THE VIEW

Economic Research

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REAPING THE WHIRLWIND

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As 2018 comes to an end, it is becoming clear that President Trump's policies have shaped not only the acceleration of growth in the United States, but many policy reactions and therefore growth trajectories outside the US. The decisive fiscal stimulus and financial deregulation in America have created significant momentum: wages, investment, and financial markets all show positive developments. What looked like a possible recession in 2019 is much less likely today than a year ago. In the meantime, Europe, China and the emerging world are plateauing at best, after a too short pickup between early 2017 and mid-2018.

The reasons for this growing divergence are: the uncertainty shock related to the so-called trade war, and the tightening monetary and financial conditions in dollars because of a high-pressure US economy. As of September 2018, the average US import tariffs entered the grey area at 5.2%, from 3.5% last year. The scarring effect on imported inflation and trade diversion is visible yet under control, including through the successful renegotiation of the US-Mexico-Canada trade deal (USMCA). On the contrary, China has started feeling the heat, both in terms of export growth and financial stress. The problem is that the US-China feud is not de-escalating. Some call it the "Thucydides' trap", others the new "Cold War". For economists, the biggest risk is policy bullying, whereby countries are cornered and pushed to make policy mistakes as a coping mechanism when affected by the double-whammy of protectionism and drying up liquidity. China has immediately reacted to the drop of confidence over the past months with more subsidies, more credit, and more economic diplomacy. The risk of a Minsky moment in China is increasing, but more importantly, the hostility towards China has put on hold the natural opening of the country at a critical time for companies.

China is complex and certainly has many assets to withstand a cold war. Just like Europe or Japan, President Trump's policy-making is a concern, but buffers and agility will help them weather the storm and hopefully benefit from a stronger America. This is not the case for fragile emerging markets. Argentina and Turkey are cases in point: both countries have become more vulnerable (twin deficits) and more politically unstable in the past years. The resoluteness of American policies has precipitated their fate with important financial stress. Policy mistakes explain their contractionary situation today. On the edge, Russia, because of possible new sanctions, and Brazil and South Africa, with potentially unorthodox policy-makers, must be watched. To a lesser extent, Indonesia, India, Hungary and Romania must continue to proactively curb overheating. Interestingly enough, most emerging markets are doing the right things, but it is the ones that are not that hit the front page of the news.

US 10Y government bond yield in October

3.2 %

The significant increase of interest rates in the US led President Trump to state that the Fed is now "his biggest threat"

THE EYE OF THE CYCLONE

A cyclone is brewing in the global economy. The US – with its erratic policy-making causing major shocks of uncertainty – is in the eye of the storm, sending headwinds toward the rest of the world.

While China, Japan and the Eurozone are in the stable vortex of the cyclone, able to absorb the shocks, emerging markets are in the unstable vortex, leaving them in a vulnerable position. Nevertheless, we predict the global economy can weather this storm, with world GDP growth expected to remain resilient in 2018 and 2019.

The eye of the cyclone

The storm centers on the US, a 'high pressure economy' tirelessly creating jobs. Approaching a situation of overheating, the Fed won't hesitate to tighten its monetary policy, and this could have global repercussions on the most cash dependent economies and companies. The US fiscal policy also plays the role of a powerful absorber of global USD liquidities by offering attractive returns to investors. Beside these centripetal forces, we have also centrifugal forces originating in the US in the form of real and potential threats of protectionism.

The last initiative from President Trump targets USD200bn of Chinese imports, with a 10% tariff to be increased to 25% by the end of 2018. We are now heading close to a scenario where global trade growth could be cut by 2pp should the trade spat between the US and China further deteriorate.

The US economy has positively reacted to the fiscal impulse initiated by President Trump. The current investment cycle remains favorable despite high uncertainty, as the monetary policy remains supportive despite its progressive normalization. The level of US rates, despite worrying signals from the so-called flatness of the yield curve, remains far below the level of household saving rate, which in our view means an extremely low probability of recession.

More interestingly, the US deficit is likely to reach 3.7% of GDP in 2018 and 4.5% of GDP in 2019. The widening deficit, coupled with a tax holiday on foreign profits, has contributed to attract a wave of inward capital flows.

This is triggering a shock on global liquidity, which is at the core of the troubles for the most fragile emerging economies. This disturbance is also accompanied by a huge shock of uncertainty related to the US trade policy.

In our view, these major sources of uncertainty should progressively decrease post mid-term elections. We expect a rebalancing of the US Congress in favor of Democrats with two major consequences: more constraints on the fiscal policy and less severity on trade policy.

This is the reason why we still consider protectionist initiatives by President Trump are more a trade game than a real threat, and that global trade should be preserved, as shown by the real volume of growth remaining in a healthy regime of 2% to 4%. However, the recent implementation of a 10% tariff on USD200bn worth of Chinese imports bring us closer to the trade feud scenario, where global trade could land in the low growth band of 0–2%.

Asia-Pacific to benefit from China's stabilization

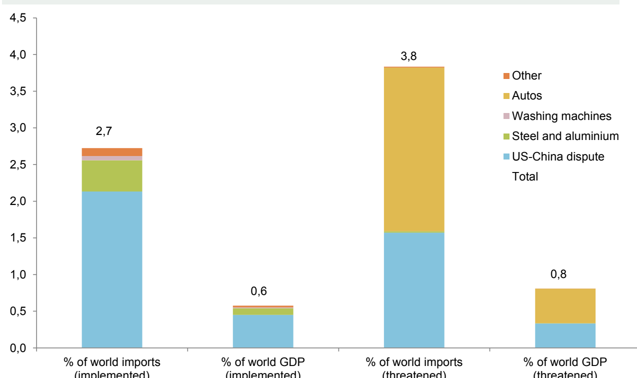
Asia-Pacific economic growth is expected to slow to +4.9% in 2018 and +4.8% in 2019 (from +5.1% in 2017), supported by stabilizing policies in China and Japan. In China, the soft landing is expected to continue, with a growth of +6.6% in 2018 (after +6.9%) and +6.3% in 2019 supported by pro-growth policies.

Fiscal policy is already expansionary, with measures ranging from tax cuts and support for SMEs to infrastructure projects. Monetary policy is set to become more accommodative, with further cuts in the Reserve Requirement Ratio (50bp more) and a gradual boost to credit growth.

On trade, the authorities are multiplying measures to reduce risks related to US protectionist measures.

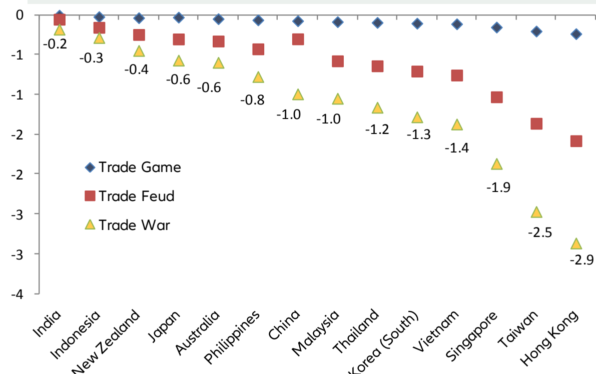
Photo by

Figure 1 Nurturing global uncertainty with protectionism (centrifugal forces)



Sources: IHS Global Insight. Allianz Research

Figure 2 Impact of US tariffs and second round effects from China on Asia-Pacific economies (pp GDP growth)



Sources: IHS, Euler Hermes

This includes the implementation of new protectionism measures, a depreciation of the currency to preserve exports competitiveness, the acceleration of strategic partnerships to find new growth outlets (e.g. negotiations for the RCEP) and gaining political leverage on the US. In Japan, the BOJ will likely keep its policies accommodative until 2020 in a context of still-below-target inflation, rising external risks and an upcoming hike in the sales tax (October 2019).

Asia as a whole has the room to absorb the impact of Fed hikes. Apart from higher currency risk in markets with twin deficits (e.g. Indonesia, Indonesia, and Philippines), risk on demand growth is relatively contained, as the most vulnerable countries have enough buffers (strong private demand) to support their growth.

The main risk relates to trade. The region can handle the second round effects of a rise of US tariff on USD50bn of imports from China. Yet, it would struggle to cope with much higher tariffs, especially if the tariff hikes were to impact USD200bn at a rate of 25% instead of 10% today (trade feud scenario) or USD500bn (trade war) of Chinese imports. China could lose -0.3pp in the case of a trade Feud scenario and -1pp of GDP growth in the case of trade war. Trade hubs such as Hong Kong, Taiwan and Singapore would be the most affected economies in the region.

The Eurozone to buffer liquidity and protectionism shocks

The Eurozone remains in the stable vortex of the global economy as its margins can absorb the negative external shocks of liquidity and trade uncertainty. However, after +2.6% in 2017, the highest in 10 years, GDP growth should slow down to +2.1% and +1.8% in 2018 and 2019 respectively.

We expect Eurozone GDP growth to reach 0.4–0.5% q/q in Q3 and to remain stable for the next coming two quarters. Going forward, lower net external contribution is expected to be partly offset by stronger domestic demand. The moderation in inflation (1.7% at end-2018) coupled with a fall in unemployment rate to 8% at end-2018 and moderate wage acceleration (+2.3% y/y at end-2018) will be supportive for consumer spending going forward.

Companies are expected to invest as they still enjoy high margins and low financing costs. Turnover growth for non-financial corporations stood around 5-6% annually in Germany, France and Spain, and a bit above 3% in Italy.

While slowing down, turnover growth remains above the financing costs (at 2% on average for SMEs in the Eurozone). The ECB is expected to continue to play the safeguard role: (i) the first interest rate hike is expected in Fall 2019 only with the refi rate reaching 0.75% at the end-2020; (ii) the reinvestment of bonds maturing will last until 2021 post end of the QE program in December 2018.

In Italy, the peak of the economic expansion is clearly behind us: Italian GDP growth looks set to slow to 1.2% in 2018 and 0.8% in 2019, down from 1.6% last year.

Investment and hiring decisions are set to be impacted by strengthening headwinds for Italian exports amid rising global trade tensions and elevated domestic policy uncertainty following the formation of a populist coalition government.

The first 100 days of the populist government saw relations with the EU become increasingly confrontational, including clashes with the EU over the handling of the European refugee crisis, as well as fiscal pledges that are likely to put Italy on a collision course with EU fiscal rules.

Table 1 The UK: Brexit scenarios

2019

"Blind" Deal (70%)	No Deal (25%)	Remain (5%)
Status quo GDP growth remains weak (1.2%) as consumers bear the brunt of a weak sterling and high inflation The BoE hikes further (+0.25bp to 1%) Business insolvencies rise further (+6%)	**Strong recession, WTO rules** 4-5% average import tariffs on EU goods GDP fells by -1% driven by contraction in consumer spending, investment and exports GBP/EUR below parity. BoE on hold 15% increase in business insolvencies	**Growth recovers to 2016 levels** GDP growth accelerates to 1.8% on the back of positive confidence effects GBP/EUR recovers to pre-vote levels (1.16) The BoE stays on course for 1 rate hike only Business insolvencies growth slows down

2021

Extensive FTA (55%)	Limited FTA (35%)	No FTA (10%)
Norway-type / Full access to Single Market GDP growth at 0.8% GBP/EUR around 1.12 Business insolvencies rise by 1%	**CETA-type / Duty-free access to Single Market for 98% of goods, equivalence for services** GDP growth at 0.3% GBP/EUR below parity Business insolvencies rise by 8%	**Recession, WTO rules** GDP growth fells by -0.5% driven by contraction in consumer spending, investment and exports GBP/EUR below parity Business insolvencies rise by 5%

Sources: ONS, Bloomberg, Allianz Research

As expected in our baseline scenario, Italy put forward an expansive 2019 budget draft exceeding market expectations. Despite a -2.4% target we estimate the budget to be closer to or above 3% as the government's economic projections are too optimistic. We expect bond spreads to the Bund to remain high (200 to 300bp) and borrowing costs to continue to rise.

However, given the long maturity of the Italian debt (above 7 years) and current low average interest rate on the debt (2.8% for all maturities vs 7% in 2012) interest expenditures should rise gradually (3.9% of GDP in 2020 from 3.6% in 2018). This, coupled with lower nominal GDP growth, will bring Italian public debt up to 132.9% of GDP in 2020 (from 131.7% and 130.9% in 2019 and 2018 respectively).

Even a small reduction in the primary surplus will quickly reverse this trend, particularly as nominal GDP growth looks set to slow to 2.1% in 2019. In our baseline scenario, we expect the Italian government to tone down its ultra-expansive EUR125bn fiscal policy agenda amid elevated market pressure (with only 40% of proposed measures implemented in 2019/20). The reversal in the positive debt dynamics is likely to trigger a one-notch rating downgrade before end-2018.

In the UK, we expect a last-minute Brexit deal under the form of a political declaration stating close ties with the EU post-Brexit.

An FTA à la Norway is the most likely compromise to avoid Ireland's dislocation by 2021 and is likely to be announced towards the end of the transition period after tough negotiations. The political environment is likely to be shaky, as the Conservative Party could face internal instability should hard Brexiters launch a procedure to oust PM Theresa May.

In an international context of growing instability, Europe is facing numerous new challenges that pose threats to its cohesion, Brexit among others.

Against this background, Europeans must reclaim their common project and agree on the priorities and common goods they wish to share at the Union level.

This could prove challenging as the European elections approach and national parties start entering the electoral campaign. A balance between reforms and winning electoral support would be government's key priority.

Indeed, the environment is challenging as our simulations based on current national polls suggest that between 39–41% of the seats of the next European Parliament could be held by "anti-establishment" parties against 36% in 2014. The rise in populism poses significant obstacles to the speed of reform. A "grand-coalition" scenario between traditional parties is likely, which shows a high risk of polarization in the European political landscape.

Eastern Europe still preserved by the market

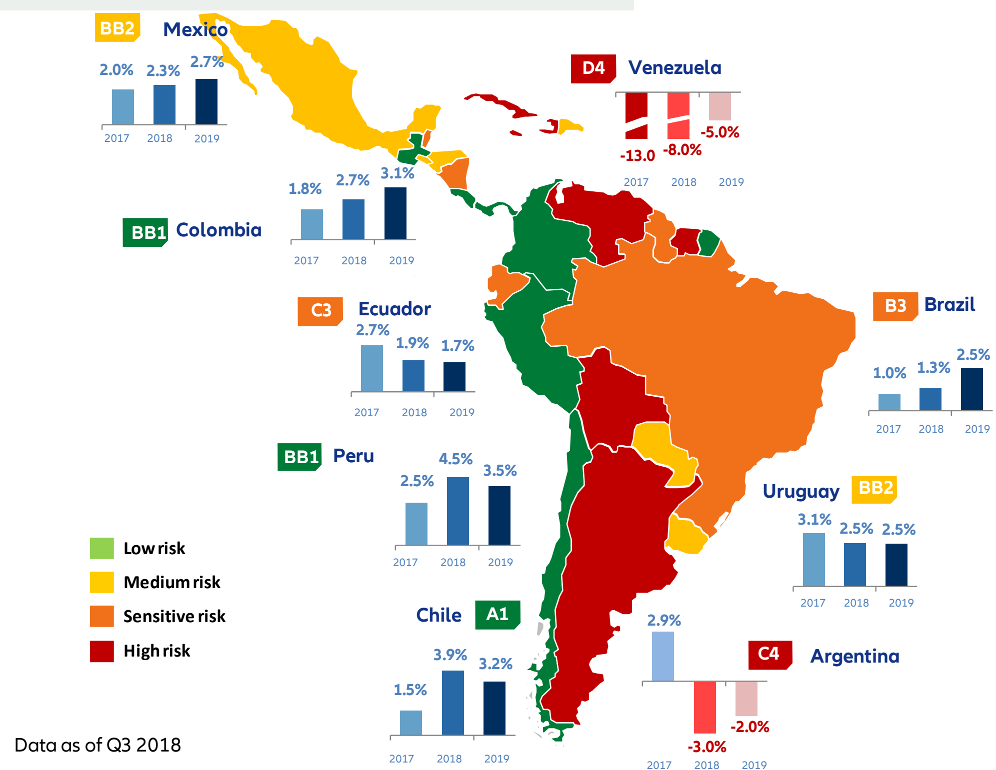
Eastern European countries continue to benefit from the Eurozone recovery and ongoing strong investment activity thanks to improved absorption of EU funds.

However, over the past two years, this has fostered the accumulation of imbalances and increased the risk of overheating. This has been the case for Turkey and Romania, and more recently for Hungary.

In Turkey, continued policy mistakes have led to a currency and balance of payments crisis that has become full-blown in Q3 2018 and the economy is now heading for a hard landing and recession.

In Romania, tepid monetary tightening has been implemented since the start of 2018 and the economy will experience a sharp slowdown, but inflation is still hovering around 5%.

Figure 3 Latin America country risk and economic growth



Sources: IHS, IMF, Euler Hermes

Elsewhere in Central Europe, labor markets have also overheated in some places but without any impact on inflation or the wider economy so far.

In Russia, new and tougher U.S. sanctions have adversely affected financial markets and should impact investment activity and growth in the medium term. Any short-term impact on the economy has been mostly offset by higher oil prices and increased oil output in 2018. Still, annual growth will remain subdued around +1.6% in 2018–2019 as structural rigidities persist.

The Eastern European region as a whole will experience a slowdown of growth from +3.9% in 2017 to +2.9% in 2018 and +2% in 2019.

Latin America's recovery threatened by headwinds

We downgraded prospects for the region again (+1.2% in 2018, and +2.1% in 2019) because of the projected recession in Argentina, and a downward revision in Brazil's forecast. In comparison, Andean countries are faring well. In Argentina, market tensions eased as a result of the IMF credit line, however poor activity data and communication errors of the government precipitated a massive ARS peso sell-off (-50% ytd).

The consequent huge interest rate shock (+15pps to 60% policy rate), a bad harvest this year after the worst draught in decades, tight fiscal consolidation and runaway inflation (40% at end-2018) should sink the country into recession (-3% in 2018, -2% in 2019). We identify three other vulnerable markets going forward:

The "Fiscal Laggard": Brazil, now the most vulnerable market in the region, is a typical tightrope walker. There are no external vulnerabilities, but public finance dynamics are weak.

Our baseline scenario is that any president-elect will take measures to reassure markets and preserve business confidence. We don't expect a fiscal crisis in the immediate aftermath of the election (October 28th). In 2019, we expect a moderate acceleration of growth to +2.5%. External conditions will continue to tighten and there will be no easy overhaul of the pension system.

Two other countries are on the watchlist. The "Still Borderline but Good Student": Colombia, despite its twin deficits, the encouraging policy orientation and oil price developments are significantly lowering the probability of policy mistakes.

The "Not Yet Fully Out of the Woods": Mexico, sees positive trade developments, while external vulnerabilities are contained and monetary policy is proactive. The probability of policy mistakes is moderate and so we need to carefully monitor any signs of a resurging nationalistic stance on the oil sector in particular.

Middle East still benefitting from the current commodity cycle

In the Middle East, annual growth will pick up from just +0.9% in 2017 to around +2% in 2018–2019, mainly because the GCC region is finally recovering from the recession. This is thanks to higher oil prices and the revision of the OPEC deal in June 2018, which will end the previous over-compliance with the deal since end-2016. In the non-GCC region, Iran will see a sharp growth deceleration in 2018 and recession in 2019 due to the re-imposition of U.S. sanctions and secondary sanctions that were lifted in early 2016. Elsewhere, annual growth will remain robust in Israel (around +3.7%) and muted in Lebanon (+1.5%) and Jordan (+2.2%).

Is the African recovery fading?

Africa's growth is expected to stall in 2018 to +3.1% from +3.1% in 2017 (-0.8pp revision). Key economies showed a deceptive cyclical momentum, still weakened by a poor political environment. South Africa is the main bad surprise (the 2018 forecast is revised down by -1.3pp to +0.7%), but other commodity exporters such as Algeria (+1.8% in 2018, -0.7pp revision), Angola (+0%, -2pp revision) and to a lower extent Nigeria (-0.5pp revision to +2%) also disappointed.

This fading momentum is more severe for the economies with already high level of debt since it is weakening their overall liquidity. Zambia is a case in point, with foreign reserves depleting to just two months of import cover.

Otherwise, growth is still accelerating in the regions that made more policy progresses in the past, such as Egypt (+5.4% in 2018, from +4.2% in 2017) and Kenya (+6.5% in 2018, from +4.9% in 2017).

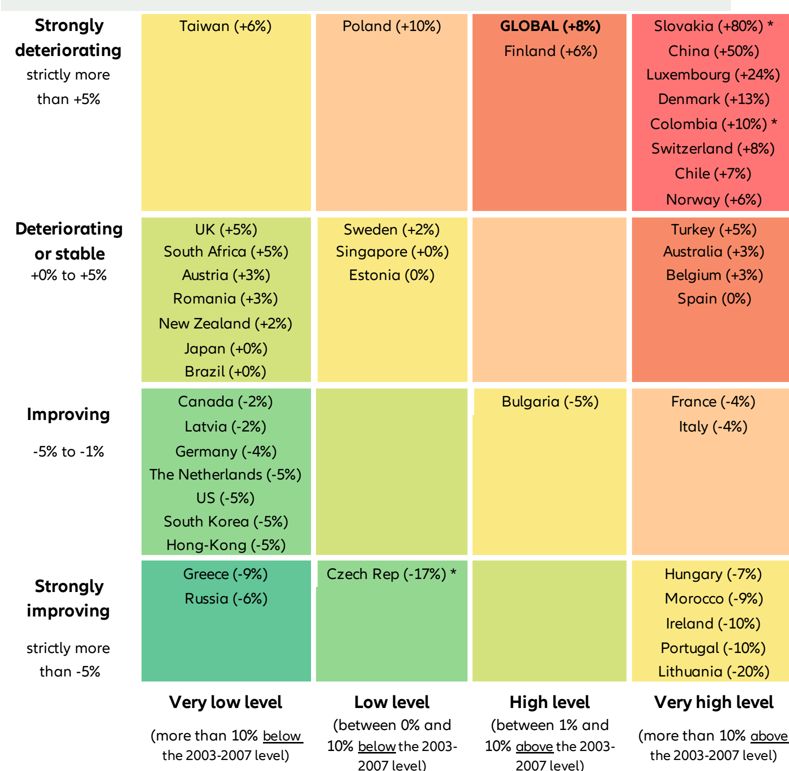
How will the whirlwind affect global insolvencies?

As a result of this whirlwind dynamic originating in the US economic policy, we expect the world economy to grow by 3.2% y/y in 2018, the same as in 2017, representing a -0.1 ppt downward revision compared with our previous scenario. In 2019, we still expect world growth to reach 3.1% y/y in 2019. Global insolvencies should be in line with this scenario. We expect our Global Insolvency Index to remain on the upside for a second consecutive year in a row in 2018 (to +7% from +6% in 2017) and to keep on increasing in 2019 (+5%).

However, this global view masks uneven trends by regions and countries: the decrease in insolvencies is to remain on track in 2018 in North America, but to soften in Western Europe, notably in France and Italy, with several countries posting a rebound in insolvencies (UK, Nordics, Switzerland, Belgium). The improvement in Brazil is likely to mark a pause in 2018 and postpone the decrease of insolvencies for Latin America as a whole to 2019.

The surge in insolvencies is expected to continue in China, notably for zombie companies, and to boost the regional overall figures. The quasi-stabilization of insolvencies in Central and Eastern Europe will mask an increase in Poland and Turkey.

Figure 4 Insolvency Heat Map 2018



	Very low level (more than 10% below the 2003-2007 level)	Low level (between 0% and 10% below the 2003-2007 level)	High level (between 1% and 10% above the 2003-2007 level)	Very high level (more than 10% above the 2003-2007 level)
Strongly deteriorating strictly more than +5%	Taiwan (+6%)	Poland (+10%)	**GLOBAL (+8%)** Finland (+6%)	Slovakia (+80%) * China (+50%) Luxembourg (+24%) Denmark (+13%) Colombia (+10%) * Switzerland (+8%) Chile (+7%) Norway (+6%)
Deteriorating or stable +0% to +5%	UK (+5%) South Africa (+5%) Austria (+3%) Romania (+3%) New Zealand (+2%) Japan (+0%) Brazil (+0%)	Sweden (+2%) Singapore (+0%) Estonia (0%)		Turkey (+5%) Australia (+3%) Belgium (+3%) Spain (0%)
Improving -5% to -1%	Canada (-2%) Latvia (-2%) Germany (-4%) The Netherlands (-5%) US (-5%) South Korea (-5%) Hong-Kong (-5%)		Bulgaria (-5%)	France (-4%) Italy (-4%)
Strongly improving strictly more than -5%	Greece (-9%) Russia (-6%)	Czech Rep (-17%) *		Hungary (-7%) Morocco (-9%) Ireland (-10%) Portugal (-10%) Lithuania (-20%)

(*) Historical data is not fully consistent because of changes in law or national figures
Sources: National statistics, Euler Hermes, Allianz Research

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