Growth: A giant with feet of clay
10 industry short stories expose macroeconomic fragility
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The seven deadly sins of growth

The purpose of a business is to grow. This can come in many forms—profits, revenues, market share, brand or community influence. It sounds easy enough, but it’s not. Underlying factors can make growth difficult: rapidly changing customers, a softer market, and of course fragile economic policies. Today, on the macroeconomic front, it seems that there’s some light at the end of the tunnel. Everyone has faith in better days to come. The problem with faith is that it is about beliefs, dogmas and politics - and not about questions, results, and analytics. And when it comes to growth, there are still many questions to ask, results to come, and analytics to understand. This is particularly true when looking at coping mechanisms across industries. From air pockets in the US manufacturing sector to expensive energy for Japanese companies to the artificial reindustrialization in the UK (mainly due to tax inversion), we identified ten micro reasons to question macro growth. In addition, behind our industry short stories, there seems to be a set of common pitfalls why we’re not seeing the recovery trickling down to companies. These are the seven deadly sins of growth:

- **Lust.** After years of austerity, Europe just found an interesting way to boost nominal GDP: to include drugs and prostitution in national accounts! Billions of dirty Euros for Belgium, Italy, and the Netherlands— but nothing for the real economy.
- **Gluttony.** Are accommodative monetary policies about to end? Do we know how to wean companies from easy money? What we do know for sure is that the risk of credit crunch is still high in emerging Asia and Latin America, and bubbles continue to form in the US.
- **Greed.** Commodity prices have been quietly plateauing, sometimes receding. Demand for natural resources, however, is set to increase (and prices with it) with increasingly fierce competition over— for instance— minerals, rare earth elements, and oil and gas.
- **Sloth.** Reformitis seems to have become a new public disease, with every country competing to announce yet another reform. The problem is how lazy reformers are when it comes to actually carrying out their new policies, and how loosely the reforms are often implemented. Political cost or lack of innovation?
- **W rath.** As we enter summer time, conflict zones around the globe are heating up. Stock markets are barely moving, but for many people, suffering is very real. Meanwhile for companies, disincentives and risks are increasing.
- **Envy.** Fate du prince and other Acts of Gods are back on the front burner making investment decisions— especially capital-intensive ones, or ones in more exotic places— much trickier for companies.
- **Pride.** Finding solace in a low-growth-low-inflation environment is maybe the worst sin of all. Carryover debt and lack of purchasing power can be— temporarily— less of a problem, but future generations will have to deal with them. For all of them, the devil is in the detail, but redemption is possible— it will just be one step at a time.
OVERVIEW

Growth: A giant with feet of clay
10 industry short stories expose macroeconomic fragility

ANABOATA, MAHAMOUD ISLAM, MAXIME LEMERLE

World GDP growth is finally gaining traction (+2.7% in 2014), allowing for a more favorable sector outlook (34 industries with better risk ratings in Q2).

However, the pace of the recovery is modest, below +3% for the third year in a row, and it remains unevenly distributed. This limited recovery makes it complicated for several businesses to grow their topline as they face fiercer price competition. In addition, changes of business models and more complex risks (political, monetary, change, non-payment) continue to expose vulnerable microeconomic foundations.

Better prospects in advanced economies help improve sector risk, but vulnerabilities remain

Advanced economies are now expected to grow by +1.8% in 2014, the fastest pace since 2010, opening the door to better sector risk assessments in the main countries, notably in North America and Western Europe. In the former, despite a particularly weak U.S. economy in Q1 due to unusually cold weather, the labor market is improving and the unemployment rate is expected to fall below 6% by end-2014, business and consumer confidence levels are both rising, the outlook for the manufacturing sector is positive and interest rates will remain at record low levels at least until mid-2015. GDP should grow by a robust +2.9% in 2015 after +1.9% in 2014, but overly accommodative monetary policy over the past years has raised concerns regarding possible bubbles in some sectors (High-tech). In Western Europe, the eurozone entered a progressive recovery after two consecutive years of recession (+1.1% in 2014 and +1.4% in 2015) and the ECB support measures have slightly improved expectations for 2015. The positive effects start to be visible in several sectors in the region, most notably in Southern eurozone countries where the competitiveness gains and the progressive pick-up in domestic demand led to improvements in the automotive and retail sector. Core eurozone countries are also facing the need to adjust economic models. On one hand, Germany has to complete its industrial (r)evolution in order to maintain its leading position in manufacturing, whereas France is struggling to sustainably boost total exports, still heavily dependent on the performance of big contracts. Furthermore, the UK is set to remain one of the best performers of the region (+2.6% in 2014 and +2.5% in 2015), mainly thanks to the recovery in financial services and the increasingly growth-friendly fiscal policy. However, the challenge is in attracting high-value industries in order to stimulate employment and real activity. All in all, the trend is indeed positive in Western Europe, with 25 improved sector risk ratings in H1 (and only 4 worse ratings), but the negative effects of the 6 years of crisis have not been entirely absorbed: on a global scale, the region continues to be the one with the highest risk across all sectors, in particular with a sensitive or high risk profile in construction in most of countries. In Japan, the policy-mix impact has been augmented with the recent announcement of structural reforms, which has slightly improved the economic outlook through posi-

GDP growth
annual change, %

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*Weights in global GDP at market price, 2013
Sources: IHS Global Insight, Euler Hermes forecasts
Emerging economies are stabilizing but adverse effects due to capital flight have not been fully absorbed

Emerging economies recovered from the capital flight shock induced by the change in the pace of asset purchases by the US Fed, but are still experiencing turbulences and are struggling to gain momentum (+4.3%). Across core emerging countries, financing costs increased on the back of more restrictive monetary policy, and divergence remains high. Asia is benefiting from the positive confidence effects linked to stabilizing growth in China and improving economic outlook in India due to the change in government, which has increased the attractiveness in terms of capital inflows. Sector outlook remains broadly stable with the lowest level of risk worldwide. However, the change in China’s business model has some adverse effects on several sectors, in particular metal, and could trigger pressures on other sectors due to fiercer competition (e.g. retail and e-commerce). Further, political turmoil in Thailand has clearly contributed to increase the risk of domestically-oriented sectors (retail, IT services) - with the end of the Government’s first-car buyer scheme (automotive, car component). On the contrary, countries in Latin America continue to face structural issues due to unresolved external imbalances, high inflationary pressures and therefore weaker economic outlook. In particular, economic prospects have been lowered for Brazil: +1.8% in 2014 and +2.1% in 2015, well below the 5% annual pre-crisis pace. This weighs on the overall performance of the region and sector risk has shown signs of deteriorating since the start of the year, especially for the metal industry. However, close business relations with the United States benefit notably to some of the Latin America economies, notably Mexico, although this has yet to prove sustainable in the medium-term. In Eastern Europe, eurozone dependent economies have shown a pick-up in activity, but too moderate to support an improvement in sector risk outlook, especially while being counterbalanced by the negative effects from the crisis between Ukraine-Russia. GDP is expected to be close to stagnation in 2014 in Russia (+0.1%) and the recession in Ukraine will certainly be more severe than expected. In the Middle East, economic activity is set to accelerate (+3.4% in 2014 and +4.3% in 2015) boosted by oil revenues that benefit the overall sector outlook, which remains positive. However, there is a concern that the construction sector, one of the main contributors to GDP growth, could face speculative attacks in the medium-term.
Economic activity will be supported by ongoing infrastructure projects (+4.4% in 2014 and +4.2% in 2015). However, external vulnerability remains significant.

NICARAGUA

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ITALY

Better than expected economic prospects (+0.4% in 2014 and +1.0% in 2015) will gradually benefit the private sector, as credit conditions improve and the risk of non-payment stabilizes.

GREECE

Economic activity is stabilizing after 6 years of recession while financial pressure eased significantly. Uncertainties related to the end of the EU/IMF program this December remain.

SPAIN

Net exports and improved domestic demand will boost GDP growth (+0.8% in 2014 and +1.3% in 2015). Insolvencies are expected to fall by -23% this year, for the first time in six years.

PORTUGAL

Domestic demand is stronger than expected, driven by investment. GDP is expected to expand by +1.0% in 2014 and by +1.3% in 2015. A return in confidence allowed a successful exit from the EU/IMF program.
IRELAND

Financial independence, growing net exports and strong economic momentum in the UK are pushing GDP growth to +2% in 2014 and +2.3% in 2015. The banking sector is on the mend.

HUNGARY

Lower inflationary pressures support the economic recovery (+2.5% in 2014 and 2015). Macroeconomic imbalances improved with four consecutive years of current account surplus.

SERBIA

GDP growth is expected to reach +1.0% in 2014 and +1.5% in 2015. The exchange rate has stabilized and inflation will remain low until 2015. Foreign exchange reserves are adequate.

COTE D’IVOIRE

A relatively more stable political backdrop allowed for economic activity to improve (+8% in 2014 and 2015) while external vulnerability remains subdued.

INDIA

GDP growth expected at +5.6% in FY2014-15 and +6.1% in FY2015-16. The newly elected government is likely to implement business-friendly reforms. The Central Bank credibility will allow less pressure on prices.
34 changes of sector risk ratings at the end of Q2 2014

SECTOR AND INSOLVENCY RESEARCH TEAM

↑ 21 sectors with improved ratings

↓ 13 sectors with deteriorated ratings

Source: Euler Hermes, as of July 16, 2014
United States

CLÉMENTINE CAZALETS, DIDIER MOIZO

No tech bubble, but an air pocket for manufacturing

5 years
to return to pre-crisis level of employment

No real threat of a tech bubble
The significant amounts of liquidity injected in the US economy in the recent years did not create inflationary pressures but boosted equity markets. Record-high market valuation and a (too) dynamic primary market may suggest a bubble is forming in the ICT and the biotech sectors in the US, but, if it does exist, it is unlikely that it would suddenly burst and lead to the collapse of the whole sector. Indeed overvaluations are restrained to very few players and there is no evidence of over-optimism concerning the entire industry.

A promising outlook for the ICT sector
The ICT market in North America enjoys a leadership position with a 31% share of the global market. The sector benefits from a buoyant domestic market: IT & audiovisual per capita expenditures increased by more than 60% between 2009 and 2013 in the US. In 2013, the ICT market recorded a +2.8% growth rate (which was faster than the overall US economy at +1.9%). This sector has been a valuable driver of growth during the past few years: ICT-related investments contributed for +0.2pp per year to GDP growth since 2010.

Beware of the air pocket regarding job creation
However, the ICT market in North America is mainly driven by 2 segments: IT services (41%) and audiovisual services (38%) which recorded the strongest growth in 2013 (+4.4% and +3.8% respectively). The more employment-intensive segments are far from proving as dynamic: telecom and IT equipment production is still below its pre-crisis level and audiovisual equipment production remains very weak. As it is very unlikely that companies will repatriate the production to the American territory, the ICT sector cannot provide a boost to the country’s reindustrialization. Yet, for the country to return to dynamic levels of growth, job-creating industries need to be promoted. Indeed, the ongoing decline of unemployment rate is partly attributable to the fall of the participation rate and it was only in May that the economy was able to regain all the jobs lost during the recession. Overall, we expect GDP growth to approach its long-term trend in 2015 (+2.9%), after growing by only +1.9% in 2014,
Mexico

YANN LACROIX, DANIELA ORDÓNÉZ

The car industry under the yoke of foreign direct investments

Cruising speed for the car industry
The Mexican automotive industry has the wind in its sails. The production of the sector has grown twice as fast (+10% per year) as world automobile production (+4% per year) over the last decade. Mexico has become the 8th largest automobile producer in the world, making up 3.5% of total production, and the 4th largest exporter. The steady increase in the rate of integration of equipment further increases the size of the sector, with 89% of the world’s top 100 suppliers present in Mexico. The automotive industry makes up 3% of Mexican GDP (up from 2% in 2008) and 16% of industrial production. This trend should continue in the following years as a result of ongoing and announced major investments. We estimate the production of the industry will grow by +6.5% in 2014 and by +7% in 2015, much faster than GDP (+3.3% in 2014 and +3.9% in 2015), bringing the production capacity to 4.5 million units by the end of the decade, currently at 2.9 million in 2013.

The engines are elsewhere
Yet, the domestic automotive market remains small, with new vehicle registrations below 700K per year (2.6 million in Brazil). More than three out of four vehicles produced in Mexico are exported, notably to the American market. Over 70% of vehicle exports and 90% of automotive equipment exports are bound for their American neighbor, where one of every ten cars sold comes from Mexico.

Watch out for highway exits
The rapid development by the industry has been widely financed by foreign direct investment (FDI) capital. Surely, the ambitious structural reforms underway in the country, seeking to improve the Mexican business environment, competitiveness, and international integration, have had a role in attracting this capital. However, the nature of these FDI shows that investors mainly respond to Mexico’s key position in the re-industrialization underway in the US. Therefore, one should be wary of the positive flow of these investments, as it reveals the inherent weaknesses of the Mexican economy: (i) extreme dependence on American activity; (ii) investment is mostly geared towards basic industries with low value-added; (iii) risk of a sudden flight of capital with a slowdown of the U.S. economy, or as a result of the re-location of certain industries.
The placebo effect of the pharmaceutical sector

Pharmaceuticals, a strategic sector for the UK government

The pharmaceutical sector, which includes AstraZeneca and GSK, two labs amongst the 10 largest worldwide, is the leader in exports (7% of total exports) for the UK. Its national production stands at USD 24 billion. The sector is known for its innovation, as it boasts 25% of R&D expenditures (GBP 4.2 billion in 2012) and employs 70K persons (0.2% of the total labor force), of which over one third are in highly skilled positions. The pharmaceutical sector is one of the eleven strategic sectors for the government, along with aeronautics, automobile, nuclear, and financial services sectors.

This does not necessarily mean that it contributed to the economic recovery

In 2013, GDP grew at its highest rate in the last 6 years (+1.7%) and should display the strongest performance in the region moving forward: +2.6% in 2014 and +2.5% in 2015. However, pharmaceutical production didn’t contribute at all. Production contracted by -4% between 2009 and 2013 on average and it remains 8pp below the 2005 high. Productivity losses have been accelerating since 2007, and exports have quickly lost momentum. Due to this, the trade surplus, which hit a peak of GBP 7 billion in 2009 and 2010, has hit a low of GBP 2.8 billion in 2013. As a result, the true catalyst of the British revival since 2013 has been services (notably financial services), which account for around 80% of GDP.

The UK, a victim of the Irish fiscal illusion

Contrarily to its neighbors, Irish pharmaceuticals have registered an average annual growth of +9% over 2009-13. This is a result of the fiscal attractiveness when compared to countries across the channel. While corporate tax rates are at 40% in the US and 23% on average in the EU, UK rates will drop to 20% in April 2015, the lowest within the G-20. It is therefore easy to imagine Pfizer’s potential gains in moving its headquarters from the US to the UK had its takeover of rival AstraZeneca materialized. However, with rates at 12.5%, Ireland pushes the British economy to its limits. But this also increases the dependence of the country’s economy on the sector: pharmaceuticals represent 30% of total Irish exports and 27% of GDP. Therefore vulnerability is high as shown in 2013 when GDP fell by 1.2% y/y due to the expiration of multiple patents while GNP increased by 2.6% y/y.

Corporate tax rate

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Sources: European Commission, Euler Hermes
France

FRÉDÉRIC ANDRÈS, YANN LACROIX

Large export contracts - mirage or miracle?

Exports are increasingly dependent on two key sectors

Disappointing Q1 figures have confirmed our below-consensus +0.7% GDP growth forecast for 2014. Net exports were one negative driver contributing -0.2pp to growth, with exports showing particular weakness. Two reasons: first, disinflationary pressures are taking hold thus reducing incentives to export. Indeed, export prices have fallen for five consecutive quarters. Second, there are only 120K French exporting firms (vs. 300K in Germany). France is thus clearly dependent on the export performance of large companies, among which aeronautical firms are key. This sector has shown the best performance since 2008 in terms of exports (+30%) and the highest trade surplus in 2013: EUR 22 billion, followed by agrifood (EUR 11.5 billion).

The mirage of large export contracts in emerging countries

In 2013, the sum of large export contracts exceeded the 2007 pre-crisis level of EUR 37.2 billion, reaching EUR 38.7 billion. While this may seem encouraging, it helps to understand the true reasons behind it. In 2007, economic activity outside of aeronautics, notably in energy, major works, and railways, made up 55% of total exports. However, this share has been decreasing since 2010, and is currently at a meager 21% in 2013. In reality, the growth of large export contracts is due to the success of Airbus, as France is losing ground in all other sectors. The recent closing of Alstom’s energy branch reveals our struggles in developing international firms capable of rivaling their competitors in tendering several USD billion, which require the establishment of massive bank securities. Will Alstom’s refocus towards transportation activities allow it to participate in the reconstruction of the sector, or has achieving a critical size become a necessity to do so? What else can be said concerning the repeated failures with regard to Dassault’s Rafale sales (defense sector), or even the costs of Areva’s EPR (nuclear sector) that have yet to be mastered? If we hope to return to past levels, we must use powerful financial tools to catalyze the development of large international firms than can help us achieve this goal.

growth of turnover for the aeronautics sector since 2008 whereas that of the manufacturing industry grew by less than 2%
Germany

CLÉMENTINE CAZALETS, BRUNO GOUTARD

Managing the digital (r) evolution

+12%

Increase in investment from producers of data processing equipment and electronics products

A shift back to domestic demand as main driver of growth

Since H2 2012, corporate margins rates have been declining (from 42.2% in Q2 12 to 40.5% in Q4 13), a trend attributable to very low inflation within the eurozone and declining competitiveness (deteriorating productivity, dynamic wages, important competitive advantages of the two main competitors - Japan and the US), which has impacted German exports since early 2013. However, the economy registered strong GDP growth in Q1 2014 (+0.8% q/q) on the back of sustained domestic demand and we expect this trend to go on in 2014, boosting GDP growth at +1.9% (against +0.5% in 2013).

Industry 4.0, yet to become a reality, but likely to ensure many opportunities for the German industry

After two years of decline, we expect a strong rebound in investment which could reach +8% in the manufacturing industry in 2014, according to the ifo survey. The +12% increase reported by producers of data processing equipment and electronic products may be the first hint of the start of the industry's digitalization ("Industry 4.0"). This (r)evolution should make products and processes smarter through direct communication between the workforce, machines, and resources. Implementing "Industry 4.0" should improve competitiveness by securing higher productivity and cost-cutting. It would also make up significant business potential for already leading mechanical and plant engineering, for data processing equipment and for associated services offering big data management and exploitation.

A long way still ahead

Through long-established partnerships between all stakeholders (companies, services, academics), leading position in manufacturing, and financial state backing (EUR 200 million), German Industry 4.0 should succeed in embracing the close collaboration between a large scope of disciplines (electrical engineering, electronics, engineering and IT). However, this expected far-reaching (r)evolution entails risks related to (i) the plausible "shocks of culture" between all these players, (ii) heavy investments with a return expected only in the long term, (iii) the reliance on telecommunication infrastructure and network and (iv) data protection.
Italy

Is ‘made in Italy’ more than just (re)branding?

+49%

Extra-EU export growth between 2009-2013 for textile and furniture

Exports, the Cinderella story of the Italian economy

Although GDP growth remained negative over the past quarters (except in Q4 2013) on the back of contracting domestic demand, good news came from the continued positive trend in exports, which provided the highest contribution to GDP growth for the third consecutive quarter in Q1 2014. Italian exports are among the most diversified worldwide in terms of products, while the exposure outside Europe is strengthening (46% of total exports compared to 37% in Spain and 40% in France). In particular, exports to emerging countries showed strong performance over the past 12 months (+8% y/y on average compared to +2% for exports to the advanced economies).

The magic of “Made in Italy” still in effect overseas

Textile (apparel, leather, footwear) and furniture manufacturing are playing a crucial role in this overall pick-up in exports, making up more than a quarter of the growth posted in 2013, while accounting for only 11% of total exports. These industries have made such a dramatic inroad in extra-EU markets (+49% over 2009-2013 and +8% last year) that the European Union was the destination for only half of their exports.

But the magic could run out if counterfeiting is not fought

High standard of quality, excellent design as well as innovation are strongly associated with the label “Made in Italy” in textile / furniture manufacturing. Average intangible fixed assets per company (supposed to encompass brands and patents among other things) in these sectors outline Italian dominance as they are around 2.5 times larger than those in France and Germany. Moreover, Italian SMEs in these sectors are largely ahead of their French and German counterparts on the same criteria. However, counterfeiting may wreak havoc in this successful business model, depriving Italian companies of revenue, and above all tarnishing the brand due to poor quality goods. Therefore, protecting Italian intellectual property capital, especially in emerging markets, should amount to a national cause. In this respect, the EU Action Plan on enforcement of Intellectual Property Rights recently announced by the European Commission is welcome.
Eurasia

Pipelinomics is not sustainable

Gas imports: high dependence and rapidly rising bill
Ukraine’s dependence on gas imports from Russia – accounting for about 60% of its gas consumption – has remained high and nearly unchanged over the past 20 years, because it has hardly restructured its energy-intensive manufacturing sectors. Today, Ukraine’s economy is three times more energy-intensive than Poland’s and 25% more than Russia’s. Moreover, the price for imported gas from Russia has rapidly increased from just USD 50 per tcm¹ until 2005 to over USD 400 per tcm in 2013. Currently Russia is asking for almost USD 500 per tcm from Ukraine since earlier gas price discounts have been cancelled in the wake of the ongoing conflict between the two countries. As a result, the gas import bill has risen from 3.5% of GDP in 2005 to 7% in 2013.

Pipelines: dwindling importance?
For two decades, Russia has supplied the EU with 27% of its gas consumption. Thereby 80% of its exports have passed Ukraine, using the two major Brotherhood and Soyuz pipeline systems. Today, Russian gas supply through Ukraine has fallen to around 60% since the North Stream pipeline joining directly Russia and Germany under the Baltic Sea became operational in 2011. It might drop to 30% by 2016 if the South Stream pipeline under the Black Sea goes on line as scheduled. The combined capacity of the North Stream and South Stream pipelines would be roughly equivalent to the amount Russia currently exports to the EU.

Clinging to the gas transit monopoly, a pipe dream
Owing to North Stream’s coming on line and because the fee for gas transit through Ukraine has increased more moderately than gas prices, from USD 1.1 per tcm per 100km in 2005 to USD 3.1 in 2013, total transit receipts have fallen from 2.3% of GDP in 2005 and a peak of 2.5% in 2010 to 1.9% in 2013. The outlook for the pipeline sector is bleak as Russia’s reliance on Ukraine as a transit country is likely to fall further with the eventual completion of South Stream. Ukraine needs to restructure in this regards as well. And it must get along with its neighbor as it needs Russian gas.

1.9% of Ukraine’s GDP for transit receipts

¹ Thousand Cubic Meters
Middle East

ANDREW ATKINSON, DIDIER MOIZO

Stress cracking in the construction sector?

The construction sector helps drive GDP growth

Growth in the construction sector in many countries in the Middle East continues to be rapid. Infrastructure and housing needs are boosted by significant demographic changes and urbanization, political will and financial resources. Growth in the construction sector is an important positive contributor to overall economic growth. However, this virtuous circle involves some potential risks as a construction boom could turn in risks, inflated by speculative forces, and a correction of this, whether by managed correction, raises questions over the sustainability of current relatively high overall GDP growth rates.

Qatar is a leading example...

Through the Qatar National Development Plan Vision 2030, this country has significant ambitions reliant on inputs from the construction sector. However, there have been recent questions raised over whether Qatar should be allowed to host the football World Cup in 2022, given uncertain bidding procedures. Restricted (or cancelled) revenue streams from this international event would not cause a systemic crisis for state finances but could impact adversely on the construction sector and thereby on overall growth.

...and the UAE have been there before

In Dubai, which experienced a severe property-related crisis in 2009, the number of property dealings increased by 11% in Q1 2014, to reach 15,694 real estate transactions. Property prices, again, are soaring, with an increase of 43% for some units in 2013. As with the football World Cup in Qatar, construction activity in Dubai has been spurred by the Emirate’s success in November 2013 in being awarded the organization of the 2020 Expo. In addition, rents in Dubai have also increased significantly and there are concerns relating to the potential for a real estate speculative bubble. It should be remembered that between 2008 and 2011 the real estate market collapsed with some prices falling by up to -60%. Currently, Dubai’s stock market is down by around 25% since mid-May, partly reflecting a sell-off in real estate stocks and, in particular, uncertainties relating to a leading construction group.

Value-Added output in the construction sector

% of real GDP in 2014

<table>
<thead>
<tr>
<th>Country</th>
<th>Value-Added</th>
</tr>
</thead>
<tbody>
<tr>
<td>Egypt, Arab Rep.</td>
<td>6.3</td>
</tr>
<tr>
<td>Oman</td>
<td>7.5</td>
</tr>
<tr>
<td>United Arab Emirates</td>
<td>10.8</td>
</tr>
<tr>
<td>Qatar</td>
<td>12.2</td>
</tr>
</tbody>
</table>

Sources: Oxford Economics, Euler Hermes

Real estate transactions in Dubai in Q1 2014

15,694
A good combo: A wealthier consumer and an increasing Internet penetration rate

A perfect storm of conditions seems likely. First, Chinese personal income is growing rapidly, with wages projected to increase by +11% in 2014. Second, opportunities for the sector are large as the reach of the Chinese internet continues to grow. At the end of 2013, internet usage rate hit 45.8% of the population in China with 54 million new users, which places it at a midpoint between emerging countries (32.4%) and developed countries (78.3%). The worldwide pursuit of increasing this rate, including in developed economies (3pp per year), sparks the hope of potentially doubling current levels in China with 422 million additional new users.

Substitution effect or value added?

Similarly to America and other pioneers of e-commerce, China is likely to experience a substitution effect between traditional retail sales and online retail sales, without creating any significant true value, as e-commerce has proven to be the demise of in-store retail sales. In addition, it requires investments that firms with low profit margins cannot afford, as they promote a downward pressure on prices that cannot be absorbed by a majority of Chinese companies. Lastly, e-commerce can also hurt local firms, ranging from production to retail sales, as it decreases the influence of national borders and increases competition between countries. This allows neighboring countries with a comparative advantage, such as Vietnam, to offer the same products at cheaper prices. As a result, certain Chinese markets, such as the one for electronic components, could suffer in the long run.
Japan

MAHAMOUD ISLAM, MARC LIVINEC

True or fake energy?

+17%

Rise in electricity costs between 2010 and 2013

Electronics and paper, two struggling sectors despite the rebound in growth

Japanese growth is expected at +1.4% in 2014 and +1.2% in 2015, above its long term average, driven by a pro-growth “policy-mix”. This performance may get weaker, due to cost constraints on several electric-intensive industries in Japan, particularly the manufacturers of electrical appliances, electrical equipment, and paper suppliers. Japan is usually at the mercy of variations in energy costs. Ever since the Fukushima nuclear disaster in 2011, the country has seen its energy imports rise by +41% to USD 262 billion between 2010 and 2013. At the start of this year, these imports accounted for one-third of Japanese total imports. The shutdown of its 54 nuclear reactors, from which came around 30% of Japanese total electricity, has brought on the cost of electricity to soar by +17% over the 2010-2013 period. This in turn has raised by +35% the production costs of silicon required in the manufacturing of any electrical component. Similar effects apply for the Japanese paper industry. The rise in electricity costs has greatly increased the cost of its paper production; it has hit USD 660 a ton on average in 2013, compared to USD 580 in Europe, and half of that in Russia.

Profit margins subject to severe energy cost pressure

Particularly for these two sectors as for those requiring a significant supply of electricity (such as metallurgy and chemicals), downward pressures on their profit margins will be strong. On the demand side, worldwide growth should remain moderate at +2.7% in 2014, still below +3%, thus limiting the rise in export outlets. On the supply side, in addition to higher material costs, these sectors have to cope with the shock wave of a changing foreign exchange rate - with ambiguous effects - and growing salary costs at the same time. In order to maintain growth, Shinzo Abe’s government has had to proceed with an aggressive monetary policy, inducing a strong depreciation of the yen (-15% since December 2012). While this policy may have stimulated Japanese exports by raising their competitiveness (+2% and +4% in 2013 and 2014), the downside lies in the rise in supply costs for the Japanese industry. In addition, rising inflation and a strong improvement in the labor market exerts an upward pressure on salaries and compounds the production costs of Japanese industries.
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