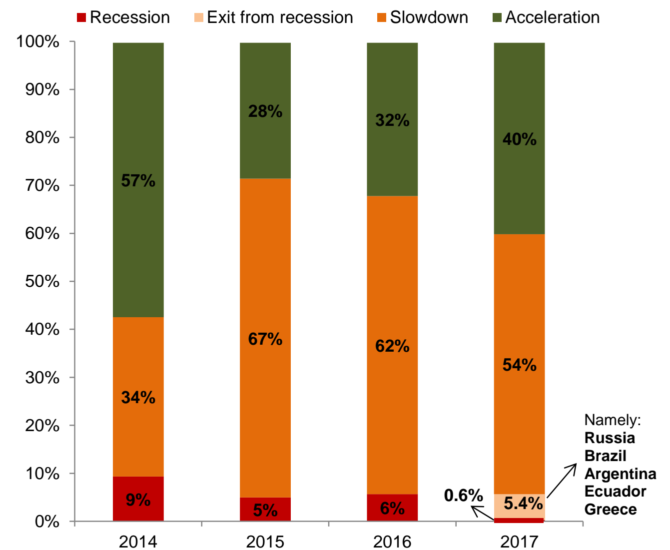
We believe that the **FLOP(s)**: **Flows**, **Liquidity**, **Oil prices**, **Public Policies** and **Surprises** will hinder robust growth this year. **In 2017**, global GDP growth is expected to slightly accelerate to +2.8%, the highest pace since 2011, yet the 7th consecutive year below +3%. To achieve this forecast, recessions will have to end in Brazil and Russia, and oil prices to recover above the 50 USD/barrel mark (to support growth for oil exporters).

#1 Subdued Flows

Trade Flows will remain anemic in 2016 with stable volume growth at +2.7% and continued contraction in value (-2% after -10% in 2015, see Figure 3). Yet, judging by the number and record-value of cross border mergers and acquisitions, investment flows may be picking up a notch. Direct Investment Flows will be supported by cash abundance, attractive pricing in emerging markets, and weak organic growth for companies. China, for instance, has played an increasingly important role as an investor abroad (mainly in Europe). Consumer-related, tech and innovation sectors stand out as the largest targets for investment.

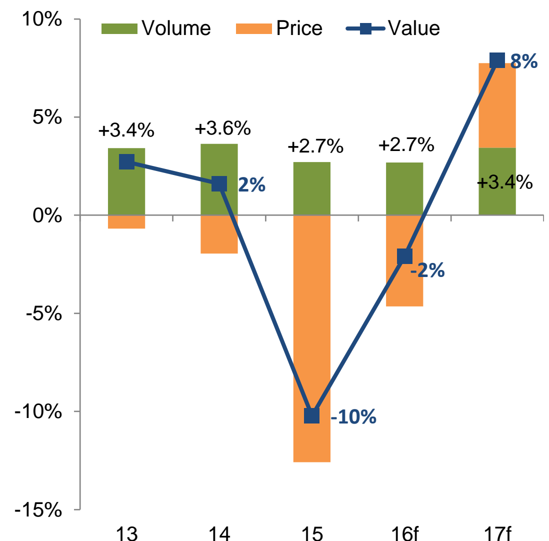
Despite the recent upturn in capital Flows in some emerging markets in Q1, investors will remain selective as capital flows are fickle. Sudden surges and sudden stops are still likely. Indeed, there are still a few negative factors that could offset the positives: still disappointing GDP growth, increase in business insolvencies, China's slowdown and increasing political hotspots. Figure 4 shows vulnerable countries given their exposure to the commodity cycle, their dependency on external financing (current account deficit) and the moves of their currencies related to the dollar since mid-2014. Countries like Brazil, Venezuela, South Africa, Angola, Ecuador, Egypt and Turkey look vulnerable and need close monitoring.

Figure 2: Global country risk profile



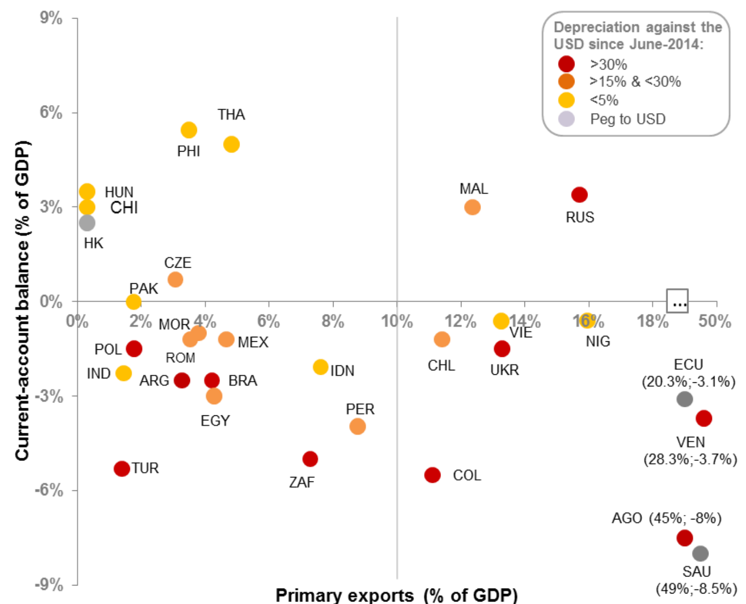
Source: Euler Hermes

Figure 3: Exports of goods and services (volume vs. value)



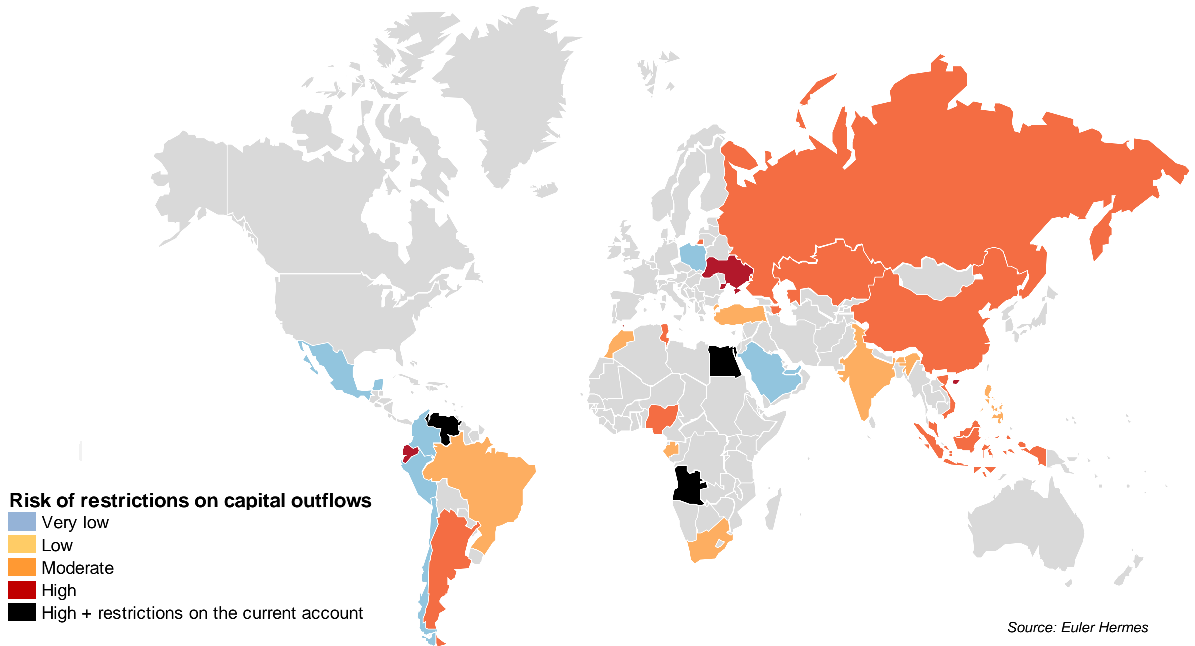
Sources: IHS, Euler Hermes forecasts

Figure 4: Emerging markets exposure to short-term capital flight



Sources: Chelem, IMF, IHS, Euler Hermes

Figure 5: Risk of capital and current account restrictions in emerging markets in 2016 relative to 2015



Source: Euler Hermes

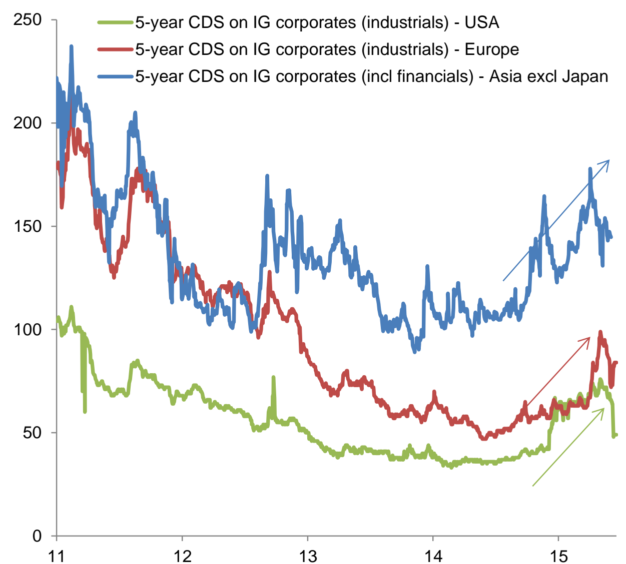
If the risk of short-term capital flight was to increase in countries such as Angola, Egypt, Venezuela, Ecuador, Malaysia, Turkey, South Africa, and – to a lesser extent China, Chile and Colombia – a counter-reaction might take place. Some governments could resort to further interest rate hikes (Chile, Colombia, Turkey) and interventions in foreign exchange markets (China, Turkey e.g.) while others could opt to introduce or strengthen controls on the capital account (Angola, Venezuela, Ecuador) and controls on the current account (trade) such as Angola, Venezuela and Egypt – see Figure 5.

#2 Segregated Liquidity

Central banks in advanced economies are still expanding their balance sheets and key policy rates are no longer constrained by the zero lower bound. Several countries introduced negative interest rates. While the latest policy moves were dovish (e.g. the extended asset purchase program by the ECB and the Fed's stance), easy money does not necessarily mean more liquidity. Bouts of liquidity squeeze magnified past shocks, as the so-called commodity price slump and capital flows reversals in emerging market economies.

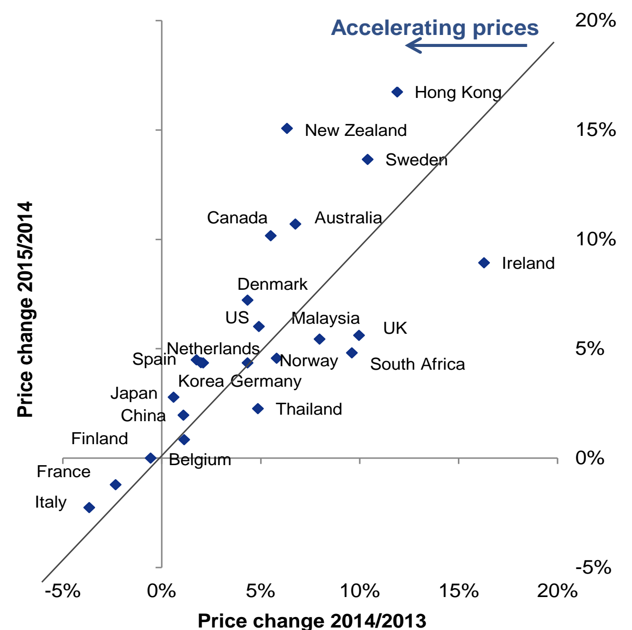
As the credit cycle is somewhat mature in a growing number of asset classes, credit risk is on the upside (see Figure 6). Low liquidity (low risk appetite, lack of hedging supply) contributed to a sudden surge in risk premiums over the last months. As Central Banks eased again, negative interest rates are generalizing and returns on financial markets are low. However, as savers are still pessimistic on growth prospects, they prefer financial risk-taking to economic risk-taking. The next asset class to outperform should be the housing sector (see Figure 7), but one should stay cautious. Asset price often overreact and revert: beware of the associated credit cycle.

Figure 6: Corporate CDS premium (*basis points*)



Sources: Bloomberg, Euler Hermes

Figure 7: Housing price dynamics



Sources: BIS, Euler Hermes

#3 Low for longer Oil and commodity prices

We maintain our scenario of low oil prices for longer with an average of 38 USD/barrel in 2016 and 51 USD/barrel in 2017. It is useful to note that oversupply is expected to remain above 1 mn bbl/day throughout 2016 as inventories are at very high levels (accounting for 60% of the price variation). Lower demand, which explains 30-40% of the price drop, is still weakening as China readjusts its economic model. A sharp increase by 2017 is a tail risk.

As explained in our Economic Insight Low for longer: Impact of long-lasting weak oil prices, the negative impact on oil producing countries is severe (e.g. -3.4pp of GDP growth for Venezuela, -1.2pp for Colombia, -0.5pp for Russia). Second-round effects started to kick in: widening current account deficits (-26pps for Saudi Arabia and Venezuela, between 2014 and 2016 for instance); depreciating currencies and declining fiscal space caused higher credit risk; depleting reserves (Equatorial Guinea, Gabon, Angola, Oman and Venezuela) remind the world of the risk of default; last, the risk of social unrest increased (Venezuela, Russia, Algeria). In the meantime, benefits reaped by net oil importers are fading away: In Europe for instance, retail should only increase by +2% y/y this year, after +3% at the peak period.

#4 Hesitant Public Policies

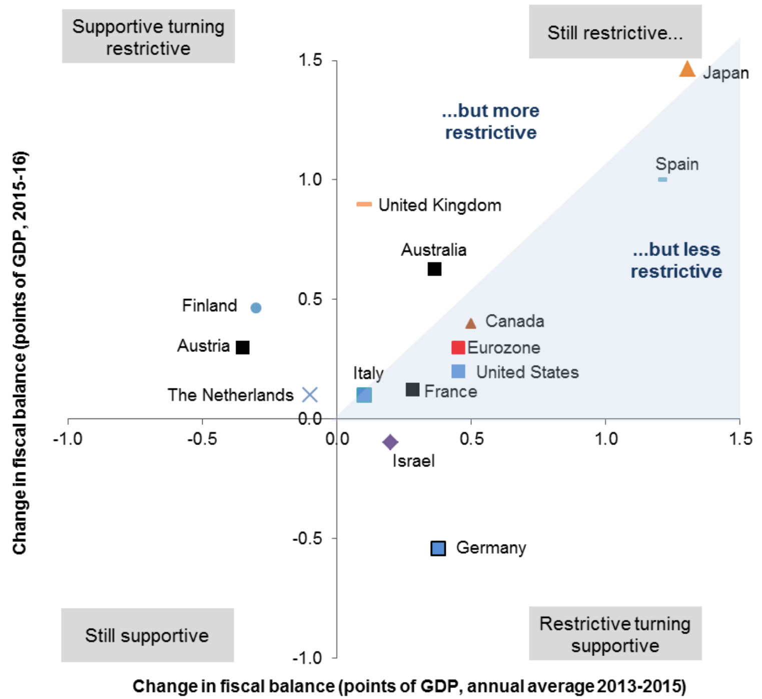
Public Policies are out of sync across countries and out of touch with private sector reality. Most emerging markets begin to feel the blow of austerity measures while European economies, and major economies such as Turkey, China, India are less obsessed with fiscal consolidation (and debt elimination) these days. Figure 8 summarizes fiscal consolidation trajectories. Some countries are still too restrictive for their own good (and in desperate need of an affordable stimulus) but overall, policy mix is back in the game, especially where monetary policy has not delivered the growth promise. As a result, tax policy will take the center stage: Spain, for example, reduced its corporate tax by 5pp to 25% since 2014 while the UK will further reduce it from 20% to 17% by 2020.

Figure 9 thus aims to shed a light on what to expect from the private sector in supporting growth (and how). Four clusters of countries can be identified, two are worth worrying about. First, countries (Singapore, Turkey, Canada, Indonesia, Australia) where the private sector could be reminded to start saving sooner than later; second, countries (China, Brazil, Poland, Korea) where the private debt overhang is already forcing the private sector to withdraw.

#5 Watch-out for Surprises: they always come from politic(ian)s

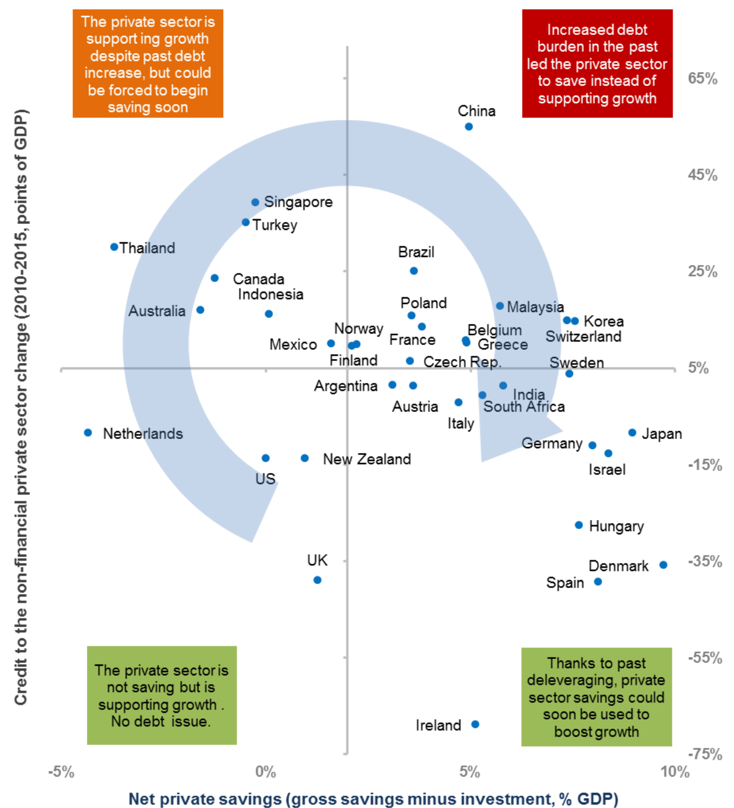
Several governments will have to face serious tests: *Brexit*, US elections, interim governments (Spain, Thailand) come to mind. Add Europe's everlasting stress test and the risk of escalation in the Middle East region,

Figure 8: Change in fiscal balance (points of GDP)



Sources: IMF, Euler Hermes

Figure 9: Debt and savings of the private sector and growth cycle



Sources: IHS, BIS, Euler Hermes

and you get a heightened level of nervousness (see Figure 11).

A slight digression on Brexit is needed as polls are tied and the externalities could have important reach. Euler Hermes continues to give *Bremain* (the UK staying in Europe) a 70% likelihood. However, GDP growth forecasts has been revised downwards for both 2016 and 2017 (-0.2pp to 1.9% and -0.1pp to 1.8% respectively), partly due to the increasing uncertainty causing a drag on attractiveness (FDI inflows) and organic growth (corporate investment).

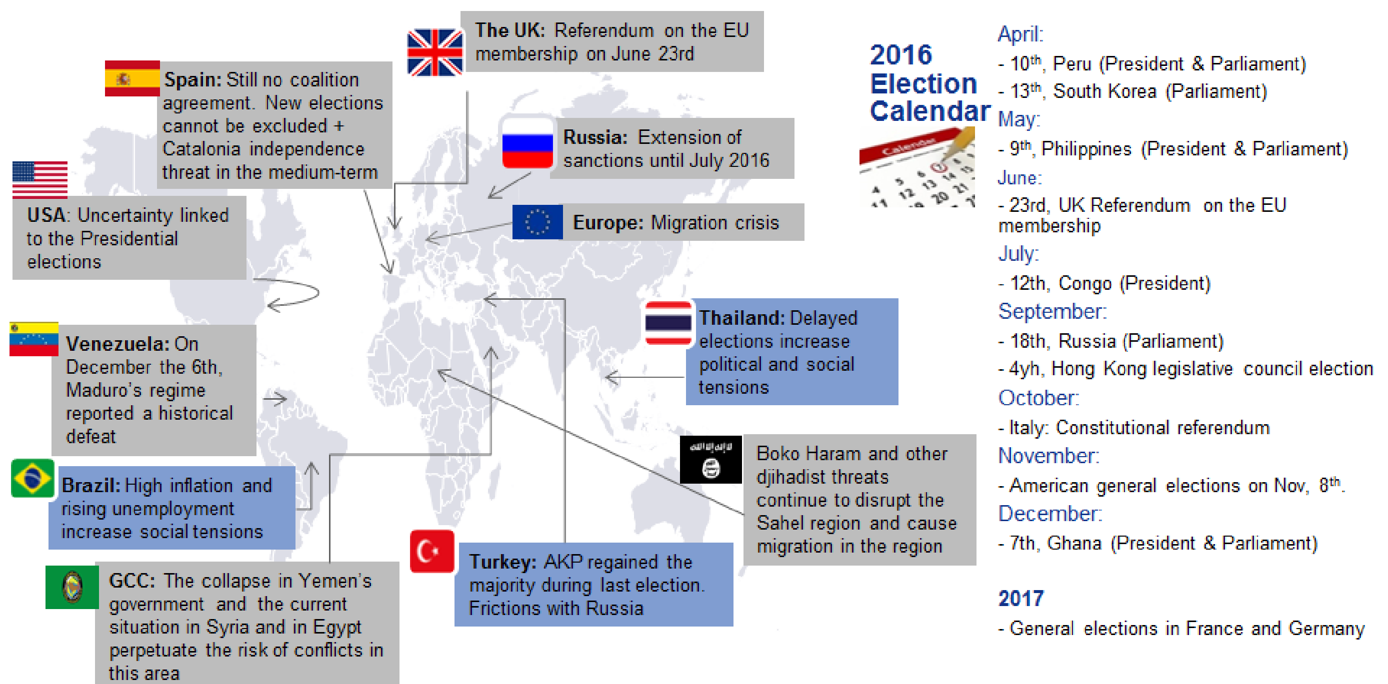
If there is a *Brexit*, our estimation point to nil GDP growth in 2019 if a Free Trade Agreement (FTA) with the EU is signed (see Figure 10). Cumulated (2017-20) shock on nominal GDP growth could amount to -2%. If no FTA is signed (worst case scenario), we forecast a recession of -1.3% in 2019 and a cumulated 2017-20 shock on nominal GDP growth of -4%. For more details on the estimated impact of a Brexit please read our Economic Insight [Brexit me if you can: Companies to suffer the most.](#)

Figure 10: Three main scenarios for the UK referendum on the EU membership

No Brexit (70%)	Brexit – FTA (20%)	Brexit – no FTA (10%)
• Nominal GDP growth above 3% • Real GDP growth at c. 1.7% in 2019 • Import & financing costs unchanged • Foreign direct investment unchanged	• Cumulated shock 2017-20 on nominal GDP growth estimated at -2% • Economic stagnation in 2019 • Higher import input & financing costs: 10% GBP depreciation, margins lose 1pp • Limited disinvestment and negative impact on flows	• Cumulated shock 2017-20 on nominal GDP growth estimated at -4% • Economic recession in 2019 (-1.3%) • Higher import input & financing costs: 20% GBP depreciation, margins lose 2pps • Disinvestment and negative impact on flows

Source: Euler Hermes

Figure 11: Political calendar



Sources: GTA, Euler Hermes

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