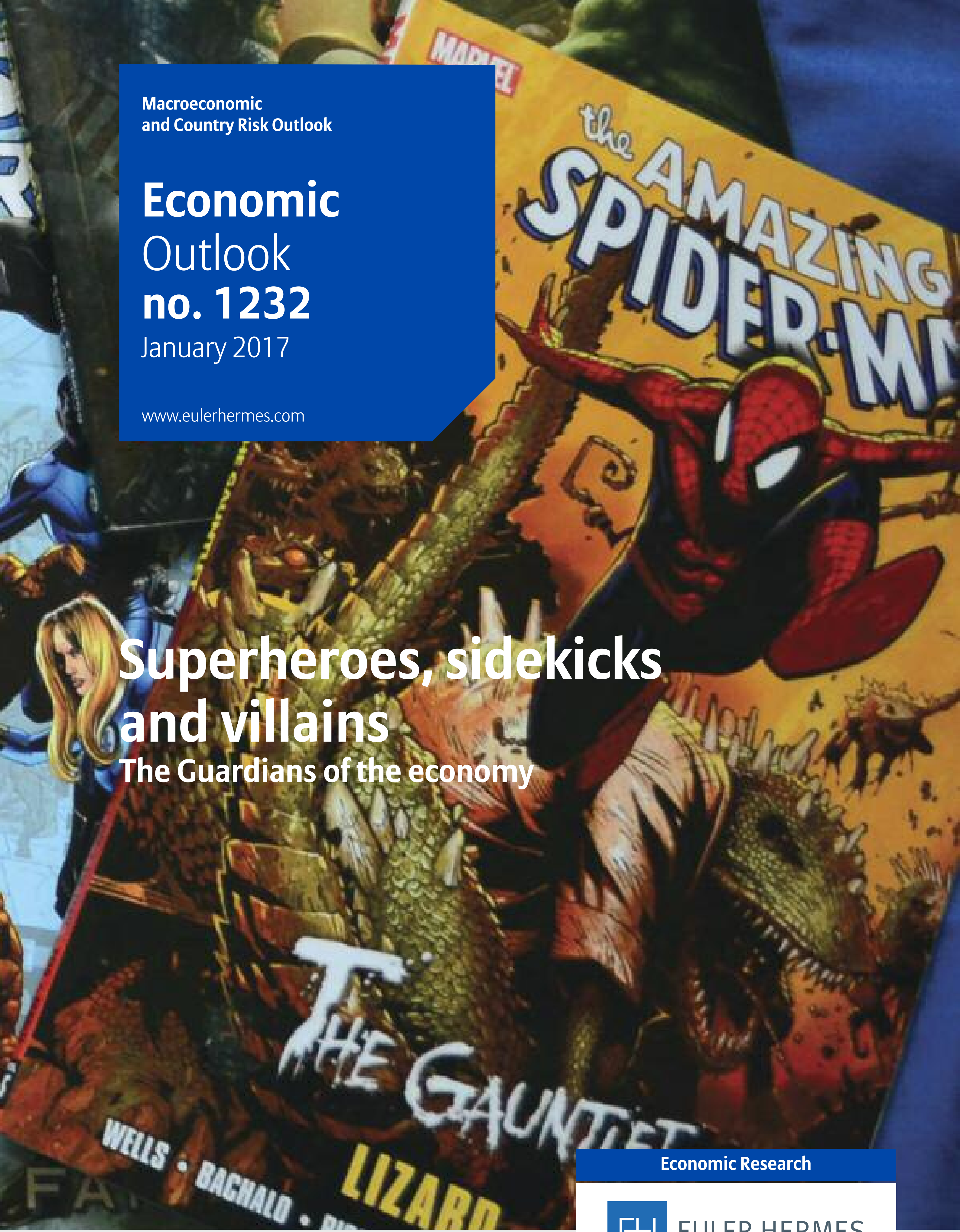

Macroeconomic
and Country Risk Outlook

Economic Outlook no. 1232

January 2017

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Superheroes, sidekicks and villains

The Guardians of the economy

Economic Research

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EDITORIAL

Superpowers

LUDOVIC SUBRAN

As much as we like to share the awe and wonder the global economy has in store for economists, we have to spell out one harsh truth. 2017 will neither be MARVEL-lous, nor comic, nor super. But it may have more in common with those superheroes in Marvel's comic books you used to read as a child. They have all matured into blockbuster movies and adult-size costumes and most likely invaded a supermarket near you.

Yet it is not too late if you haven't yet indulged in such fun reads. Sit back, download the movie (legally), dress up if you wish as Superman, Batman or the Hulk – we will no judging you - and enjoy. The Guardians of the Economy are here.

Why is it important for you to rediscover your inner child? Why should you frolic along with your inner clown?

Because around the G20 negotiation table, the UN Assembly General, the Eurogroup, and any other global forum, there are superheroes, sidekicks and villains are going through the motions. Surprise! Fiction may, once again, be not that far from reality.

Yes, they may have lost some speed and aura. But what they lack in stamina, they will be making up in malice. The real fun part is that they all want to use their superpower, at the same time and without much coordination or afterthought. The results can be HUGE.

Keep an eye for Captain America, the European Spiderman, the Chinese Ironman and the Fantastic Four of the emerging world. 2017 promises to be quite a show. Sidekicks will attempt to gravitate around superheroes, flexing their muscles and vivifying the masses. Villains will be looking for mistakes and causing mischief.

From monetary shields to policy web shooters, from super resilience to shocks to the hyper flexibility of companies, super countries around the world - and their sometimes less super policy-makers - will have to make full use of their superpowers to face another year of surprises.

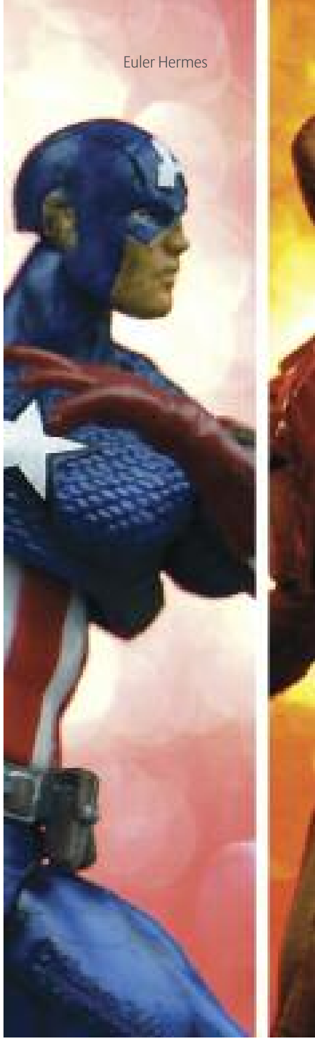
One must "*Govern [them]selves with love, kindness, and service to others*", as Wonder Woman quipped. She was right.

"*Heroes are made by the paths they choose, not by the powers they are graced with*" Iron Man summarized.

But when it comes for super quote that explains why policy choices will matter more than anything else Batman rules. "*It's not who I am underneath...but what I do that defines me.*" Wise words.

After years of mutant economics, global growth will face three of the most powerful X-Men. The price Wolverine, the trade and finance (de)Magneto, and even more policy Storm(s). Reflation, de-globalization, and political risk are once again running the show this year.

Yet, the global stage could be quite secondary this year. In the end, the only kryptonite superheroes know are polls.



OVERVIEW

Superheroes, sidekicks and villains

The Guardians of the economy

MACROECONOMIC AND SECTOR RESEARCH TEAMS

- Global GDP growth is expected to end up at +2.5% in 2016, showing resilience in spite of the many economic and political hurdles. In 2017, growth should pick up to +2.8%, staying below +3% for the seventh consecutive year.
- The US would benefit from a fiscal boost pushing growth to +2.4% in 2017. After a year of uncertainty and economic pause, the aftermath of the election is already bringing confidence back. The active policy-making should spur private investment if political noise, tighter financing conditions, and renewed protectionism are contained.
- The Eurozone will grow +1.6% in 2017. It will continue to face its usual set of teething troubles from Brexit and the Italian banks situation to a busy election year in key countries. Strong institutional stopgaps (accommodative monetary policy, fiscal stimuli, and European programs) will help contain risks.
- China will address its fragilities such as credit risk and excess capacities to avoid volatility. Yet strong public support and cautiously accommodative monetary policy will help reach +6% growth this year.
- In emerging markets, the absence of a broad-based acceleration will increase selectivity. Private sector spending will be pivotal in some countries (e.g. Russia and India). The business cycle may be limited by ongoing adjustments in others (Brazil and South Africa), while another group of countries may even face growing imbalances (Mexico, Turkey).
- Reflation, isolationism for trade and financial flows, added to policy nudges will shape most of 2017-18 risks and opportunities for businesses around the world.

+2.8%
Expected global GDP growth in 2017

Unbreakable growth hits a glass ceiling

A series of unexpected events jeopardized global growth in 2016: from the Chinese stock market crash in January, to the oil prices drop to USD27/bbl in Q1, to the Brexit vote in June, to the busy political scene in emerging markets, to the US elections outcome in November. All defied expectations. Along with the rise in populist and protectionist votes, global trade volume growth reached +1.9% in 2016, its lowest level since 2009. Yet various forms of global and local resilience came to the fore to offset the tremors and turbulences. World GDP growth did not collapse and is expected to finish the year at +2.5%. With Chinese GDP growth at +6.7%, UK growth at +2%, oil prices back above 50 USD/bbl, and stock markets scaling new peaks to reach record highs post Trump's election, things are not all bleak. In 2017, GDP is forecast to increase by +2.8%. This slight pick-up may be due to a large extent to the acceleration in the US, the exit from recession in Russia and Brazil, and the resilience in Europe and Asia. Yet, the diverging fate of the Four Musketeers (US, Europe, China, and the Emerging World) and the possible dueling between them - as globalization is deemed guilty of all woes - should keep global growth below +3% for the seventh consecutive year, a glass ceiling that has become harder to break, year after year.

Indeed, the US and China could take a more aggressive stance on trade and investment whereas Europe will be keener on balancing growth and politics. Decision makers want to make sure that European stopgaps and policy-making from the accommodative monetary policy of the European Central Bank (ECB) to the recommended fiscal stimulus by the European Commission provide enough buffers against the pain points of 2017. And there are quite a few of those: elections in France, Germany and the Netherlands, the everlasting Brexit route, the vulnerability of the Italian banking sector, will continue to make it to the headlines. As a consequence, emerging markets will be making a timid comeback as selectivity and home bias will prevail.

Such a cap on economic expansion could trigger an increase in business insolvencies (+1% in 2017), the first since 2009. In 2016, insolvencies have decreased by -2%, much slower than in the past two years. Major increases in business insolvencies in 2017 are expected in Brazil (+15%), China (+10%), South Africa (+5%), Turkey (+5%), and the UK (+5%).

Chart 1 Real GDP growth,annual change, %

	2015	2016	2017f	2018f
World GDP growth	**2.7**	**2.5**	**2.8**	**2.8**
United States	2.6	1.6	2.4	2.2
Brazil	-3.8	-3.5	0.6	1.8
United Kingdom	2.2	2.0	0.9	0.6
Eurozone members	**1.9**	**1.7**	**1.6**	**1.5**
Germany	1.5	1.8	1.7	1.7
France	1.2	1.3	1.4	1.3
Italy	0.6	0.9	0.6	0.8
Spain	3.2	3.3	2.3	2.0
Russia	-3.7	- 0.6	1.0	1.2
Turkey	6.1	1.3	1.0	2.0
Asia-Pacific	**4.9**	**4.8**	**4.7**	**4.5**
China	6.9	6.7	6.2	5.8
Japan	0.6	0.8	1.0	0.9
India	7.6	7.2	7.5	7.5
Middle East	**2.1**	**2.1**	**2.2**	**2.6**
Saudi Arabia	3.4	1.2	2.0	2.5
Africa	**3.1**	**1.6**	**2.6**	**3.3**
South Africa	1.3	0.5	1.5	1.5

* Weights in global GDP at market prices, 2016

Sources: IHS, Euler Hermes forecasts

REGIONAL OUTLOOK

© figurine. image courtesy of Pat Lolka, flic

US Captain America: Flexing fiscal muscles, picking trade battles

Our baseline scenario for the US (65% likelihood) foresees a partial implementation of the electoral policy pledges made by President Donald Trump, including the launch of a fiscal stimulus package for 2017. The subsequent reflation will cause the Fed to tighten at a faster pace over the next three years

As a result, we expect a short-term boost in US growth to +2.4% in 2017 with a slight slowdown to +2.2% in 2018. This will take place against the background of a somewhat contained medium-term risk of negative spillover of the policy-making (e.g. retaliatory protectionism).

The rise of the fiscal Avenger

First, fiscal measures could include a decade-long spending on infrastructure to the tune of USD0.5tn over 10 years. This amounts to half of what the new president promised during his campaign and though disbursements may be delayed as projects are identified (and private investment and debt called to the rescue), this will be an important policy stance.

As for taxes, companies may operate in a more hospitable environment thanks to a corporate tax rate cut from 35% to 15% and the expensing of capital expenditures over the first year instead of 10 years. This should be enacted in line with the electoral promises. This will favor private investment and should incentivize cash piles on balance sheets to be put to work. Certain individuals could benefit from partial personal income tax cuts, but to a lesser extent compared to electoral promises.

However, the fiscal stimulus is expected to bring total public debt above the debt ceiling of USD20.1tn (to be reinstated in March 2017). The US Congress would probably lend its support to increase the limit further, but a temporary government shutdown cannot be excluded.

Secondly, domestic, non-tradeable sectors such as Retail and Construction should benefit the most this demand boost. Some tradeable sectors could also benefit from improved competitiveness and deliberate support, such as the anti-dumping measures in the metal industry. Others such as textile or electronics could, on the contrary, be more impacted by the negative spillovers of the Trump Administration's trade policy than by positive externalities of the fiscal boost.

+2.4%

Expected US GDP growth in 2017

Chart 2: US policy baseline and alternative scenarios

	Full policy implementation 10%	Partial policy implementation 65%	Minor policy implementation 25%
Tax cuts	✓Corporate tax to 15% ✓Expensing of CapEx over the first year and (presumed) disallowance of interest expenses deductibility ✓Full personal income tax cuts	✓Corporate tax cut from 35% to 15%, ✓Expensing of CapEx over the first year and (presumed) disallowance of interest expenses deductibility ✓Partial personal income tax cuts	✓Corporate tax to 15% ✓Expensing of CapEx over the first year and (presumed) disallowance of interest expenses deductibility ✓Partial personal income tax cuts
Public spending	USD1tn infrastructure spending over 10 years	USD0.5tn infrastructure spending over 10 years	USD0.25tn infrastructure spending over 10 years
Trade	✓China: 45% tariff on goods ✓Mexico: 35% tariff on goods, full withdrawal from NAFTA	✓China: 15% tariff on goods effective late H2 2017 ✓Mexico: start of NAFTA renegotiation, some non-tariff barriers could be implemented	

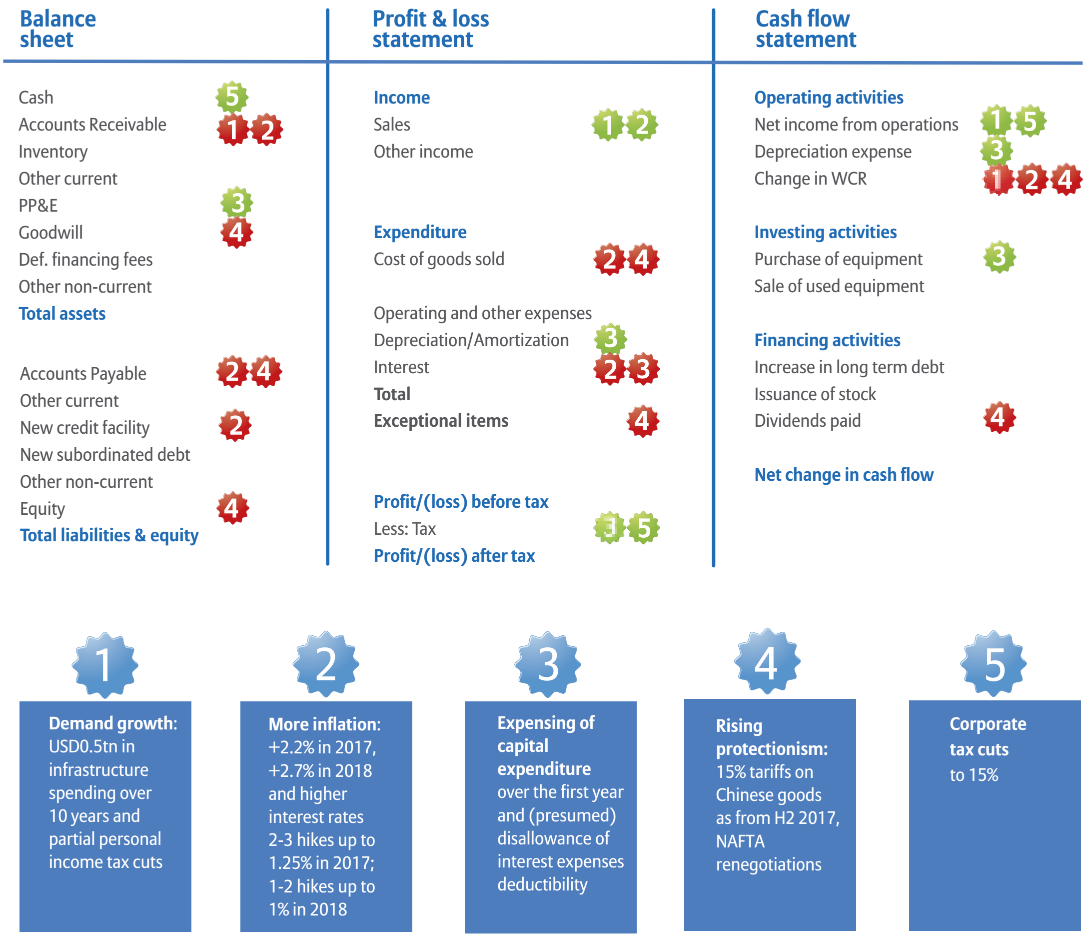
Source: Euler Hermes

Chart 3: US Economic forecasts – Baseline and alternative scenarios

	Full policy implementation 10%		Partial policy implementation 65%		Minor policy implementation 25%	
	2017	2018	2017	2018	2017	2018
Real GDP growth	2.7%	1.4%	2.4%	2.2%	2.3%	2.1%
Nominal import growth	-0.1%	-4.7%	2.3%	0.4%	4.0%	4.5%
Wages	4.6%	4.9%	3.8%	4.1%	3.4%	3.7%
Inflation	3.2%	3.5%	2.2%	2.7%	2.0%	2.2%
Unemployment	4.4%	4.6%	4.9%	5.0%	5.0%	5.1%
USD scenario (variation)	4.5%	4.0%	3.3%	3.2%	3.1%	3.0%
Fed scenario	3-5 hikes	2-3 hikes	2-3 hikes to 1.25%-1.5%	2-3 hikes to 1.75%-2.25%	1-2 hikes	0-1 hike
Deficit (USDbn)	-994	-1,220	-794	-920	-694	-720
Total debt (USDbn)	20,642	21,487	20,573	21,643	20,530	21,487
Business insolvencies	0.0%	7.0%	1.0%	5.0%	2.0%	5.0%

Source: Euler Hermes

Simulated impact of selected policy actions of the new administration on US companies' financial statements



Source: Euler Hermes

Last, at the company level, there is a series of channels of impact to be expected and eventually favor American companies: the demand boost and corporate tax cuts will favor cash generation, while capital expenditures incentives will ensure future productivity. On the other hand, inflation and the rise of interest rates may increase cost of financing and will make debt harder to access. Also, protectionist measures will strain input costs, hence deteriorating profits and cash flow from operating activities. Eventually, the combination of business growth, supply cost uncertainties, and more expensive financing could increase working capital requirements and credit risk.

The monetary shield will be deployed faster

Robust consumer confidence coupled with a near full employment labor market and rising wages means that the economy will run the risk of slight overheating in 2017. The fiscal stimulus (even without imported inflation from new trade barriers) will push inflation expectations and thus US long-term yields higher. The Fed has hiked interest rates a second time in December 2016 (+25bp to 0.5%-0.75%) after the first hike in December 2015 and has suggested a more sustained path of rate hikes going forward. Though a scenario à la 1994 – a rapid tightening which caused a credit crunch – is not likely, we expect 2 to 3 rate hikes each year until 2019 to get the key interest rate closer to the 3% mark. This will end up the long-awaited normalization cycle after experimentally accommodative monetary policy. Potential negative effects of scarcer liquidity in USD could be found in the emerging world.

Protectionism: Beware of the Winter Soldier when it comes to trade

Implications for the rest of the world may be determined by financial (currencies), trade (exports to the US) and investment (net FDI to the US) flows. Two regions appear as highly exposed: the Americas and Asia Pacific. Two other regions are exposed to a lesser extent: Europe, and Middle East North Africa (MENA). Buffers such as public finances, monetary policy, and current account balances appear limited in Latin America and MENA while they are quite strong in Canada, Europe, and Asia Pacific.

If President Trump keeps his electoral promise, a substantial shift in trade partnership is to be expected, from multilateralism and regional accords to bilateral deal-making. Relations with the Pacific (TPP) and Europe (TTIP) will be put on hold. Concurrently, a more restrictive trade policy will affect countries with large trade surpluses with the US. China and Mexico are at the top of this list. The 45% tariff announced during the campaign seems far-fetched but a 15% tariffs on imported goods from China and non-standard measures such as the reinforcement of the Buy American Act, differentiation through fiscal regime, and protectionism on services could mushroom. Last, though a renegotiation of NAFTA is not likely in 2017, non-tariff barriers (tightened standards, e.g. packaging) and incentives to re-shore activities could be implemented. This would have negative consequences for US companies producing part of their products in Mexico (car industry for instance).

European Spider-Man: Agile policy-mix to protect growth

Euler Hermes expects Eurozone's GDP growth to remain resilient at +1.6% in 2017 (after +1.7% in 2016). Private consumption will continue to drive growth thanks to a pick-up in employment while oil prices remain favorable, below 63USD/bbl for the Brent (neutrality threshold). Private investment should continue to recover as turnovers and margins increase, although the busy electoral calendar ahead could create a wait-and-see syndrome and cost some GDP points. Trade should be boosted by a lower EUR in 2017 (1.05 to the USD) as the monetary divergence between the ECB and the Fed increases. The rise in input prices (lower EUR, higher commodity prices) will be partially passed through to consumers.

Watch out the Sinister three: Brexit, the Italian banking sector, and general elections

First, the Brexit Sword of Damocles continues to weigh on confidence in the UK. It is a long and painful road to secession from the EU, with many political twists. As a consequence, the British currency and new investment will continue to bear the brunt. We expect GDP growth to slow down to +0.9% in 2017 (down from +2% in 2016) and to +0.6% in 2018.

Second, the Italian banking sector remains fragile for three reasons: (i) the high stock of non-performing loans, notably bad debts equal to 12% of GDP; (ii) low profitability; and (iii) undercapitalization, especially of small-medium sized banks. Restructuring and consolidation efforts will follow in the upcoming months, with support from the public sector and European institutions. We expect Italian GDP growth to slow down to +0.6% in 2017 (from +0.9% in 2016) and to slightly recover in 2018 (+0.8%).

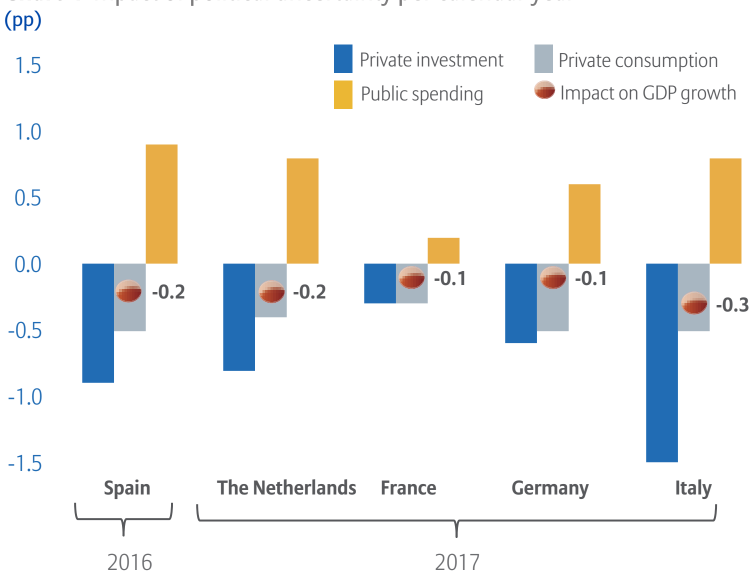
Third, France, Germany, and the Netherlands will hold general elections this year. Italy could also possible call for general elections earlier than 2018. Limited fiscal space (France, Spain), growing populist vote (Germany, France, Italy, the Netherlands) and concerns about the efficacy of public policies are among the downsides. Yet our central scenario is a series of optimistic outcomes in these elections, including a pro-European stance.

All in all, we except growth to be moderately impacted by another year of political chutzpah: -0.2pp of GDP for the Netherlands, -0.1pp for France and Germany, and -0.3pp for Italy.

Relying on policy web-shooters

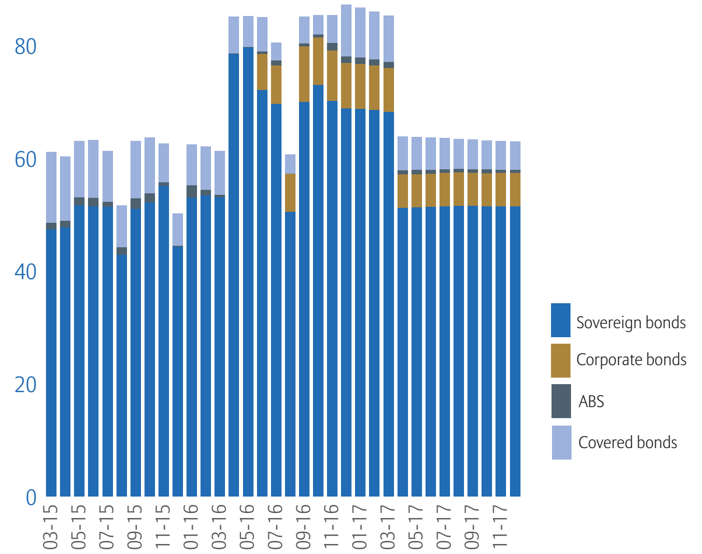
Despite balanced and stable economic growth, Europe has suffered from some jitters. The dis-

Chart 4 Impact of political uncertainty per calendar year



Sources: policyuncertainty.com, Euler Hermes

Chart 5 ECB QE program – Monthly net asset purchases
(EUR bn)



Sources: Eurostat, Euler Hermes

course across the continent has descended into populist and protective arguments. Faced with the pro-Brexit vote in the UK and the rise in populism, Europe has demonstrated better policy-making. The ECB maintains its safety net while the European Commission is pushing for more fiscal stimulus when fiscal space is available, as well as an extension of the Juncker Plan for investment.

The ECB announced in December 2016 that the asset purchases program will continue until end-2017 or beyond at a pace of EUR60bn per month instead of EUR80bn previously. This untaperish tapering (since the total balance sheet continues to increase) is the beginning of a long-awaited normalization. The ECB also announced an extension of the perimeter to more debt securities to ensure a successful implementation of the program. This means additional support of EUR540bn bringing the total program to EUR2.1tn at end of 2017. The ECB's guidance and its dovish stance continue to anchor and reassure. The risk of deflation has largely disappeared and inflation expectations are limited to +1.1% in 2017 and +1.4% in 2018. This confirms steady interest rates till 2019.

As for fiscal policy, it should be neutral in 2017 and positive in 2018. The European Commission recommended 0.5 GDP point of stimulus to support the recovery. This welcome recommendation poses concerns for countries such as Spain and France who still are above 3% deficit targets while countries who have contained their deficit such as Germany could postpone such public support to after the election. As a consequence, active fiscal policy should remain limited to already planned tax breaks in the Law of Finances of countries where the private sector has advocated for competitiveness (Ireland, Italy). At the pure European level, the tool box is being enriched as the European Commission's proposal to increase the size and the duration of the Juncker Plan (EUR500bn until 2020, an increase of EUR185bn for 2 more years) has been approved. The impact on GDP growth could be up to +0.5pp per year if fully implemented. However, disbursement today stand around 73% (EUR154bn have been currently mobilized).

EUR60bn

Monthly ECB asset purchases until at least end of 2017

The regime switch in multilateralism could also mean that Europe flexes its policy muscles on industrial, innovation and trade policy to dodge the balls coming from the US and China. The busy election calendar could postpone decisive action to 2018 but major ideas could be put forward this year to get traction from the Member States.

The Chinese Iron Man is fine-tuning its policy battle suit

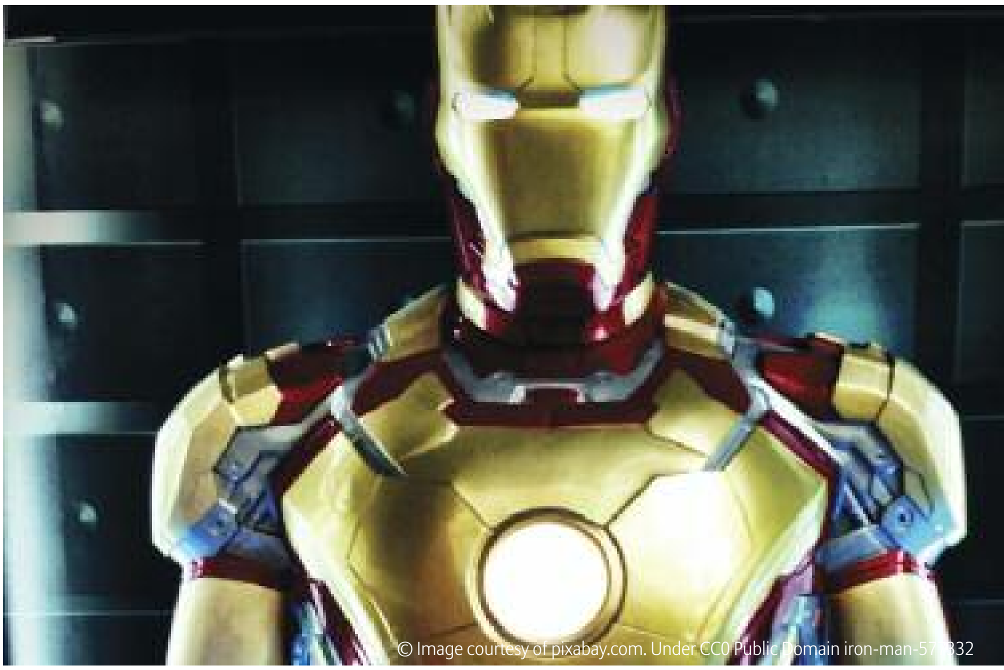
In 2017, GDP growth will remain above +6% thanks to strong public support and solid private consumption. Exports and private investment would underperform. Services will remain the main driver of the economy, while the manufacturing sector will continue to restructure.

Calibrating policy weapons will be pivotal to temper negative externalities

The authorities' ability to support growth through credit has deteriorated. For each RMB1bn of additional growth, there was RMB1.8bn of additional domestic credit in 2011. It is now RMB3.6bn. As credit was not used to finance productive investments the impact on economic activity has diminished. Investment efficiency has also worsened. In 2016, 6.6 points ►

RMB3.6bn

Of additional credit needed to generate RMB1 of additional growth



of capital are needed to generate 1 unit of additional GDP while in 2005, only 3.5 points were required.

Improving the efficiency of macroeconomic policies will be pivotal in the longer term. First, this will help reduce the reliance on debt. Corporate debt has increased by an average of 10 points of GDP per annum since 2012. Second, improving the return on investment could help to keep savings and capital in China. At least USD500bn have left the economy in 2016.

As a consequence, authorities are expected to focus on the following five Cs in 2017-18:

❶ Promote Credibility. Improving investors' faith in government policies will be pivotal to avoid volatility, maintain adequate capital inflows, and support private investment. Clear communication and a reasonable GDP growth target of +6% ± 0.5pp in 2017 are keys. We expect the economy to expand by +6.2% in 2017.

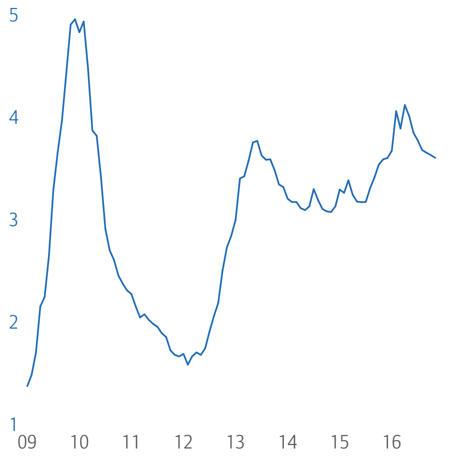
❷ Contain Credit risks. Corporate debt accounts for 170% of GDP and corporate bankruptcies are set to increase by +10% in 2017 (+20% in 2016). A tighter monetary stance in 2018 could initiate a gradual deleveraging. Meanwhile, the fiscal stance will remain accommodative to support growth.

❸ Reduce excess Capacities in the production of basic materials. This task will be tackled with a step by step approach. New orders will likely be weak with more protectionist measures overseas and a tightening property market. But supply growth would adjust at a slow pace as authorities prioritize employment over overcapacity reduction. Reforms of State Owned Enterprises (SOEs) – which are major suppliers - will likely be gradual.

❹ Manage the Currency. The RMB could depreciate by -3% in 2017 against the USD. Pressures could mount due to a diverging monetary policy with the US, less favorable news, and higher returns on investment abroad. In this context, the authorities may pursue currency internationalization but at a gradual pace to minimize the impact on growth. They would intervene in Forex markets to limit sharp adjustments of the currency, use temporary capital controls, and initiate tighter regulation to limit the pace of capital outflows.

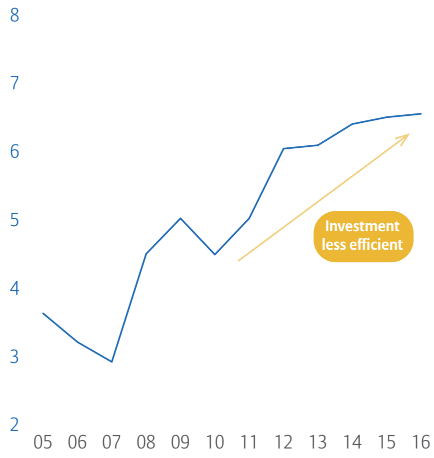
❺ Tweak the Commerce strategy. USD-denominated goods exports decreased by -7% in 2016. The US, which accounts for 18% of China's exports, may increase trade barriers. China will seek new commercial drivers: a price competitiveness boost (Market Economy Status), new customers and new investment revenues (One belt One Road), strong partnerships and political influence (Regional Comprehensive Economic Partnership).

Chart 6 Credit Intensity needed to generate 1 RMB of growth



Sources: IHS, Euler Hermes

Chart 7 Incremental Capital Output Ratio (Investment over GDP/GDP growth)



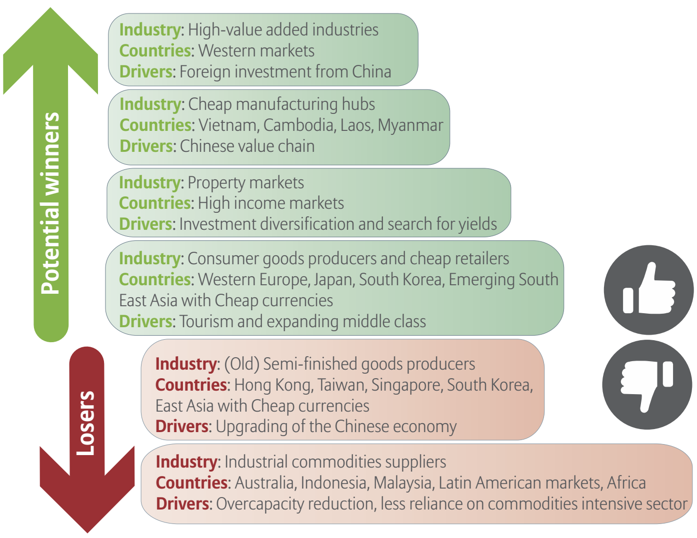
Sources: IHS, Euler Hermes

Creating its own league to promote and finance growth rebalancing

China's rebalancing has already started to impact sectors and countries around the world. Going forward, established semi-finished goods producers - Hong Kong, Taiwan, Singapore, and South Korea – along with longtime industrial commodity suppliers, will continue to feel the pinch. On the positive side, Asia's low value-added retailers, as well as high value-added Western producers, could benefit from China's new economic model.

The failed attempt to get Market Economy Status and slated protectionist measures from the US could mean retaliation and heightened political tensions between the two biggest economies in the world. The EU and Japan are expected to make concessions to preserve trade relations. As a consequence, China is expected to accelerate its outside influence agenda: (i) The One Belt One Road initiative already kicked off with projects in Pakistan and East Africa. Infrastructure financing (Asian Infrastructure Investment Bank, Silk Road Fund) has been pivotal; (ii) an agreement could be reached on the Regional Comprehensive Economic Partnership, a free trade agreement between ASEAN Members, Australia, New Zealand, India, Japan, South Korea and China; and (iii) on the currency front, the RMB internationalization as a means of payment and as reserves currency should gather steam in 2017. The overvaluation of the RMB has also been a strong enabler for China's influence agenda: acquisitions have been at a record high level for the past 18 months. This momentum should continue till mid-2017.

Chart 8 Potential winners and losers of China's readjustment



Source: Euler Hermes

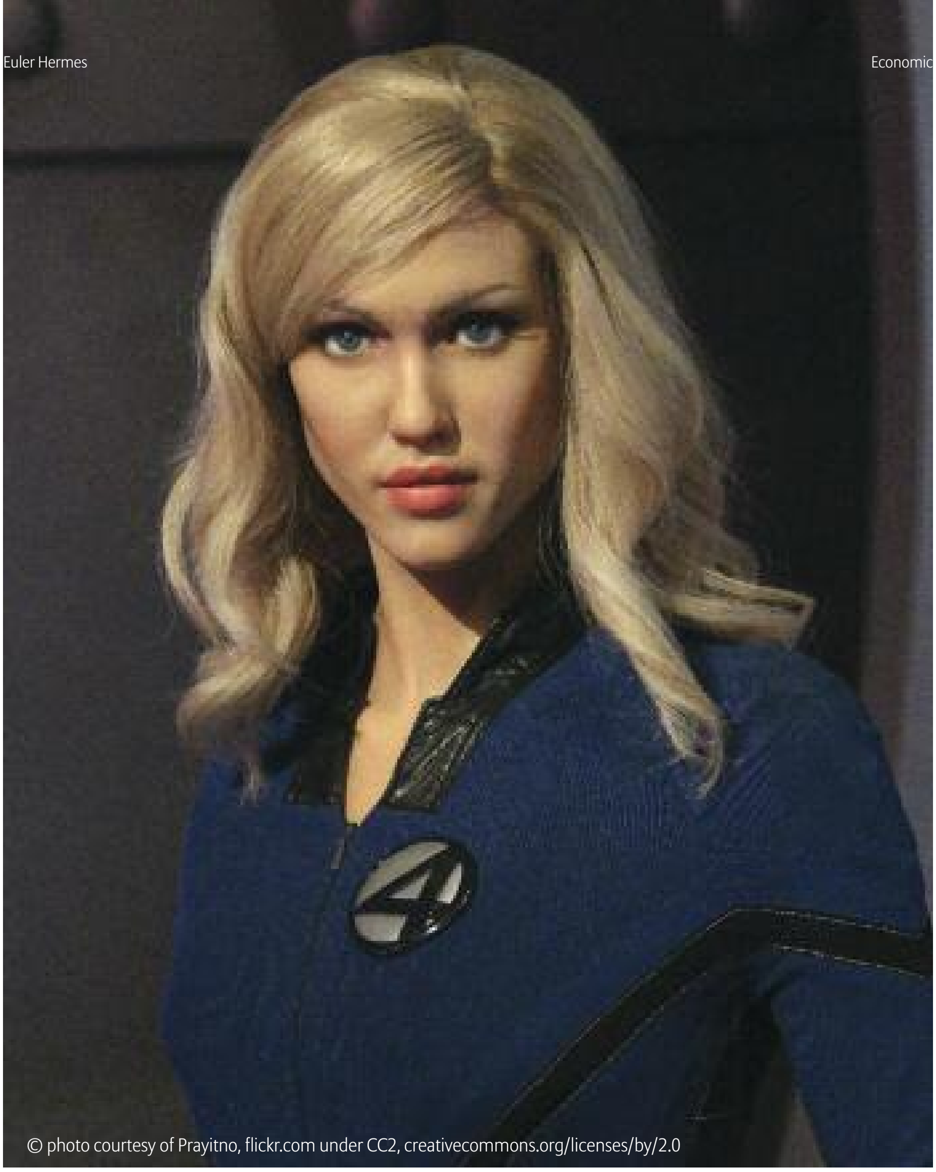
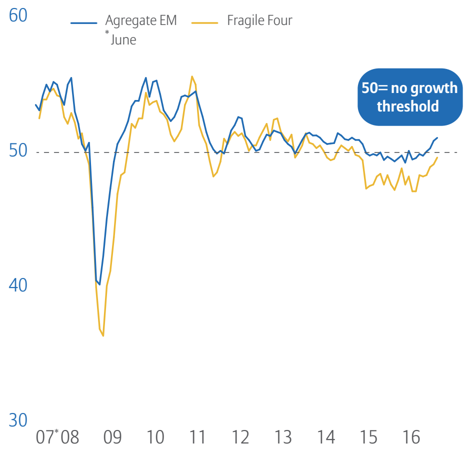


Chart 9 Emerging Markets aggregate manufacturing PMI
Fragile 4 = Brazil, Russia, Turkey and South Africa



Sources: Bloomberg, Euler Hermes

The emerging Fantastic Four will need superpowers to attract investors

Outside of the US, China, and Europe, GDP growth took a hit after the commodity price slump. The shock stemmed from China and hit many commodity exporters in emerging markets and some advanced economies such as Canada and Australia. Now that prices are recovering even mildly, growth is back in the emerging world, but not everywhere and not fully. Growth prospects and existing vulnerabilities depend on imbalances and how they are addressed: current account imbalances and internal ones (inflation) are sending strong signals for the expected exchange rate and GDP growth.

Using the inflation and current account dynamics, we defined a typology of markets outside the G3 to understand investors' selectivity going forward. First, countries with low inflation and a current account surplus (South Korea) are our Mr. Fantastic: they have ample buffers and will show higher growth in 2017. Second, countries with vibrant growth prospects as rebalancing is done both internally and externally are The Torch (India, Russia, and Poland). A third group consists of countries with stagflation and important current account deficit, trying to reduce their imbalances. They are our Mrs. Invisible since no growth is in sight this year (Brazil and South Africa). Last, The Thing: economies and policies are heading in the wrong direction (Turkey and Mexico) which would mean a backlash down the road.

Mr Fantastic (South Korea) will capitalize on buffers

Among Asian economies, one can discern several income groups (advanced economies like South Korea, and middle-income ones like China). Yet a common growth strategy emerged after the 1997 Asian Crisis: strong savings base, targeted protectionism, reinforced manufacturing sector. At the end of the day the elements that make a real difference are innovation and competitiveness.

While some countries like China welcomed an economic rebalancing, other opened advanced economies in the region such as South Korea experienced a drag on growth related to sluggish trade. But balances remained good, and the growth slowdown was contained. Buffers (strong savings) allowed an easing bias to monetary policy. Vibrant domestic credit and the oil dividend (net importers of oil) fueled domestic demand. As worldwide growth improves, Asia Pacific economies should benefit gradually.

The Torch (Russia, India, Poland) will light up growth prospects

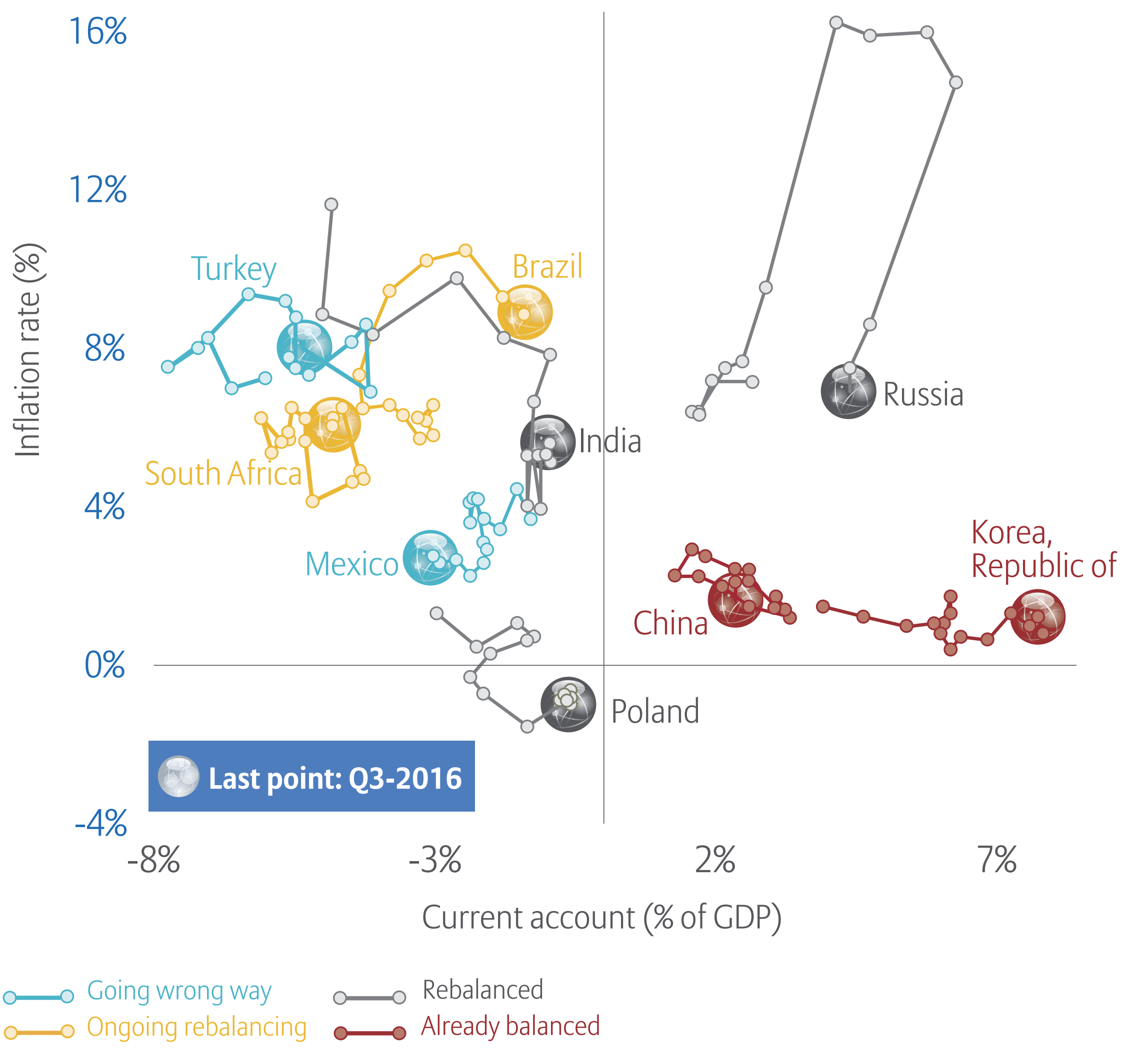
Some emerging economies decided to front load reforms and belt-tightening (or were forced to) to avoid policy slippages and start to rebalance faster than others. In a nutshell, exchange rate adjustments tamed demand prospects: lower import volumes allowed current account balances improvement. India and Poland were the first large Emerging Markets to achieve this rebalancing and thus initiated a cycle of high growth, expected to continue.

As for Russia, the improved balance means that capital inflows will be only partially needed to finance growth. The current account surplus increased from +2% to +5% of GDP despite a staggering -55% fall in export prices due to the oil price slump. This means that the private sector has been piling up savings and is now ready to finance the recovery.

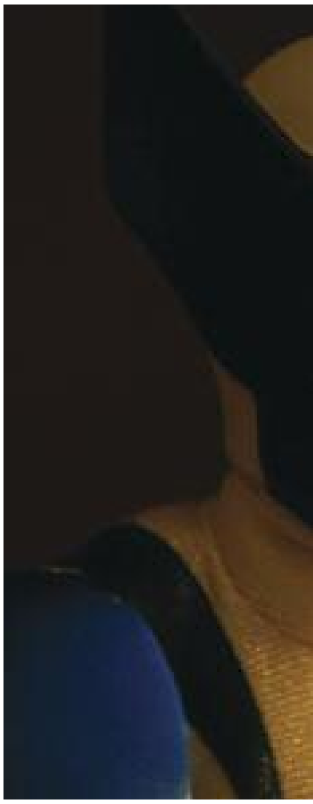
Mrs. Invisible (Brazil, South Africa): No growth in sight, for now

Among commodity-rich emerging markets, some did not take the right policy decisions in the face of adversity, often because of political ►

Chart 10 Inflation vs. current account balance dynamics over the past four years
(quarterly data)



Sources: IHS, Euler Hermes



inertia. As a result, negative and low growth episodes lasted longer and the private sector had to rebalance more aggressively to cope with a lagging consolidation of the fiscal deficit. This was particularly true in Brazil and South Africa where targeted credit support to the commodity-related investment did not adjust when prices dropped.

These economies should fare better in 2017, but prospects are limited as efficient (but costly politically) policy choices may be postponed: private sector confidence is still very low in Brazil and South Africa and elections are looming head (end-2018 in Brazil and 2019 in South Africa)

The policy Thing (Turkey, Mexico) is weighing on growth

Limited world growth over the past years was triggered by rebalancing efforts in key economies. Savers drove the world economy to low growth. Now that this global rebalancing is almost over, most countries are growing again. However, there are still economies going in the wrong way: from countries relying too heavily on commodity exports which suffered cash constraints (Ghana, Tunisia, Egypt) and sharp currency depreciations (Nigeria, Egypt) to economies where dynamics turned in the wrong way even without adverse export price change. Turkey and Mexico are two such examples. Increasingly dovish policy smoothed shocks too much, scrambling the price signal that would have nurtured diet growth. As a result, these economies are increasingly unbalanced. These countries are prone to shocks and bumpy growth should become the norm.

The X-Men: Big ticket items shaping 2017 and beyond

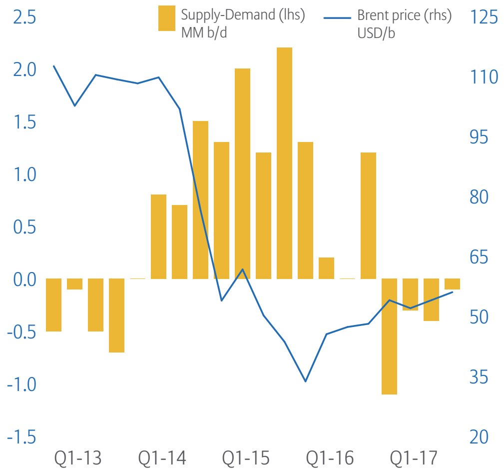
The low growth environment has yielded to key changes in the world economy. Like in X-Men, mutant economic trends can be positive heroes or toxic characters.

+15%
Rise in business insolvencies in Brazil in 2017

3
Changes in monetary policy stance in Turkey in 2016

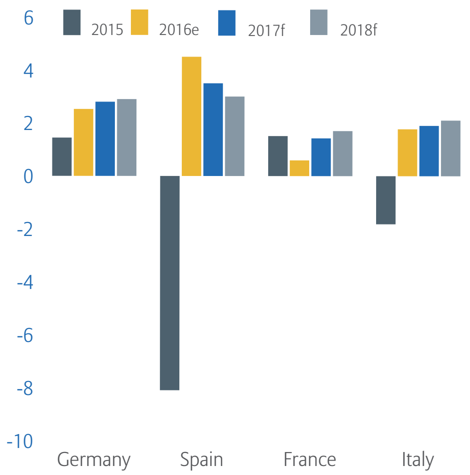
+7.5%
Expected GDP growth in India in 2017

Chart 11 The global oil market and Brent prices



Sources: EIA, Euler Hermes forecasts

Chart 12 Turnover growth (manufacturing excl. energy, %)



Sources: Eurostat, Euler Hermes

Price Wolverine to reflate the World Economy

Low growth drove balance sheet adjustments of indebted countries and sectors. As a result of lower demand growth, commodity prices and the general price level took a hit. Now, several forces favor a price recovery.

First, there is a base effect on oil prices. Oil prices have fallen by -17% in 2016 (yearly average), though markedly up from their record-low price of USD27 per barrel in February 2016. The recent OPEC deal signed in November 2016 to cut production by 1.2 million barrels a day as of January 2017, to reassure secondary producers, also worked for non-OPEC oil producers: Russia and Mexico will cut output by 0.6 million barrels a day. All this should reduce global oil supply by -2% over the year. As a result, Euler Hermes forecasts the yearly average Brent price to rise by +21% to USD54 per barrel in 2017. Two important caveats to this increase are: (i) US shale producers are rushing back into the oil market; and (ii)Iran, Libya, and Nigeria are exempted from the OPEC output cuts. Second, supportive policies are finally working. This is particularly the case for China from Q2 to date: the construction sector made a noticeable comeback, supporting worldwide metal prices. The result is the end of deflation for Chinese producer prices and even a timid recovery of the manufacturing sector globally. Accommodative monetary policy is also helping: low credit costs have paved the way to a recovery in residential investment across the board (France, in Europe, is a good example), and market inflation expectations are now fairly above +2% in the US. In addition, new pledges to boost infrastructure spending plan are driving prices up. This price recovery should be contained as higher inflation expectations will be eventually curbed by the series of rate hikes the Fed slated for 2017. Core inflation is very much in check. A wage-price spiral risk is limited in the US (maybe not in non-tradeable segments with full employment such as services and construction) and other Central Banks have been prudent with inflation targeting in the advanced economies and the emerging world. All in all, the first-round effect of this reflation trend should be positive in the short-run for companies' turnover growth and indebtedness. Negative second-round effects (higher input costs, accelerated transmission to consumer prices, wage-setting-price-setting loop to name a few) are not foreseeable at the moment.

+2.3%

Nominal GDP growth in France in 2017, above **2%** for the first time since 2011

(De)globalization: The end of the Magneto effect for trade and financial flows?

After two consecutive years of contraction, trade growth could recover in 2017 in value terms (+3.5%). Imports from the US, from Europe, and from the emerging world (Brazil and Russia, exiting recession; China growing fast) are on the rise. The recovery in value is also explained by the reflation trend, especially on commodities: food prices up +12% y/y in December 2016, and Chinese steel prices up +16% in 2016.

Yet volume growth will stay below +4% in the medium-term: we forecast +2.9% in 2017, after ►

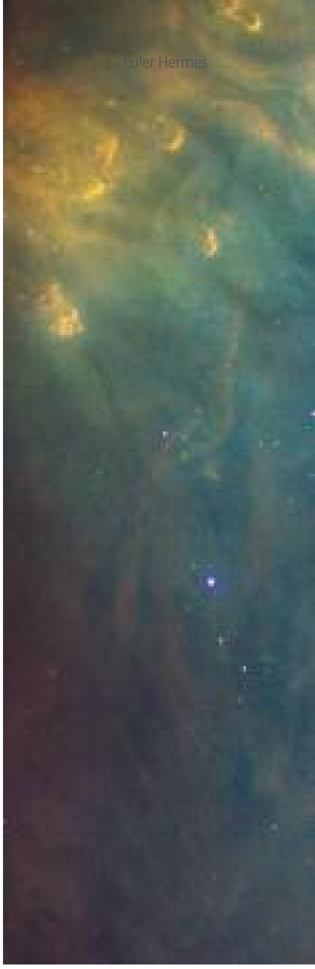
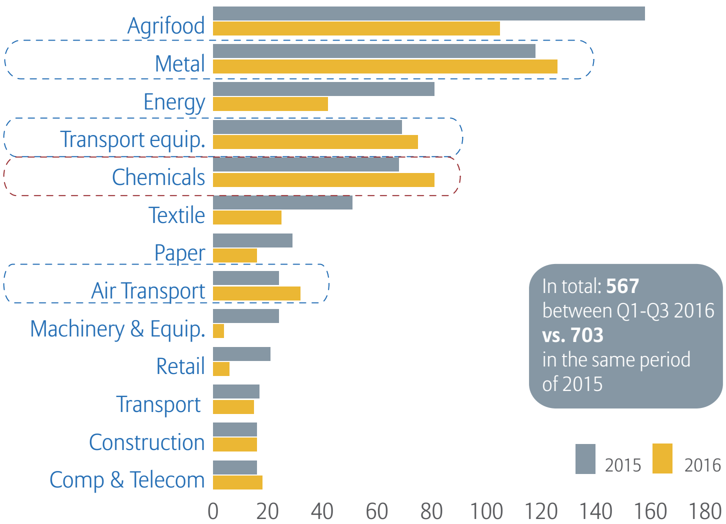


Chart 13 Protectionist measures on a global scale
(cumulative Q1-Q3 2016*)



*Date of implementation known by GTA
Sources: GTA, Euler Hermes

a record low at +1.9% in 2016. Regime switch in demand (China's rebalancing; energy autonomy in the US; adjustments in the emerging world), isolationism and servitization/digitalization explain this daunting trend. Protectionism has been increasing for the past years: 700+ new restrictive measures were introduced each year between 2012 and 2015. In 2016, only 567 trade barriers were issued during the first nine months of 2016, compared to 703 in the same period in 2015. But indirect protectionism is on the rise (public procurement, subsidies, compensation).

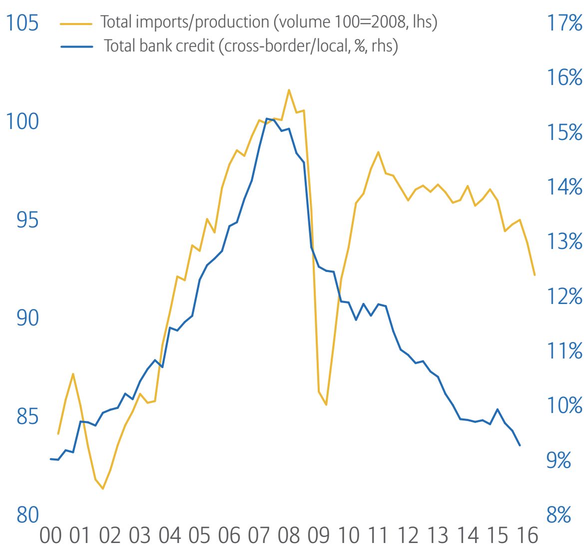
Sector-wise, three sectors concentrate 70% of all measures: Chemicals (27%), Energy (24%) and Agrifood (19%). Yet, the recent introduction of protectionist measures are in industries usually immune to such behaviors: Metal (+9% in number of measures) – the US increased import tariffs on steel by +266% with a clear impact on profits –, transport equipment (+9%) and air transportation (+33%). Investment- and job-intensive sectors in both the advanced and emerging markets are on the radar.

Going forward political escalation on location choices for visible industries (car industry for instance), shortening of supply chains, and retention of value-add will be the norm as the US and China have decidedly moved into that direction. Europe and large emerging markets have also shown they can decide to open parsimoniously to avoid a protectionist vote and use public support for transitioning sectors. However, another trend is more vivid: the financial balkanization or financial de-globalization. It will create an acceleration of isolationism if not addressed.

Indeed, financial flows within and between countries continue to disappoint: (i) capital is not going into the real economy. Credit conditions are still too conservative in Asia Pacific and Latin America for instance; and (ii) savings are staying in high-income markets, even if not yielding much (negative interest rates in Japan and the Eurozone for instance).

Domestic M&A deals are increasing faster than cross-border ones and more importantly total domestic financing grew at a compound annual growth rate of +5% between 2011 and 2015 compared to only +0.5% for cross-border bank credits delivered.

Chart 14 Deglobalization: goods vs financial flows



Sources: BIS, IHS, Euler Hermes

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Advanced economies finance and invest domestically and receive savings from countries with strong current account surplus (China e.g.). The number of M&A deals between China and Western European companies has been multiplied by five since 2010 illustrating how Chinese savings are looking for safe havens outside China.

In the meantime, emerging markets with large financing needs (Indonesia, Turkey, e.g.) still rely on short-term capital flows.

Policy nudges everywhere look like a perfect Storm

2017 will be another year of heavy politics weighing on the economic performance. Of course, the US is under scrutiny as policy decisiveness is a trait of the Trump Administration. Diplomatic faux pas will be many and non-US companies' business interests will be elbowed here and there. The risk of retaliation is high. Contagion risks are high too as the US is the largest economy, the most interdependent (largest current account deficit, the hegemony of the dollar), and the market place for many global goods and services.

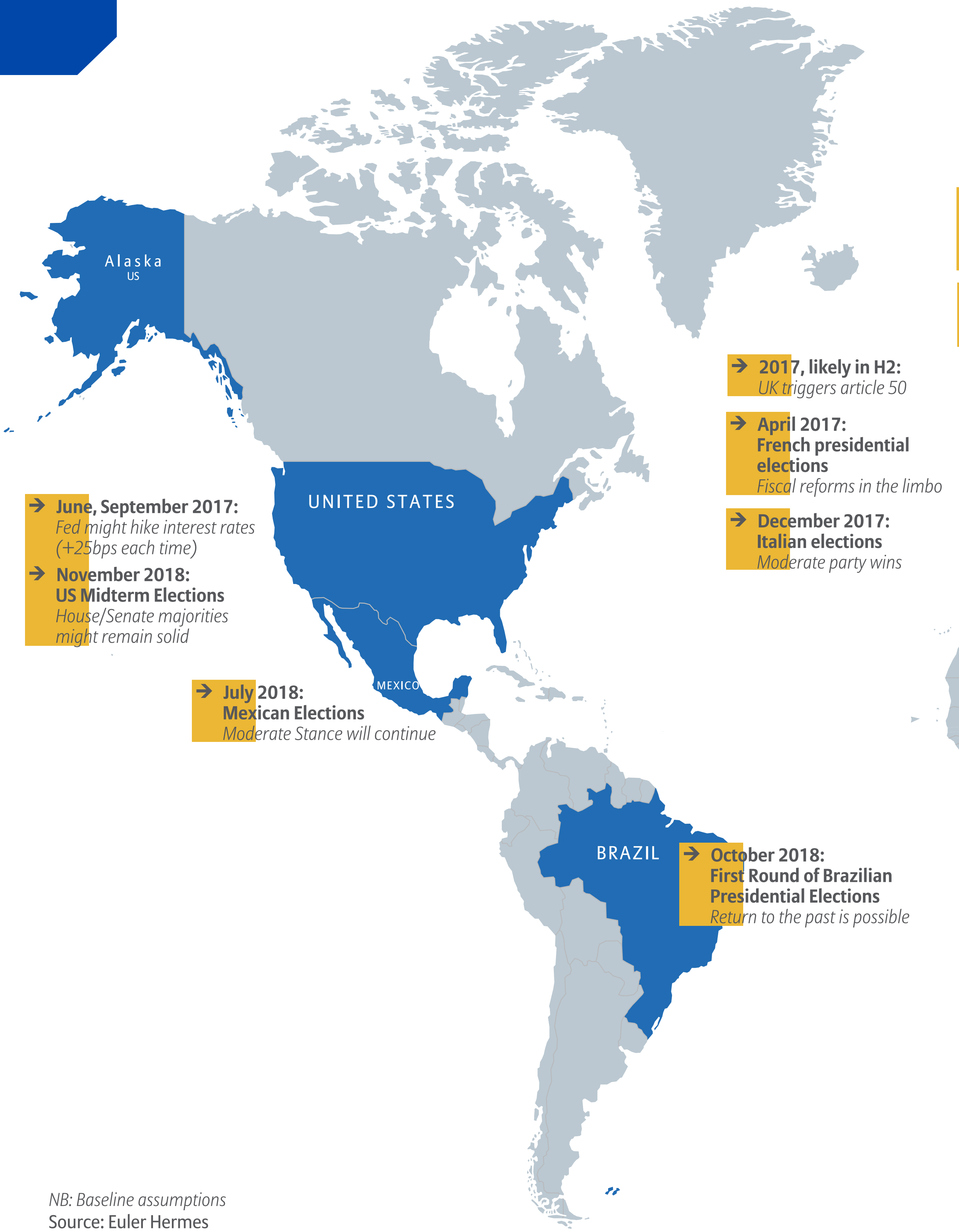
Europe will have to deal with its usual politicized agenda from the very architecture of the economic and monetary union to the refugee crisis and border control to pivotal elections: The Netherlands in March, France in April and Germany in September. Mainstream parties face strong challengers. Our core scenario excludes a populist storm but the wake-up call is already here for politicians to fix the defiance conundrum, embrace an inclusive reform agenda (to boost the middle class), and promote long-term prosperity instead of a crisis management mode. At the European level, the patches to the Italian banking sector need to hold, the Brexit process to be managed without breaking confidence (as hardliners seem to dominate the talks), and the completion of the third Greek bailout (scheduled for 2018) needs to be tight.

In China, pressures are mounting to deliver promises and restore confidence to finance growth with savings from the Chinese people. The divisions at the top are more and more visible between more market economy features and fewer ones. China's leaders seem determined to stimulate the economy to meet growth targets in the lead-up to the Communist Party Congress in October 2017 to solidify their grip on power. Still, the country is likely to become more reform-oriented and less supportive after the Congress meeting.

In other emerging markets, stormy weather will be clouding the outlook. For instance, May elections in Iran may be a game-changer for the country's recent opening, especially as the Trump Administration has voiced concerns. In December 2017, the South African National Congress will elect its new leader, who will automatically become its candidate to the 2019 presidential elections. The ongoing battle for the soul of the ANC may determine whether South Africa will continue to be frozen by rating downgrades, and political turmoil. In March 2018, the poll in Russia will likely renew the government's mandate, despite two consecutive years of recession, which are aggravated by sanctions. Mexico, which is the most vulnerable to American protectionism, will hold its elections in July 2018. Finally, Brazil's presidential elections are scheduled for October 2018. As the political spectrum remains highly polarized, the stakes are high and a return to political turmoil is not unlikely.

To conclude, the adequacy of policy responses by established political forces, and the resilience of private enterprises, will largely determine who will weather political uncertainty and a decrease in global liquidity. Beggar-thy-neighbor policies are a clear risk and businesses around the world have to rediscover economic, political and country risk intelligence, scenario and contingency planning, as well as existing hedging instruments. ■

Policy nudges 2017-2018



➔ **June, September 2017:**
Fed might hike interest rates (+25bps each time)

➔ **November 2018:**
US Midterm Elections
House/Senate majorities might remain solid

➔ **July 2018:**
Mexican Elections
Moderate Stance will continue

➔ **2017, likely in H2:**
UK triggers article 50

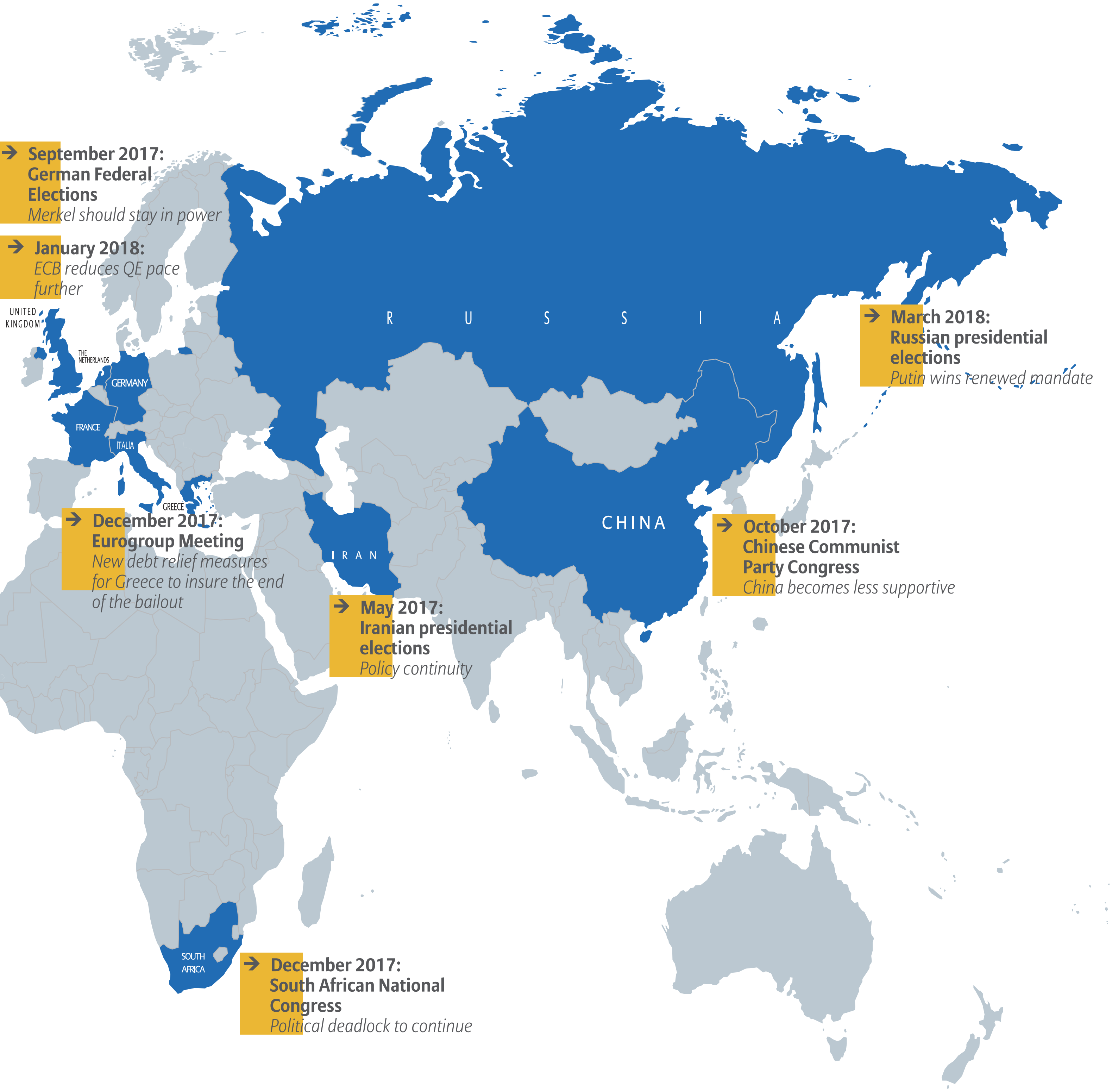
➔ **April 2017:**
French presidential elections
Fiscal reforms in the limbo

➔ **December 2017:**
Italian elections
Moderate party wins

➔ **October 2018:**
First Round of Brazilian Presidential Elections
Return to the past is possible

NB: Baseline assumptions
Source: Euler Hermes

Political seasons and policy nudges 2017-2018

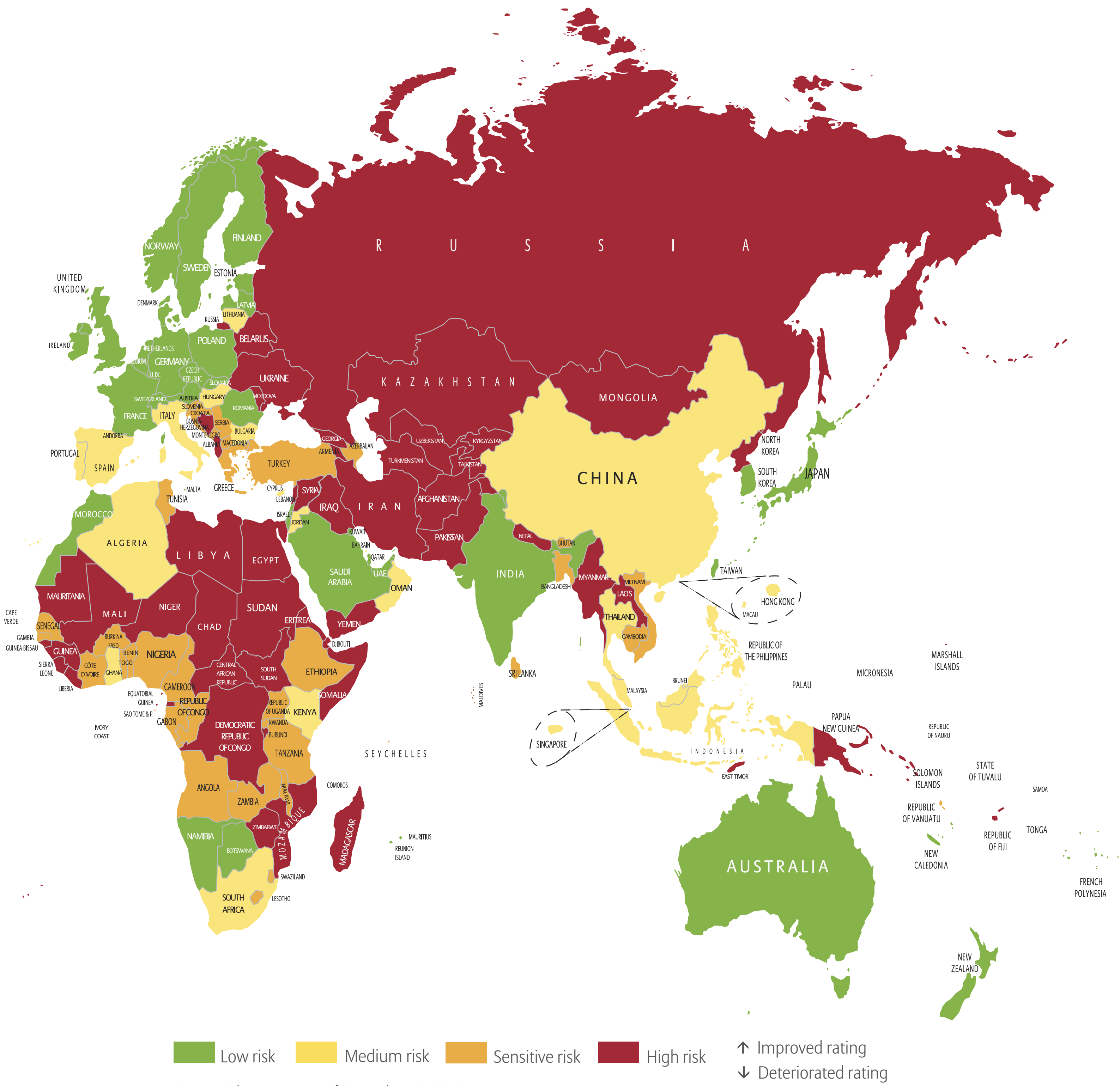


Country Risk
Levels
2016

Medium term risk:
the scale comprises **6** levels:
AA represents the lowest risk,
D the highest.

Short term risk:
the scale comprises **4** levels:
1 represents the lowest risk,
4 the highest.

Country Risk Map at the **end of 2016**



Source: Euler Hermes, as of December 16, 2016

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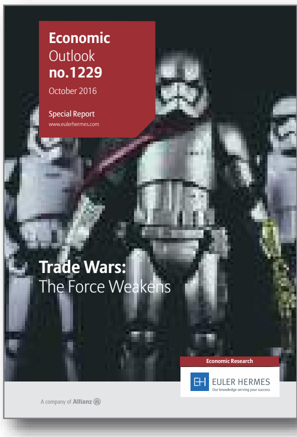

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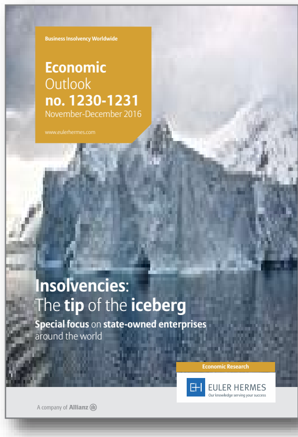

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