THE VIEW

Economic Research

November-December 2018

2018-2019: LOOKING BACK, LOOKING FORWARD

Allianz

EULER HERMES

BYE BYE 2018, HELLO 2019

LUDOVIC SUBRAN

Global Head of Macroeconomic Research at Allianz and
Chief economist at Euler Hermes

As the holiday season starts, it's time to reflect on what 2018 brought to us, and what 2019 holds in store. Looking back we can see the end of synchronization, more populism, selectivity in a volatile environment, and the end of easy money. For me, there are three lessons I learned from 2018:

1. *Trumponomics* did wake up the US – at a high cost. With a massive fiscal stimulus and financial deregulation, President Trump managed to deliver +3% growth for GDP and wages, and +6% growth for markets and investments. That is an OK performance compared to the rest of the world. Still, when taking into account widening imbalances (twin deficits), and mounting risks (corporate debt, pressure on the Fed), this is a costly awakening.
2. Emerging markets are back in the spotlight – for good. Trade threats (average tariffs at 5.2%, from 3.5% end of 2017) and tightening monetary and financial conditions (stronger dollar and higher US treasury rates) created uncertainty and balance of payment crises in already-weak emerging markets (Argentina and Turkey). In addition, large emerging markets (Mexico, Brazil, e.g.) opted for strong political leaders with unorthodox policy approaches.
3. Europe and China started to feel the heat – in a different way. As growth slowed down, China had to react with strong policy measures (subsidies, liquidity support, economic patriotism) and more risk piling as internationalization efforts stalled (financial liberalization, Belt and Road). In Europe, the difficult coordination of fiscal and structural efforts, and already supportive monetary policy made it hard to react. Political risk increased as a result: From Italy and Brexit to France and Germany.

Looking forward, what does all this mean for companies in 2019? The question is essential especially when it comes to businesses' transformation and growth agenda, as well as risk management:

1. The rules of the games are changing fast. In our economic scenario, we have penciled in positive outcomes for most political and policy-related risks (trade war, Brexit, Italian crisis, changing leadership). However, the news, especially in Europe, call for cautious optimism. Rapidly changing business conditions – and limited multilateral safety nets – are the new normal. Businesses must nimbly optimize their supply chains (trade diversion), financing and balance sheets.
2. The price of risk is increasing. In particular, the costs to grow, to trade, and to invest are growing. This takes place as we observe a soft landing across borders, financial conditions tightening, and conditional trade opportunities. Markets have become more volatile and the search for hedging increases. For companies with large refinancing needs, this is a pivotal year, and credit risks should pick up as insolvencies may be on the rise for the third consecutive year in 2019. The construction, retail, and services sectors are to be watched.
3. Will businesses invest more or less next year? The real question is whether prolonged uncertainty will stop the business transformation. Though demand should remain strong as purchasing power continues to increase in 2019, precautionary savings and risk intolerance, prevalent from 2012 to 2016, could very much make a comeback. This slowdown may provide little incentives for businesses to do the heavy lifting in 2019. Digitalization, internationalization, and sustainability, however, call for substantial and costly investments by companies.

Photo by Kyle Head on Unsplash

GAFA's loss of market capitalization since the summer 2018 peak

USD -602.5 bn

HOUSEHOLD DEBT

THE POST-CRISIS ERA OF RESTRAINT IS OVER

- **Debt growth accelerates further to 6.0% in 2017**
- **Eight years after the crisis, global deleveraging process has ended**
- **Household debt still poses no risk in most – but not all – countries**

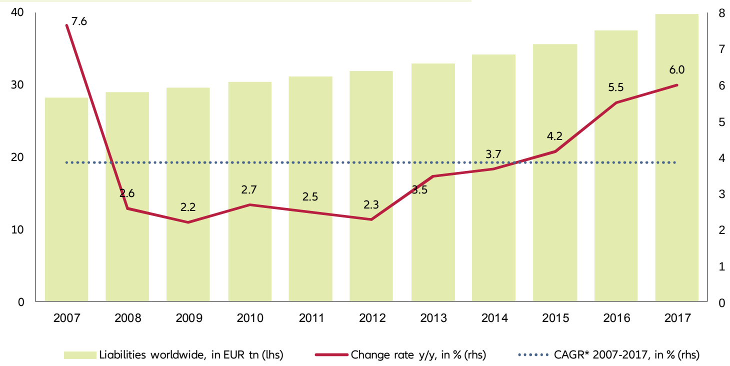
Worldwide private household liabilities reached a historic high of EUR 39.8 trillion in 2017.

At 6.0%, the growth rate was not only slightly above the previous year's level of 5.5%, but also well above the long-term average annual growth rate of 3.9%.

Debt growth has accelerated noticeably since 2013 and is gradually returning to levels seen before the financial crisis.

Low interest rates make borrowing more attractive while loan volumes have increased, particularly in the case of mortgages, in line with developments in house prices.

Figure 1 Development of global household's debt



Source: Allianz Global Wealth Report 2018

According to the Organization for Economic Cooperation and Development (OECD), the nominal house price index for OECD countries has on average risen by 21 percentage points in the last four years.

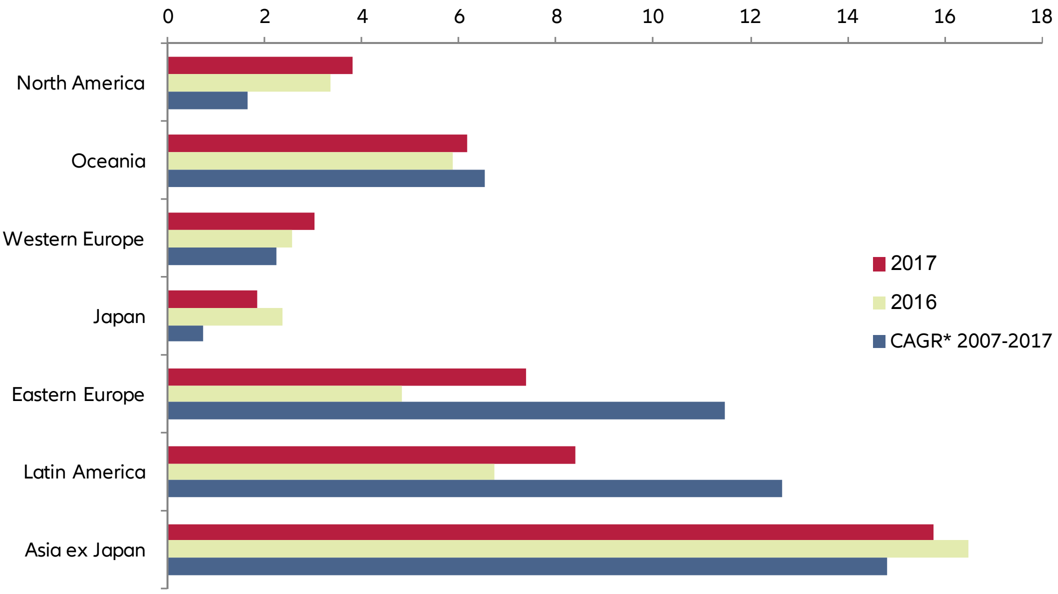
Emerging regions catch up

In most parts of the world, debts grew faster in 2017 than in the previous year. The growth rate increased over the course of the year from 3.3% to 3.8% in North America, from 5.9% to 6.2% in Oceania, from 2.6% to 3.0% in Western Europe, from 4.8% to 7.4% in Eastern Europe and from 6.7% to 8.4% in Latin America.

In contrast, borrowing slowed slightly in Japan (from 2.4% to 1.8%) and the rest of Asia, albeit it remained on a very high level (from 16.5% to 15.8% of GDP).The geographical distribution of liabilities is similar to that of assets. The richer parts of the world accounted for a total of three-quarters of global debt at the end of 2017 (North America 36.4%, Western Europe 27.6%, Oceania 4.2% and Japan 6.6%). However, their total share came to around 90% at the beginning of the last decade, which means that the emerging regions of Latin America, Eastern Europe and Asia (excluding Japan) have significantly increased in importance. Private liabilities in these three regions more than quadrupled to around EUR 10 trillion in total in the period from 2007 to 2017, with average annual growth rates of 11.5% in Eastern Europe, 12.6% in Latin America and as much as 14.8% in Asia (excluding Japan).

However, in Latin America and Eastern Europe, the impact of the financial crisis can clearly be detected. Households have been considerably more cautious when it comes to borrowing in the past five years than in the first half of the last decade: Average growth rates almost halved.

Figure 2 Increase of debt by region, in %



Source: Allianz Global Wealth Report 2018

In Asia (excluding Japan), on the other hand, credit growth remained more or less constant in both five year periods. As a consequence, liabilities in the region increased fivefold over the decade as a whole and totaled EUR 8.2 trillion at the end of 2017, 63% of which related to China alone. China's share had been only about half of this figure ten years ago.

In the developed regions of North America, Western Europe and Japan, average growth in liabilities has been a low single-digit percentage. Japan is bottom of the list with average growth of just 0.7% per year in the period from 2007 to 2017, after North America (+1.6%) and Western Europe (+2.2%). In most countries positive debt growth is a rather recent development. In Japan, for example, private debt declined until 2012. Only since did demand for credit increase again, causing liabilities in Japan to grow and bringing them to a total of around EUR 2.6 trillion at the end of 2017. In the US, too, households were forced to restructure their asset balance sheets in the wake of the subprime crisis, causing liabilities to fall by an average of 0.8% per year from 2008 to 2012. The trend has changed since then and average annual growth has risen to 2.2%. This was primarily due to student and car loans, which have grown at an average rate of 7.2% and 6.5% per year respectively in the last five years, reaching a total of EUR 2.6 trillion, or just under 17% of the total volume of loans, at the end of 2017. Before the property bubble burst, their share of the total was just under 10%. Total private debt in the US reached a new record level of around EUR 12.9 trillion.

The financial crisis also heralded a phase of restraint in borrowing in Western Europe, especially in the euro crisis countries. Households in Greece, Ireland, Portugal and Spain, for example, reduced their liabilities by a total of EUR 287 billion, or an average rate of 2.4% per year, since the end of 2008. In the region as a whole, however, the trend towards debt growth slightly picked up in the last few years. After borrowing stagnated in 2012 and 2013, annual growth accelerated continuously and reached 3.0% last year, the highest growth rate since 2008. Total debt in the region thus came to around EUR 10.9 trillion.

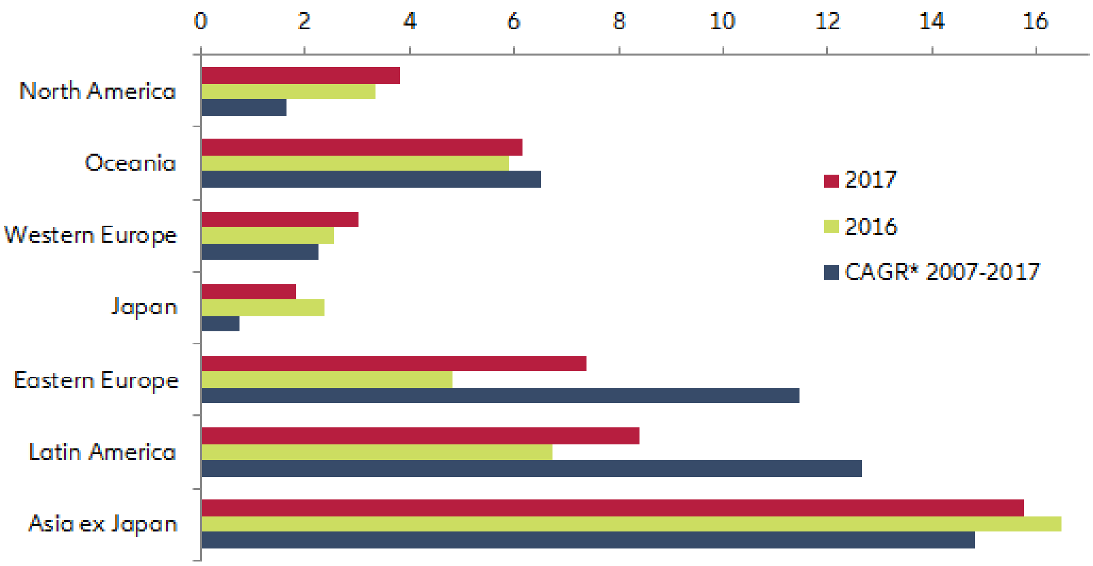
Private liabilities in Oceania grew much faster than in Western Europe and North America, with annual growth averaging 6.5% over the last decade. Average growth nevertheless dropped to less than half the levels reached in the years prior to the crisis.

Significant differences in the debt ratio

Households in Oceania have by far the highest per capita debt in a regional comparison. At an average of EUR 56,530 at the end of 2017, they were more than twice the average for Western Europe (EUR 26.180) and Japan (EUR 20.470). Even the North Americans had almost 30% less debt in per capita terms than households in Oceania, at EUR 39.880.

The gap between these two regions widened massively owing to diverging trends in debt. While average per capita debt in the two regions was almost equal as recently as 2008, at EUR 38,420 in North America and EUR 38,720 in Oceania, the difference increased to nearly EUR 17,000 per capita by the end of last year.

Figure 3 Debt per capita in euro, 2017



Source: Allianz Global Wealth Report 2018

Per capita debt in emerging regions was much lower. Eastern Europe (EUR 2,000), Latin America (EUR 2,180) and Asia (excluding Japan) (EUR 2,560) were at similar levels. If we look at Asia (excluding Japan) without including the industrialized countries in the region, Israel (EUR 18,440), Singapore (EUR 35,310), South Korea (EUR 25,750) and Taiwan (EUR 18.550), the average drops to EUR 1,960.

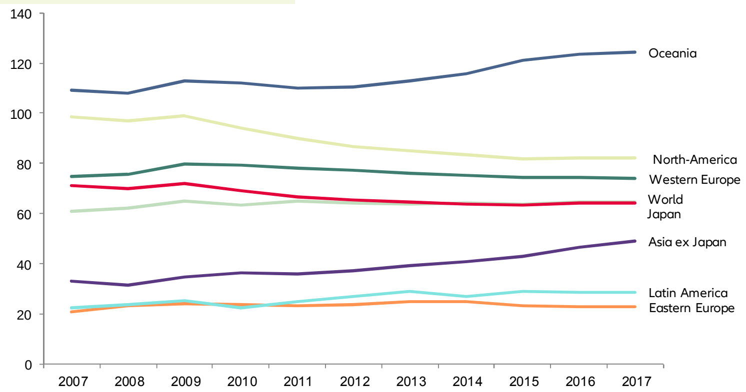
Just as in per capita terms, there are also significant differences between the world's wealthier regions and emerging regions when it comes to the debt ratio, i.e. liabilities measured as a percentage of nominal economic output. Once again, Oceania is well ahead of all other regions: the ratio here has risen by just under one percentage point to 124.3% over the last year, while the increase since the end of 2007 comes to around 15 percentage points. That means that Oceania is drifting further and further from the global average.

This is the reverse of the trend in North America, where the ratio of debt to economic output has contracted by almost 17 percentage points compared with 2007 to 82.0%.

The region was thus still slightly above the average figure for industrialized countries of 78.7%. In Western Europe the ratio came to just under 75% in 2007, and two years later climbed to its highest level to date of 79.6%. Since the it declined by 5.6 percentage points to 74.0%, putting the region below the average for industrialized countries at the end of 2017. The debt ratio of Japanese households was much lower still. Although it increased by almost four percentage points compared with 2007, largely as a result of weak economic growth, it still stood at only 64.8% at the end of 2017.

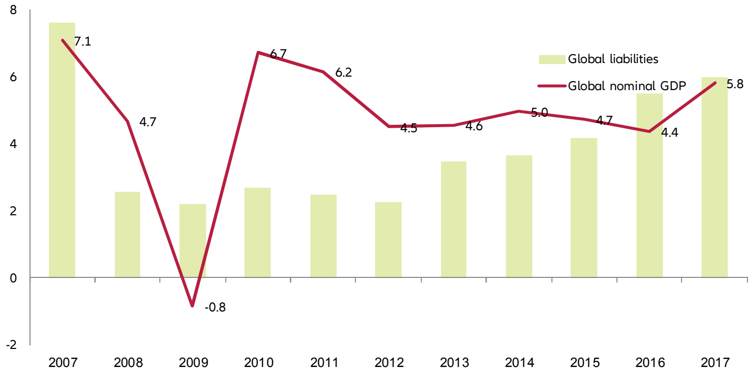
Among emerging regions, the ratio of private liabilities to gross domestic product was lowest in Eastern Europe. After debt growth slowed considerably in the last three years, falling well below the pace of economic growth, the ratio dropped from its historic high of 25.0% in 2014 to 22.7% at the end of 2017. The ratio in Latin America was approximately 6 percentage points higher than in Eastern Europe at just under 29%.

Figure 4 Liabilities as % of GDP



Source: Allianz Global Wealth Report 2018

Figure 5 Economic and debt growth, y/y in %



Source: Allianz Global Wealth Report 2018

Asia (excluding Japan) is giving greater cause for concern. The debt ratio there was more than twice as high as in Eastern Europe, at around 49%. Even if we exclude industrialized countries in the region, the ratio at the end of 2017 came to just under 43%, around 14 percentage points above the level in Latin America. At global level, the ratio of private liabilities to economic output increased slightly in 2017 to 64.3% (2016: 64.2%).

This ratio fell by nearly 8 percentage points since reaching a historic high in 2009 (71.9%). Since then, growth in debt has increasingly converged towards economic growth, until finally in 2016 liabilities grew faster than worldwide GDP, bringing the deleveraging process that began with the global financial crisis to an end.

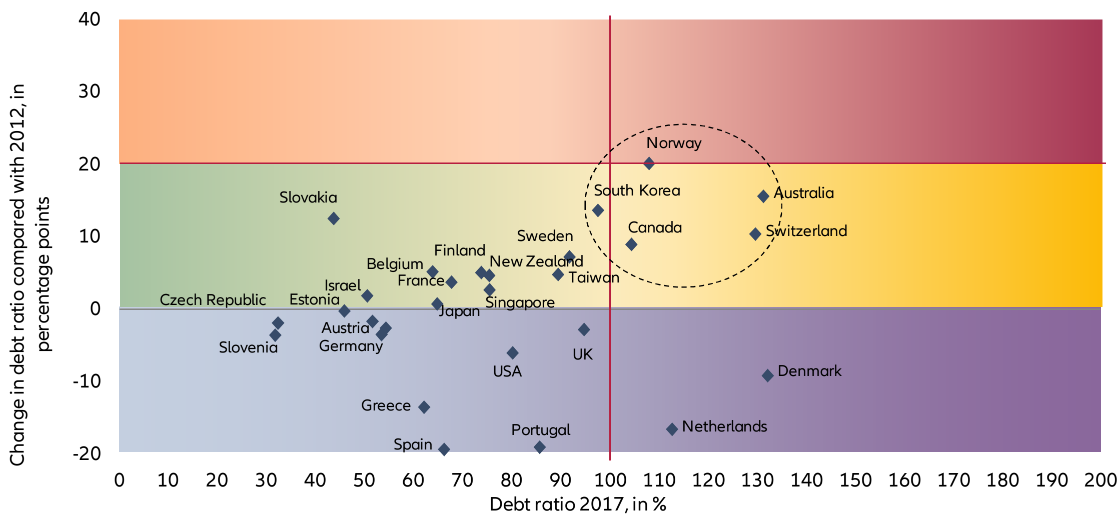
Household debt still sustainable in most countries

These global and regional figures, however, conceal significant differences between individual countries. With debt restructuring efforts subsiding in recent years, private debt ratios have again reached new records in some economies.

This leads to the obvious but troubling question: How sustainable is the debt ratio in the household sector? To answer this question, the situation in the US shortly before the property bubble burst can be used as a benchmark. In 2007, the ratio of private household debt to GDP was around 100% and had increased by 20 percentage points over the previous five years.

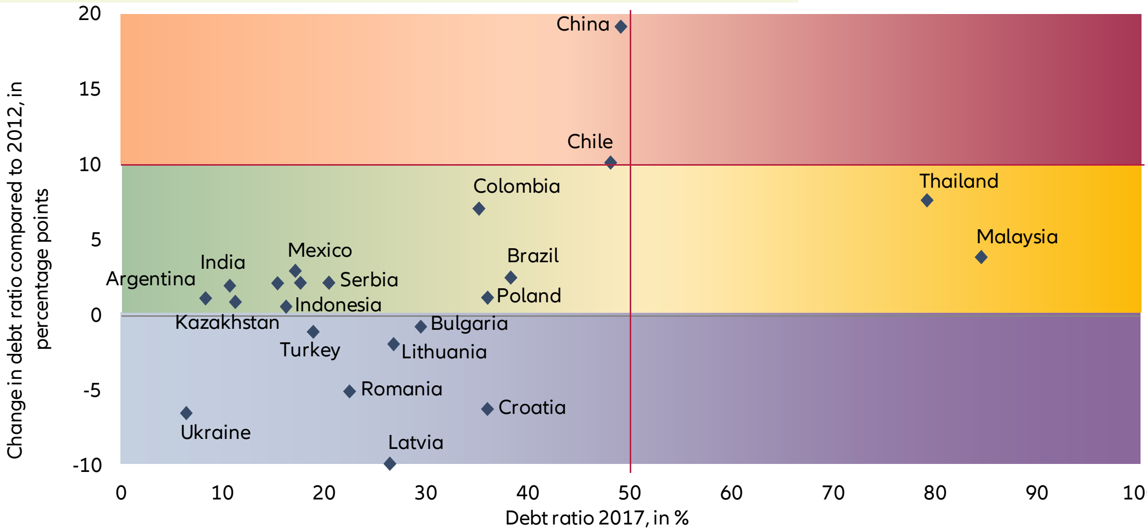
The analysis thus compares these data with the current situation in industrialized countries. Where has the debt ratio risen similarly dramatically in the last five years and in which economies is it currently above 100%?

Figure 6 Debt ratios 2017 and their change compared with 2012, advanced economies



Source: Allianz Global Wealth Report 2018

Figure 7 Debt ratios 2017 and their change compared with 2012, emerging economies



Source: Allianz Global Wealth Report 2018

It becomes clear that most developed economies are outside the "danger zone", i.e. the debt ratio is currently still less than 100% and the increase compared with 2012 is well below 20 percentage points.

The ratio of debts to GDP has even declined in 14 countries over the last five years.

These include the countries that were hit hardest by the (debt) crisis (the US, Spain, Portugal and Greece), which also rank among the economies that have made the most progress in reducing their debts.

However, Denmark and the Netherlands, whose ratios are currently still 132% and 113% respectively, have also had some success in bringing their debt ratios back down towards the 100% mark.

There are five countries in particular where the debt dynamic in recent years appears problematic, as high debt ratios of around the 100% threshold and above are combined with a sharp increase. These are South Korea (97.5%, +13.7 percentage points), Canada (104.3%, +9.0 percentage points), Switzerland (129.6%, +10.4 percentage points), Australia (131.2%, +15.6 percentage points) and Norway (107.9%, +20.1 percentage points). Of all industrialized countries, however, only Norway matches the US benchmark from the subprime crisis

To conduct a similar analysis of the private debt situation in emerging countries, the benchmark has to be adjusted to the situation there, i.e. the "critical" thresholds are 50% for the debt ratio and 10 percentage points for the increase in the debt ratio. Unlike in industrialized countries, a regional pattern is apparent among emerging economies. Here, it is only households in Eastern European countries that not only have a debt ratio of less than 50% but have also reduced the ratio of liabilities to GDP compared with 2012. The exceptions are Poland, Serbia and Kazakhstan, where the debt ratio has risen slightly since then.

A debt ratio of less than 50% combined with a moderate increase in the ratio over the last five years prevails in parts of Asia (India and Indonesia) and in Latin America. Yet once again, one exception proves the rule here: Chile. Following a large increase of 10.2 percentage points in the ratio of liabilities to GDP, the debt ratio is now 48% and is thus approaching the 50% mark.

Other than Chile, there are three Asian countries in particular where development of private debt appears critical.

These include Thailand and Malaysia on one hand, where debt ratios are already coming close to the 100% threshold of industrialized countries at 79.1% and 84.4% respectively; the increase over the last five years has at least been less than 10 percentage points.

The other country is China, where the ratio is 49.1%. Although this still falls very slightly short of the 50% mark, it has risen by 19.2 percentage points in the last five years. This rapid rise almost matches the experience of the US in the run-up to the subprime crisis.

In conclusion, private household debt is still at a moderate level in most countries; debt reduction and restraint in lending in recent years had an impact.

Along with the US, this applies above all to Eastern Europe and the crisis-hit Southern European countries. However, in some economies – including both industrialized and emerging countries – developments seem very worrying and close monitoring is required. This applies, among others, also to China.

Kathrin Brandmeir, Michaela Grimm, Arne Holzhausen

Photo by Sharon McCutcheon on Unsplash

RUSSIA
WEATHERING A U.S. STORM

- **Higher oil prices versus new U.S. sanctions**
- **Prudent economic policies and robust fundamentals**
- **Long-term structural bottlenecks**

Higher oil prices versus new U.S. sanctions

The U.S. imposed new sanctions against Russia in April and August 2018 and a number of further sanctions have been discussed since the summer by the U.S. Congress (for an overview of new and potential sanctions see the Box on the opposite page).

The Senate was more active in urging new sanctions while the hitherto Republican-dominated House was hesitant before the mid-term elections. Now that the House will be controlled by the Democrats, it may be more amenable for tighter sanctions as the Democrats are still upset by alleged Russian interference in the 2016 U.S. presidential election, amongst others.

We expect further U.S. sanctions affecting banking, air transportation and international trade-related sectors at the beginning of 2019. They will have a negative impact on already fragile investment activity. If the U.S. also sanctioned Russian sovereign debt, capital outflows should intensify. However, such sanctions are not part of our baseline scenario as their impact would not be limited to Russian businesses but also affect the competitiveness of large U.S. asset managers.

Back in 2014, the U.S., the EU and other countries imposed a first wave of sanctions on Russia in the context of the conflict in Ukraine.

These sanctions caused large-scale capital outflows and forced the Russian private sector to deleverage. Combined with sharply falling global oil prices from mid-2014 to early 2016, they also triggered a strong currency depreciation and a recession in Russia. A look at Figure 1, however, suggests that the exchange rate of the RUB versus the USD was mainly driven by the oil price and only marginally by sanctions. This seems to have changed now.

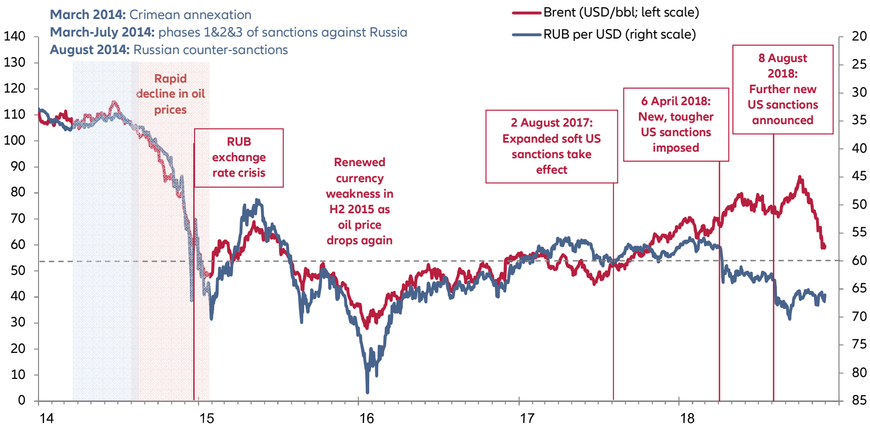
The sanctions imposed in 2018 so far appear to be the first ones that have had an impact on the RUB. While the price of benchmark Brent followed a broad uptrend from 45 USD/bbl in June 2017 to a peak of 86 USD/bbl in October 2018, the accompanying RUB appreciation ended abruptly in April 2018 when the first phase of tougher U.S. sanctions was imposed. And, although the oil price has markedly retreated since early October, its average in 2018 year-to-date is still +33% above the average in 2017. At the same time, the RUB has lost an average -7% against the USD in 2018 year-to-date.

The immediate impact on the economic performance has been negative, apparently. Preliminary estimates indicate that real GDP growth decelerated to +1.3% y/y in Q3, down from +1.9% in Q2.

The outcome in Q3 was disappointing as increased oil production and higher oil prices as well as the FIFA World Cup had led to expectations of stronger growth. But monthly activity data painted a mixed picture. Real retail sales growth edged down to +2.9% y/y in Q3 from +3.1% in Q2, indicating that private consumption remained the key albeit slowing growth driver in Q3.

The increase in calendar-adjusted industrial production picked up to +2.8% y/y in Q3 from +2.6% in Q2. However, agriculture dropped by -6.1% y/y and construction output fell by -0.4%. Uncertainty regarding the new U.S. sanctions possibly curtailed corporate investment in Q3.

Figure 1 Exchange rate and Brent oil price



Sources: IHS Markit, Allianz Research

However, early indicators point to a rebound of economic activity in Q4 2018. Industrial production growth accelerated to +3.7% y/y in October.

And the Manufacturing PMI improved to a six-month high of 51.3 points in October, up from an average 49.0 in Q3 and back into growth territory, supported by robust and faster increases in output and new orders, including new export orders. Moreover, the Services PMI jumped to an 11-month high of 56.9, also driven by strengthening output and new orders.

Overall, we assume that the impact of the new U.S. sanctions on economic growth was temporarily negative in Q3. But going forward, any negative impact should be mitigated by higher oil prices as well as by increased oil production in the near term.

We forecast the average oil price of benchmark Brent at 72 USD/bbl in 2018 and 69 USD/bbl in 2019. And in June 2018, OPEC member states and a number of non-OPEC allies (including Russia) agreed to increase oil supply.

In Russia, the move led to an estimated increase in average oil output per day by 0.3 barrels in Q3 (to 10.65 barrels) as compared to H1 2018. Although OPEC led by Saudi Arabia is in the meantime considering to cut oil supply again in response to the recent fall in oil prices, there is no indication yet of Russia following such a reversal. Moreover, we believe that prudent economic policies and robust economic fundamentals – as outlined in the following chapter – provide some cushion against new sanctions in the near term. All in all, we have revised down our full-year GDP growth forecasts only slightly to +1.6% in 2018 and +1.5% in 2019.

NEW U.S. SANCTIONS ON RUSSIA IN 2018

April 2018: New sanctions against

- 17 government officials
- 7 businessmen and 12 industrial conglomerates they control (mainly in energy, metals and automotive sectors).

August 2018: New sanctions on

- US exports of sensitive technology
- 2 shipping companies for violating N. Korea sanctions

Further potential sanctions under discussion:

- Curbing US trade with Russia generally
- Limiting bank loans to Russia
- Suspending landing rights for Aeroflot
- Prohibiting transactions in property and related interests of Russian state-owned banks
- Sanctions on Russian sovereign debt could come now that US mid-term elections are over, especially if there is proof of Russian interference

Banking, energy, air transportation and international trade-related sectors would be the most affected

Prudent economic policies and robust fundamentals

Monetary policy credibility

At the height of the currency crisis and the resulting surge in inflation at end-2014, the Central Bank of Russia (CBR) raised its key policy interest rate drastically by 650bp to 17% which proved sufficient to halt the slide in the RUB. The CBR also completed its transition to an inflation targeting regime and set the goal to lower consumer price inflation to 4% by 2017 and keep it close to this level thereafter.

As inflation began to decline from April 2015, the CBR started to cautiously cut interest rates correspondingly. In doing so, it has kept real interest rates clearly positive since 2016, even though this has curtailed credit expansion and economic growth to some extent.

However, this course also disclosed a high level of central bank independence and raised the credibility of the CBR, which has been led by Governor Elvira Nabiullina since June 2013.

The monetary easing cycle ended in September 2018 when the policy rate was raised by 25bp to 7.5%, even though headline inflation (at 3.1% in August) was still well below the 4% target and the macroeconomic environment was challenging amid new U.S. sanctions. However, inflation had gradually edged up from a low of 2.2% in February 2018 (and has in the meantime further risen to 3.5% in October). Moreover, the CBR justified the rate hike as pre-emptive, with a view on inflation expectations for 2019 which began to rise and have exceeded the 4% target since mid-2018 (see Figure 2), in part due to the forthcoming VAT increase from 18% to 20% at the beginning of next year.

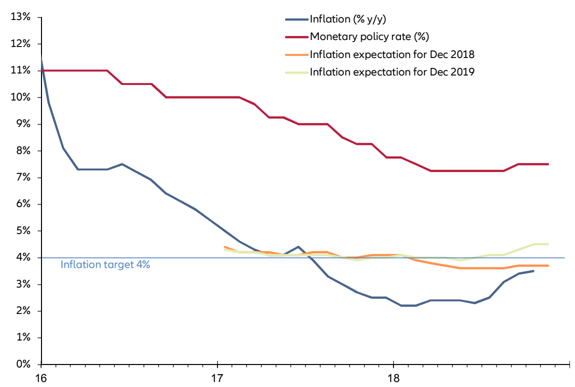
Overall, thanks to the larger independence of the CBR and the high credibility of Governor Nabiullina, who also shut down many nonviable banks, monetary policy in Russia has been smarter than in Argentina and Turkey, for example.

Diligent fiscal policy

Government expenditure in Russia is fairly moderate as compared to other countries, accounting for around 35% of GDP. This is, for example, similar to the ratio in China but lower than in South Africa (39%), Poland (41%), Hungary (47%) or the EU average (46%). In 2018, the government has already reduced the pace of debt issuance (for Q4 the plan was cut from RUB450bn initially to RUB310bn) with shorter-term maturities to absorb the shock of uncertainty related to sanctions and the global sell-off for Emerging Markets which have already led to an increase in Russia's risk premiums.

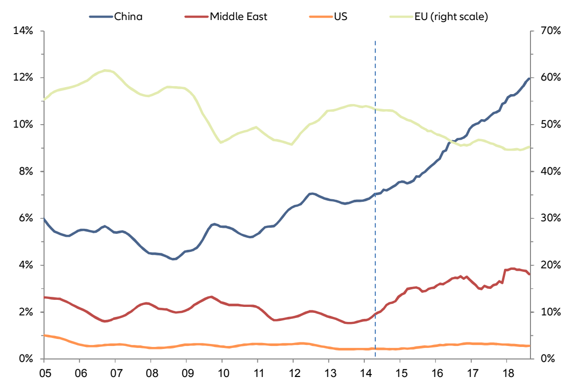
On the revenue side, oil income accounts for about one fourth of total government revenues, making public finances susceptible to oil price fluctuations. As a result, the budget posted significant deficits in the crisis years 2009-2010 and 2015-2016 while it was close to balance or in surplus in most of the other years since 2000. The Russian government plans to diversify its fiscal income base in order to reduce the vulnerability to global commodity prices. One step in the right direction is the planned VAT increase from 18% to 20% in 2019.

Figure 2 Inflation and inflation expectations, monetary policy interest rate



Sources: IHS Markit, National sources, Consensus Economics, Allianz Research

Figure 3 Russian exports to selected countries / regions (% of total exports)



Sources: IHS Markit, Allianz Research

Export diversification

After the implementation of Western sanctions against Russia (and Russian counter-sanctions) in 2014, falling Russian trade with sanction-imposing countries was to a significant extent substituted by rising trade with non-sanction-imposing countries. From end-2013 to mid-2018, the EU's share in Russian total merchandise exports fell from 54% to 45%. During the same period, China's share increased from 7% to 12% and the Middle East's share from 1.6% to nearly 4% (see Figure 3).

The share of the U.S. in Russia's exports is relatively small, however, it surprisingly increased over the same period from around 2.1% to 2.8% (in value terms it accounted for about USD11bn at end-2013 as well as in mid-2018).

This diversification of export destinations has mitigated the impact of the 2014 sanctions and supported the recovery of exports since mid-2016. In the 12 months up to July 2018, the value of Russian total exports to the world amounted to USD411bn, equivalent to 78% of the value reached in 2013. This means that in real (or volume) terms, exports are today roughly back to the level pre-imposition of sanctions, because the average oil price was about -40% lower in the 12 months up to July 2018 compared to 2013 and oil products account for 48% of Russian exports (and gas products for 12%).

De-dollarization

Against the background of deteriorated inter-bank lending conditions in the context of tightening global liquidity and the intensified U.S. sanctions against Russia, the Russian government is reportedly working on measures to reduce the economy's dependence on the USD. The plans include encouraging and facilitating the usage of alternative currencies in international trade. For example, transactions with the EU and China, Russia's main trading partners accounting for nearly 60% of its foreign trade, could be shifted into EUR and CHY while trade with CIS countries could be done in RUB. However, previous efforts to do so have had little success, highlighting that close cooperation with other countries is needed. But this may be easier now in a world of rising U.S. protectionism.

Other measures could be delisting of major Russian companies from foreign stock exchanges and increasing gold and EUR reserves. Russia has already reduced its holdings of U.S. government debt by around USD80bn this year. And the CBR's gold reserves stood at USD81bn at end-October 2018, +10% higher than a year earlier.

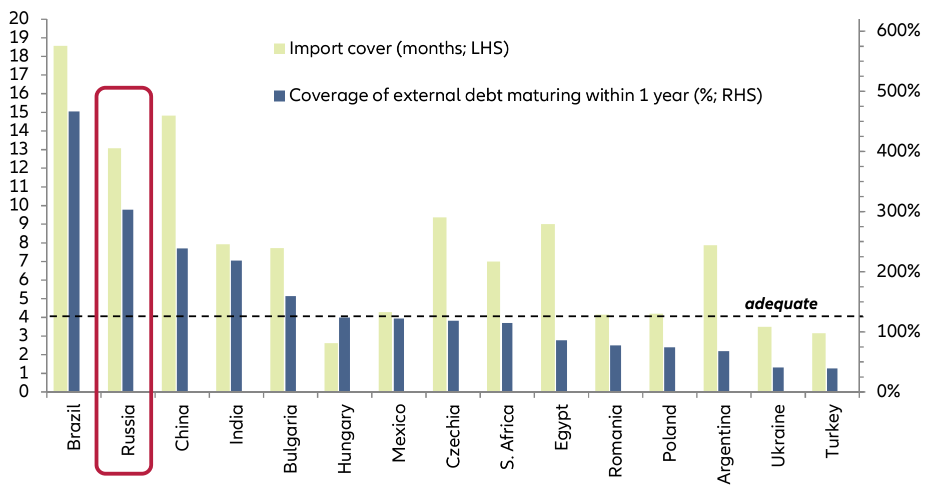
Still, large-scale de-dollarization will take time – estimates range between 1.5 and five years.

FX reserves are adequate over a two-year horizon

Official foreign exchange (FX) reserves dropped from USD470bn at end-2013 to a low of USD308bn in April 2015 as a result of large capital outflows and large-scale FX interventions by the CBR in an attempt to fight the RUB depreciation at the time. Then the CBR discontinued those FX interventions in order to halt the decline in its FX reserves while at the same time capital outflows faded away.

Thereafter, FX reserves stabilized and began to increase again in 2017. At end-October 2018, reserves stood at USD379bn, a comfortable level in terms of import cover (13 months). In other terms, reserves cover thrice the external debt maturing in the next 12 months, well above an adequate level of 125%. Also when compared with peer countries, Russia does well on these indicators (see Figure 4). All in all, current FX reserves provide a cushion against a liquidity crisis on a macro level for the next two years or so. Yet, the future development needs to be monitored closely and is not fail safe.

Figure 4 Foreign exchange reserves adequacy



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After the implementation of Western sanctions against Russia (and Russian counter-sanctions) in 2014, falling Russian trade with sanction-imposing countries was to a significant extent substituted by rising trade with non-sanction-imposing countries. From end-2013 to mid-2018, the EU's share in Russian total merchandise exports fell from 54% to 45%. During the same period, China's share increased from 7% to 12% and the Middle East's share from 1.6% to nearly 4% (see Figure 3).

The share of the U.S. in Russia's exports is relatively small, however, it surprisingly increased over the same period from around 2.1% to 2.8% (in value terms it accounted for about USD11bn at end-2013 as well as in mid-2018).

This diversification of export destinations has mitigated the impact of the 2014 sanctions and supported the recovery of exports since mid-2016. In the 12 months up to July 2018, the value of Russian total exports to the world amounted to USD411bn, equivalent to 78% of the value reached in 2013. This means that in real (or volume) terms, exports are today roughly back to the level pre-imposition of sanctions, because the average oil price was about -40% lower in the 12 months up to July 2018 compared to 2013 and oil products account for 48% of Russian exports (and gas products for 12%).

De-dollarization

Against the background of deteriorated inter-bank lending conditions in the context of tightening global liquidity and the intensified U.S. sanctions against Russia, the Russian government is reportedly working on measures to reduce the economy's dependence on the USD. The plans include encouraging and facilitating the usage of alternative currencies in international trade. For example, transactions with the EU and China, Russia's main trading partners accounting for nearly 60% of its foreign trade, could be shifted into EUR and CHY while trade with CIS countries could be done in RUB. However, previous efforts to do so have had little success, highlighting that close cooperation with other countries is needed. But this may be easier now in a world of rising U.S. protectionism.

Other measures could be delisting of major Russian companies from foreign stock exchanges and increasing gold and EUR reserves. Russia has already reduced its holdings of U.S. government debt by around USD80bn this year. And the CBR's gold reserves stood at USD81bn at end-October 2018, +10% higher than a year earlier.

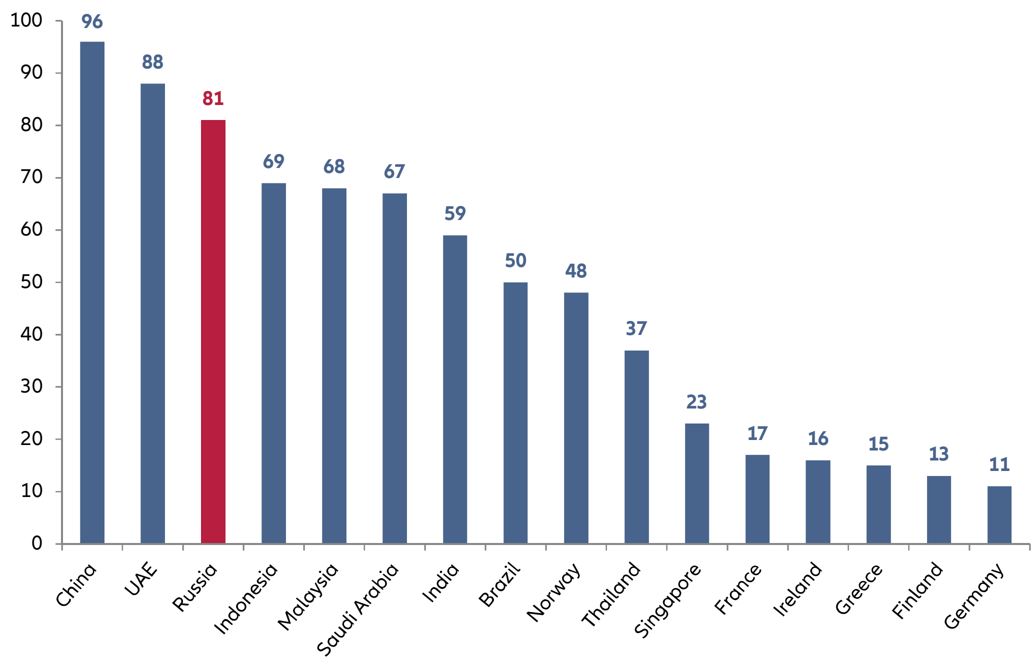
Still, large-scale de-dollarization will take time – estimates range between 1.5 and five years.

FX reserves are adequate over a two-year horizon

Official foreign exchange (FX) reserves dropped from USD470bn at end-2013 to a low of USD308bn in April 2015 as a result of large capital outflows and large-scale FX interventions by the CBR in an attempt to fight the RUB depreciation at the

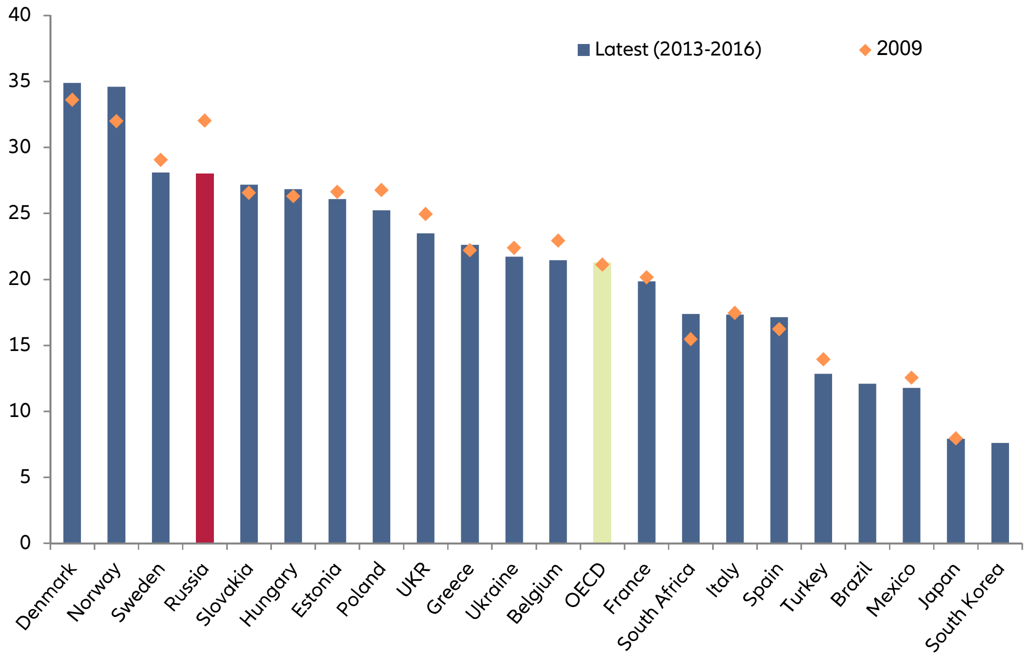
Manfred Stamer

Figure 5 SOE's shares among countries' top 10 firms



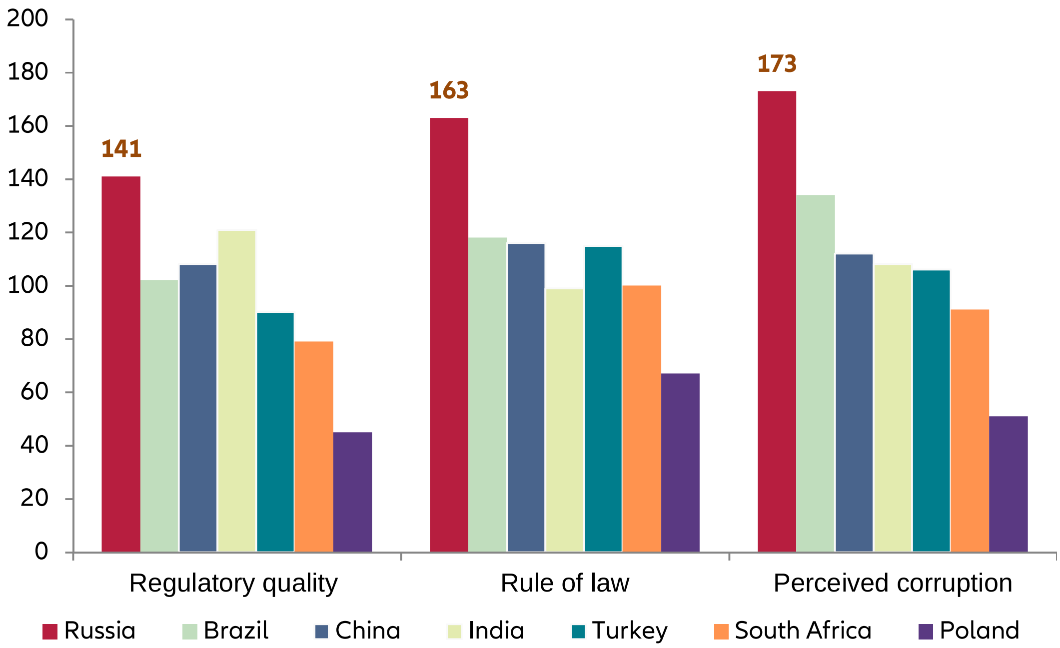
Source: WEF

Figure 6 Share of public sector employment in total employment



Sources: OECD, IMF

Figure 7 Ranking according to selected governance indicators



NB: Ranking out of 206 economies.

Source: World Bank "2018 Worldwide Governance Indicators"

NORTH AMERICA
US: NEGOTIATING AN AMERICA-FIRST TRADE DEAL

President Trump is a different kind of negotiator: Inside the Maximax strategy of the US President

President Trump has no fear of (protectionist) consequences

Trade negotiations have a strategic aspect with a cooperative or conflictual dimension. Game theory makes it possible to rather precisely formalize different types of options and actors implicated in such interactions.

In 1930, in the beginning of the Great Depression, the United States implemented the Hawley-Smoot tariffs to protect domestic industries from further damages and other countries followed suit and implemented tariffs on their own. The tariffs and the trade war that followed, however, are believed to have harmed every economy and accentuated the impact of the Great Depression.

The 1930s trade war was akin to a classic "Prisoners' Dilemma" – which well-known outcome is a bad Nash equilibrium even when a good equilibrium is available through cooperation: both countries end up imposing tariffs, leading to a trade war and to further deterioration of global macroeconomic conditions. The GATT in 1947, then the WTO in 1995 were therefore set up to prevent such negative outcome again and ensure cooperation and negotiation between countries instead of unilaterally imposed tariffs.

Similarly with other aspects of the US economic policy, President Trump has upended the way of negotiating with trade partners, expressing no fear of protectionism and harshly criticizing existing trade agreements.

As a result, the US decided to increase tariffs on aluminium, copper, washing machines and a series of Chinese products worth USD 200 bn. In terms of average US tariffs, we are now back in 1980 as it reaches 5.2% compared with 3.5% before President Trump's elections. This new approach of trade policy therefore implies a better understanding of the President's strategy to have a better idea on how to negotiate with him.

Enter President Trump, the maximax player

President Trump, who is openly sceptical about trade, believes that "trade wars are easy" to win and is keenly aware of the importance of the US as a trade partner for many countries. This accounts for his maximax strategy in a game theory setting i.e. he develops of strategy consisting of maximizing his expected payoff without consideration for the risks that a trade war involves. He knows that smaller countries are more likely to cooperate because their economy is dependent on US imports and more at risk than America's in a trade war. By comparison with his predecessors, President Trump is willing to bear the adverse consequences of tariffs and a trade feud because he knows that the US economy is big enough to do so. For another country hugely reliant on the US market, say Mexico, consequences are starker.

All in all, his whole reasoning relies on the asymmetrical payoff that characterizes this new game and on the basis that existing trade deals already hurt the US. President Trump thus expects to bring countries with which he deems trade relations "unfair" to the table in order to negotiate deals that would advantage the US – and he does so by using the fear that comes with the US economic power.

This maximax approach can be visible under different aspect of President's Trump:

- Maximax and fiscal policy: the objective of the US President consists of maximizing growth with a lower weight given to the importance of debt stabilization (implying high risks in terms of debt sustainability)
- Maximax and foreign affairs : There is now a clear link between security and economic issue with an implicit request from the US of economic compensations
- Maximax and environment policy: the US President's decision to withdraw from the Paris agreement also shows a sense of prioritization in favor of growth with a lower consideration for

Photo by Thought Catalog on Unsplash

In the end, how to negotiate with President Trump? An example

We attempted to explain President Trump's negotiating strategy using game theory, in which an accord found between countries would be described as an equilibrium.

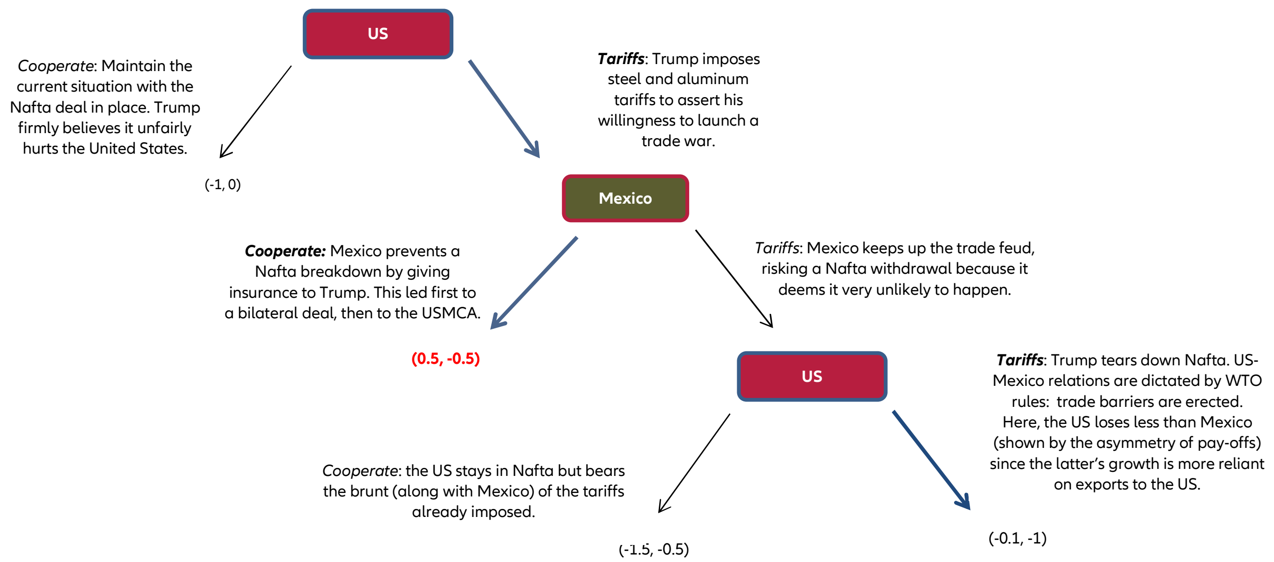
The result of this game (i.e. the existence or not of an equilibrium) might serve as a guide to players currently in negotiations with the U.S. In order to build a relevant game, we must first describe a rule of action for the players. President Trump maximizes his expected payoffs without consideration for the downside risks (i.e. a trade war), which in game theory translates into a Maximax strategy. Take Mexico and the US. The game described below is sequential, in which each branch of the tree represents an outcome with a respective pay-off (x, y) where x represents the American pay-off and y the Mexican pay-off. In the end, the Nash equilibrium found by backward induction is the one where Mexico cooperates by actually buying an insurance policy.

We also illustrated the withdrawal on both sides from the NAFTA with the following payoffs : (-0.1, -1), which represent the 0.1ppt and 1ppt loss of GDP induced by such event, for the U.S. and Mexico respectively.

The best possible solution for the country negotiating with the US is to buy an insurance by doing a payment to the US (diverse concessions on US value added content for example or dairy products for Canada) in order to avoid the worst case scenario i.e. a trade war.

Alexis Garatti, Abdul Rahman Kassab

Nash equilibrium between US and Mexico for trade discussions



In the end, the Nash equilibrium found by backward induction is the one where Mexico cooperates by offering an insurance policy. We also illustrated the withdrawal from Nafta with the following payoff : (-0.1, -1). It illustrates the GDP loss of each countries due to exports losses in the case of the end of Nafta.

Sources: IHS Markit, Allianz Research

WESTERN EUROPE
THE EUROPEAN BANK STRESS TEST DON'T FULLY REASSURE

European policymakers need to make considerable progress on the precautionary tools (ESM) and on finalizing the Banking Union

The much awaited EU banks stress test showed a positive progression of banks' resilience to shocks when compared to the previous test conducted in 2016. All banks passed the test, but small Italian, UK and German banks showed weakness, with the last two being a surprise. Hence, it shows that the banking sector vulnerabilities are not fully resorbed, notably regarding legacy issues from the high stock of bad loans. This is crucial as we are entering a period of slower economic growth for the few years to come. In our view, these results show that there is a need to strengthen existing tools in case of a crisis triggering a wave of bank recapitalizations. European policymakers need to make considerable progress on the precautionary tools (revamped European Stability Mechanism) and on finalizing the Banking Union. In the end, the adverse scenario tested by the EBA is not a tail risk and this means that it is key to be better prepared!

The European Banking Authority stress tested the resilience of 48 banks in 15 EU and EEA countries in an adverse scenario, which identified a set of systemic risks that may pose a threat to the financial stability of the EU banking sector. It including two consecutive years of recession in the EU of -1.2%, -2.2% and 0.7% as of 2018, 2019 and 2020 respectively, with a deviation of -8.3% from the baseline level as of end-2020. In our view, the 2019 GDP contraction considered by the EBA would be equivalent to a scenario where there is no deal on Brexit by March 2019 (25% probability) and where there is no U-turn in the Italian government fiscal expansionary policy (20% probability) which ends-up into a crisis requiring financial assistance from the European Stability Mechanism (ESM).

While the UK and the German banks surprised on the downside, results for the big Italian banks were reassuring. The four Italian banks registered a capital ratio (CET1 ratio measuring a bank's capital against its assets) above 5.5%, a threshold that is commonly used by investors to assess if a bank passed a stress test. Out of the four banks, Banco BPM had the lowest capital ratio in the adverse scenario at 6.7%.

Why do these stress tests matter?

First they were expected to reassure investors as per the resilience of the European banks in a crisis environment notably in a context of remaining sovereign-bank nexus and a start of monetary policy normalization by the ECB in late 2019. Looking at the banking sector performance YTD, rising tensions are indeed visible: -30% since January 2018, significantly underperforming the rest of the equity market. Renewed turbulence in sovereign debt markets may then hit the weakest banking sectors – some of which still hold significant amounts of their sovereign's debt: around 18% in Italy, 13% in Spain, 8% in Germany and 6% in France. Attention could also go towards core banks (German, French) with large subsidiaries in most vulnerable countries. Markets are currently closely watching developments in Italy where the state-bank nexus is the strongest in the Eurozone. They are getting increasingly concerned about the erosion of banks' capital due to the rise in BTP yields. Should the Italian 10-year yield increase to 4.5% banks' would enter a dangerous zone: a rise in +200bp rise in yields would reduce by more than -50bp the capital ratio for biggest Italian banks and more than -150bp for the smallest. The ECB Bank Lending Survey shows that Italian banks already face a significant increase of their funding costs. This will translate into higher bank interest rates on loans to the private sector. We estimate that +100bp of rise in the sovereign yields in Italy would translate into +80bp of rise in the bank interest rates for corporates 3 to 6 months later given the low profitability of Italian banks.

Photo by Robert Bye on Unsplash

In addition to the state-bank nexus, solving the legacy issues from still high stock of bad loans is crucial for the banks in the Southern European countries, notably Italy.

We have argued earlier in the year in our report [The Italian Economy: 2 Years to Transform, 5 Macron-Omics, 12 Actions] that one solution would be to improve collateral rules on corporate loans to restore the credit channel. The IMF estimates that halving the NPL ratio from 14% to 6% would lead to +2% higher real GDP growth and +4% higher investment growth after five years.

Currently, the bulk of NPLs continues to be corporate-related (70%) and the 11.4% of total loan book in bad debt continues to be a significant drag on bank profitability and economic activity as they require significant loan-loss provisions, which in turn reduces credit availability.

Simplifying and harmonizing collateral rules on corporate loans would make NPL valuation and sales much easier and could unleash additional bank financing. Currently, corporate loans are backed by anything from factories, to machinery, to shares of a firm and real estate, which make their valuation complex compared to residential mortgages, for example.

Second, the bank stress tests results were expected to reassure EU policymakers as per the consolidation of the banking sector in Southern European countries and pave the way for progress on the Eurozone reforms currently in the pipeline.

Three main reforms are pending:

(i) the set-up of a common backstop to bank resolution, (ii) the ESM reform aiming to include precautionary instruments for countries with sound fundamentals that need financial assistance, and (iii) setting out a roadmap for political discussion on the Deposit Insurance Scheme. In our view, the banking sector's weakness spreading to other banks than in Southern Europe only (i.e. German banks) could be a catalyst for implementing these reforms in a timely manner.

Finally, reducing the burden of non-performing loans could be faster through securitization and more efficient should the Eurozone push ahead with the Capital Market Union.

Ana Boata

Bank landing Survey - factors contributing to banks' credit conditions

	Cost of funds and balance sheet constraints		Banks' risk tolerance	
	Q2 2018	Q3 2018	Q2 2018	Q3 2018
Eurozone	-3	3	-1	-1
Germany	0	0	0	0
Spain	-10	0	-10	-10
France	0	0	0	0
Italy	-10	10	0	0
Netherlanc	0	0	0	0

Note: The net percentages for the questions relating to contributing facors are defined as the difference between the percentage of banks reporting that the given factor contributed to a tightening and the percentage reporting that it contributed to an easing.

Source: ECB, Euler Hermes

ASIA CHINA 2019 OUTLOOK: SHOCKS AND STIMULUS THERAPY

Three shocks weigh on the outlook: US protectionism, currency and financial market weaknesses; Authorities are stepping up their support with a wide range of measures and economic growth is likely to be resilient; Corporates are expected to be faced with a more diverse sales outlook, higher risks related to re-leveraging non-payment risk

Three shocks: US protectionism, currency depreciation and weak financial markets

The Chinese economy continued to slow down in Q3 (+6.5% y/y in Q3 from +6.7% y/y in Q2) due to slower performance in the secondary industry. From a demand perspective, investment growth continued to decelerate while consumption remained resilient.

Trade remained strong as US corporates front-loaded orders in anticipation of further tariffs and weaker RMB helped to cushion the impact of recent US protectionist measures. We estimate that the 10% RMB/USD depreciation that occurred between March and September 2018 helped absorb an increase of cost of USD50bn due to tariffs.

Business surveys portend weaker growth in the next months. Both official and private Manufacturing PMIs have decreased compared to Q2 levels on the back of weak new export orders and heightened tensions with the US. Official non-manufacturing and private services PMIs indicate further strength helped by the resilience of domestic demand and proactive policies to promote services.

Looking further ahead, three big ticket items will likely shape the macroeconomic outlook for China: trade war threats, the movement of currency depreciation and depressed financial markets.

The stimulus therapy… or how to keep the (economic) ball rolling

In the short-run, economic growth will depend on a wide range of expansionary measures.

We pencil a general government balance below -4% GDP over 2018 and 2019. Expansionary measures, already at work, consist of tax cuts (for households, SMEs and innovative companies); export tax rebates and infrastructure spending have also been enacted. So far, we estimate that measures which have been announced represent c.2% GDP.

On the monetary side, the authorities have to deal with their traditional dilemma: boost growth without creating too much leverage and too much financial risk.

We expect financial regulation to remain relatively tight to keep shadow banking activities under control. A more stringent framework regarding the housing markets is expected to tame property-related risk going forward.

What will likely not be avoided is a continued rise of leverage. Non-financial corporate debt has already increased to 164% GDP in Q1 2018 (from 160% GDP end 2017); credit quality is deteriorating (NPL ratio up to 1.9% in Q2 from 1.75% in Q 2018). While this leads to an increase of financial risks, we believe that systemic risk is contained so far considering: (i) the large pool of saving of China (45% GDP); (ii) limited external debt (14% GDP); (iii) and a unique financial system configuration highly centered on the public sector.

Regulators have slightly eased financial conditions. The regulator (CSRC) has eased conditions for share buybacks as an attempt to revive financial markets. Combined with the support of China's national teams and the PBOC, this new framework aims at providing a floor and ultimately boosting financial markets in the short run.

On trade, policies were twofold. On the one hand, China continues the opening of its domestic markets with tariff cuts for various products ranging from agri-food to textile and


Photo by 五玄土 ORIENTO on Unsplash

On the other hand, it pursues gigantic trade initiatives such as the Belt and Road (already in place) or the Regional Comprehensive Economic Partnership (in negotiation).

Looking ahead, the impact of these measures is not visible yet in the real economy. We expect the impact to start kick-in from Q4 onwards. Here are our four calls:

- We maintain our GDP forecast for this year (+6.6%) and 2019 (+6.3%). The soft landing is expected to continue but the pace might be a bit more bumpy than expected. While trade contribution is set to slow on the back of protectionist measures and more moderate growth in global demand, domestic demand will remain resilient powered by stimulus.
- We cautiously expect: (i) a more constructive approach between China and the US in the coming months, as the Trump administration hinted the possibility of a trade deal; (ii) the negative impact of trade tensions with the US to be partially mitigated by expansionary policies and China's efforts to increase trade partnerships with other economies (EU, Asia-Pacific markets).
- We project the RMB per USD to remain low in the near term (6.9-7RMB per US) in the context of trade tensions and divergence in monetary policy with the US.
- Last, on financial markets, the intervention of the national team (group of state-backed institutional investors) will likely provide some support in the short-run. The long-term outlook will heavily depend on China's ability to reinsure private investors. A potential improvement of trade relations with the US next year, stabilization effects from stimulus measures could help. Yet, a resolution of structural issues namely a clear plan to stabilize corporate leverage and open the economy further will be critical.

Impacts for corporates: diverse sales outlook, re-leveraging and non-payment risk

The impact for corporates will transit through three channels: sales, debt and payment.

We expect domestic sales growth to remain broadly resilient. Private consumption remains firm (growing c.7% y/y in real terms) and fundamentals namely incomes, jobs and credit are still supportive.

Expansionary fiscal measures but also trade related measures to reduce import costs (through tariff cuts) will help to keep demand in-check and import related products at affordable price. We see some pressure points: (i) for sectors related to the housing sector as tighter regulation is set to hinder activity; (ii) exports due to the impact of the already implemented US tariffs.

The main risk for the next coming months will be the re-leveraging of the economy.

At the current pact, corporate debt could exceed 170% of GDP at the end of this year.

This would be a historical high and would erase all the efforts that have been put last year. This increase credit risk but it is also negative for private sector's confidence.

Last, non-payment risk could increase as Chinese importers paying in USD dollar might see it difficult to pay their bill as costs rise due to RMB depreciation.

This would translate mechanically to a more moderate growth in imports.

Sector-wise, domestic consumption related sectors (consumer staples, healthcare, agri-food, e.g.) would still have some legs sustained by positive households fundamentals and fiscal stimulus.

A mixed outlook could be expected for sectors that are heavily related to global trade and subject to tariffs (electronic, automotive e.g.) as domestic sales will likely not be enough to compensate for slower exports sales (electronic) and higher tariffs (imported cars).

Last, (i) capital intensive sectors such as construction, machinery and equipment, (ii) basic raw material will likely remain under the radar as regulations related to the property market get tighter.

Mahamoud Islam

LATIN AMERICA GOOD OL' RISK

Since September, Latin American economies have not taken any rest. And 2019 gives no reasons to cheer, as policy risk looms

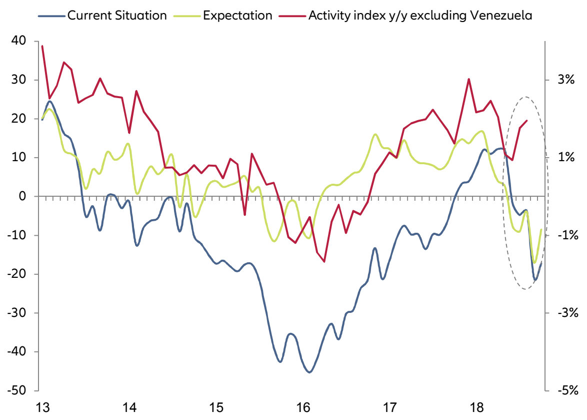
Since our last update, Mexico cancelled a USD13.3bn airport infrastructure project, Brazil now has a new president and the IMF updated its forecasts for the Argentinian economy.

Lower confidence, softening activity

At the regional level, market turmoil and policy uncertainty had a clear impact on confidence: the Sentix index (Figure 1) shows a trend reversal in sentiment starting in June, after Argentina requested IMF help and Brazil's trucker's strike curbed economic activity. Despite a slight improvement in October, institutional and private sector respondents remain pessimistic about the future economic situation in Latin America.

The drop in the activity index (Figure 1) was temporary and caused by Brazil (-1.5% in May) and Argentina (-4.6% in June); indeed, better August figures in Brazil and solid performance of the Andeans compensate for the recession in Argentina. However, we are likely to revise downwards our forecasts for Mexican growth next year (currently at +2.7%) after a risky policy choice of the president-elect, who is losing investor support. Besides, we see Brazilian growth capped at +2.5% and Andeans decelerating as central banks will start tightening monetary policies while commodity prices (copper, oil) are easing or stalling; 2019 gives no reasons to cheer.

Sentiment indicator (Sentix) and growth of activity index in Latin America (y/y, %)



Source: IHS, Euler Hermes, Allianz Research

Headwinds for private sector credit

Lower confidence could further hamper financing for companies amid rising global interest rates, in turn curbing even more growth. Argentina's real private sector credit growth (Figure 2) decelerated abruptly to +14% down from +25% in March, firstly due to a surge in inflation. Going forward, the emergency rate hikes (from 30.25% in April to 60% in August) which mechanically raised lending rates should take a toll on credit growth, in a depressed economic environment and higher policy uncertainty. Mexico's tight monetary policy (the latest June rate hike left the policy rate at its highest level in 9 years, at 7.75%) and imported inflation led to a deceleration in real credit growth. The recent confidence shock after the announcement of the cancellation of a USD13.3bn airport project by the president-elect could also hinder credit supply and demand, with banks increasingly cautious about political risk and companies' investment in wait-and-see mode.

Mexico: mind the next policy choice – oil in focus?

Mexico's president-elect, Andrés Manuel Lopez Obrador (AMLO) had done its best to reassure investors since his election early July: he aligned with the current administration's stance on NAFTA, committed to fiscal discipline and met extensively with business leaders and financiers to reaffirm the compatibility of his social policies with investors' interests. Yet, we had warned early this fall that Mexico was not fully out of the woods, due to a still sizable probability of policy mistake. The political decision of cancelling the USD13.3bn airport infrastructure project – one third of which was already built – spooked investors indeed. Should AMLO's nationalistic stance on the oil sector lead to restrictions on future foreign investment or cap gas prices, markets could definitely turn their back on his administration's policies, curbing growth prospects even more significantly. AMLO touted his opposition to the previous administration's energy sector reform, which opened the industry to foreign investment. Yet, overturning such constitutional reform is unlikely as it would require two thirds of Congress. Hence, he intends to revise contracts in place and consider each future auction on a case by case basis. He plans on expanding the role of national oil company PEMEX, adding two big fuel refineries at least and end trade deficits in energy and agriculture.

Georges Dib

EMERGING EUROPE
GRADUAL SLOWDOWN


Photo by Victor Xok on Unspla

Poland: As economic growth slows but remains robust, the labor market is cooling

Losing some momentum

A series of economic data releases over the past weeks suggest that Poland's economy begun to slow down in the second half of 2018. September saw a deceleration in output and domestic trade growth and October saw the continuation of declines in several surveys of business and consumer confidence that began in Q3, indicating the potential for a further moderation in Q4. In particular:

- Seasonally and calendar-adjusted industrial production contracted by -0.7% m/m in September, the first m/m decline since April 2013, taking output growth in Q3 to +5.9% y/y, a marked slowdown from +6.8% y/y in Q2.
- Similarly, seasonally and calendar-adjusted real retail sales decreased by -0.6% m/m in September, after -0.7% m/m in August, taking the y/y growth rate in Q3 down to +6.1% from +7.2% y/y in Q2.
- The Manufacturing PMI fell to 50.4 points in October (from a recent high of 54.2 in June), a two-year low. Notably, the decline in new export orders that began in August continued in October, with firms highlighting weaker demand from Germany. This is mirroring a sharp drop in German auto production due to major problems with the certification of cars according to a new emission test procedure.
- The overall Economic Sentiment Indicator published by the European Commission fell to 106.8 in October, the lowest level since December 2017, though it remained above its long-term average of 99.0 points. Its five sub-indicators all declined as well but remained above the long-term averages:
    - The Industrial Confidence Indicator fell to an 11-month low of -6.0.
    - Construction Confidence decreased to a two-month low of -8.4.
    - Services Confidence declined to a 10-month low of 4.5.
    - Retail Trade Confidence fell to a 17-month low of 4.5.
    - The Consumer Confidence Indicator decreased to an 11-month low of -1.7.

Overall, these high frequency indicators signal that very strong economic growth in the five quarters until Q3 2018 (+5.2% y/y on average) will give way to a more moderate but still robust performance until end-2019. We expect real GDP growth to ease to +4.2% in Q4, resulting in full-year growth of +4.9% in 2018 (after +4.7% in 2017), followed by +3.5% in 2019.

Labor market overheating is retreating

The strong growth performance in Poland since 2014 has been accompanied by a tightening labor market, reflected in rapidly declining unemployment, firm employment growth since 2016 and strongly rising wages since 2017. For some analysts this had raised concerns of an overheating economy, even though inflation remained subdued – headline inflation stayed well below the Central Bank's 2.5% target and eased to 1.8% y/y in October while core inflation has remained below 1%.

Meanwhile, employment growth has lost some pace, decelerating from a peak of +4.6% y/y in December 2017 to +3.2% in September 2018. Moreover, nominal wage growth has moderated from a high of +7.8% y/y in April 2018 to 6.7% in September. The unemployment rate has further fallen to 5.7% in September and is expected to continue to do so until levelling off between 4% and 5% in 2019. All in all, this implies that the labor market has begun cooling.

Monetary policy remains accommodative

The Polish zloty (PLN) has remained fairly resilient to earlier overheating concerns and global headwinds. It has lost -3% in value against the EUR in 2018 year-to-date, but only -0.7% since end-July, meaning that the currency crises in Argentina and Turkey have not had any significant contagion effects.

Against the background of relative price and currency stability, the National Bank of Poland has maintained a loose monetary policy stance to date, keeping its key policy rate at 1.5%, unchanged since March 2015. We expect gradual monetary tightening to begin in 2019, in line with ECB tightening as well as to fend off potential downward pressures on the PLN in the wake of the expected slowdown in economic growth.

Manfred Stamer

MIDDLE EAST
PUMP IT UP

GCC: Higher oil prices and "revised" OPEC deal support regional recovery

Disappointing recovery in H1 2018

Regional real GDP growth disappointed in H1 2018, posting +1.1% y/y in Q1 and +1.7% in Q2. The recoveries were muted in Saudi Arabia, the UAE and Kuwait, with the latter's performance in Q1 being sharply revised downwards to -0.5% y/y from an initial estimate of +1.6%. In Bahrain, GDP contracted by -1.2% y/y in Q1 owing to output cuts stemming from maintenance activities at the offshore Abu Sa'afah field but rebounded to +2.4% in Q2. Oman has not provided any GDP data for this year yet, but based on a -0.2% y/y decline in oil output in H1 we estimate that the whole economy expanded by just +0.9%. Only Qatar grew by more than +2% in H1 as the country rebounds from its 23-year growth low in 2017 which was due to due to the blockade by the GC3+1 (Saudi Arabia, UAE, Bahrain, Egypt).

Swings in OPEC agreements and oil output

At the end of June 2018, OPEC member states and a number of non-OPEC allies including Russia agreed to scale back their over-compliance with oil supply cuts that had been decided at the end of 2016 amid ongoing low oil prices at the time. The new agreement was projected to add close to 1 million barrels per day to the global market. In the GCC region, the move led to an estimated increase in average oil output per day by 0.55 barrels in July-August as compared to H1 2018. With regard to the original OPEC deal, this reflects a shift from over-compliance in H1 (109%) to under-compliance in July-August (37%). However, as of mid-November, oil producers led by Saudi Arabia expressed discontent with the latest oil price development and suggested another swing in output targets.

On 9 November, the oil price had lost almost -20% since early October, in part because the U.S. granted last-minute waivers with regard to its re-imposed sanctions on Iran on 5 November to eight countries (including India, Japan, South Korea) to allow them to temporarily continue buying Iranian oil.

For now Saudi Arabia plans to cut its oil supplies by 0.5 barrels per day in December. Potential cuts by other producers and plans for 2019 are still under discussion. Hence, for 2018 as a whole we forecast an (under-)compliance ratio of 79% with the original 2016 OPEC deal for the GCC region (see Table 1 for an overview of the figures as well as a disaggregation by country).

GDP growth forecasts after output increases in June and output reduction plans from November (* Q1 2018 for UAE and Oman)

	Compliance with OPEC deal			Share of oil sector in GDP	Impact of "revised" OPEC deal on	H1 2018 y/y GDP growth*	2018 GDP growth forecast	2019 GDP growth forecast
	H1 2018	July-August	Full-year 2018					
Saudi Arab	105%	40%	69%	26%	+0.4pp	1.4%	2.0%	2.5%
UAE	109%	39%	74%	15%	+0.3pp	1.2%	2.2%	2.6%
Qatar	171%	108%	140%	16%	+0.3pp	2.3%	2.6%	2.7%
Kuwait	101%	29%	66%	44%	+0.8pp	0.7%	1.8%	2.8%
Oman	96%	80%	78%	25%	+0.2pp	0.9%	1.8%	2.0%
Bahrain	225%	40%	139%	3%	+0.2pp	0.6%	1.6%	2.0%
GCC	109%	37%	73%	23%	+0.4pp	1.4%	2.2%	2.5%

Sources: National statistics, IMF, IHS Markit, Bloomberg, Allianz Research estimates and forecasts

Regional recovery set to gain momentum from H2 2018

Overall, the OPEC decision from June and November should result in an additional +0.34pp for regional growth in the GCC in full-year 2018. Taking into account the share of the oil sector in GDP, the impact varies by country, from +0.2pp in Oman and Bahrain to +0.8pp in Kuwait. Moreover, the increased oil output combined with higher average oil prices will have resulted in larger fiscal revenues and thus provided some leeway for continued or additional fiscal stimulus. This should have resulted in strengthening growth in H2. For now we continue to forecast that the recovery will continue in 2019 though uncertainties have increased with the latest plans as it is too early to foresee the combined impact of potentially lower output (negative) and higher prices (positive) on growth. Note that the fiscal stimulus channel will not work for the smaller and weaker economies of Oman and Bahrain which have to exercise fiscal constraint as their public finances sharply deteriorated during the period of very low oil prices in 2015-2017. Bahrain even requested for financial aid from its neighbors as credit conditions have tightened (the yield on 5Y Government Bond is currently at 7%, up from 5% a year ago) . Saudi Arabia, the UAE and Kuwait agreed in October to provide a USD10bn support package which, however, is likely to be conditioned on strict fiscal consolidation, which will curtail growth in the non-oil sector in the next years.

All in all, we now forecast a recovery of regional growth from -0.3% in 2017 to +2.1% in 2018 and +2.5% in 2019 for the GCC region as a whole.

Manfred Stamer

AFRICA IMPROVING BUSINESS CONDITIONS

Photo by Adeolu Eletu on Unspla

Africa keeps the pace of reforms despite challenging times

African countries' *ease of doing business* soars

The World Bank Group just released its Doing Business 2019 Report. For 15 years, through the examination of data on 11 areas of business regulation, the World Bank has released a report which measures processes necessary to the conduct of business in 190 countries. The report assigns to each country a ranking, a general score and a ranking and a score per category.

For many years, African countries have been lagging behind developed countries and other emerging economies. In the last year, however, they have markedly progressed as they made it easier to do business. We have defined a "Modified Ease Of Doing Business (MEODB) score, taking into account the four sub-indicators Protecting Minority Investors, Trading Across Borders, Enforcing Contract and Resolving Insolvency which are particularly relevant for exporters and foreign investors. Based on this MEODB, Mauritius ranks 30th, neck to neck with developed economies. Djibouti upgraded its score from 50.81 to 62.6 while Morocco, Sudan and Kenya also improved their scores with gains of 5.32, 5.82 and 8.68, respectively. Rwanda, a former war-torn country, dramatically recovered from its past thanks to advances in the business environment. As a consequence, private investment soared (+60%) over the last 8 years as well as Foreign Direct Investment which increased by 40% over the same period.

At the same time, emerging economies have been rocked over the past year and this shows in their score: South Asia and Latin America and the Caribbean are the two regions absent from the top 40 ranking. Nicaragua and Mexico top the list of countries which lost the most points on the MEODB score. And while four of the top 10 improvers of this score are African countries (Djibouti, Kenya, Sudan and Morocco) none from Latin America made it into the list.

Their success stems from a sizable number of reforms implemented through the years

Looking at the overall Doing Business survey, an impressive 107 reforms were captured in 2017-2018 across 40 economies in sub-Saharan Africa alone. One third of all business regulatory reforms recorded were also in the economies of sub-Saharan countries. Since 2004, of the three regions which improved the most – Europe and Central Asia, sub-Saharan Africa and the Middle-East and North Africa – with 905 reforms, sub-Saharan African again stands out as the group with the highest total number of reforms.

Such new performances can be accounted for by a long term work. Coordination between countries led to an improvement of the judicial framework: the Organization for the Harmonization of Business Law (OHADA), which includes 17 African countries, led to reforms regarding the conduct of dispute settlement with the introduction of mediation.

Africa also proved a frontrunner in digitization which played a huge role in their advancement. Emerging and developing countries have long struggled with collecting tax revenue and African countries proved innovative to solve the issue: Ivory Coast and Togo for example created online systems for filing corporate income tax and value added tax returns.

Among all, Rwanda stands out as the second biggest reformers in the history of Doing Business. The post-war consensus that the private sector should be the main driver of the economy led the government to create an environment that makes it easier for business and investment to prosper with reforms in property registration, business registration (from 43 days to 4 days), credit access and tax paying.

Nevertheless the African success needs to be qualified: there is still a long road ahead

The average Ease Of Doing Business score in Africa is less than 40 compared to 73 in OECD, underscoring the long road that African countries are faced with. More importantly, it is important to highlight the discrepancies between African groups notably regarding the trading across borders, the getting electricity and the resolving insolvency categories. For example, Angola and Eritrea perform poorly in front Zambia and Rwanda in getting credit.

Likewise, gaps exist even within a country: Rwanda is 2nd in registering property and 3nd for getting credit but 88 for trading across borders and 51 for starting a business; Morocco ranks 25 for paying taxes but 112 for getting credit.

South Africa, the continent's economic powerhouse, ranks 82 this year – its position unchanged compared to last year. In 2017, it was ranked 74. And in 2014, it ranked 41. The country's bleak figures contrast with its neighbors' which have significantly improved their rankings and scores over the previous years. South Africa is still plagued by the corruption in public services which may account for the particularly low ranking in the Starting a Business (134), the Registering Property (106) and the Dealing with Construction Permits (96) scores. Its overall score, 66.03, is higher than the regional average of Sub-Saharan Africa (51.6) but is still lower than OECD's countries which economic prosperity South Africa aims to achieve. In May 2018, the IMF called for bold reforms to boost the economy and allow it to reach its potential.

Manfred Stamer, Alexis Garatti, Abdul Rahman Kassab

Director of Publications: Ludovic Subran, Chief Economist
Euler Hermes Allianz Economic Research
1, place des Saisons | 92048 Paris-La-Défense Cedex | France
Phone +33 1 84 11 35 64 |
A company of Allianz

http://www.eulerhermes.com/economic-research
research@eulerhermes.com
euler-hermes
eulerhermes