

**Economic
Outlook
no.1239**

November 2017

Special Report

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Game of Trade

Unbowed, Unbent,
Unbroken?

Economic Research



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Special Report

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Mithridatism

LUDOVIC SUBRAN

Mithradates the Great ruled from 120–63 BC. A great military leader, a brave warrior, and a cunning politician, he was one of the few serious threats to Roman domination in the ancient world. Though King Mithridates is not a fictional character from *Game of Thrones*, he could have been, as his life was one of dangers and perils. His mother assassinated his father by poisoning him and then held regency over Pontus until a male heir came of age - she definitely is a Cersei Lannister. Unfortunately, Mithridates was in competition with his brother for the throne, whom his mother began to favor. She was a nice and loving woman... and she started to slowly kill her son off by poisoning each and every one of his meals. Mithridates noticed it and decided to flee to escape death. While in the wild, preparing his comeback to the throne, he began ingesting non-lethal amounts of poisons and mixing many into a universal remedy to make him immune to all known poisons. Mithridatism then became the practice of protecting oneself against a poison by gradually self-administering non-lethal amounts.

In this third edition of our *Global Trade Report*, *Game of Trade: Unbent, Unbowed and Unbroken*, we ask ourselves one question: Is the world mithridated against deglobalization and protectionism? It looks like we are more tolerant to trade risks after all.

After two years of decline, global trade is finally back from the ashes. This comeback happens the very same year that

President Trump's America First creates havoc in the global community: protectionism, tax on foreign companies, deregulation shock. Is it the end of the Iron Throne of globalization to which the seven Kingdoms pledged allegiance? It does seem like it will be riskier, costlier and more adventurous, especially because Mithridatism is not effective against all types of poison, and, the practice can lead to the lethal accumulation of a poison in the body. Political risk is one good example of a toxin hard to recover from, especially when you are a smaller company.

Is it this bad? Can we have a happy ending please? Just like in *A Song of Ice and Fire*, the book by George R. R. Martin after which the HBO blockbuster was produced – and allegedly much bloodier – there will be many casualties along the way (it is called insolvencies in our world), but there is a Khaleesi in the making with her powerful dragons: plenty of cash on companies' balance sheets for another M&A waves, disciplined support from governments for longer-term investments, and the digital revolution. Will it be enough? We hope it will. "The Night is dark and full of terrors" but in the end, they defeat the Night King, right? #SpoilerAlert

OVERVIEW

Game of Trade: Unbowed, Unbent, Unbroken?

MAHAMOUD ISLAM AND MARCO HAUSCHEL

■ **Trade Stark: "Growth is coming".** The volume of global trade is estimated to increase by +4.3% in 2017 and +3.9% in 2018. In value terms, it is forecast to expand by +7.5% in 2017 and +6.3% in 2018. The latter trend is in line with the synchronized acceleration of growth across the globe after two disappointing years (2014-16), during which global trade has lost close to USD3tn. The main culprits were demand shocks and a collapse of commodity prices.

In 2017, due to a significant rise in prices, we expect the trend to reverse. By 2018, global trade should recover the massive losses. Furthermore, trade recovery is set to add half a point to world GDP growth this year and next and help it edge above +3%.

Strong demand growth will come from the US, the Eurozone, and emerging Asia. On the export side, Europe and Emerging Asia are set to benefit the most from the trade momentum.

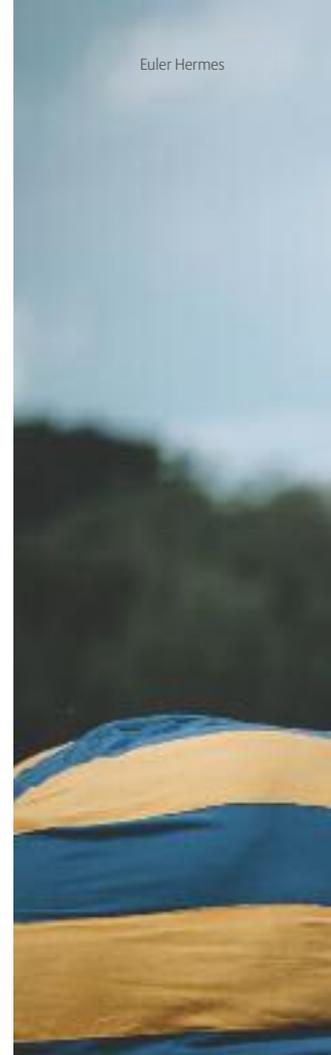
■ **The White Walkers of Trade: Protectionism, Trade Financing and Geopolitics.**

Still, in the foreseeable future, the global trade in goods and services is set to grow at half the pre-crisis pace. Between 2003-2007, volume growth averaged +8% and value growth soared by +16% on average.

We identify three issues that hamper the acceleration. First, the number of protectionist measures is high and keeps on rising. More than 400 new measures are expected this year (somewhat less than in 2016). Second, financial balkanization remains a cause for concern. Global cross-border bank lending contracted by -0.2% y/y in Q2 2017 due to asymmetric regulation. Our estimates of the trade financing gap concur with the Asian Development Bank's figure of USD1.5tn (annually). Pro-relocation policies in advanced economies (so-called tax wars) may divert capital from emerging markets. Monetary policy normalization could impact the availability of hard currency and raise the costs of trade finance across the board. Last, increasing geopolitical tensions – in the GCC region, Korean Peninsula or elsewhere – pose an additional risk to trade flows.

■ **The New Globalization Dragons: Cash, Regional Industrial Policies and Digitalization.**

We see three positive boosters for global trade going forward. First, investment flows should grow by +3% in 2018. These should be supported by stronger corporate balance sheets and a record USD7tn of cash on balance this year. Second, smart industrial policies help. These include large infrastructure projects such as China's Belt and Road Initiative. Another example is Japan's investment in infrastructure and energy reforms. Moreover, regional free trade agreements fill the void left by defunct global deals. The Regional Comprehensive Economic Partnership in Asia and the Comprehensive Economic and Trade Agreement between Canada and the EU are two examples of this approach. Last, services and digitalization may drive a new golden age for trade, although it may still be hard to trace their impact on national statistics. Startups in these fields are global at inception while emerging markets attempt to focus more on services. Add to that the growing number of innovative solutions for safer and stronger supply chains, including the growing field of TradeTechs.



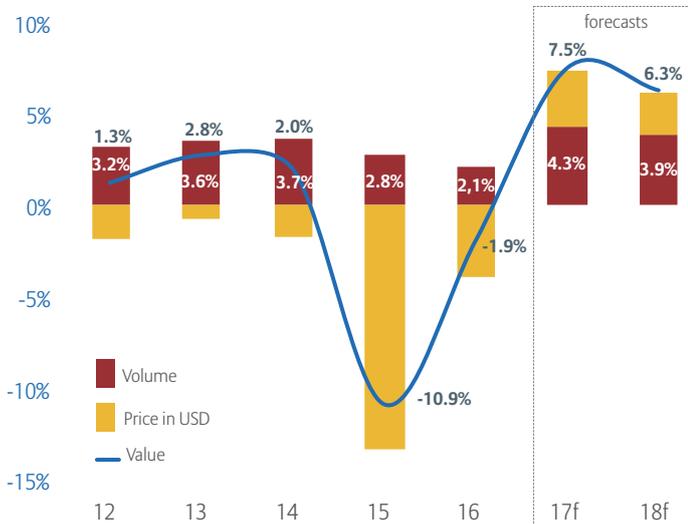


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+3.9%

Growth in volume of global trade in 2018

Figure 1 USD denominated global trade of goods and services (growth)



Sources: IHS, Euler Hermes

Trade Stark: "Growth is coming"

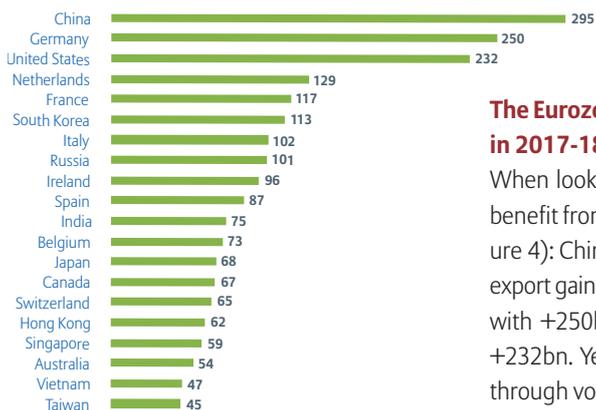
Global Trade Outlook: "Look into the fire, my king"

Global trade is expected to increase by +4.3% and +3.9% in volume in 2017 and 2018 respectively, +7.5% and +6.3% in value. Thus, after two years of contraction, the value of global trade of goods and services is finally expected to recover. Global Trade has lost close to USD3tn between 2014 and 2016. The main culprits were lower imports growth from emerging markets, weaker investment growth in advanced economies in the context of a busy political agenda (Brexit, US election, e.g.) and a collapse of commodity prices. We expect the trend to reverse in 2017 supported by a significant price improvement. By 2018, we should recover the lost 3tn.

2017 marked a turning point as demand growth picks up speed and commodity prices recover. Global GDP growth is expected to accelerate slightly above +3% (from +2.6% in 2016) for the first time since 2011. In advanced economies, the investment cycle is on a stronger footing helped by rising profits, improved corporate confidence and broadly accommodative monetary policies (Eurozone, Japan). In emerging markets, China's economic growth remains firm supported by continued fiscal stimulus and a solid growth in private consumption. In commodities exporting markets such as Brazil and Russia, rising commodities prices and lower pressure on the currency help boost purchasing power and central banks get more leeway to support growth as inflation normalizes.

What does 2018 hold? The momentum should continue but at a more moderate pace reflecting a lower base effect for commodity prices, slower economic growth in China as authorities move to tackle financial risk, and slightly more expensive trade finance. A fiscal boost to the tune of ►

Figure 4 Potential export gains by country
(Goods and services, cumulated change in 2017 and 2018, USD bn)



Sources: IHS, Euler Hermes

(iii) **Essos** refers to markets where real imports growth would be lower than the global average. This cluster includes countries that are recovering slowly from the commodity price shock (South America and the Middle East); markets that are going through trade-related political turbulences (the UK amid Brexit; Mexico facing NAFTA renegotiations); and markets with weak fundamentals, namely current account and fiscal deficits (Turkey). In the latter, a weaker currency would raise costs of imports which depress demand for foreign goods.

The Eurozone to Conquer the Export Throne in 2017-18

When looking at export growth and who is to benefit from the demand momentum (see Figure 4): China leads with USD295bn cumulated export gains in 2017 and 2018. Germany follows with +250bn and the US comes in third with +232bn. Yet a closer look at exports dynamics through volume growth and changes in export market share provides a more nuanced picture. When summing all of Eurozone, export gains in 2017-18 amount to +956bn which makes it the de facto Queen of Exports.

Figure 4 plots countries according to their real exports performance and change in exports market shares to establish a typology of winners:

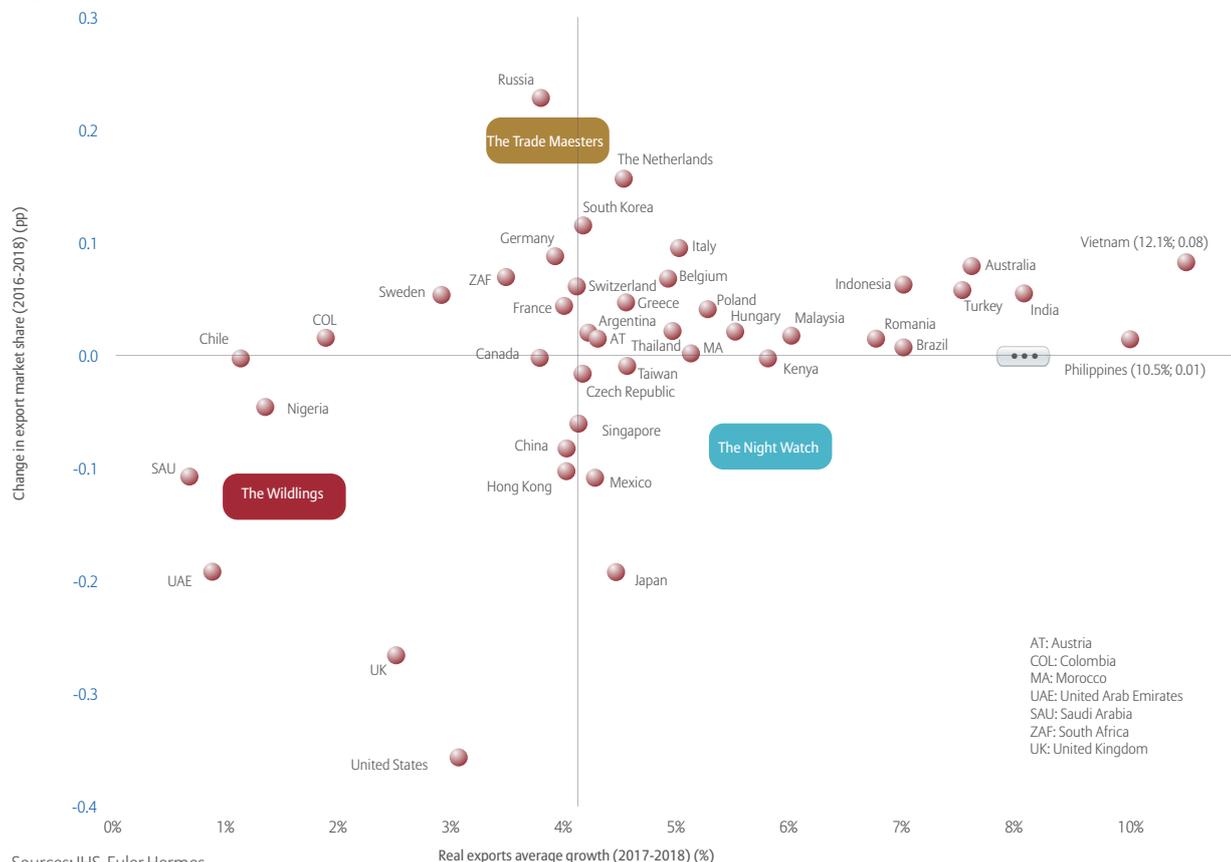
(i) **The Trade Maesters** is the strongest group of countries, well positioned to grab a larger share of global exports. Firstly, competitive primary commodity exporters (Russia, Indonesia, South Africa), and production hubs (Malaysia, Vietnam, e.g.) are set to thrive supported by solid demand growth from China and a rise in

prices. Secondly, manufacturing hubs in Eastern Europe are forecast to benefit from a positive economic cycle in the Eurozone. Third, Eurozone markets that are specialized in high-end goods production (Germany, France, e.g.) may benefit from higher new orders and solid pricing power.

(ii) **The Night Watch** refers to fast economies that will lose market share but maintain strong exports performance. Advanced economies in Asia (Singapore, Taiwan, e.g.) represent the bulk of this category. Strong innovation efforts in these markets help ensure robust growth in exports through improved competitiveness. Yet, growing competition on high range products from China will have an impact.

(iii) **The Wildlings** are historically rich economies where the export performance is lower than the global average and where the countries are losing market share. In China, loss of market share stems from strong competition from new manufacturing hubs in ASEAN (Cambodia, Laos, Vietnam, and Myanmar) and South Asia (Bangladesh). In the US, deteriorated terms of trade, and deteriorating trade relations hinder the export outlook. In the UK, lower GBP may provide some competitive advantages. However, trade diversion in the context of Brexit would translate into lower new orders. ▶

Figure 5 Growth in real exports of goods and services and change in global market shares



Sources: IHS, Euler Hermes



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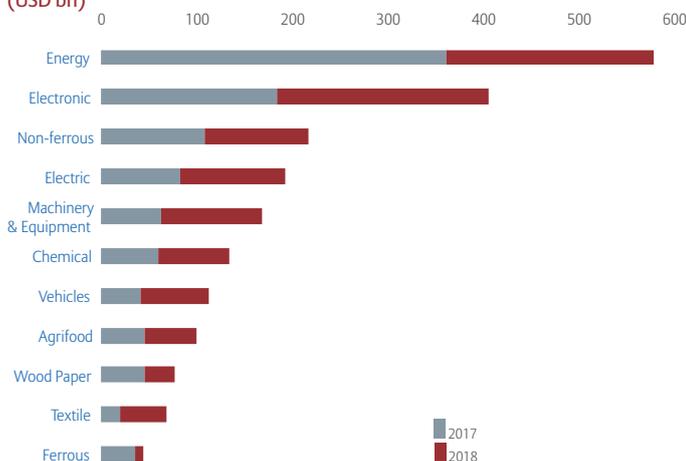
In 2018, The Commodities Gods May Surprise

When we break down export performance by sectors, we see three areas of improvement. First, primary commodities are set to pick up speed after two years of contraction thanks to improving demand from both advanced and emerging markets, and recovering prices. In particular, energy (+USD578bn over 2017-18) is set to post a strong comeback, followed by nonferrous (+216bn). Second, Electronic (+USD406bn) and Electrical products exports (+193bn) are expected to grow at a fast pace supported by

accelerating private consumption in emerging markets especially in Asia and global innovation efforts. Third, Machinery and Equipment (+USD168bn) and Chemicals (+134bn) are set to strengthen gradually on the back of higher investment cycle and rising industrial production.

+USD578bn
energy export gains
in 2017-18

Figure 6 Sector gains in goods exports (USD bn)



Sources: Chelem, Euler Hermes

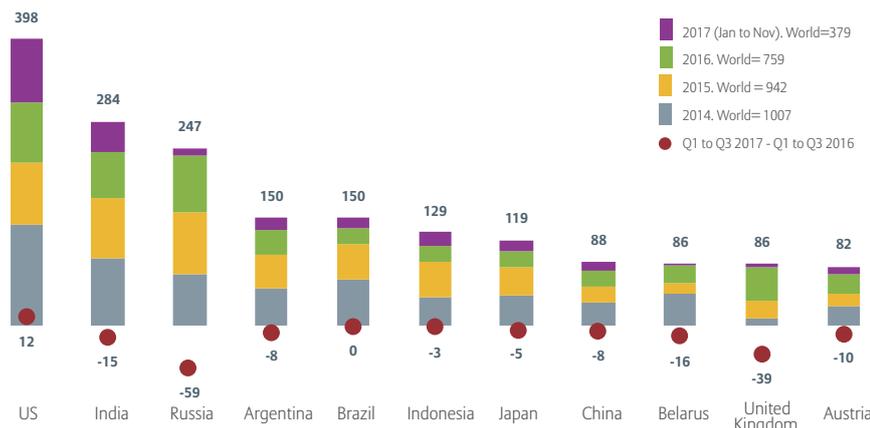
The White Walkers of Trade: Protectionism, Financial Balkanization and Geopolitics

In spite of a welcome pick up in global trade, growth will likely be half of pre-crisis rates (8% for volume growth in 2003-07, 16% in value terms). There are three headwinds for global trade: Trade Protectionism, Financial balkanization, and Geopolitics.

The Protectionist Wall

The stock of protectionist measures remains high (Figure 7) with the bulk of these measures coming from the US (23%) and India (12%). Latest figures point to a continued increase but at a slower pace. From January to November 2017,

Figure 7 New protectionist measures by country



Sources: GTA, Euler Hermes

400
protectionist
measures to be
adopted
in 2017

379 measures (we expect 400 for the full year) have been adopted compared to 759 in 2016 and 942 in 2015.

Some countries such as the US started to rapidly increase the number of barriers. Up to November 2017, 87 new measures were recorded, more than the whole year 2016 (84) and 2015 (86). Measures were heavily aimed at two economies. 20% of US protectionist measures targeted China and 18% were aimed at Canada, up from 10% and 12% respectively in 2016. Such a trend is particularly important when considering the importance of the US as a final goods consumer. It accounts for 30% of global private consumption.

Moreover, some sectors such as primary commodities remain heavily protected. Agrifood, metals, and energy taken together represent almost 50% of the measures that have been

adopted this year. After the commodities super-slump, countries have resorted to protectionism to help their primary industry. India raised imports duty on peas and wheat, increased import tariffs on raw and refined sugar, issued a certain number of measures to restrict gold imports and promote the usage of domestic manufactured goods for government procurement. The United States issued rules to raise tariffs on a number of items including steel, imported meats but also to favor local food suppliers (Buy American requirement for school lunch, e.g.).

The Winds of Winter Affect Capital Circulation

The second drag on global trade growth relates to a still difficult access to financing stemming from a continued balkanization of financial flows, pro-relocation policies in advanced

economies and global monetary policy normalization.

Global cross-border bank credit contracted in Q2 2017 (-0.2% y/y) after an improvement in Q1 2017 (+1.8% y/y). This poor performance continues to contrast with pre-crisis growth (+15% y/y p.a. in 2003-07) when a strong momentum in financial integration has accompanied the acceleration in global trade. Risk intolerance and ring-fencing by large banks in the US, combined with asymmetric financial regulation (capital requirement) and capital controls (in emerging markets) explain the disappointing trade volume growth in our forecasts. Using proprietary data, we found a trade financing gap of approximately USD1.5tn this year, in line with the Asian Development Bank (ADB) recent estimate, which warned the international community of the fact that 40% of the gap is concentrated in emerging Asia. ▶



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In addition, capital flow will likely see some diversion from emerging markets due to pro-relocation policies in advanced economies including tax war – the US announced a major over taxation of foreign businesses in its November Tax Bill proposal –, and a more aggressive Europe in financing innovation and green investments, and a very accommodative China (AIIB, RMB facilities).

The synchronized monetary policy normalization will also mechanically increase trade finance costs. The lower availability in hard currency is a major impediment to trade for large emerging markets which witness the currency regionalization (USD|EUR|RMB). Second-round effects of the reduced liquidity include higher costs of credit and imports in USD for instance.

Geopolitics: The Breaker of Trade Flows

Third, geopolitical concerns remain a key determinant of the reshuffling of trade routes.

► **In Europe**, prevailing tensions with Russia and the difficult-to-reach Brexit transition deal pose a serious risk to the trade outlook. Total

trade of goods between the EU and Russia in dollar terms contracted by -46% between 2014 and 2016, and the outlook is not well oriented as sanctions could last until 2018. Brexit would also affect trade flows within the region as corporates gradually relocate their production base to EU members.

► The growing tensions **in the Middle East** come on top of an already difficult regional situation. The Strait of Hormuz and the port of Dubai are strategic strongholds; any supply shock - especially on commodities - could endanger the recovery of global trade and growth.

► Last, the heightened risk in the **Korean Peninsula** features trade champions as key protagonists (China, South Korea, Japan and the US). China has already banned imports of certain South Korean cosmetics and entertainment industry products. The US has increased political pressure on China through increased protectionist measures.

► **In America**, President Trump's intention to withdraw the US from NAFTA will be a historical event for global trade, as it is considered a flagship trade agreement.

The New Globalization Dragons: Investment Flows, Trade Agreements and Digitalization

Though trade may be jeopardized by structural brakes, some positive developments should be noted.

Dragon #1: Cash Has No Frontiers

After a contraction in 2016 (-2%), global investment inflows would plateau in 2017 especially because of tighter regulation in China. We expect a modest recovery in 2018 (+3%) on the back of improving corporate balance sheets and a renewed investment cycle. Eurozone corporate profits edged up by +2%y/y in Q2 2017, US corporate profits increased by +7.2% y/y in Q2 2017 and China experienced a surge in industrial profit (+22.8% YTD y/y in September). If you add the record level of cash on balance sheets, which we estimate at USD7tn this year, and the favorable confidence advanced indicators, one can see why risk appetite is back. It is important to note that multinationals, and especially those from the new economy, want to play an active role in connecting the dots. For instance, driving applications such as Grab and Lyft have joined forces to leverage respective competitive advantages in South East Asia and North America. Another example is the announcement by Samsung Electronics that it partners with Alibaba

+3%
increase in
investment inflows
in 2018



Group Holding re mobile payments to circumvent Chinese financial protectionism. Such cooperation between industry giants, to avoid the local regulatory burden and accelerate growth, though anecdotal at this stage, could explain the resilience of trade in services.

Dragon #2: Industrial Policy and Regional Blocks

Though transoceanic and global approaches may have hit the pause button as the US actively withdraws from the talks, bilateral agreements and regional partnerships are under negotiation in all the regions of the world. Supply chains complementarities are at stake.

In Asia for instance, China positions itself as a champion of globalization, pushing forward the Belt and Road Initiative but also more formal regional Free Trade Agreement such as the "Regional Comprehensive Economic Partnership (RCEP)", which includes the ten ASEAN member states as well as Australia, China, India, South Korea, New Zealand. Across regions, new agreements take shape. The EU, for example, moves toward closer cooperation with both Japan and Canada.

In addition, it looks like states are ready to take back an active role in driving industrial policy and helping companies manage the risks – the other side of the protectionist coin? The Chinese Belt and Road initiative, whose aim is to boost connectivity around Africa, Europe, and Asia, will be one of the main drivers. Since the project

was launched in 2013, China's investment and construction projects in the world have increased by +USD960bn, with Asia (+USD420bn), Europe (+USD208bn) leading and Sub-Saharan Africa (+USD152bn) rising at a fast pace. In addition, the governments of Japan and India jointly launched the "Asia-Africa Growth Corridor (AAGC)" initiative, which links Africa to India via maritime routes. Japan is to act as the principal financier, which will increase FDI flows towards India as well as East Africa. In the rest of the world, the renewed European project and a clear infrastructure stimulus promised by President Trump should also play a guiding role in fostering domestic and cross-border investment flow. Emerging markets have also shown chutzpah with public investments: From Colombia to Turkey to Indonesia, it looks like austere budgets are behind us.

Dragon #3: The Services and Digital Dividends

Services will account for 72% of global GDP by 2018 (from 70% in 2016). This increase will be driven by emerging markets especially China and a more service-oriented manufacturing sector: research and development, marketing and sales, customer support, and financial services (for automakers, e.g.). Emerging markets are gradually moving towards more service-based economic growth model, as the middle class everywhere is impacted by new consumer needs. In addition, such transformations make

countries less sensitive to external shocks especially when non-tradable services represent a high share of the economy, less capital intensive and create jobs.

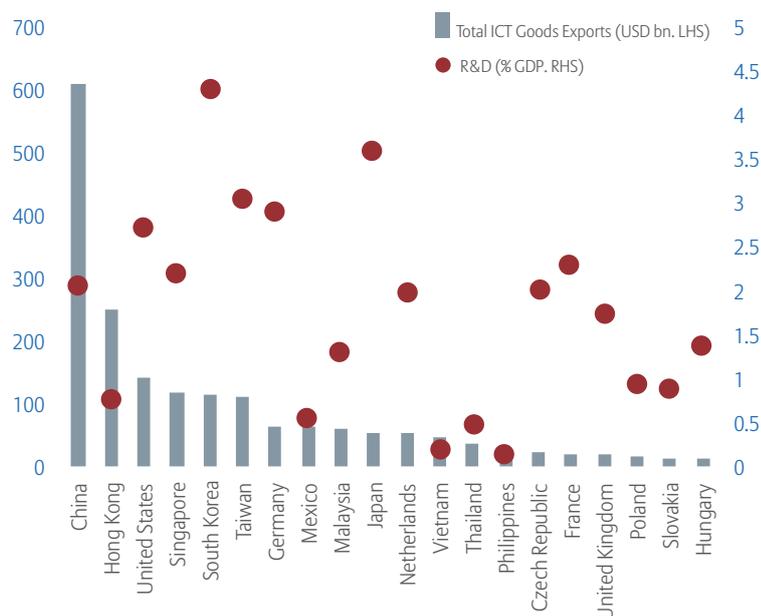
Digitalization brings an important internationalization dividend including increased access to information and payments, efficient supply chains, wider (and more inclusive) catchment area, and online sales platforms optimized by Artificial Intelligence. Young and small companies are leapfrogging logistics-based internationalization everywhere. Alibaba or eBay provide opportunities for SMEs looking for external growth.

Countries are expected to step up their digital efforts to help businesses increase market shares and competitiveness. Using Information, Communication and Technology exports data as a proxy of effective digitalization, figure 7 points to the strength of Asian countries in the digital contest. To differentiate real innovators, we use R&D expenditures (as % GDP). As a rule of thumb, we assume that R&D expenditures ratio below 1.8% GDP (average of our sample) indicate weak innovation efforts and lower performance in the long run. China tops the ranking benefiting from its economic size and strong efforts to enhance digital activities. Hong Kong follows closely but weak R&D expenditures nuance its potential. The US is ranked third thanks to a strong and innovative tech base. Singapore, South Korea, and Taiwan follow closely. ■



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Figure 8 ICT goods exports (USD bn) and R&D expenditures (% GDP)



Sources: UNCTAD, Euler Hermes



House United States

Growth Behind the Wall?

- **US nominal exports of goods and services are set to rise by +USD113bn in 2018 (after +119bn in 2017). As for merchandise exports (+USD74bn), +USD24.9bn could go to Europe and +USD22.5bn to Canada and Mexico.**
- **Gains will come to a large extent from three sectors: Chemicals (+USD13.8bn), Machinery and Equipment (+USD12.5bn), and Precious Metals and Jewelry (+USD10.9bn).**
- **Rising protectionism is unlikely to provide a satisfactory answer to job losses in the manufacturing sector.**

A return to modest growth

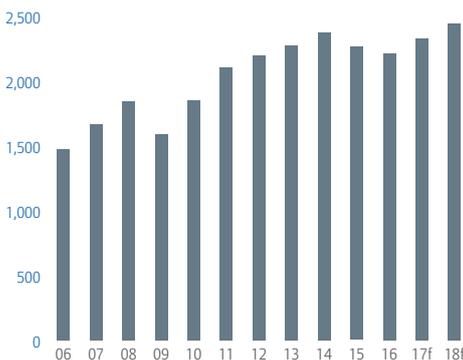
After two straight years of declines in 2015 (-USD102bn) and 2016 (-USD162bn), U.S. nominal exports of goods and services are set to rise. These increases are estimated to amount to +USD113bn in 2018 and +119bn in 2017. As for merchandise exports (+USD74bn), USD24.9bn could go to Europe and USD22.5bn to Canada and Mexico.

A buoyant global economy and firming prices explain the reversed trend. American exporters will benefit from the rebound in global demand, in itself boosted by long-lasting ultra-accommodative monetary policies. Qualitative easing and low-interest rates have been at first beneficiary to the US, followed by the Eurozone and Japan, and, eventually, emerging economies. This process of growth diffusion triggers a new

global investment cycle. As a result, animal spirits have been awakening worldwide and should remain alive and well.

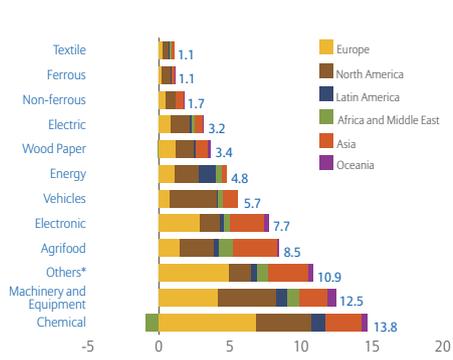
In this context, cyclical activities and global trade will remain strong. Exports of goods will account for two-thirds of the increase. Gains will come to a large extent from Canada and Mexico and Europe. The Chemicals industry, which traditionally benefits from a new global investment cycle, will see major gains. Another potential big winner is the Machinery and equipment sector – the US’s largest export sector. Growth in the vehicles sector relies to a certain extent on re-exports between the three NAFTA countries – US, Canada, and Mexico – whose supply chains are tightly integrated. Over the longer term, the U.S. will become a larger exporter of energy as fracking taps into vast new reserves of oil and natural gas. In particular, natural

Figure 1 Level of nominal exports of goods and services (USD bn)



Sources: IHS, Euler Hermes estimates

Figure 2 Potential 2018 merchandise export gains by sector (USD bn)



Sources: IHS, Chelem, Euler Hermes estimates

64%
of merchandise export gains will be directed to North America and Europe

gas exports to Asia through the Panama Canal will see strong growth.

Can protectionism unwind US de-industrialization?

This positive outlook on exports is now being threatened by the specter of trade protectionism. President Trump pledged to defend American jobs allegedly decimated by global trade. The current U.S. administration has already launched a slew of new protectionist measures against China and Canada. It also rejected grand bargains and multinational deals such as TPP. Furthermore, the U.S. calls for a renegotiation of the North American Free Trade Agreement (NAFTA). This may entail amendments to the rules of origin on autos to favor American companies, changes to dispute resolution mechanisms. On top of that, the US foresees the inclusion of a sunset clause, meaning the deal would have to be re-approved by all three countries in five years or it dissolves. The federal government has launched investigations into several Chinese import sectors. These include steel, where new tariffs have been proposed on top of 500% duties imposed in 2016, and aluminum, with potential taxes of up to 81%.

Despite such measures, the losses in the US manufacturing sector appear to be unreparable. Potential unfair practices of main trade partners are not the only culprits when it comes to American deindustrialization. A recent study by the Center for Business and Economic Research found that 85% of job losses are attributable to technological innovation. This does not mean that trade has no impact. A study by the Massachusetts Institute of Technology (MIT) showed that 2.4m American jobs could have been lost due to rising Chinese imports from 1999 to 2011. ■



House Mexico

Growth Behind the Wall? Season 2

- Mexico's exports of goods and services are estimated to rise by +USD20.7bn in 2018 (after +USD10.4bn in 2017).
- Gains from merchandise exports stem from three sectors: Vehicles (+USD4.6bn), Electronics (+USD4.0bn), and Electric (+USD2.3bn), mostly from trade with North America (+USD16.0bn).
- Implementation of a new NAFTA deal is unlikely before 2019. Mexico now turns to the Pacific Rim as it continues to reform its economy.

Trade outlook narrowly linked to US activity

After contracting in 2015 (-3.5%) and 2016 (-1.4%), Mexico's exports of goods and services returned to positive growth in 2017 (+2.6%). We expect a nominal rise in exports USD10.4bn in 2017 and USD20.7bn in 2018 as oil prices recover and US activity accelerates. This follows a decline of -USD20.1bn over 2015 and 2016. 80% of Mexican exports go to the US. Thus, export gains in 2018 will be driven to a large extent by a rise in demand from North America (82% of export gains). Europe (6.7%), Latin America (4.6%) and Asia (4.5%) lag behind. Mexico should benefit from the strong American economic activity and planned US fiscal stimulus in 2018.

NAFTA talks have been extended until March 2018, reducing the risk of termination in the

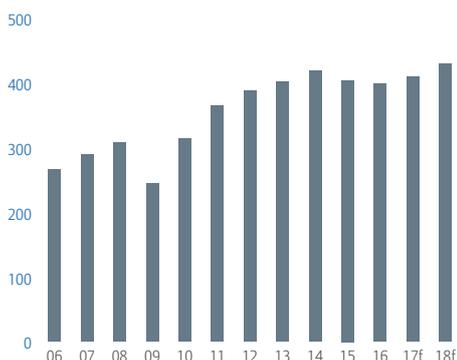
short-term. Hence parties would not ratify the agreement before H2 2018. This would push its implementation to 2019, as the political calendar will be busy (presidential elections in Mexico in July 2018, and midterms in the US in November).

The sectors set to enjoy the most gains will be vehicles (+USD4.6bn in 2018) and electronics (+USD4.0bn). These should be followed by electric (+USD2.3bn) and machinery and equipment (+USD2.2bn).

Reforms and partner diversification

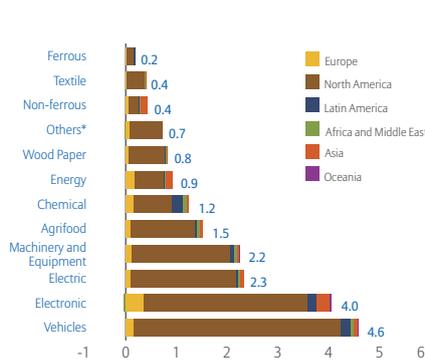
Better export performance also stems from successful reforms. Since 2012, the pro-business administration has worked to enhance the business environment and facilitate trading across borders. It implemented an electronic single-

Figure 1 Level of nominal exports of goods and services (USD bn)



Sources: IHS, Euler Hermes estimates

Figure 2 Potential 2018 merchandise export gains by sector (USD bn)



Sources: IHS, Chelem, Euler Hermes estimates

82%
of Mexican merchandise export gains to come from North America in 2018

window system and created a small claims court to enforce contracts. It also announced plans to invest MXN646bn (around USD34bn) in transport infrastructure from 2014 to 2018. Yet, shortfalls remain in areas such as corruption, crime and government efficiency.

At the same time Mexico has diversified its trade partnerships. It now has in place Free Trade Agreements (FTA) with 45 countries (60% of the world GDP). The country remains part of the Transatlantic Partnership negotiations, unlike the US. The EU-Mexico FTA is also under scrutiny. The Mexican Economic Minister recently mentioned potential negotiations with regional partners such as Argentina and Brazil for alternative sources of imports in case of a NAFTA termination.

Two risks to the outlook

What if the US pulled out of NAFTA? The treaty provides for a 6-month notice of withdrawal. Trade between Mexico and the US would then be subject to the World Trade Organization's (WTO) Most Favored Nation regime. This would entail a 3.5% average tariff (2.4% weighted-average tariff) for US imports and 7% average tariff (4.5% weighted-average tariff) for Mexican imports. Yet, it is possible that in order to correct for the US trade deficit with Mexico - USD63.2bn in 2016 - the US may take additional protectionist measures. Besides, the peso has proven to be sensitive to developments in negotiations, which creates uncertainty for exporters.

The second risk relates to political uncertainty ahead of July 2018 elections in Mexico. The current frontrunner's campaign hinges on nationalistic sentiment; this could jeopardize Mexico's openness to trade, with a reciprocal reaction to US protectionism. ■



House China

Trade is the Fury

- **China's exports of goods and services are estimated to rise by a robust +USD129bn in 2018 (after +USD166bn in 2017).**
- **The bulk of the improvement will come from three sectors: Electronics (+USD35bn in 2018), Textile (+USD19bn) and Machinery and Equipment (+USD15bn).**
- **The long-term trade strategy will be premised on two major initiatives: the Manufacturing 2025 and Belt and Road Initiative (BRI).**

Rising global demand, rising exports

China's exports of goods and services are estimated to rise by +USD129bn in 2018. That robust jump should come at the heels of an already big rise in 2017 (+USD166bn). This is a major shift compared to the sharp decline to the tune of -USD265bn between 2014 and 2016.

The improvement will be driven by a rise in demand from Asia (37% export gains), Europe (28%) and North America (24%). The leading sectors set to enjoy the gains will be electronics (+USD35bn in 2018), textile (+USD19bn), and machinery and equipment (+USD15bn).

The Chinese economy is benefitting from a recovery in consumption and investment in advanced economies, growing consumer appetite in Asia, and stronger integration with regional counterparts. Moreover, a lower currency com-

pared to 2013 and 2014 (6.2RMB per USD) improves price competitiveness. Ultra-loose macro-policies translate into eased credit conditions and favorable fiscal policies (tax cuts and other fiscal incentives).

Looking ahead, while credit conditions may tighten, fiscal policy will likely remain supportive. This should take the form of a lower tax burden for exporters in sectors related to the new economy (high tech, automotive, e.g.).

A two-pillar strategy

In the longer term, China's export growth will hinge on a two-thronged approach.

First, there is the Belt and Road Initiative. This ambitious scheme aims at improving trade and transport infrastructure among 65 countries across Asia, Europe, and Africa through invest-

37%
of Chinese
merchandise
export gains to
come from Asia
in 2018

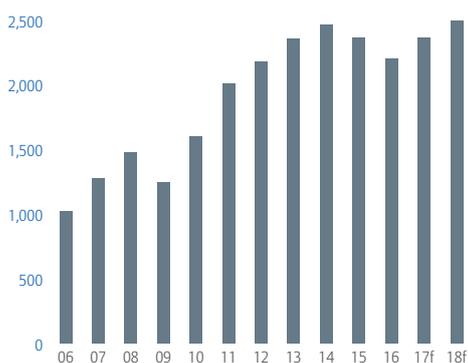
ments in infrastructure. This should translate into greater export opportunities for Chinese corporates operating in the fields of basic material and heavy machinery. Moreover, Chinese supply chains (electronics, e.g.) could improve efficiency when providers in Cambodia and Laos benefit from an upgraded logistics infrastructure. We estimate that a 2pp increase in exports growth to Belt and Road countries could boost China's GDP growth by +0.1pp.

Second, the Manufacturing 2025 initiative consists of a comprehensive upgrade of China's manufacturing sector to higher tech and higher value-added activities. Key measures include fiscal incentives, pro-innovation measures such Intellectual Property rights protection and public investments. These could support the expansion of ten key sectors ranging from Next Generation Information and Technology to Biotech.

Beware of US protectionism and rising production costs

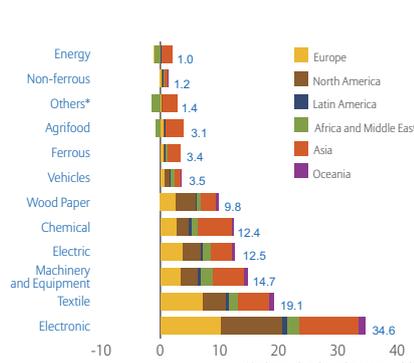
Going forward, two risks could stunt growth. The first stems from protectionist measures by the US, which accounts for 18% of Chinese total exports. Out of the 398 trade tariffs and barriers enacted by the world's largest economy over the last four years, 16% were targeted at China. The second risk relates to a deterioration of Chinese price competitiveness. Production costs have climbed as labor becomes more expensive - wages have been up +13 % p.a. since 2001. International companies are on the hunt for countries with lower labor costs as new hubs for production such as Vietnam, Cambodia, Laos, and Myanmar. Low value-added sectors such as textile and cheap electronics are more vulnerable to price competition. ■

Figure 1 Level of nominal exports of goods and services (USD bn)

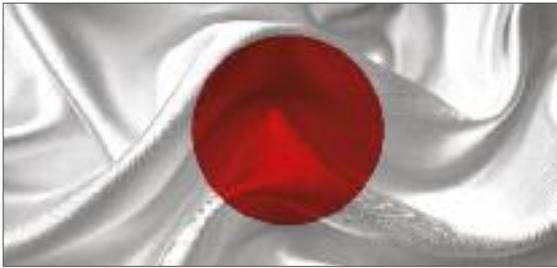


Sources: IHS, Euler Hermes estimates

Figure 2 Potential 2018 merchandise export gains by sector (USD bn)



Sources: IHS, Chelem, Euler Hermes estimates



House Japan

Policy is Power

- Japan's exports of goods and services are forecast to increase by +JPY5.7tn in 2018 (after +7.9tn in 2017).
- Vehicles (+JPY970bn), Machinery and Equipment (+966bn) and Electronic (+702bn) will lead the trend.
- Financial assistance, productivity-boosting measures, and partnerships will support corporate internationalization.

Growing fast

Exports of goods and services are expected to rise by +JPY5.7tn in 2018 (after +7.9tn in 2017). Vehicles (+JPY970bn), Machinery and Equipment (+966bn), and Electronics (+702bn) are set to be the best performing sectors in terms of merchandise export gains.

First, exporters will benefit from a rise in new orders from all major markets. In North America and Europe, rising private demand will help boost vehicles sales. In Asia (52% of goods export gains), strong market penetration of Japanese corporates, rising household's incomes, and a positive growth in investment will provide an impetus to sales of Machinery and Equipment, Electronic and Chemical products.

Second, Japanese corporates should continue to rely on the Bank of Japan's (BoJ) accommodative monetary policy. This will take place through

still-favorable credit conditions and low JPY at 116 per USD in 2018. After a big electoral win in the October 2017 election, PM Abe reiterated his commitment to use every policy lever to beat deflation and create a positive growth environment. This portends a continued accommodative monetary stance from the Central Bank and slow moves towards fiscal consolidation. Abe already announced his intention to provide a stimulus for human resources investment to the tune of JPY2tn by 2018. This would mitigate the negative impact of the VAT hike scheduled for October 2019.

Three Priorities: Policies for internationalization, Productivity-boosting measures, and Partnerships

In the long run, three priorities will shape the outlook.

First, the authorities will likely maintain an active international policy to support Japanese corporates. Continued financial assistance in the form of exports credits overseas and investment loans should ease the access of Japanese firms to foreign markets.

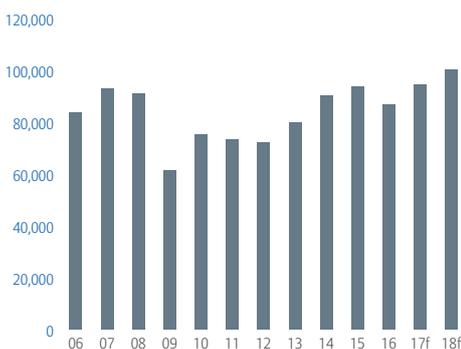
Second, adopting productivity-boosting measures will be pivotal to improve competitiveness. The government will likely step up its support for transformative tech innovation the like of Artificial Intelligence and the Internet of Things. In fact, Research and Development expenditures are among the highest in OECD markets at 3.3% GDP. Authorities are also set to move forward on labor law reform to develop talent, encourage mobility and increase female participation.

Last, securing solid trade partnerships with large and growing markets will also be crucial. One should bear in mind that US demand might suffer from an American shift towards further protectionism. Also, competition from China could increase as part of an ever-aggressive trade strategy. The Chinese One Belt One Road initiative could be a case in point.

One option Japan could pursue is to strengthen ties with the EU - the recipient of 11% of Japanese goods exports - as part of the Economic Partnership Agreement. This aims at reducing trade barriers for sectors ranging from Agrifood to automotive and aligning best practices on issues such as labor laws and consumer protection. Another way forward would be to develop ties with promising markets that are under-served by Japanese corporates. India and Africa as a whole account, respectively, for 1.3% and 1.2% of Japanese goods exports. In that sense, the announcement of a Japan-India partnership to develop infrastructure in Africa represents a good opportunity. ■

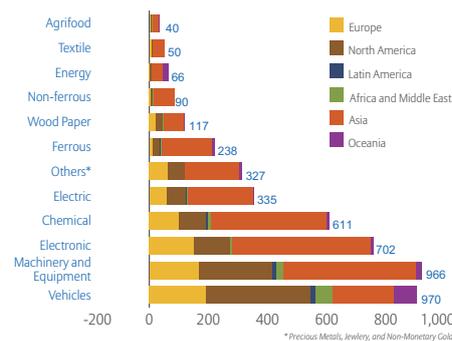
52%
of Japanese
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export gains to
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in 2018

Figure 1 Level of nominal exports of goods and services (JPY bn)



Sources: IHS, Euler Hermes estimates

Figure 2 Potential 2018 merchandise export gains by sector (JPY bn)



Sources: IHS, Chelem, Euler Hermes estimates



House Germany

The Khalasar of Trade

- With real export growth expected at +3.8% in 2018, gains from merchandise exports could total +EUR68bn. Growth is driven by stabilized euro area countries (+EUR 49.5bn) and Asia (+EUR 9.0bn).
- The bulk of potential goods export gains (58%) stems from Machinery and Equipment (+EUR 14.5bn), Chemicals (+EUR 12.5bn), and Vehicles (+EUR 12.3bn).
- Risk to exports relate to a rise in protectionism and extensive technological changes.

Exports once again an economic engine

The export motor is purring again in 2017. The volume of new orders from abroad in the manufacturing sector is likely to increase by more than +4% this year. In 2016, the increase amounted to +2%, and in 2015 to a mere +0.9%. Furthermore, orders from the eurozone see an even stronger rise than overall foreign orders. For now, at least, this should end the slide in the euro area's importance for the German export economy, which to a large extent was the result of the prolonged economic crisis in important neighboring countries.

Until now, German companies have been recording above-average increases in exports in 2017, particularly to Asia. This holds true first and foremost for export sales to China, India, and Japan. So far in 2017, the only notable de-

clines in German exports are those to the UK, Brazil, and Turkey.

As a result of the robust domestic economy, for the third successive year real imports are expected to record a growth rate (estimated at +4.5%) that is higher than real exports. Furthermore, given that the terms of trade – the ratio of export to import prices – have deteriorated in 2017, the trade and current account surpluses will edge down from record values reached in the prior year. We estimate the 2017 current account surplus at EUR 246bn (7.6% of GDP). This follows EUR 262bn in the previous year (8.3% of GDP).

Solid German competitiveness, potential export gains of EUR68bn in 2018

With an expected real export growth of +3.8%, Germany is likely to maintain its share in world

+EUR49.5bn
merchandise export
gains to Europe

trade in 2018. Looking forward, the conditions for German exporters are likely to remain favorable. As Germany is relatively exposed to Asian economies (export share of about 16% in 2017), exports can substantially benefit from strong growth in Asia.

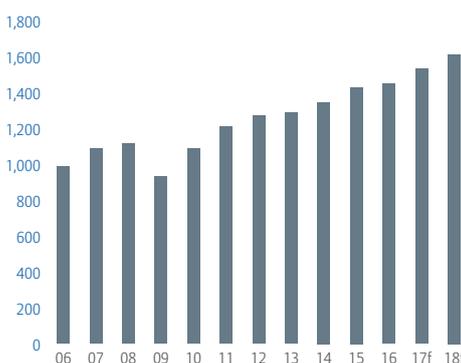
Moreover, the euro area - accounting for 37% of German exports - continues to regain momentum. No wonder that of the potential export gains of EUR68bn in 2018, the biggest chunk comes from Europe (EUR49.5bn), followed by Asia (EUR9.0bn).

The German export industry is highly diversified in terms of products and very competitive. Small and medium-sized enterprises (SMEs) play a key role, with many of them actually global market leaders in their respective area, so-called hidden champions. Sector-wise, the top three export sectors in terms of value, namely Machinery and Equipment, Chemical Products, and Vehicles, stand to gain the most from rising global demand. They are responsible for EUR39bn or almost 60% of the potential export gains in 2018.

Two main risks: Protectionism and missing the boat on technological change

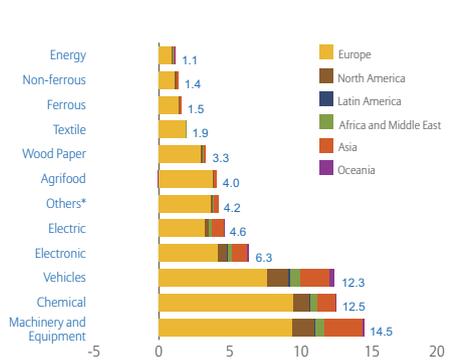
As Germany is heavily export-oriented and has close links to the US (9% of German exports) and the UK (7%), it is especially vulnerable to a rise in protectionism and trade barriers. Moreover, technological innovations, especially in the automotive sector (e-mobility, self-driving cars), could lead to far-reaching structural changes in traditional German export industries. ■

Figure 1 Level of nominal exports of goods and services (EUR bn)



Sources: IHS, Euler Hermes estimates

Figure 2 Potential 2018 merchandise export gains by sector (EUR bn)



Sources: IHS, Chelem, Euler Hermes estimates



House France

Emmanuel Snow to the Rescue

- France's external trade is currently among the worst performers in the Eurozone. The Achilles of goods and services are nonetheless expected to rise by +EUR37bn in 2018 (after +EUR39bn in 2017) as demand for French goods and services increases.
- The majority of export gains in goods (+USD21bn) come from Machinery and Equipment (+EUR5.5bn, including Aircrafts), Agrifood (+EUR4.4bn), and Chemicals (+EUR3.0bn).

Exports: The Achilles heel weighing on French growth

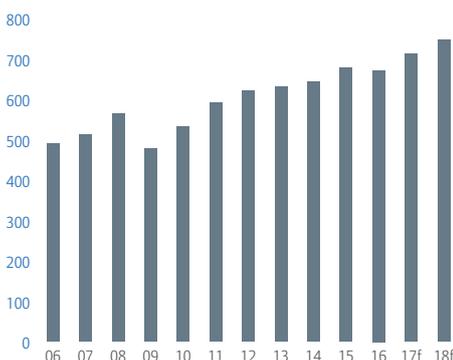
France's last external trade surplus was in May 2004 whereas 2018 will be the 15th consecutive year of subpar performance. France should, however, benefit from accelerating growth in its main destinations, thus exports of goods and services should grow by +5.9% in 2017. This is a stark contrast and a much-awaited improvement compared to the measly -0.8% recorded in 2016 - the worst performance since the great recession. Still, half of the growth is attributed to a catch-up effect on export prices, on the back of increasing commodity prices. Posting +3.2% volume growth remains disappointing when compared with overall performance in the Eurozone, and is to be put in perspective with the EUR50bn+ trade deficit: For every euro of consumption, 33c is imported and

for every euro of investment, 25c is imported. Accelerating France, without remedial solutions, could mean a widening trade deficit.

+EUR37bn goods and services exports win-fall in 2018

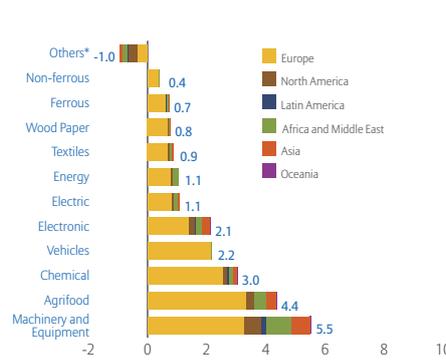
France's trade relies on its neighbors. Since these markets are quite mature, the country must generate nominal growth to increase exports (different from Germany that is more open to fast-growing economies like China). As nominal growth in 2018 in the Eurozone's should resemble 2015, French export gains are set to rise. Exports of goods and services are expected to rise by +EUR37bn in 2018 (after +USD39bn). Goods exports only would generate +USD21bn. Top contributors will be Germany (+4.8 bn), the US (+1.9 bn) and the Netherlands (+1.5 bn). The sectors

Figure 1 Level of nominal exports of goods and services (EUR bn)



Sources: IHS, Euler Hermes estimates

Figure 2 Potential 2018 merchandise export gains by sector (EUR bn)



Sources: IHS, Chelem, Euler Hermes estimates

60%
goods export gains
to come from
Machinery and
Equipment, Agrifood
and Chemicals

that will benefit the most are geared towards traditional French strengths. The three Musketeers will drive around 60% of export gains: Machinery and Equipment (+EUR5.5bn, including Aircrafts), Agrifood (+EUR4.4bn), and Chemicals (+EUR3.0bn).

Two basic needs: More exporters and more innovation in Exports

The French export sector is smaller than other key Eurozone economies. Italy is a case in question. While French GDP growth is stronger, exports account for a lower share of GDP (20% vs. 25%) and are beset by lower growth rates. Moreover, the French export sector has a narrower base compared to other European economies. To some extent, the problem is intrinsic. In 2016, 124,100 French corporates exported according to Customs. While just a slight decrease compared to 2015 (-700), this figure pales in comparison to Germany with its 300,000 exporters or even Italy (200,000). Furthermore, the export business is a double edge sword, rife with risk and full of opportunities. 23% of corporates listed in 2015 terminated export activity in 2016. The exact same share of corporates listed in 2016 was new exporters.

The other culprit is the increased specialization of European economies since the adoption of the Euro. An index computed by Unctad shows that diversification decreased in France, but also in Germany. The real gap emanates from the technological content of exports. A significant R&D content in exports boosts competitiveness. This is a typical advantage of German manufacturers. France's performance deteriorated in this regard. The country was ranked 9th out of 124 economies in Harvard University's Complexity Index. In 2015 it was ranked 17th. ■



House United Kingdom

The Red Divorce aka Brexit

- **UK exports of goods and services look set to increase by +GBP20bn in 2018 (after +50bn in 2017).**
- **As far as merchandise exports are concerned we expect gains of +GBP11bn in 2018 (after +28bn in 2017) with three sectors making up the bulk of the improvement: Chemicals (+2.1bn), Machinery and Equipment (+2.0bn) and Jewelry and Precious Metals (+1.8bn).**
- **Demand for British exports is currently benefitting from the cyclical upswing in Europe. Yet export dynamics will increasingly come under pressure as the formal Brexit date approaches given the uncertainty about the UK's future trade regime. In the long run, post-Brexit restricted access to the EU Single Market will hurt UK exports.**

Goods and services export gains of +GBP20bn expected for 2018

UK exports of goods and services are expected to rise by +GBP20bn in 2018 (after +50bn in 2017). As far as merchandise exports are concerned we expect gains of +GBP11bn in 2018 (after +28bn in 2017). The forecasted export gains in 2018 will be mostly driven by higher demand from traditional key export markets in Europe which absorb around 50% of British goods exports - in particular, Germany, Switzerland, France and the Netherlands. Yet the US and China will also contribute to the rise. The sectors that stand to benefit the most are Chem-

icals (+2.1bn), Machinery and Equipment (+2.0bn) and Jewelry, Artworks and Precious Metals (+1.8bn).

British exports: Robust momentum, but no sign of an export boom despite weak Sterling

In 2018 demand for British exports will continue to benefit from the cyclical upswing in Europe. Yet the sharp depreciation of Sterling following last year's Brexit vote in favor of leaving the European Union has so far failed to trigger an export boom.

This is unlikely to change anytime soon. For one, most UK manufacturing and service exports are

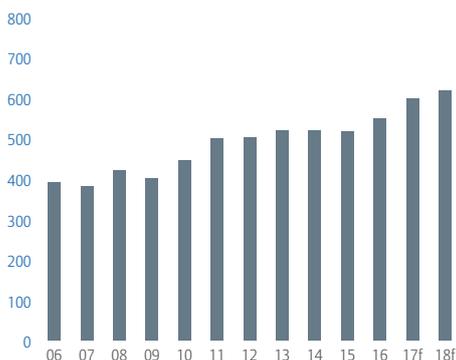
+GBP2.1bn
export gains to come
from chemicals

very high-value-added. Thus, they are not very price sensitive. More importantly perhaps - given the integration in global supply chains - UK exports feature a high import content. Since the Sterling depreciation has pushed up the cost of imports, UK exporters have responded by raising export prices in an effort to protect profit margins. Instead of an export boom, quite to the contrary, exchange rate volatility and Brexit related uncertainty in the run-up to the formal EU exit date (March 2019) will keep a lid on UK export dynamics in 2018.

Brexit to impact UK exports in the long run

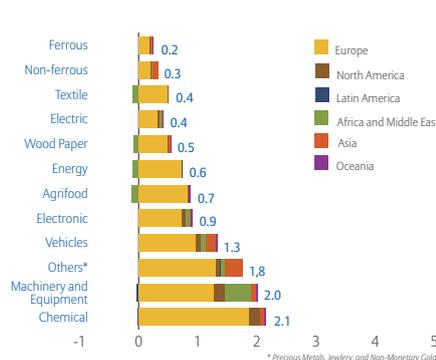
Beyond the short-term, British export dynamics will hinge on the degree of access to the EU Single Market that the UK will secure in trade negotiations with the European Union. Our baseline scenario expects a limited EU-UK free trade agreement (FTA) in place by 2021 – following a two-year transitional period – which will fall well short of the degree of integration that has been achieved within the European Single Market. Trade in services stands to suffer the most given that it could face high if not prohibitive non-tariff barriers - such as rules of origin, customs administration and divergence in regulations - which FTAs often fail to tackle. FTAs with non-EU countries such as the US or Canada are unlikely to make up for the negative impact of lower EU-UK trade since geographical proximity is a key determinant of trade flows. Moreover, trade deals usually take many years to negotiate, and it is hard to see how the UK on its own may extract better terms in negotiations from non-EU countries than the EU, which enjoys more bargaining power as a bigger economic player. In the long run, we expect the UK to see a marked Brexit-related reduction in trade. ■

Figure 1 Level of nominal exports of goods and services (GBP bn)



Sources: IHS, Euler Hermes estimates

Figure 2 Potential 2018 merchandise export gains by sector (GBP bn)



Sources: IHS, Chelem, Euler Hermes estimates



House Italy

Valyrian Steel

- Exports of goods and services look set to increase by +EUR33bn in 2018 (after +EUR37bn in 2017).
- Three sectors will make up the bulk of the improvement in 2018: Machinery and Equipment (+EUR6.9bn), Chemicals (+EUR4.6bn) and Textile (+EUR3.3bn).
- Demand for Italian exports is currently benefiting from the cyclical upswing in Europe. Yet export dynamics could come under pressure if Italy fails to implement the necessary reforms to maintain its export competitiveness.

Italian exports: Bright prospects

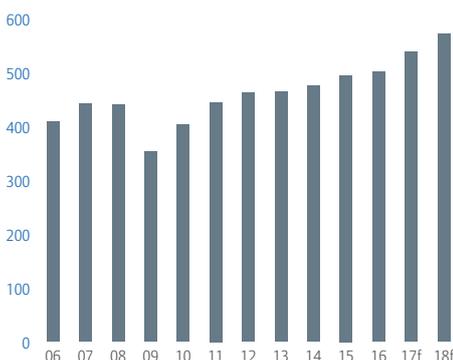
The stars are aligning for Italian exporters. Demand for Italian exports is clearly benefitting from the cyclical upswing in the Eurozone with real GDP in the currency area expected to grow around 2% in 2018 – for the fourth consecutive year. Moreover, in 2017 the relatively weak EUR has helped boost export demand from non-EUR countries, even if the gradual appreciation in the second half of the year is bound to moderate the tailwind from the lower exchange rate to some extent. On top of these temporary factors, Italy’s robust export performance has also been driven by improved competitiveness as the implementation of structural reforms since 2010 is bearing fruit. In fact, annual growth in unit la-

bor costs per person has moderated since 2010 at 0.6% on average compared to 3.3% for the period 2003-09. This has helped Italy maintain its share in global exports of 2.8% since 2012 – in contrast to the early years of monetary union. Moreover, Italy has managed to turn a large trade deficit of -EUR26bn in 2011 into a surplus of EUR58bn in 2016. This is the fourth highest positive balance in Europe after Germany, the Netherlands, and Ireland.

Goods and services export gains of +EUR33bn expected for 2018

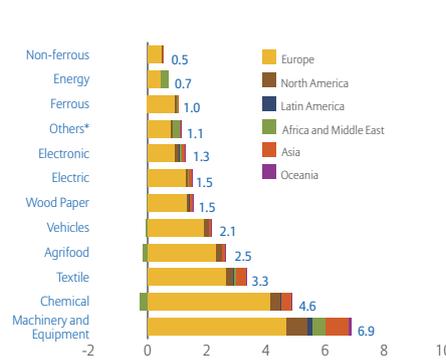
Italy’s exports of goods and services are expected to rise by +EUR33bn in 2018 (after +37bn in 2017). Merchandise exports would

Chart 1 Level of nominal exports of goods and services (EUR bn)



Sources: IHS, Euler Hermes estimates

Chart 2 Potential 2018 merchandise export gains by sector (EUR bn)



Sources: IHS, Chelem, Euler Hermes estimates

25%
of merchandise export gains driven by the Machinery and Equipment sector in 2018

rise by +USD22bn. The expected gains in 2018 will be driven to the most part by higher demand from traditional key export markets in Europe in particular Germany, France, the UK and Spain which absorb about 30% of total exports but also the US. The sectors that stand to benefit the most are Machinery and Equipment (+EUR6.9bn), Chemicals (+4.6bn) and Textile (+3.3bn).

Beware eroding competitiveness

Along with major risks to global trade – such as rising protectionism – the outlook for Italian export dynamics will hinge in particular on two conditions.

For one, to maintain - or even further boost – the performance of its external sector, Italy will have to further diversify its exports across geographic markets focusing more on fast-growing economies. Demand for Italian exports has climbed in China and Japan in 2016. Still, these countries account only for a small share of the total: 3% and 1% respectively.

Second, Italy will have to overcome reform complacency to avoid an erosion of its export competitiveness. The reforms implemented since 2010 have shown clear results. Yet in 2017, the government’s reform drive has come to a standstill and momentum is unlikely to pick up after the general election scheduled for the first half of 2018. The most likely scenario is that of a ‘grand coalition’ consisting of unnatural partners from across the political spectrum. Such a government is unlikely to agree on a wide-ranging reform agenda to boost Italy’s competitiveness. ■

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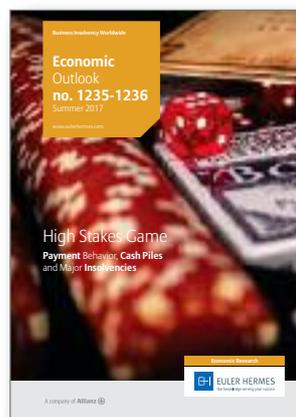
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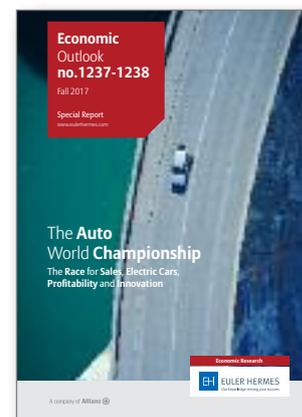
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