Middle East: Escalation spiraling out of control?

On 14 September Saudi Arabia suffered from a heavy assault on its oil infrastructure. National oil company Saudi Aramco’s most important crude processing facility at Abqaiq and the Khurais oil field were attacked by drones and/or missiles, removing 5.7 million barrels per day or about half of Saudi oil production, reducing feedstocks to petrochemicals, and cutting gas production by 50%. Details have remain opaque so far. Iran-backed Houthi rebels in neighboring Yemen – which Saudi armed forces have fought against since 2015 in support of the Yemeni government, largely without success – have claimed responsibility for the attacks. But the U.S. has blamed Iran though without evidence for now. Iran has denied any involvement. Saudi Arabia has so far not blamed anyone directly. While it is still speculative to guess about the eventual consequences of this very dangerous incident, it is almost certain that (geopolitical) risks in the Middle East will rise further. So, what are the near term economic implications for the key players in the conflict and for oil prices?

In Saudi Arabia, the return to full oil production capacity could last from some weeks to several months, in which reduced oil output will impact fiscal and export revenues, widening the fiscal deficit (forecast at -6.8% of GDP before the attack) and narrow the current account surplus (+6% of GDP) in 2019. However, the negative impact on economic growth will be roughly counterbalanced by increased (re-)construction output; hence we maintain our +1.2% GDP growth forecast for 2019.

Iran’s economy has already been in dire straits since the re-imposition and extension of U.S. sanctions since May 2018; and its widely alleged involvement in the attacks will increase its international isolation further. Real GDP is forecast to drop by -7% in fiscal year 2019/20 and should shrink further thereafter. The benchmark Brent crude oil price climbed by +20% from 60 to 72 USD/bbl intraday on 16 September, as Saudi Arabia accounts for about 10% of global output, half of which was disrupted as a result of the attacks. But the price has fallen back to 65 USD/bbl at the time of writing, as Saudi Arabia sought to reassure markets that it can keep up supplies in the near term, in part by utilizing oil held in storage.

We expect that this will be tested in the next weeks and that oil prices should remain volatile. Our central forecast remains for an average Brent price of 66 USD/bbl in 2019, for now. There is an upside risk in case of protracted Saudi supply loss, beyond 30 days. The high case would be 68 USD/bbl.

U.S.: Fed cuts but future path is uncertain

As expected, the Federal Reserve lowered the overnight Fed Funds rate by 25bp from a range of 2%-2.25% to 1.75%-2%. The statement accompanying the move was largely unchanged, citing strength in the labor market and consumption but weakness in business investment, exports and inflation. Also lending support to the decision was “…the implications of global developments for the economic outlook…” (trade war, Brexit, etc.). However the future evolution of rates became more uncertain as two Fed members dissented, wanting to keep rates unchanged, while another dissented and wanted to cut rates by 50bp. Similarly the “dot-plot” showing where Fed members expect rates to be at the end of 2019 and 2020 showed wide dispersion. Ten of the 17 members expect that rates would not fall below the current level, but seven expect another cut this year. Futures markets put the odds of another cut at 59% and EH believes that more cuts are in store. The cuts are intended to support the economy in the face of a slowing labor market, a contraction in manufacturing and a possible rise in trade tensions.

Algeria: Benign neglect is not an option

Algeria now has a date for its presidential election (12 December) but still does not exhibit any growth per capita. In Q1 2019, GDP expanded by +1.5% y/y, below population growth for the eight quarter in a row. This has put pressures on debt and liquidity ratios. Export growth was hardly above 0% during the past quarters, not allowing for any rebalancing of the trade deficit. And the weak business climate (protectionism, political crisis) did not allow for financing through capital inflows. Thus foreign reserves have continued to decline at a rapid pace, with import cover falling from 16 months at end-2018 to an estimated level of 12 months as of August 2019, based on recent capital flows and trade dynamics. The current political paralysis also means that hardly any efforts of fiscal consolidation will be made, resulting in a fiscal deficit of -7% of GDP per year, financed through money creation, but without avoiding higher public debt (48% of GDP forecast in 2019). GDP growth should slow down to +1% in 2019 (from +1.5% in 2018).
Countries in Focus

Brazil: Dovish window of opportunity
The second straight cut in the monetary policy rate (by 50bp to 5.5%) by Banco do Brasil (BCB, Brazil’s central bank) can be interpreted as an attempt to ignite a cyclical boost amid structural impediments to economic growth. In other words, after having been cautious for a year, recognizing domestic and external risks to the inflation outlook, the BCB has adopted a dovish stance. The monetary policy committee (Copom) acknowledged “the consolidation of the benign scenario for prospective inflation should permit additional adjustment of the degree of stimulus,” which opens the door for one or two more rate cuts this year. Such rate cuts should have the desired stimulus effect only after policy risk dissipates and business confidence is partially restored, notably when the pension reform is voted in the Senate next month. Yet the BCB remains cautious, stating that “the outlook remains uncertain, however, and risks of a more pronounced slowdown in global growth persist.”

EU: Further trade diversion from the U.S.-China trade dispute
Year-to-date, trade flows between the U.S. and China decreased by -EUR45bn with -EUR33bn lower U.S. imports from China. However, the EU continues to benefit from the trade diversion through higher export flows to both the U.S. and China (+EUR28bn to the U.S., more than double compared to the same period in 2018, and +EUR10bn to China, almost the double). But the fall in trade flows between the U.S. and China has not been fully compensated: in total a loss of -EUR16bn compared to the same period of last year was registered. Brexit is also disturbing EU trade flows with a rebound in EU exports in July (+5% m/m) as UK companies accelerated their contingency stockpiling. Year-to-date the EU gained +EUR2.4bn in exports to the UK, with France being the top exporter (+EUR2.1bn vs a loss of -EUR2.5bn for Germany). Export growth for European companies should moderate going forward as the trough in global activity should be reached in Q1 2020 (incl. a technical recession in the UK at the turn of the year).

Benin vs. Nigeria: Free trade – deeds vs. words
Benin and Nigeria jointly signed the African Continental Free Trade Union in July, but no more than just a month later Nigeria closed a part of its border in order to limit its food imports from Benin (and Niger). Nigeria and Benin are also two members of the Economic Community of West African States, promoting free trade in West Africa. Nigeria is importing food despite enough land and labor to be self-sufficient, as a result of output losses driven by infrastructure bottlenecks. Its neighbors have become trade hubs for imports to be re-exported to Nigeria (Benin plays this role, as well as Lomé port in Togo) including through informal channels. Nigeria now wants to encourage the development of food processing at home instead of importing it. The problem for Benin is its sizeable current account deficit (-8.5% of GDP) which is unlikely to narrow given Nigeria’s blockade, and a likely deterioration of its liquidity situation and payment behavior if the conflict persists. Benin’s GDP growth is expected to decelerate to +5% in 2019 and +4% in 2020 (from +6% in 2018).

Taiwan: Growth set to slow down after a strong Q2
The economy has surprised on the upside so far in 2019 as unexpectedly strong real exports and investment boosted GDP growth to +2.4% y/y in Q2, after +1.8% in Q1. Higher tariffs on mainland Chinese exports have prompted Taiwanese companies to move investment and production back home from the mainland. As a result, exports to the U.S. have been boosted, in particular by surging shipments of information and communication products. Hence, USD-denominated exports of goods fell at a slower pace of -1.2% y/y (or a +2.3% y/y gain in TWD) in Q2 and increased by +1.2% y/y in July, compared with a -4.7% y/y drop in Q1. Coupled with a +19% y/y rise in tourist arrivals, this resulted in a +4.1% y/y expansion in real exports of goods and services and a +6% increase in fixed investment in Q2. That said, the recent export recovery may prove short-lived amid increasing external uncertainties, including the prolonged uncertainty in U.S.-China trade tensions with new tariffs added as well as the trade conflict between Japan and South Korea. We forecast full-year growth of +1.8% in 2019 and +1.1% in 2020.

What to watch
- September 20 – Canada July retail sales
- September 20 – Poland August retail sales
- September 20 – Poland Sept. business confidence
- September 20 – Turkey Sept. consumer confidence
- September 23 – Eurozone September flash PMIs
- September 24 – Czechia Sept. economic sentiment
- September 24 – France Sept. business confidence
- September 24 – Germany ifo business climate index
- September 24 – Hungary monetary policy meeting
- September 24 – Turkey Sept. business confidence
- September 24 – U.S. Sept. consumer confidence
- September 25 – Argentina August trade balance
- September 25 – Czechia monetary policy meeting
- September 25 – France Sept. consumer confidence
- September 25 – U.S. September new home sales

DISCLAIMER
These assessments are, as always, subject to the disclaimer provided below.
This material is published by Euler Hermes SA, a company of Allianz, for information purposes only and should not be regarded as providing any specific advice. Recipients should make their own independent evaluation of this information and no action should be taken, solely relying on it. This material should not be reproduced or disclosed without our consent. It is not intended for distribution in any jurisdiction in which this would be prohibited. Whilst this information is believed to be reliable, it has not been independently verified by Euler Hermes and Euler Hermes makes no representation or warranty (express or implied) of any kind, as regards the accuracy or completeness of this information, nor does it accept any responsibility or liability for any loss or damage arising in any way from any use made of or reliance placed on, this information. Unless otherwise stated, any views, forecasts, or estimates are solely those of the Euler Hermes Economics Department, as of this date and are subject to change without notice. Euler Hermes SA is authorized and regulated by the Financial Markets Authority of France.© Copyright 2019 Euler Hermes. All rights reserved.