HIDDEN WALLS

The Underside of Trade and Growth

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Every year, for the Chinese New Year, Chinese families clean their houses and decorate windows and doors with red paper stripes and couplets with signs for good fortune.

This tradition comes from the legend of the Nian (年獸), a mythical beast who would go to the village on New Year’s eve, eat the crops and sometimes the children. One year, all villagers decided to light up firecrackers, hang up red lanterns, and wear red robes to frighten the Nian. It turned out the monster did not like the color red and was afraid of loud noises. The famous Chinese lion dance (舞龍舞獅) was born and the Nian never returned to the village.

As we get ready to celebrate the transition from the Fire Rooster to the Earth Dog year, it looks like the Nian came back to the financial markets quite flamboyantly. He reminds us that the end of an expansionary economic cycle often coincides with the beginning of a new era of volatility. This time the Nian was not scared of equity markets in deep red, and noises of despair on trading floors as markets were thrown into a tailspin when rising bond yields triggered a sell-off in stocks.

It all started well. 2017 turned out to be a year of awakening in monetary and fiscal policy, politics, and markets. The crowing of roosters is often a natural wake-up call. Throughout the year, the footprints of the Fire Rooster were visible everywhere: They helped Emmanuel Macron take France (the gallinaceous’ home country) and Europe back to center stage; they gave President Trump an extra boost to his comb and his America First economic policies; and they provided President Xi with the right amount of grit – roosters’ main quality according to Chinese astrology – to build a global China one step at a time.

The good news is that the Nian could be less cruel than in previous times. No need to eat all the profits and dividends. The ongoing market correction does not reflect a worsening of economic and corporate fundamentals. It is mainly driven by technical factors, including the unwinding of short-volatility trades, already stretched valuations and jittery investors used to complacency.

Central Bankers had been quite clear about their intentions all along. Growth, inflation and debt have increased, and they are getting ready to start draining the global economy of some of the trillions of dollars they have pumped into the financial system in recent years. Financial markets will automatically feel less numb, and though investors will eventually refocus on the healthy economic backdrop, volatility will remain elevated.

The end of cycle, just like the end of a Chinese year means markets are acutely sensitive to shifts in expectations – for interest rate increases and the Nian. 2018 is a pivot year in many ways: For the US where pro-cyclical policies take the economy into unchartered debt territory; for Europe where the very vulnerable political landscape contrasts with the economic momentum; for China, where atypical policy-making continues to awe international observers. In an environment of widespread beggar-thy-neighbor policies, the importance of dialogue and solidarity, frugality and creativity – all promised by Chinese astrologists for the year of the Earth Dog –, will be very much needed. Failing to do so could end up in unnecessary barking on markets, political stages and in the real economy.
The VIX index - a gauge of volatility - surged in 2018 (compared to 2017 average) +33 %
The force strikes back: The US and trade retaliation

There is little question that the US has increased protectionist measures since President Trump entered the White House, though this development goes against current trends elsewhere around the globe, where 467 new protectionist measures were implemented in 2017, compared to 827 one year ago. The US alone was responsible for implementing 90 new measures last year, a whopping one-fifth of total global activity, up from 84 in 2016. So, while the protectionism movement overall has kept alive over the past year, its pace has hit the brakes. This decreasing trend is not so surprising, however, as growth is returning to the world economy (+3.2% in 2017, +0.6pp from 2016).

Digging down a little deeper, our data indicated that the US decided to bolster measures to counteract perceived protectionism from key competitors. The number of import tariff measures increased to 30 in 2017 from 6 in 2015, while anti-dumping measures rose to 20 from 13. The expected clash was particularly visible as China was widely in the US’s scope, targeted in 2017 by 17 new measures from 8 in 2016.

The current US administration also voiced its concerns about an imbalance in its trade relationship with Mexico. In this regard, the data is contrarian: the US did increase its trade barriers especially against Canada (18 new measures in 2017) while Mexico was barely hit (only 2). More protectionism against Mexico would be self-defeating for US corporates’ business models, since they use the low labor cost in Mexico to stay competitive. The most targeted sector in Canada was energy, in a frontal competition on shale oil & gas with the US.

The Trade Federation: Export promotion in Asia and Europe

When other keys trade powerhouses implement some degree of protectionism, this is about export promotion rather than import diversion. Japan export’s engine has lost some ground in the world ranking during the last few years, but the country still has its own model to protect its remaining market share. Japan adopted 137 protectionist measures during the last four years, targeting primarily Machinery & Equipment, its main export sector. A total of 57% of these measures involve financing for Japanese corporates in foreign markets, through the Japan Bank for International Cooperation.

Moreover, such impetus by Japan in its promotion of exports also helps to debunk one myth about the UK. Yes, the UK was among the most protectionist countries even before Brexit, and increased its stance in the run-up to the recent poll, with 48 new measures in 2016, but this is not something new. Measures implemented in the UK arose from local sourcing and trade finance instruments many years before the vote, since the country has been an entry point in Europe for Japanese corporates for years.

In Europe, one may be quite surprised to find Germany and Switzerland in the 4th and 6th positions in the worldwide ranking. In the same vein as Japan, protectionist measures were promoting the main export sectors, particularly Machinery & Equipment (including aeronautics). Regarding these aspects, one could view the situation as the glass being half-empty rather than full and surmise that it may create trade distortion in an area supposed to be ruled by a common EU trade policy.
The Planet of the Clones: Commodity oversupply and protectionism

Countries sometimes use protectionism to replicate the same old sectors that have traditionally supported their economies, though this may open the doors to oversupply. This evidence is particularly striking for commodities, since agrifood is ranked 1st, and metals ranked 2nd in the most targeted sectors list. Oil is not far down the list, with chemicals and energy ranking 4th and 5th. Obviously, it is normal to see stronger protectionism in sectors excluded from past liberalization rounds and still frequently state-owned.

Such a level of protectionism is a key driver behind the oversupply that pushed commodity prices well below observed past peaks. Compared to 2008, industrial metal prices are still at -61% and agricultural prices - 62%.

Chart 1: New protectionist measures by top 10 countries (number of measures)

Sources: GTA, Euler Hermes
Cocoa prices slumped by 50% during the last two years, as Ghana and Côte d’Ivoire (jointly supplying 62% of the world cocoa output) each increased their national output, despite agreements to coordinate limits to their production when prices are low.

More generally, agrifood was primarily targeted by emerging economies. These countries bred 87% out of the 697 new measures implemented worldwide. All the regions were particularly active, with the widest arsenal seen in sizeable countries, such as Russia and India.

In Russia, trade retaliation against sanctions put in place by Western Europe after the conflict in Ukraine was a key rationale, but some measures were also enacted to reduce exports in order to fuel local supply and limit food price inflation. An interesting feature was also that Argentina still added 23 measures against agrifood in 2016 and 2017. Despite an alleged shift in terms of trade policy after Mauricio Macri’s election, the protectionist trend was unbroken.

Industrial metals have also been particularly targeted. Strategies designed to provide China with all the raw materials needed pushed supply very high.

Moreover, each country tried to mop up the value chain by performing the first transformation of a commodity instead of just exporting it. This triggered protectionism from resource-rich countries, like Brazil or Australia. In response, advanced economies have also implemented many new measures, as the transformations of metals are at the core of many manufacturing sectors.

Again, the US added the most measures during the last four years (164), triggered by the TIGER (Transportation Investment Generating Economic Recovery) plan implemented by the Obama administration, designed to protect US suppliers in public procurement issues.

Julien Ayme-Dolla, Stephane Colliac

**Chart 2** Most targeted sectors (number of measures)

<table>
<thead>
<tr>
<th>Sector</th>
<th>2017</th>
<th>2016</th>
<th>2015</th>
<th>2014</th>
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<tbody>
<tr>
<td>Agrifood</td>
<td>323</td>
<td>279</td>
<td>218</td>
<td>153</td>
</tr>
<tr>
<td>Machinery &amp; Equipment</td>
<td>512</td>
<td>323</td>
<td>279</td>
<td>218</td>
</tr>
<tr>
<td>Chemicals</td>
<td>323</td>
<td>279</td>
<td>218</td>
<td>153</td>
</tr>
<tr>
<td>Energy</td>
<td>323</td>
<td>279</td>
<td>218</td>
<td>153</td>
</tr>
<tr>
<td>Construction</td>
<td>323</td>
<td>279</td>
<td>218</td>
<td>153</td>
</tr>
<tr>
<td>Automotive manufacturers</td>
<td>323</td>
<td>279</td>
<td>218</td>
<td>153</td>
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<td>Textiles</td>
<td>323</td>
<td>279</td>
<td>218</td>
<td>153</td>
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<tr>
<td>Services</td>
<td>323</td>
<td>279</td>
<td>218</td>
<td>153</td>
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<tr>
<td>Transport</td>
<td>323</td>
<td>279</td>
<td>218</td>
<td>153</td>
</tr>
<tr>
<td>Electronics</td>
<td>323</td>
<td>279</td>
<td>218</td>
<td>153</td>
</tr>
<tr>
<td>Computers &amp; Telecom</td>
<td>323</td>
<td>279</td>
<td>218</td>
<td>153</td>
</tr>
<tr>
<td>Household Equipment</td>
<td>323</td>
<td>279</td>
<td>218</td>
<td>153</td>
</tr>
<tr>
<td>Automotive suppliers</td>
<td>323</td>
<td>279</td>
<td>218</td>
<td>153</td>
</tr>
<tr>
<td>Pharmaceuticals</td>
<td>323</td>
<td>279</td>
<td>218</td>
<td>153</td>
</tr>
<tr>
<td>Commodities</td>
<td>323</td>
<td>279</td>
<td>218</td>
<td>153</td>
</tr>
<tr>
<td>Retail</td>
<td>323</td>
<td>279</td>
<td>218</td>
<td>153</td>
</tr>
<tr>
<td>Software &amp; IT services</td>
<td>323</td>
<td>279</td>
<td>218</td>
<td>153</td>
</tr>
</tbody>
</table>

Sources: GTA, Euler Hermes
THE IMF recently upwardly revised its forecasts with world growth expected at its highest since 2011. Paradoxically, Christine Lagarde expressed a lot of reservations on the sustainability of this new regime of high growth, underlining the accumulation of debt, insufficient progress in terms of structural reforms and rising risks mainly related to overstretched financial markets.

Mirroring the interrogations of Janet Yellen on the absence of inflation, IMF’s contrasted outlook embodies a persistently high level of uncertainty on the characterization of the new world economic cycle.

We propose three tracks of interpretations allowing a precise identification of where we are in the cycle, in which way the fundamental nature of the cycle has changed and how to evaluate the solidity of this cycle.

The glass ceiling factor weighing on global economic cycle

The current level of synchronization in national cycles is exceptionally high.

This is the first and most important characteristic of the current regime of growth. In 2017, World economic growth rose above +3% for the first time since 2011.

The succession of unconventional programs of monetary policies, consisting of aggressively injecting liquidity into the real economy, eventually managed to boost global demand, which in turn triggered the rebound of global trade observed in 2017.

In 2018, the largest economies still have room to grow at a fast pace, based on their position in the economic cycle, but room for further acceleration are rather limited.

We believe that the US is at a late stage of its business cycle and has one year of strong growth before cooling.

The US economy has been expanding for 32 consecutive quarters, which is longer than the average length of past periods (31 quarters).

In 2018, we expect economic growth to continue to rise above trend supported by supportive fiscal policy as tax relief could add +0.5pp of GDP.

As fiscal stimulus impacts fade away, and monetary policy tightens, we expect growth to lose some steam from 2019 onwards. Economic growth would rise by +2.6% in 2018 and 2.2% YoY in 2019 compared with 2.3% YoY in 2017.

The Eurozone is also entering a late-cycle phase, although we believe that growth could rise above trend another two years.

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Private sector sentiment gauges are at all-time highs, indicating a strong cyclical momentum supported by fast-paced growth in all key economies.

The ECB is set to terminate asset purchases in October 2018, keep assets level unchanged thereafter, and deliver first rate hike in Q2 2019. Against this background, we expect economic growth to rise to +2.2% in 2018 compared with 2.5% YoY in 2017.

For the Eurozone, distance to the peak of the economic cycle is larger compared with the US but this peak is in sight and decelerating forces are already at work.

In China, growth has already peaked. Tighter credit conditions are set to hinder investment growth and debt intensive activities.

The rest of emerging markets have more room to see higher growth as they just start reap the benefits of the recent recovery in global trade and particularly accommodative credit conditions.

All in all, the world economy is expected to grow by 3.2% YoY in 2018, the same as in 2017, with a probable deceleration at 3.1% YoY in 2019.

The identification of world growth regimes with moving quintiles shows that we are already in an overheating area, suggesting that room for further acceleration is rather limited at a global level.
The “supply” side of the global economic cycle

Global growth will remain elevated in the short run, especially because the central banks in advanced economies would tighten their policies very gradually on the back of a slow pace of inflation.

While growth is accelerating, inflation acceleration remains remarkably soft for now.

We believe this phenomenon is due to supply-side adjustments. One is the US’ emergence as leading energy supplier, as it creates downward pressures on energy prices globally. Another is an accelerating diffusion of new technology, especially thanks to the exponential development of the Internet, which reduces input and transaction costs.

A third is the wave of competitive tax reforms that is happening in advanced economies, the US being the best and most recent example. And finally, there is qualitative growth in China, which is slowly converging toward a new model of growth that is less dependent on commodity and energy consumption.

This conjunction of supply shocks is the other argument explaining why there is a strong common component in world economic growth, as typically, supply shocks boost growth and depress prices over the long-term.

The dark side of global economic cycle

Structural factors such as supply-side policies or positive transmission of a technology-driven impact explain why the band of fluctuations in world growth has begun to stabilize as a whole, but does not really clarify why we are in the upper part of this band, close to the overheating range.

In this regard, short-term factors temporarily impacting demand are more important.

To better analyze and synthesize these factors, we have built a world monetary and financial condition index, which mirrors the degree of ease with which economic players in world economies can access credit to pursue growth.

In this context, higher interest rates, declining equity prices and an appreciation of the currency all represent a tightening of credit conditions (and inversely for an easing).
From the start of 2016, the USD has begun a phase of depreciation, which, in conjunction with European liquidity injections and a massive credit stimulus in China, has produced a significant easing in world credit conditions.

As a result, world growth has suddenly reaccelerated from the second half of 2016. Since then, global credit conditions have remained significantly accommodative. The rebound of world growth alongside a rebound of commodity prices and emerging economies therefore originated from a significant credit impact, which is still in place today.

This credit factor explains IMF’s concerns and represents the dark side of the current cycle, as it foresees potential bubble corrections with direct repercussions on the real economy.

Mahamoud Islam, Julien Ayme-Dolla, Alexis Garatti
Globally, collection complexity stands at 51 on our 0-100 scale. From the lowest level of complexity in Sweden to the highest in Saudi Arabia, Chart 1 presents our updated ranking of the best and worst places to collect a debt.

Complexity proves to be ‘Notable’ in less than 3 out of 10 countries. Most of them are located in Western Europe, the only exception being New Zealand. Sweden and Germany are the best in class, just ahead of Ireland and Finland.

Nine countries register a ‘High’ level of collection complexity, notably in Asia (Japan, Hong-Kong and Singapore), but also in Europe (Poland and Romania for the Eastern side, Italy and Greece for the Western side).

A ‘Very High’ level of collection complexity appears to be the standard in most regions. In Latin America, Africa, Eastern Europe and even North America the share of countries rated ‘High Level’ exceeds 50%.

Latin America has 3 out of 5 countries with very high collection complexity: Chile, Colombia and Argentina.

Source: Euler Hermes
Africa has 3: Cameroon, Morocco and Togo. Eastern Europe has 4: Czech Republic, Hungary, Slovakia and Turkey.

The US and Canada both stand in this category as well as several countries identified in Asia, notably Australia, India and Thailand.

All in all, this ‘Very High’ level of collection complexity is the reality for more than one-third of our panel, totaling 17 countries.

Saudi Arabia, the United Arab Emirates and Malaysia are the three most complex countries when it comes to international debt collection.

These belong to the ‘Severe’ rating, totaling slightly less than a fifth of the sample. Asia has the highest number of severe countries: Malaysia, Indonesia and more significantly China leading the pack.

The Middle-East and Africa feature Saudi Arabia and the United Arab Emirates for the former, South Africa and Benin for the latter.

Russia and Mexico are also part of the group.
A closer view by region shows that Western Europe stands out with the highest number (17) and share of countries (88%) at a ‘Notable’ collection complexity, with only two countries not belonging to the same category (Italy and Greece).

This apparent homogeneity should not be misleading since this often results from uneven sources of complexity from one country to another.

For instance, dealing with debtors who have entered insolvency proceedings is more complex in Germany than in Sweden despite the fact they have the same collection complexity score.

The same story applies to North America. The US and Canada both present a ‘Very High’ complexity. But their pretty similar score is due notably to the multi-level system (e.g., County, State and Federal structure) in which protection mechanisms are generally impractical, and to the lack of efficiency in recovering an unsecured debt.

As for the Middle East, Saudi Arabia and the United Arab Emirates rank as the two most complex countries in the world.

This is due in both cases to a large number of factors: from the poor speed, high cost and general uncertainty of local legal action in Saudi Arabia to the complexity of the legal framework and the lack of independence and reliability of the courts in the United Arab Emirates.

Asia, which is the major actor in international trade, offers the most diversified picture with almost the same number of countries in each of the three most complex ratings (Severe, Very High and High), but also one better performer (New Zealand).

In Eastern Europe, there are twice as many countries with a ‘Very High’ complexity than with a ‘High’ level, and Russia which belongs to the five most complex country of the world.

FOCUS

RETENTION OF TITLE

The comparison of Retention of Title (RoT) agreements by country is relevant to collection issues because the way a RoT clause is admitted and enforced could have a significant impact on whether or not a debt could be recovered. First, numerous countries (such as Chile, Colombia, GCC countries, Russia, Mexico) would simply not recognize RoT agreements.

Second, other countries would recognize RoT agreements, but enforcement would be very limited or non-existent (e.g., US, Canada). They would discard their ability to repossess goods (thus essentially recognizing their ability to grant creditors a priority over other debts during insolvency proceedings), or they would give little importance to priority issues, thus each giving a primacy to banks (as secured creditors) against unsecured creditors. In other countries, it would not be commonly enforced because the RoT clause would be restricted, either by the nature of the goods that are concerned or by the type of proceedings (only applicable to insolvency proceedings) such as in the Nordic countries or Brazil.

Finally, in some countries, RoT is one of the best tools to collect debts (Australia, Germany, Portugal, UK). Having said this, if ownership protection clauses play a significant role in obtaining payment (or in repossessing goods), it should be recalled that registration may be necessary (the Netherlands, Portugal, Switzerland) while, unless the debtor agrees to avoid proceedings, having the clauses enforced by courts remains a prerequisite.
From one country to another, international debt collection is never the same, and its complexity depends on many different factors.

Our score gives a harmonized cross-country comparison by benchmarking local practices through objective indicators relating to the same set of core issues on payment practices, local court proceedings, and judicial proceedings.

At a global level, the score reveals that the critical factor of complexity in international debt collection is by far the local insolvency proceedings. On average, they contribute to half of the collection complexity of countries (51%). These refer to the difficulties in dealing with debtors who have entered insolvency proceedings. To name a few examples, this may be relevant when the legal framework for insolvency is excessively complex, renegotiations could lead to significant debt write-off, restructuration mechanisms are used and out-of-court negotiation proceedings exist, retention of title (RoT) would grant priority during liquidation proceedings, or unsecured creditors would have a chance to recover any part of their debt after liquidation.

**METHODOLOGY**

The Euler Hermes Collection Complexity Score is a measure of the level of complexity relating to international debt collection procedures within each given country from 0 (least complex) to 100 (most complex). The score combines expert judgment by Euler Hermes’ Collection specialists worldwide and over 40 administrative indicators relating to three areas:

**Local payment practices:** The local payment habits and regulatory framework overseeing payments. Based on the availability of financial information, payment methods, payment terms, days sales outstanding figures, local payment behavior and the legal framework relating to late payment interest and collection costs.

**Local court proceedings:** The complexity and efficiency of court proceedings - measure of the regulatory environment, chances of success, fast-track proceedings, default judgments, the formal legal action process, ownership protection and alternative dispute resolution methods.

**Local insolvency proceedings:** The existence of effective insolvency proceedings - taking into account out-of-court negotiation, restructuration and liquidation proceedings, priority rules and cancellation of prior transactions. The score is then split into a four-modality rating system: Notable (score below 40), High (score between 40 and 50), Very High (50 to 60) and Severe (above 60).
Insolvency-related complexity is clearly more of a challenge in the Middle East than in Western Europe. The most frequent issue, mentioned for almost all countries, is the low probability to recover a debt as an unsecured creditor in practice when the liquidation proceedings have commenced.

Court-related issues represent the second source of complexity at a global level.

On average such obstacles contribute 31% of the overall complexity, but with more importance in the Middle East and Asia, in relative as well as in absolute terms.

These refer to how difficult it is to deal with domestic courts.

In other words, whether the judiciary system is understandable/transparent, whether fast-track proceedings are available, whether ownership protection clauses (such as RoT) are admissible, whether ADR (Alternative Dispute Resolution methods) is an effective way to avoid courts, whether foreign forums/judgments are available/enforceable, etc.

Interestingly, those issues are the key additional factors of complexity for the countries at ‘Very High’ and ‘Severe’ ratings.

The two most frequent issues are brought up in 3 out of 5 countries. First there is the lack of a regional framework offering harmonized fast-track proceedings. Then one must tackle the rigidity in relation to reciprocity when enforcing a foreign decision.

<table>
<thead>
<tr>
<th>Issue</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>No chance to recover the debt in practice when insolvency proceedings have commenced</td>
<td>96%</td>
</tr>
<tr>
<td>No “debt write-off limitation” / loss potentially higher than 75%</td>
<td>90%</td>
</tr>
<tr>
<td>Debt restructuration mechanism available but unused or pointless</td>
<td>52%</td>
</tr>
<tr>
<td>No / limited impact of RoT agreements</td>
<td>32%</td>
</tr>
<tr>
<td>No out-of-court / amicable mechanisms available</td>
<td>30%</td>
</tr>
<tr>
<td>Insolvency framework is particularly complex, unclear or inefficient</td>
<td>22%</td>
</tr>
<tr>
<td>No debt restructuration mechanism available</td>
<td>16%</td>
</tr>
</tbody>
</table>

Source: Euler Hermes
The local payment context and practices are also often a factor of complexity, despite much less vital importance in relative terms (on average they contribute to 18% of the overall complexity).

They refer to local payment habits and regulatory framework overseeing payments.

The most frequent issue is the low level of payment culture, in almost 8 out of 10 countries.

The most complex practices occurred notably in China, India, Kazakhstan, Mexico, Saudi Arabia and South Africa.

Maxime Lemerle
NORTH AMERICA

GHOSTS OF THE PAST

The View by Economic Research

The US fiscal reform is likely to have low multiplier effects on growth and nurture debt over the long-term

Trying to follow Reagan’s footsteps

On December the 22nd 2017, Donald Trump signed into law the “Tax Cuts and Jobs Act”, while he invoked Reagan’s legacy so as to rally a greater support to his tax reform bill.

The two presidents indeed share the ambition to free up market forces through a reduction of the government’s weight and a greater deregulation. Reagan managed to pass two major tax reforms: the Economic Recovery Tax Act in 1981 and the Tax Reform Act in 1986.

If the new bill’s magnitude is similar to the 1981 fast tax reduction, the prevailing logic is closer to the 1986 bill which aimed to simplify the federal tax system and prevent fiscal dumping.

The lessons of history are sometimes cruel. During the Reagan’s era, cuts in tax rates were not accompanied by reductions in public expenditures. Reagan in fact slightly increased public expenditure, notably defense spending, to 31% of GDP from 29% of GDP between 1980 and 1988.

Ironically, the ‘Reagan recovery’ began weeks after the 1982 tax increase called the Tax Equity and Fiscal Responsibility Act (TEFRA), which significantly counterbalanced the 1981 ERTA tax cuts.

Reagan raised taxes 11 times over the course of his presidency. The double dip recession of 1982 eroded fiscal revenues, in turn requiring support in terms of public expenditures. As a result, public debt ballooned, inciting the Congress to push for tax hikes in order to restore its sustainability.

Following midterm elections, to be held in November 2018, we consider that there is a good chance for tax cuts to be reversed for debt sustainability purpose, as we don’t expect the current fiscal package to have a significant impact on growth and generate enough fiscal revenues to put US debt on stable footing.

Past tax cut programs suggest low multiplier effects

Contrary to President Trump’s argument for the largest program of tax cuts in US history, the TCJA will rank fourth in history of tax cuts program, behind the 1981 ERTA and Obama’s stimulus programs (2010 and 2013) after the subprime crisis.

These tax packages were followed by a sharp increase of public expenditures, which seems unlikely today given the fiscal hawks around Trump (e.g. the Tea Party), making President’s Trump initiatives in terms of infrastructure spending unlikely to materialize.

This could reduce investment incentives as companies will anticipate a negative contribution of the public sector to domestic demand and therefore reduce the multiplier effects of recent tax cuts.

In terms of individual tax cuts the two highest deciles of US income distribution will concentrate over 70% of the corresponding gains. Yet higher-income households have a lower propensity to consume, therefore weakening the size of the multiplier effect.

On the corporate side, tax cuts on corporations’ cash flows have also lower multiplier effects compared to infrastructure projects, which traditionally boost in a larger extent investment.

CBO’s calculations on US multipliers by category of fiscal initiative allow us to give out an average estimate of the tax reform’s impact on US growth.

We obtain a total impact on real GDP growth between 0.1-1.0 pp, taking into account the repatriation of foreign profits. The latter are expected to generate a limited impulse on domestic investment as repatriated profits are expected to be held in cash deposits, fund dividends and share buybacks as well as reduce corporate debt levels.

The spectre of debt because of partisanship

Beside the short-term multiplier impact, we attach a higher importance to the context of instability surrounding budgetary issues in the US. Partisan discussions on immigration issues blocked the voting of a continuing resolution (read: temporary fix of public finances) on budget in the US Congress.

As a result, a government shutdown (closure of non-essential federal offices) took place from December 19th 2017, and then was temporary fixed until February 8, 2018.
A government shutdown, observed several times in the past, represents a negative shock to annualized quarterly real GDP growth of 0.1-0.15 pp per week. Partisanship has reached a record high level during first year of Donald Trump’s Presidency.

Yet the IMF has demonstrated a positive relation between political fragmentation and the level of public debt.

Typically, countries with highly partisan political systems (Japan, Greece, Spain, Italy, France, US) have higher public debt compared with countries capable of bipartisanship in public affairs via a tradition of broad coalition governments (Germany, Netherlands, Finland, Sweden, Denmark).
In 2018, four Eurozone economies will top the World ranking, in terms of new export opportunities as a % of GDP

**Eurozone: The Gang of Four will lead export opportunities**

This year, four of the five world export leaders will likely be Eurozone countries: Germany, Spain, Italy and...what? France!

A pickup in global demand and regional growth is expected to have boosted euro-area real export growth in 2017 (+4.7% after +2.9% in 2016). In 2018, exports should maintain the pace, growing at +4.4%.

In 2018, exports should keep up the pace, growing at +4.4%.

In Germany, export gains should reach close to 3.8% of GDP in nominal terms. Growth acceleration in the US and France, its two largest export partners, should help German export performance.

We expect exports to grow +4.4% in 2018, as they showed continued momentum in November 2017; exports to Eurozone partners surged at their highest rate in three years. Such dynamics have added EUR +1.7bn to the trade surplus compared to November 2016. It now stands at +EUR 23.7bn (NSA).

In Italy, exports also benefited from the global trade recovery and acceleration in the Eurozone in 2017, posting a growth of +5.2%. In 2018, we expect export growth to slow to +3.4%, with export gains amounting to 2.8% of GDP.

Despite buoyant export growth in Spain the past few years, net exports only just started to positively contribute to GDP growth in 2016, which was a cherry on top of the recovery cake.

They are estimated to have added 0.5pp (after 0.7pp in 2016) to Spain’s GDP growth rate in 2017. This year, they will add +0.3pp to GDP growth, with nominal export gains amounting to 3% of GDP.

On the imports side, total imports over 12 months surpassed their 2008 levels and the EUR300bn mark in November 2017, mainly driven by the recovery of industrial intermediate goods (+8.3% 12m/12m) and consumer goods (+6.1% 12m/12m), which testifies to stronger business activity and private consumption.

**Truth and myths about France’s exports: Trying to find a balance**

Taking the above into account, France’s exports will lag behind its key Eurozone partners, even those with a lower nominal GDP (Italy, Spain), or a lower real GDP growth rate (Italy).

Belief #1: The missing SMEs: Right. According to Eurostat, there were 400,000 exporters of goods & services in Germany and 300,000 in Italy in 2015 (last data available).
In France, estimates range from 143,000 (Eurostat) to 220,000 (latest INSEE estimate), but all point to a weakness on the part of exporters, particularly SMEs.

However, solutions exist to improve the support provided to SMEs to increase their international presence, including a single export desk. This solution is (among others) being currently discussed ahead of the planned revamping of French corporate law (a kind of Macron Law: with many targeted measures but no one-size-fits-all approach).

Belief #2: France’s exports are not that weak, but our peers are particularly strong: Right.

Export-led strategies are foundations of Germany’s (with a value chain in Eastern Europe), Italy’s and Spain’s (whose manufacturers have strong exports, particularly in the car industry) economies.

Nevertheless, France still ranks 4th in our export gain rankings. Moreover, France’s exports represented 29.7% of GDP in 2017, equivalent to Italy’s export to GDP ratio.

Belief #3: More than exports, France has a trade balance problem: Partially right.

Ten years ago, domestic demand growth was the same as GDP growth, as net exports’ growth was null.

Currently, net exports change withdraws -0.5pp per year to France. So, with +2.5% domestic demand growth in 2018, GDP growth would only be about +2%. There is probably a competitiveness issue for French manufacturers.

France will likely end 2017 with a EUR63bn deficit, according to customs (-2.8% of GDP).

But, there are two reasons to stay optimistic: (i) Customs does not take into account transactions made in France but involving non-residents, despite the trade nature of these transactions.

The Balance of Payments, however, shows a trade deficit of only -42bn (-1.8% of GDP); And (ii) Both sources show a deterioration of the trade balance by -14bn in 2017.

Out of the 14bn, 11bn can be explained by higher hydrocarbon imports (a shutdown of nuclear power plants in Q1 and higher energy consumption in November). The deficit is not only explained by a competitiveness issue.

Stephane Colliac, Georges Dib
ASIA
GRADUALLY TIGHTENING

Monetary policy to tighten gradually in the region, impact on growth to remain subdued

No more easy money

After the GFC and prior to 2017, Asia-Pacific economic growth has remained remarkably high, as the region performed much better than the world average. Yet, the expansion was pretty unbalanced with: (i) rapid growth in credit; (ii) deflationary pressures in the context of over-capacities accumulation; and (iii) unsynchronized demand drivers (exports down, domestic demand up).

Since 2017, though, things have changed somewhat. Output expansion has remained strong (+5.0%), but is now associated with manufacturing reflation. Excess capacities are diminishing, and demand growth shows some synchronization as both exports and domestic sales expand at a steady pace. More importantly, this year’s capex cycle looks more promising on the back of higher risk appetite and positive corporates sentiment.

Against this background, central banks’ priorities are shifting toward a tightening bias. We expect all central banks to tighten their monetary policy gradually over our forecast horizon (2018-19).

Five reasons back our forecasts: First, inflation is set to pick up speed. Second, economic conditions are better oriented, which gives some comfort to central banks in raising their key rates. Three, downward pressures on the currency are expected to increase with tightening monetary policy in the US, China and Japan. Four, asset prices have increased at a rapid pace in markets such as mainland China, Hong Kong, Australia and New Zealand, which creates financial stability risks. Fifth, strong growth in credit must be tamed to improve growth sustainability.

Overall, the slow pace of tightening would allow Asia pacific economic growth to remain in a solid range of +4.8% in 2018.

China: Taming financial risk

Disinflationary pressures have reduced on the back of rising producer prices, and we expect inflation to pick up speed to +2.5% in 2018 (from +1.6% in 2017). Economic conditions have improved with both exports and domestic demand continuing to grow in sync, and a strong labor market (unemployment rate at 3.9%). Against this background, the authorities are set to focus on reducing financial risks namely, high debt (non-financial corporate debt at 163% GDP), high real estate prices, and high risky lending activity (“shadow banking”).

As such, we expect a continued tightening of regulations.

The government has already enacted property-related measures such as purchase restrictions, higher down payment requirements and mortgage rates, and (ii) improved the regulatory framework to reduce risky lending practices (shadow banking activities, e.g.) through tighter supervision.

The PBoC is set to raise its benchmark lending rate, but at a slow pace (from 4.35% to +4.60% by end-2018) in order to keep growth rates in a manageable range.

Japan: A two-phase tightening

On the monetary policy front, the BoJ is set to stick to its target for the 10-year JGB yield (“around zero percent”) for the time being. Yet, with a tightened labor market (unemployment rate at 2.7% currently) and a gradual rise in inflation, the central bank could start to signal a more flexible approach to the +2% price stability target later this year.

In the absence of external shocks and assuming that wages start to pick up speed after spring negotiations, we could see further inflationary pressures. We expect the 10-year JGB yield target to be raised to 0.1-0.3% (from around 0% now). The short-term policy rate will be kept at -0.1% in 2018 before an increase to 0.1% in 2019 as growth momentum consolidates.

Emerging ASEAN and India: Each country has its own pace

We see two groups of markets in the region. In Malaysia and the Philippines, central banks are expected to tighten their policy this year, as: (i) inflation moves steadily within their target ranges (2-3% and 2-4%, respectively); and (ii) growth strengthens.

Both markets are set to record a firm growth in 2018 (+5.0% in Malaysia; +6.8% in the Philippines) and the labor market is tightening.
Apart from reigning in inflation, gradual hikes will help avert financial stability risk factors stemming from high household debt (Malaysia) and downward pressure on the currency in the context of Fed and PBoC hikes.

In India, Thailand and Indonesia, we expect the first policy rate hikes to happen in 2019.

Economic growth is picking up but is fragile, underpinned by robust trade growth and a rise in public infrastructure spending (Thailand and Indonesia) and a rise in foreign direct investment (India and Indonesia).

As inflation is still under control, we expect central banks to adopt a wait-and-see approach until economic growth consolidates above +3% in Thailand, 5% in Indonesia and +6.5% in India.

High-income markets: Moving policy rates up

All high-income markets (Hong Kong, Singapore, Australia, New Zealand and South Korea) in the region have tightened their regulatory framework (constraints on housing purchases, tighter lending rules) in order to reduce housing risks and high household debt. We expect the next moves to be broader, as growth has consolidated and inflationary pressures are dissipating.

Mahamoud Islam

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*SGDNEER slope to increase as disinflationary pressures dissipate

Sources: IHS, Euler Hermes
Monetary and Financial Conditions are easing in Latin America. Yet country stories bring balance to the regional picture

The IMF defines monetary and financial conditions (MFC) as “the ease of obtaining financing.” It showed MFC’s predictive impact on GDP.

Favorable regional picture

First, the Institute for International Finance’s (IIF) bank lending survey indicates bank lending conditions in Latin America eased for the first time in four years in Q3 2017 (index above 50, at 52.9). They should have eased further in Q4 (57.0). Credit standards eased and demand for loans increased, facilitating financing of the real economy.

Second, credit spreads have narrowed after peaking in 2016, with the corporate spread (CEMBI for Latin America) now lower than in 2013, and the sovereign spread (EMBI for Latin America) back at its early 2015 level. Lower bond yields translate into lower borrowing costs, thus stimulating investment and consumption. Two-year CDS spreads have significantly narrowed, benefiting from higher levels of risk appetite. Latin American economies have thus managed to increase sovereign bond issuances by 15% in the first three weeks of 2018 compared to 2017.

Finally, the Latin America MSCI Composite index surpassed the 3000 mark in Jan. 2018 after tumbling as low as 1600 early 2016. It now approaches the pre-2015-16 recession peak of 3700 points. This easing of MFC could spread to the economy, through equity markets (better access to financing for companies) and wealth effect on households (potentially higher consumer spending).

Zooming in, country stories are more balanced

In Brazil, MFC eased, as the central bank cut the policy rate seven times in 2017, and is expected to maintain an accommodative stance. While corporates are still deleveraging, credit to households is accelerating (+5.8% last Nov.), which should strengthen the recovery of private consumption. Still, we expect market volatility (especially foreign exchange) to hamper financing; the culprit is political uncertainty ahead of October’s presidential election. This supports our scenario of a modest recovery in an exceptionally uncertain election year.

Mexico’s high level of financial integration in the region makes its MFC positively correlated with global financial conditions, which have recently improved. However, the central bank has hiked its key rate ten times since Nov. 2016 (now at 7.25% up from 3.0%) to counter the peso depreciation and inflation. Concurrently, total Mexican credit growth has started to decelerate. Moreover, peso volatility looms amid NAFTA talks and the election campaign; resilience but slight deceleration could be in sight.

In Argentina, financial conditions are closely linked to commodity prices, which steadily improved in 2017. In addition, despite a tight monetary policy regime which lasted until early Jan. 2018, credit growth has accelerated (+51% in Dec. from +31% a year earlier). Yet, this growth is explained by persistently high inflation (+25% in Dec.) and a weak banking system (financial credit now amounts to only 15% of GDP, versus 47% in Brazil). Finally, the recent rate cuts should further weaken the peso, helping curb the current account deficit by boosting exports. Along with the return of business confidence and prospects of structural reforms, MFC easing should give Argentina’s growth an additional boost.

Georges Dib
Concerns of overheating economies in Central Europe and Turkey have risen since H2 2017. Several countries have posted high and accelerating GDP growth rates, notably Turkey (+11.1% y/y in Q3), Romania (+8.8%), Poland (+4.9%) and the Czech Republic (+4.7%). In Central Europe, this was accompanied by tightening labor markets (rapidly declining unemployment and surging wages).

In Turkey, however, high wage growth came along with an increase in unemployment. Combined with recovering energy prices, rising wages contributed to a rapid rebound in inflation in Central Europe and double-digit price growth in Turkey. Nonetheless, central banks across the region did not hike their key policy interest rates in 2017, with the exception of the Czech Republic. Indeed, as energy price-related base effects waned, inflation leveled off in most Central European countries at end-2017 and remained within the respective central banks’ inflation target ranges. Yet, there is a risk that second-round effects of rising wages will boost core inflation and thus consumer prices in the course of 2018 if monetary policy stays too loose for too long. This has already happened in Romania, where inflation continued to rise until December (3.3% y/y) and is forecast to increase further. In Turkey, inflation eased to 11.9% y/y in December from the 14-year high of 13% in November, but this is still well above the central bank’s 5% target.

Another cause for overheating concerns has been the significant pro-cyclical fiscal stimulus in Romania and Turkey. Romania has also seen a markedly rising current account deficit in 2017 (expected at -3.2% of GDP), though it is fully covered by net FDI inflows. Turkey’s notoriously high current account deficit also rose to almost -5% of GDP in 2017, and to make matters worse, only 19% of it is covered by net FDI inflows. Other countries in the region have kept their fiscal and current account balances at adequate levels.

On a positive note, private sector credit growth has remained in check in Central Europe, below the long-term EM average of +10.5% y/y. However, in Turkey it surged again to +23% y/y at end-2017. To summarize, Romania is facing significant overheating risk, driven by surging wage growth and pro-cyclical fiscal stimulus. In January, the central bank began to take action, with a tentative 25bp hike in its key policy interest rate. More tightening is expected to reign in risk. Turkey is a different story. Strong cyclical swings in GDP growth and inflation, along with rapid credit expansion and large current account deficits have marked ongoing economic imbalances for at least 15 years now, reflecting continued high country risk rather than overheating. Only in the past 2-3 years, there has been a return to prudent fiscal policies, which only adds to the country’s problems.

For the region as a whole, overheating concerns are overdone, but watch out for Romania and Turkey.

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MIDDLE EAST
A TOXIC MIX

Spillovers from regional conflicts and high vulnerability to domestic political shocks continue weighing on the Lebanese economy

Political crisis is over, for now, political risk is not

The political crisis triggered by Prime Minister Hariri’s resignation in early November 2017—supposedly under pressure from Saudi Arabia amid mounting tensions between the kingdom and Iran—has cooled off in the meantime. Hariri officially revoked his resignation a month later after all members of the government reconfirmed in a rare show of unity that Lebanon should stay out of regional conflicts.

Another breakthrough was achieved in mid-December. The authorities proclaimed that, after years of delays, the first parliamentary elections since 2009 will be held on 6 May. A new electoral law will introduce a more proportional representation and give small, reformist and nonsectarian groups a chance to enter parliament.

That said, we do not expect the election to fundamentally change the balance of power in Lebanon. The political system will remain dominated by the need to preserve the fragile balance among the main religious groups. The president has to be a Maronite Christian, the premier a Sunni Muslim and the speaker of the National Assembly a Shia Muslim. This power sharing encourages patronage and limits the effectiveness of policymaking.

While outright sectarian hostilities are likely to remain contained until after the elections, tensions in Lebanon can flare up again at any point of time thereafter, especially as the two big regional powers, Saudi Arabia and Iran, tend to fight proxy wars in other countries (for example Yemen). Overall, political stability and security will remain fragile over the next two years or so.

Large macroeconomic imbalances constitute continued high economic risk

The short-term improved political environment at home is likely to better the economic outlook in the near term as well. We forecast real GDP growth to pick up to +2% in 2018 from an estimated +1.6% in 2017. However, as the situation in neighboring, war-torn Syria will continue to affect Lebanon’s economy in the medium term, a return to earlier high growth rates is unlikely (Lebanon posted annual average growth of +5.6% in 2001-2010). Inflation is forecast to ease to an average 3.5% in 2018 from 4.4% in 2017.

Otherwise, large economic imbalances will continue weighing on the economy. The government has posted high fiscal deficits which amounted to an average ~8% of GDP over the last 10 years. The shortfall narrowed to an estimated ~7% in 2017, in part due to one-off fiscal measures, and is forecast to come in at around ~7.5% in 2018. Consequently, public debt is very high at about 150% of GDP.

Moreover, the current account balance continues to record huge deficits, on average ~18% of GDP over the last 10 years. Net FDI inflows (which have a long-term nature) covered only 20% of the external shortfall in 2016, a sign of weak foreign investor confidence in the country.

On a positive note, foreign exchange reserves have remained on an uptrend. At USD44bn in November 2017, they covered some 16 months of imports and continue to support the fixed exchange rate regime, mitigating transfer and convertibility risk in the short term.

Nonetheless, the large twin deficits and the steadily rising public debt level coupled with the exchange rate peg and the fragile political environment signify a “toxic” mix that justifies the worst rating level for Lebanon in our assessment of country risk.

Manfred Stamer, Georges Dib
They’ve got the power

Infrastructure development is a structural driver of Africa’s economic growth. Filling in the infrastructure gap comes with urbanization and industrial innovation, as long as these two engines are triggering higher production capacity and income growth.

African economies can need to streamline their use of natural resources, particularly water. Hydropower can contribute to increased and more efficient power generation to fulfill growing producer and consumer needs.

Hydropower already accounts for 21% of power generation in Sub-Saharan Africa (excl. South Africa).

But the significant unused water capacity and the expected rise in power consumption will together fuel new investment in dams. As such, many new projects in the region have been planned, some of which are already approaching completion.

Dams: East coast vs. West coast

In Ethiopia, only one-third of the population currently has power connectivity. The country’s most notable project, the Grand Ethiopian Renaissance Dam (6000 MW) is currently under construction. The new dam is designed to increase Ethiopia’s hydroelectric capacity from 3800 (in 2016) to 37000 MW by 2037 (and 17000 by 2020), an initiative that is needed in order to sustain the country’s high GDP growth rates (9.5% on average during the last 5 years).

In Côte d’Ivoire, the Soubre dam was inaugurated in last November. As the inception of the project, which will increase the country’s hydroelectric capacity by 50%, was 50 years ago, this is testament to the country’s improved political stability and business climate over the past years. Côte d’Ivoire advanced in the World Bank’s Doing Easy of Doing Business ranking to 139th in 2018 from 177th in 2013. This achievement has also attracted additional investments. The dam was fully financed by a Chinese investor.

Issues for implementation

Such projects are growth-supportive in structural terms, but better if the 3 following risks are addressed:

Debt: If the financing triggers a too strong increase in terms of debt levels. External debt in Africa has increased to 35% of GDP in 2017 from 20% in 2012, but was 57% in 2012. So while this is not a limitation at present, watch for future trends.

Social cohesion: Since dams are benefitting some populations in their ability to change the repartition of water resources, they may trigger dissatisfaction among some, particularly in regions that are still quite fragile politically.

Geopolitics: Dams may change the level of water available in downstream parts of a river. This is precisely the concern expressed by Egypt, as a result of the construction of the Grand Ethiopian Renaissance Dam on the Blue Nile.

Stephane Colliac
CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

The statements contained herein may include prospects, statements of future expectations and other forward-looking statements that are based on management’s current views and assumptions and involve known and unknown risks and uncertainties. Actual results, performance or events may differ materially from those expressed or implied in such forward-looking statements.

Such deviations may arise due to, without limitation, (i) changes of the general economic conditions and competitive situation, particularly in the Allianz Group’s core business and core markets, (ii) performance of financial markets (particularly market volatility, liquidity and credit events), (iii) frequency and severity of insured loss events, including from natural catastrophes, and the development of loss expenses, (iv) mortality and morbidity levels and trends, (v) persistency levels, (vi) particularly in the banking business, the extent of credit defaults, (vii) interest rate levels, (viii) currency exchange rates including the euro/US-dollar exchange rate, (ix) changes in laws and regulations, including tax regulations, (x) the impact of acquisitions, including related integration issues, and reorganization measures, and (xi) general competitive factors, in each case on a local, regional, national and/or global basis. Many of these factors may be more likely to occur, or more pronounced, as a result of terrorist activities and their consequences.

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