Euler Hermes Economic Research

Weekly Export Risk Outlook

24 June 2016

FIGURE OF THE WEEK

51.9%

Leave vote in UK's referendum on EU membership

In the Headlines

UK: How strong is the Brexit impact?

A deeply-divided UK has made its choice; 51.9% of the electorate voted to leave the EU in a referendum held on 23 June. The vote will have both short- and long-term economic consequences. Investors will move swiftly to price uncertainty. The shock to equity and currency markets (GBP is expected to lose at least -10% this year) will impact private consumption and investment in Q3 and Q4. The risk of recession in H2 2016 is high. We expect GDP growth will slow more sharply in 2016, to +1% from +2.3% in 2015. In the longer term, economic activity will be impacted in a more profound way. A series of indicators, including GDP growth, exports and foreign investment may narrow, given uncertainties related to the outcome of negotiations with the EU. Company turnover and margins will also reflect the new reality, with an associated hike in the number of insolvencies (from 1,500 to 1,700 cases between 2017 and 2019). The official exit may occur in early 2019 but an extension of the two-year European procedure is not excluded. In a *soft leave* scenario, in which the UK signs a Free Trade Agreement (FTA) with the EU, real GDP growth could fall by -2.8pps between 2017 and 2019. In a *hard leave* scenario (no FTA) a -4.3pps cumulative shock could occur (see also our Economic Insight).

Global Economy: Market surprise, Central Bank support

The Brexit surprised financial markets and its initial impact was strong. The peak depreciation of the GBP was -10% (now -6.5%) and many financial stocks decreased by -20%. However, Central Bank support reassured somewhat. The BoE pledged to "provide more than GBP250bn of additional funds through its normal facilities" to the financial sector, if needed. Moreover, key world Central Banks (including the ECB and the BoJ) stand ready to activate their currency swap-lines and support liquidity, again where needed. The aggregate impact of the shock and policy support includes: (i) safe havens benefited strongly. The USD appreciated by +2% in effective terms, the JPY/USD appreciated by +3% and 10-year bond yields hit new lows in the U.S. (1.5%), Germany (-0.05%) and…in the UK (1.1%, -30 bps) and (ii) 10-year yields increased in "riskier" economies in the Euro Area, with Portugal (+30bps), Spain (+12bps) and Italy (+10bps), but these yields still remain below levels at end-2015.

U.S.: Fed on hold, manufacturing weak

At its June meeting, the Federal Reserve left the target range for its federal funds rate unchanged at 0.25% to 0.5%. Much of the accompanying information was dovish. In April only one Fed member forecast just one interest rate hike in 2016 and now six do. The lone dissenter - who wanted to raise rates in March and April - now agrees that conditions are too soft to do so. The official GDP forecast for 2016 was marked down to +2% from +2.2%, partly reflecting a slowing labour market and soft business investment. EH expects only one rate hike in 2016, at most. Manufacturing industrial production fell -0.4% m/m in May (-0.1% y/y), as 12 of 20 industries are now in contraction. Capacity utilisation fell -0.4pps to 74.8%, the lowest since February 2014. Meanwhile, inflation remains quiet, with CPI running at 1.1% y/y, while core CPI is at 2.2% and has been range bound between 2.1% and 2.3% for six months. PPI and core PPI are currently 0.0% and 1.2%, respectively. Housing starts fell -0.3% m/m in May (+9.5% y/y) while permits increased by +0.7% m/m (-10.1% y/y).

Brazil: Olympic shames?

With fewer than 50 days before the Olympic Games, host city Rio de Janeiro declared a "state of financial emergency". According to Governor Francisco Dornelles, commitments have not been met because of the fall in tax revenues linked to the weaknesses in the oil sector. In recent months, the state has been unable to deliver some basic services, has delayed pensions and salary payments and closed some schools and hospitals. Moreover, a total of USD8.4mn in interest payments due to multilateral banks in May was missed. The Federal government authorised an emergency financial support of BRL2.9bn (USD850mn) for the city to finance latest infrastructure projects and security needs of the Olympics. The economy is in a poor state, with GDP contracting by -3.8% y/y in 2015 and -3.5% forecast for 2016, so this latest episode is a further dent in investor confidence. Moreover, political Telenovela continues, with major political scandals including Dilma Rousseff's impeachment and numerous corruption investigations that Temer's interim government is currently facing.

Countries in Focus

Americas

Argentina: New consumer price index

After seven months of not releasing data, the Statistical Institute (INDEC) last week published a new CPI index. The methodology was entirely revamped and will be audited for approval by the IMF in July. Inflationary pressures remain evident. According to the new index, consumer prices increased by 4.2% m/m in May (50.4% on an annual basis), driven up by food and drink (+1.4pps m/m), transport and communications (+0.8pps) and housing and basic services (+0.4pps). We expect inflation will strengthen further until Q3, reflecting ARS depreciation (-35% against the USD since last December 2015), tax increases and subsidy cuts. Inflationary pressures are likely to ease gradually thereafter; inflation is forecast at 33% on average in 2016 (50% y/y by end-year). Building credible economic statistics is only one step in the strategy adopted by the government of President Mauricio Macri designed to put the economy back on track and to regain investor confidence (see also our **Country Report**).

Europe

Croatia: Government collapse despite economic upswing

Last week, parliament brought down the five-month old government led by the independent technocrat Prime Minister Oreskovic in a no-confidence move and also voted to dissolve parliament (effective from 15 July), paving the way for a snap election likely to be held in early September. Oreskovic, who was nominated by the HDZ-MOST coalition government that emerged after the November 2015 elections, had fallen out with the leader of HDZ and deputy PM, Karamarko, whom he urged to step down over an alleged conflict of interests. Growing rifts between HDZ and MOST also played a role in the developments. Meanwhile, real GDP growth surprised in Q1 2016, accelerating to +2.7% y/y, up from +1.9% y/y in Q4 2015 and +1.6% in full-year 2015, driven by strengthening consumer spending and investment. However, as base effects also played a role in Q1, Euler Hermes forecasts a more moderate full-year GDP growth of +2.1% in 2016.

Africa & Middle East

Nigeria: Better late than never?

Throughout most of H1 the authorities were adamant that the fixed naira (NGN) exchange rate to the USD would remain in force. However, the Central Bank (CBN) last week announced that the peg would be replaced by an interbank market-driven system. As expected, the NGN fell strongly on 20 June when the new system became operational; from the fixed rate of NGN199:USD1 it is now around NGN280:USD1. A measure of market liberalisation should limit the depletion of FX reserves but: (i) the CBN will still intervene, in need, to smooth potential volatility; (ii) some import controls remain in place; (iii) an unofficial exchange rate system will continue to function as there is a backlog of FX demand and (iv) policy uncertainty will continue. Market reaction to the new system was positive (albeit perceived as coming late). Expect heightened inflationary pressures (CPI 15.6% y/y in May) and associated monetary policy tightening, beginning with an additional +100bps on the 12% MPR.

Asia Pacific

Japan: Unev(Y)en consequences?

The JPY continued to rally after the UK voted in favour of a Brexit, adding further pressure on the authorities to act. The economy is currently facing strong headwinds. Firstly, a strong currency is undermining trade. In May, the trade balance deteriorated to -JPY41bn (+JPY824bn in April). Real exports contracted further (-2.4% y/y from -4.6%) with a fall in demand from the U.S., Asia and the EU. Secondly, lower profitability is hindering investment growth. Profits deteriorated significantly in Q1 (-6.8% q/q) and weak aggregate demand, deteriorating price competiveness and prevailing deflationary pressures do not bode well for a recovery in the short term. Moreover, business sentiment is weak as reflected by the Nikkei Manufacturing PMI in June, which remained below the 50-threshold for the fourth consecutive month. Against this background, Euler Hermes expects GDP growth will be limited to +0.7% in 2016 supported by resilient private consumption.

What to watch

- June 27 – Brazil June consumer confidence (forecast)
- June 28 – France June consumer confidence
- June 28 – Mexico May unemployment
- June 28 – Saudi Arabia May SAMA net foreign assets
- June 29 – Germany June GfK consumer confidence
- June 29 – Germany June inflation