THE VIEW

Economic Research

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THE WORLD ECONOMY: PARTY ON?

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EULER HERMES

DIGITAL CRISIS?

LUDOVIC SUBRAN

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

In 2017, global GDP growth reached the +3% post, a landmark it hadn't reached since 2010. That will likely stay in sight in 2018 and 2019. The general trend comes from a rare combination of favorable factors: the US economy keeps expanding, China perfectly manages its economic transition, and the Eurozone comes back to the forefront. Still, the flow of good news may hide some worrying excesses: The comeback of protectionism, mounting stocks of corporate debt and expectations of tightening monetary policies altogether make markets nervous. Everyone is already talking about the next financial crisis as if it was a given. Sure there is a risk; maybe not as significant as in 2007. The real question is whether the next confidence shock could come from elsewhere: The platform economy.

The thorny issue of personal data concerns everyone. The latest example is Cambridge Analytica: a massive consumer data breach shook confidence, from households to investors, including institutions. In response, users and personal figures widely retweeted #deteleFacebook. In the meantime, Facebook had lost 16% of its value. As a collateral victim, the Twitter stock plunged by 20%.

Drawing parallels is easy. The energy sector in the late 70s, the internet sectors in the late 90s, the financial sector in the mid-2000s all had in common the stretched market valuations, overconfidence, exorbitant salaries for young recruits, a lagging regulator and disruptive effects on society, globally. In 2018, any guess who looks guilty? Digital.

Once the exponential driver of economic growth, digital could derail it all and become a systemic risk. In the retail sector, too big to fail does not exist anymore as platforms and marketplaces wrecked entire segments from toys to whites and browns. The universality of digital (from finance to consumption, from Chile to Japan) makes it a perfect suspect for the next widespread confidence crisis. The dawn of new technologies is an extraordinary opportunity for companies to grow and reinvent themselves but I am concerned about the mismatch between the share of the digital economy (on stock markets, in GDP, in our daily lives), and the utter lack of thinking put into regulation, governance, and transparency. The lack of political vista on this topic is appalling.

While the digital economy grows, public and legal frames are yet to be enforced. Among the US, China and the EU, none has taken the lead on this issue yet. There is a will, but no firm stance has been taken to oversee the digitalization of our societies. This is alarming, knowing the digital economy accounts for 22% of world GDP. The enforcement of the General Data Protection Regulation (GDPR) on May 25 in the EU, and Zuckerberg's hearings before the Congress are a first step towards regulation, but there is a long way to go.

The question is whether the world needs a guardian to define the rules of the global digital game? In the past, preventive regulation surely could have prevented financial crises. In the future, we won't be able to say we did not know. New technologies ease our access to information and put individuals in the debate's hearts. This was not the case previously when we were kept away by inherent knowledge barriers in the energy sector, the advent of the internet, and the over-engineering of finance. This time, we can decide to avoid the crisis. All of us are user-contributors to the digital economy. We share content on social networks, we consume services online, and we access information on the internet. We are at the core of this new model, and that is why we have a role to play in its regulation. We have all we need to make our mind on digital issues and excesses. Granted, digital behemoths use personal data. It is our responsibility to choose the platforms we use and to define how we wish to use them. So instead of waiting for the regulator to take action, let us wake up the collective awareness, empower individuals, and deliver a good example of self-regulation.

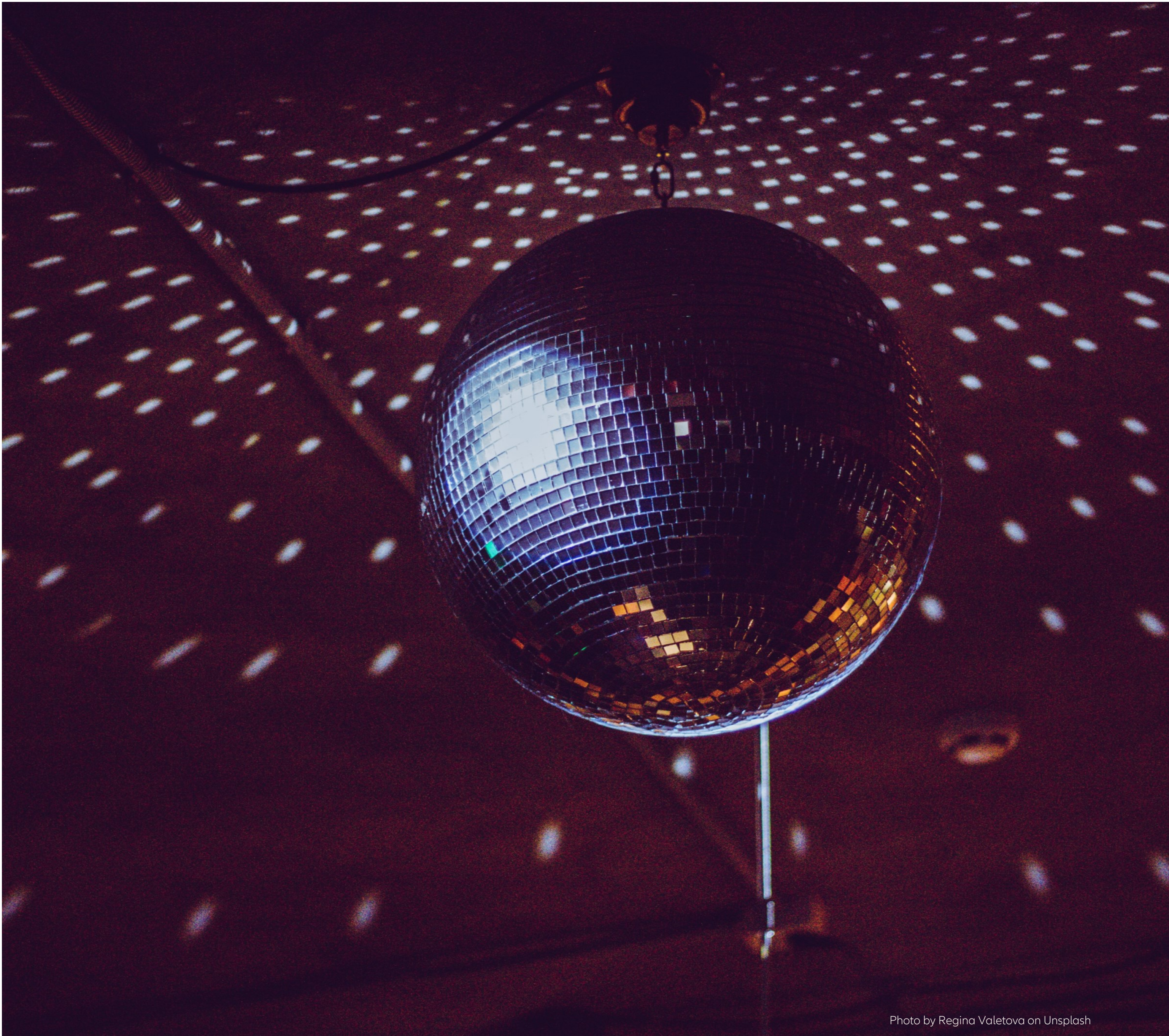


Photo by Regina Valetova on Unsplash

The US deficit has jumped by 14% in the months from October 2017 to March 2018 (compared with the same period the year before)

599.7 USD bn

PROTECTIONISM

TRADE GAMES, TRADE FEUD OR TRADE WAR?

- **Fears of a trade war resurfaced after Donald Trump decided last March to drag age-old protectionism out of the past, imposing tariffs on US imports, and triggering China's retaliation. A solution may be on its way and a closer look points to mere trade skirmishes.**
- **Alternative scenarios include a Trade Feud and a Trade War. Both would be (very) disruptive for markets, global trade, business insolvencies, and growth in the US, the EU and China.**
- **Other forms of protectionism (Financial, Regulatory, Data, Currency, Environmental, Sanitary, Security, and Intellectual Property) could be even more disruptive.**

Trump's protectionism : Fake news or old news?

Since the beginning of the year, President Trump has demonstrated a certain chutzpah for protectionism announcements and measures (see Figure 1).

Truth be told, many countries have been exempted since such announcements - from the steel and aluminum tariffs e.g. -, and the second wave of announcements, targeted at China, could end up being negotiated directly between the US and China.

Much ado about nothing?

In the meantime, global trade is actually doing well. Global trade volumes rose by an estimated +4.8% in 2017 while protectionist measures continued to pile up (+489 new measures in 2017 compared to 2016 (see Figure 2).

The acceleration of global growth was strong enough to more than offset the dampening effects of these new protectionist measures and push many countries to open up again to benefit from the synchronized acceleration in growth.

Interestingly, the US was already the most active country in developing new protectionist measures (+90 measures in 2017 from +84 in 2016). Among large economies, it is the only one with an increased number of new measures.

The US has always been a free trade promoter, initiating both the WTO (World Trade Organization) in 1995, and the GATT in 1948 (General Agreement on Tariffs and Trade, WTO's predecessor) to avoid the devastating impact of protectionist initiatives such as the US Smoot-Hawley tariffs.

Yet, trade liberalization never was a walk in the park: WTO disputes, the rise of non-tariff measures, and periods of protectionist rhetoric are common in the context of elections.

Previous American Presidents did not hesitate to have recourse to protectionist measures for electoral purposes.

Figure 1 Protectionism timeline

Date	Measure
March 8, 2018	The US government announces a 25% tariff increase on steel and a 10% tariff on aluminum, later exempting Europe, Australia, South Korea, Brazil and Argentina (Canada and Mexico were exempted from the start)
March 8, 2018	The Comprehensive and Progressive Agreement for Trans-Pacific Partnership (TPP without the US) was signed and could enter into force this year.
March 22, 2018	The US government announces a 25% tariff increase on additional products to a total of USD 60bn of imports from China
March 22, 2018	Leaders of 44 African countries agrees deal for Continental Free Trade Area (CFTA)
March 23, 2018	The Chinese government announces measures of retaliation with a 15% to 25% tariff increase on USD3bn of Chinese imports from the US
March 29, 2018	The US president Donald Trump recently threatened to revise or block a new trade pact with South Korea in order to incite Seoul contributing more to geostrategic issues implicating North Korea. The US President has also coordinated security issues and trade agreement with Australia. In this new context embodied by an interconnection between trade and security issues, the US President is revisiting the majority of its trade relation (NATO and Euro zone trade surplus are now an implicit background of all ongoing discussions between the US and main European trade partners).
April 4, 2018	The Chinese government announces further retaliation with a 25% tariff increase to a total of USD50bn worth of imports from the US
April 8-11, 2018	President Xi Jinping restated its plan to open China further in the Boao forum with: (i) further opening for the financial (removal of foreign ownership limits on banks, e.g.) and the manufacturing sector (relaxed rules for foreign investors); (ii) lower import tariffs for consumer related products especially vehicles; (iii) further legal protection of intellectual property; (iv) use the Belt and Road project as a new driver for multilateralism.
April 24, 2018	President Trump said that he is confident that both the US and China could reach a deal on both trade and intellectual property
May 22, 2018	US decision whether to impose the import tariffs or not and date for implementation (June/July)

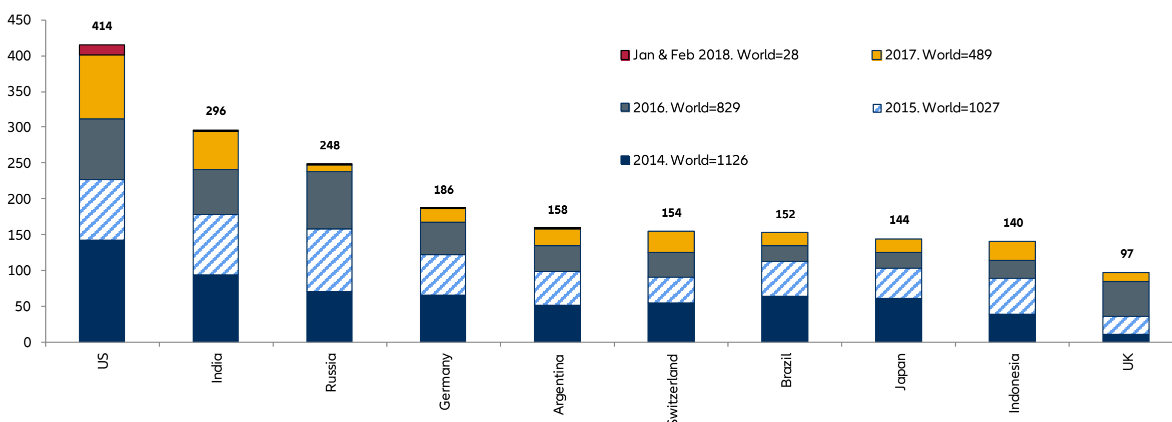
Source: Euler Hermes

The upcoming mid-term elections in November 2018 certainly explain the hostile rhetoric.

Indeed, opposing free trade to the well-being of American families is not new in a late economic cycle, marked with volatility and nervousness, rising twin deficits, and the implementation of a fiscal stimulus.

The ongoing aggravation of twin deficits in the US (the current account deficit reached 2.3% of GDP in 2017 and the fiscal deficit amounted 3.4% of GDP in 2017, the highest cumulated twin deficit since 2013) explains the higher aggressiveness in terms of trade policy of the US Government. The use of tariffs though, is from another time. As a result, the average tariff rate of the US has registered a structural decline to reach today 3.5% of duties on all imported products. Indeed, tariffs represent old instruments of trade policy, which were progressively sidelined to the profit of more imaginative or disguised forms of protectionism (technological content, anti-dumping measures, sanitary regulation, and technical constraints). However, they have the advantage to be rapidly advocated and applied in circumstances that the US President judged as representing a threat for national security, without the approval of the Congress traditionally required for trade issues.

Figure 2 New protectionist measures by top 10 countries



Sources: GTA, Euler Hermes

Figure A US trade deficit by country and by sector for top 20 import markets, USDbn (*)

	Total	Energy	Agri-food	Textile	Wood paper	Chemicals	Iron Steel	Non-Ferrous	Machinery and equipment	Automotive	Electrical equipment	Electronic equipment	Miscellaneous
China	-312.0	2.0	20.0	-59.4	-49.3	-15.2	-0.3	2.3	-33.3	-1.7	-44.8	-140.3	7.9
Mexico	-120.5	10.2	-7.6	-2.1	-5.7	18.5	2.0	2.5	-8.3	-55.4	-24.9	-47.4	-2.3
Germany	-62.9	0.7	0.7	-0.6	-0.5	-12.2	-1.1	-0.6	-20.6	-21.4	-5.1	-6.4	4.1
Japan	-61.1	2.4	12.0	-0.1	0.0	1.1	-1.5	0.6	-21.0	-44.6	-6.8	-4.9	1.7
Canada	-57.0	-41.2	-10.0	1.0	-5.3	4.4	0.3	-7.7	7.9	-21.0	4.2	3.5	6.7
Vietnam	-29.8	0.0	0.5	-15.8	-4.6	0.0	-0.4	0.1	-0.4	0.1	-1.1	-8.8	0.7
South Korea	-27.7	-0.4	5.7	-1.0	-0.3	-0.8	-2.1	0.5	-2.0	-20.8	-3.2	-7.1	3.9
Italy	-26.8	0.4	-3.2	-4.2	-1.3	-2.9	-0.6	0.4	-9.8	-3.2	-0.9	-2.0	0.4
India	-26.0	-1.2	-1.5	-7.6	0.0	-7.2	0.0	0.1	-1.3	-0.6	-0.6	0.9	-7.1
Malaysia	-25.3	-0.1	0.1	-1.6	-1.3	0.1	0.0	0.0	0.1	0.0	-1.1	-21.8	0.3
Ireland	-23.1	0.1	-0.6	0.0	-2.0	-20.0	0.0	0.1	1.0	0.0	0.1	-4.2	2.1
Thailand	-17.6	0.1	-1.3	-1.6	-0.4	-0.8	0.0	0.0	-1.4	-0.3	-1.0	-10.2	-0.7
Switzerland	-15.5	0.2	-0.8	-0.1	-0.5	-13.0	0.0	0.1	-1.6	0.2	-0.8	-3.4	4.3
Indonesia	-11.1	-0.7	-0.9	-6.0	-1.2	-0.8	0.0	-0.2	0.2	-0.1	-0.5	-1.2	0.2
Israel	-11.0	0.6	0.4	-0.2	0.0	-5.7	0.0	0.0	0.2	0.1	-0.1	-1.5	-4.9
Russia	-8.8	-7.5	-0.2	0.0	0.0	-1.0	-1.2	-2.0	0.7	0.5	0.2	0.5	1.1
UK	-8.2	-1.0	-0.3	-0.5	-0.2	-7.4	-0.4	0.0	0.4	-9.0	-0.1	-1.5	11.8
Taiwan	-7.7	0.4	2.7	-0.8	-2.3	0.1	-0.8	0.2	-0.3	-2.2	-2.7	-5.3	3.2
Sweden	-6.3	-0.1	-0.2	-0.1	-0.4	-0.8	-0.5	0.0	-1.7	-1.7	-0.3	-1.1	0.4
Venezuela	-6.2	-9.0	0.6	0.0	0.1	0.6	0.1	-0.1	0.8	0.2	0.2	0.2	0.1

* We consider as sizeable a level of above USD10bn deficit of the US by country and above USD5bn by sector

Euler Hermes' Protectionism Tracker

To anticipate protectionist announcements, one can calculate the bilateral trade balances by country and sector with the US. Electronic, Electric, Machinery and Equipment and Automotive are the most at risk.

Imports of Electronic, Electric and Textile from China are the largest contributors to the US trade deficit; they correspond to the list of Chinese products targeted: Industrial and electrical machinery, Optical equipment, Vehicles (railway, aircraft), Chemicals (incl. pharmaceuticals) and Metals (steel and aluminum mainly). Conversely, to track retaliation by China, Agri-food (where import tariffs have been increased on EUR3bn products) ran the largest deficit. The recent Chinese retaliatory measures have targeted Aircraft, Cars, Chemicals and Agri-food products (of which Soybeans, Cereals, Beef). Outside China, Mexico, Germany, Japan and Canada are the largest contributors to US trade deficits with Automotive, Machinery and Equipment, Electrical and Electronic equipment. Mind the deficit!

Why these may be trade games only

To evaluate the economic impacts of trade disruptions, we defined three scenarios based on the average tariff on imports in the US and the number of new protectionist measures (Figure 3).

First, our baseline scenarios called Trade Games, corresponds to a mild increase of the average tariff by +0.5pp from 3.5% today for the US with negligible retaliation. This is the unfolding situation, following the announcements, and our most likely scenario.

Our second scenario (Trade feud) - which is unlikely - corresponds to an increase of +2.5pp for import tariffs for the US and the rest of the world bumping them to 6% for the US and 8% globally (lingering retaliation).

This scenario could also happen in case of a concentrated bilateral quarrel between the US and China if the US tariff to all imported Chinese product were to rise to 15%.

The last time this level of trade disruption was observed was in the mid-80s with dozens of new protectionist measures per month.

Last, our Trade war scenario (very unlikely) corresponds to an increase of tariffs globally by +8.5pp i.e.to 12% in the US and 14% globally.

The bilateral version of it would mean a 45% tariff on all Chinese imported products, which echoes what President Trump used to say on the campaign trail.

Note that this situation has not happened since the mid-60s, before the sixth round of the GATT.

The results of the three scenarios (and their variants) are summarized in Figure 4.

In our baseline, exemptions and risks are taken into consideration in limiting the escalation but even with confirmed measures all being effective, world import tariff increase is less than +0.5pp but above +3pp for US-China bilaterally.

According to our model, this would cut US growth by -0.1pp to +2.9% in 2018 and have a negligible impact on inflation.

Domestic demand would remain strong and cause an aggravation of the current account deficit by -0.6pp and of the fiscal deficit by -1.1pp.

Europe will not be impacted; China would remain on a soft landing trajectory and emerging markets would continue to benefit from an early phase of recovery through:

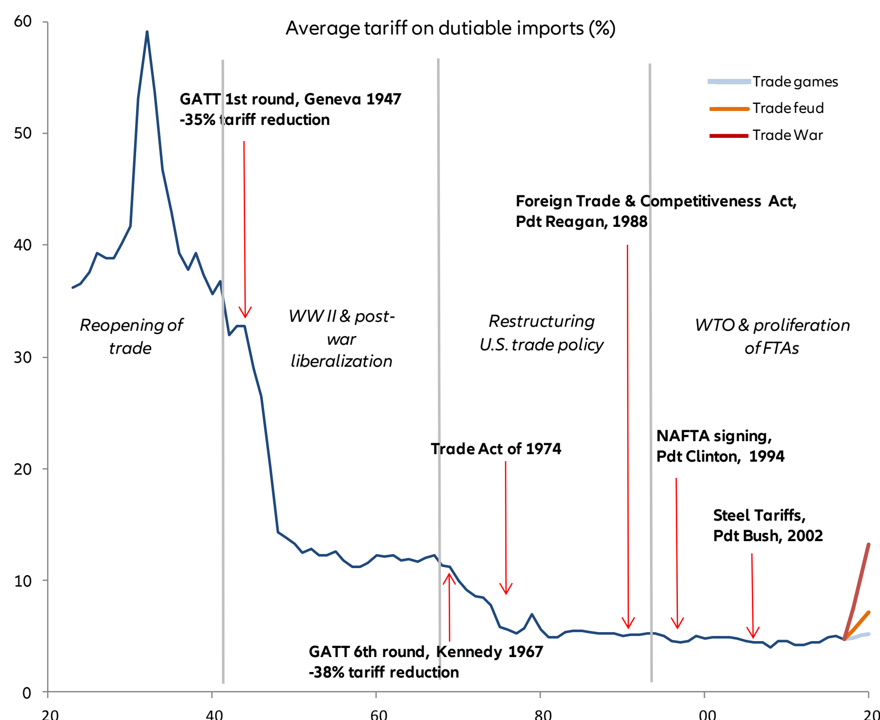
(i) a continued rise in commodity prices (for commodity exporters); and (ii) a sizable trade opportunities.

The main risks lie in the confidence shock causing volatility on the financial markets:

The VIX index should stay below 20 on average, while US yields increase steadily to 3.2% at year-end.

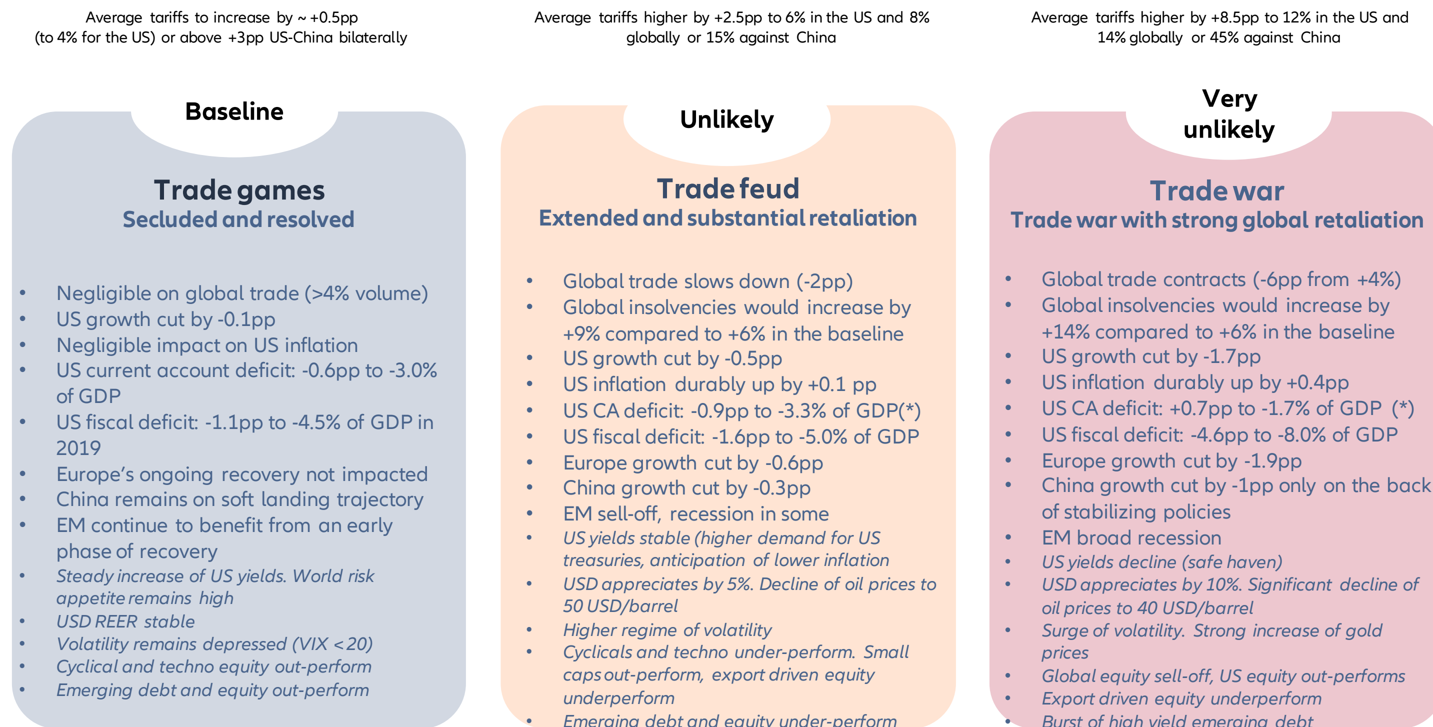
The US real effective exchange rate should remain broadly stable and the Fed tightening cycle on track.

Figure 3 Protectionism and average tariff on imports in the US across time



Sources: WTO, US ITC, Euler Hermes

Figure 4 Protectionism scenarios



Sources: WTO, US ITC, Euler Hermes. Calculations made using model developed Barattieri, Cacciatore, and Ghironi (2017)

Based on import demand elasticities, combined export losses for US and China would amount to around USD30bn per year (see Figure 5), which represents only 0.1% of global trade of goods and services.

Mexico and Canada would lose close to USD2bn worth of exports, mainly concentrated in Automotive, Electronic and Electric, Machinery and equipment. Japan and Germany would be next in line with -USD0.7bn and -USD0.6bn of potential export losses.

All in all, total losses would remain below USD50bn (0.2% of global trade) which should not be a drag on global trade growth. The latter is expected to increase by above +4% in volume terms on average in 2018-19.

Global economic growth would remain strong with an increase of +3.3% in 2018.

Figure 5 Total export losses by country, USD bn
Trade games: +0.5pp increase in tariffs (*)

(*) 25% on US imports of steel and 10% on US imports of aluminum for the remaining countries; 25% on USD60bn of US imports from China and 25% on USD50bn of Chinese imports from the US and 15% to 25% on USD3bn Chinese imports from the US

Sources: Sources: Chelem, World Bank, Allianz Research, Euler Hermes

Kee, Nicita and Olarreaga (2008) Import Demand Elasticities and Trade Distortions

How disruptive could a US-China Trade Feud or a Trade War be?

In our Trade feud scenario, global trade growth would slow down (-2pp from 4% in volume terms). The US growth would be cut by -0.5pp, Eurozone growth would lose -0.6pp, China growth would be reduced by -0.3pp and recession would be registered in several emerging markets.

The slowdown in global demand would trigger a fall in oil prices to 50 USD/bbl.

The Fed would postpone its interest rate hikes. Looking at a scenario concentrated on US-China only, the targeted products by the US should reach a total of USD230bn (compared to the USD60bn already announced) and USD170bn by China (compared to the USD60bn already announced). The bilateral import tariffs in this scenario would reach 15% and 34% respectively.

In this scenario, Eurozone losses should prove more limited thanks to increasing export market shares to both the US and China.

We would expect a total of EUR3 to 4.5bn additional exports to the US and EUR2 to 4bn to China.

Biggest trade losers include: the US (-USD22.6bn), China (-20.0bn), Mexico (-USD8.6bn), Canada (-USD7.6bn) and Japan (-USD3.6bn) – see Figure 6.

The most exposed sectors are Electronic, Vehicles, Electrical and Machinery. In terms of financial markets, US yields would remain stable, the USD would appreciate by +5% and there will be a higher regime of volatility.

Under the Trade war assumptions, global trade growth would be cut by -6pp from 4% in volume terms.

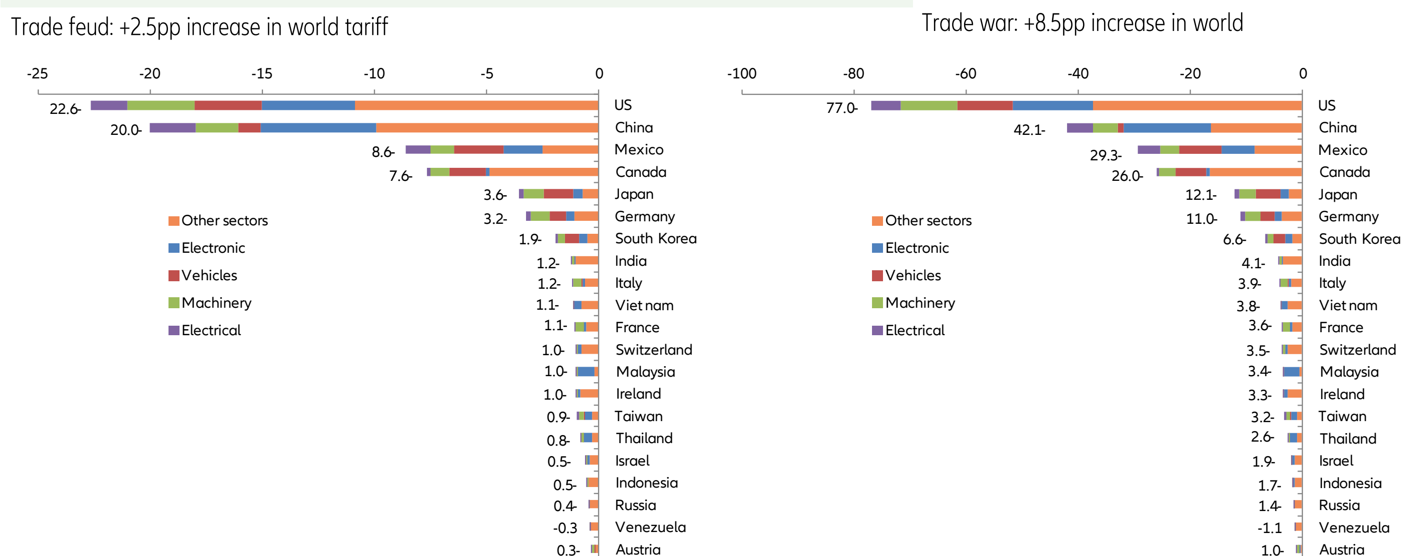
The US GDP growth would be cut by -1.7pp which could trigger an increase of +12pp in business insolvencies. Europe could be experiencing just below 0 growth (-1.9pp) which would trigger a rise in business insolvencies of +20pp. China growth would be cut by -1pp as stabilizing policies would reduce the negative impact and there will be broad recession in the emerging markets.

All in all, global GDP growth would be cut by -1.5pp. The reduction in global demand would trigger a fall in oil prices to 40 USD/bbl. The Fed would postpone its interest rate hikes and envisage rate cuts. In both scenarios, the US, China, Mexico, Canada and Japan would incur the largest export losses. Main sectors at risks include: machinery and equipment, vehicles, electronic and electrical sector.

Overall, in terms of export losses the hardest hit would be the US (-USD77bn), China (-42.1bn), Mexico (-USD29.3bn), Canada (-USD26.0bn) and Japan (-USD12.1bn).

In terms of financial markets, there will be a surge of volatility with strong increase of gold prices. The US takes over as a safe haven with US yields to decline, the USD to appreciate by 10% and the US equities to out-perform. A global sell-off on the equity markets is likely with export driven equity expected to underperform.

Figure 6a and b Total export losses by country, USDbn under trade feud and trade war scenarios



Sources: Chelem, World Bank, Allianz Research, Euler Hermes. Kee, Nicita and Olareaga (2008) Import Demand Elasticities and Trade Distortions

Financial protectionism should be monitored closely

An escalation of the trade dispute between the US and the rest of the World is not related to traditional tariffs on goods only and could easily expand on existing alternative protectionism forms. While less tweeted about, other forms of protectionism (Financial, Regulatory, Data, Currency, Environmental, Sanitary, Security, and Intellectual Property) can be very disruptive.

Focusing on the financial risks of an escalation of the tensions between the US and China, the services surplus of the US with the rest of the world could be targeted.

Financial activities in particular are a crucial element of the ongoing negotiations between the US and China as the US side requires further opening of the Chinese capital market. The structure of the US current account also reveals a net positive contribution of revenues generated from investment abroad. One aspect that retaliation could morph into is related to restrictions on foreign direct investments (FDI).

To this regard, the US, but also Europe and China, have been particularly active by limiting FDI targeting sensitive sectors of the national economy. The CFIUS (Committee on Foreign Investment in the United States) looks into mergers implying foreign investors, which could represent a threat for national interests. Several major operations have already been blocked in 2017 and 2018 in the US (see Figure 7); German, French and Italian governments recently advocated to block unwanted FDI from Chinese origin.

In this context, China could be inclined to limit the opening of its capital market, block the access to large high tech companies to its domestic market or also envisage a reduction of its holdings in US foreign exchange reserves, with potentially high consequences for the USD value given the fact that China is the largest holder of US Treasuries in the world.

Note that a potential devaluation of the RMB would result from a marked deterioration of trade relations between China and the US. Companies in sectors that rely on imported materials (energy, agriculture), sectors that are in overcapacity (mining and basic material) would feel the heat.

Outside China, South Korea, Japan, the US and Germany would suffer from increased competitiveness with Chinese products. High tech foreign companies would face stronger difficulties to be competitive when selling into China's domestic market but also abroad as Chinese corporates become more competitive.

Ana Boata, Mahamoud Islam, Alexis Garatti, Ludovic Subran

Figure 7 Deals abandoned under current US President

Target	Would-be-acquirer	Country	When killed	Deal size (mn USD)
Aleris	Zhongwang USA	China	Nov-17	1100
Cowen	China Energy Company Limited	China	Nov-17	100
Cree	Infineon Technologies	Germany	Feb-17	850
Global Eagle Entertainment	HNA Group	China	Jul-17	416
Here	NavInfo	China	Sep-17	330
Lattice Semiconductor	Canyon Bridge	China	Sep-17	1300
MoneyGram	Ant Financial Services Group	China	Jan-18	1200
Novatel Wireless	TCL Industries	China	Jun-17	50
Qualcomm	Broadcom	Singapore	Mar-18	117
Xcerra	Hubei Xinyan Equity Investment	China	Feb-18	580

Sources: Committee on Foreign Investments in the U.S. steps up opposition to takeovers from abroad, Euler Hermes

Photo by Clay Banks on Unsplash

DON'T STOP ME NOW

- There is room to grow in 2018. Allianz Research's updated forecasts point to an acceleration in world GDP growth to + 3.3% in 2018 (+0.1pp upward revision) up from +3.2% in 2017, before slowing down marginally to +3.1%
- Typical tensions of the late cycle include:
  - Increased volatility on financial markets in a context of monetary policy normalization
  - Tighter global liquidity conditions in a context of a more debt intensive economic cycle, increasing shadow banking, disruptive technologies and new forms of competition
  - Looming protectionism which could dampen company confidence despite not being as tough as initially proclaimed
- In a typical late phase of the cycle, country and sector risks mainly mirror a risk of complacency, i.e. situations of overheating or insufficient preparation to tackle disruption

image courtesy of salo al pexels.com under CC0

An economic déjà-vu?

The answer to the question: "Where are we in the global economic cycle?" has almost become self-evident.

The world economy follows a classic economic cycle: it has now reached the expansion phase, after exiting a recovery mode, which was initiated by a credit-fueled stimulus in China in 2016 and the announcement of an ambitious tax cut program in the US in 2017.

The World economy is now expected to approach the peak of this current cycle, before slowing down from 2019 onward.

Yet timing till the peak differs across regions: we forecast one more year to go for the US, whose GDP growth should accelerate to +2.9% in 2018 as President Trump administration's fiscal plan further stimulates the economy; the Eurozone is likely to register at least two more years of sound growth before decelerating more significantly (+2.3% in 2018 after +2.5% in 2017, and +2.0% in 2019), providing a unique window of opportunity to reform while surfing the ongoing momentum.

As for China, it is already handling its "soft landing", with growth projected to decelerate from +6.9% in 2017 to +6.5% in 2018 and +6.2% in 2019.

What about companies?

They are reaping the benefits of this strong economic phase of the cycle.

Robust volume growth and better pricing power inflate turnovers. Companies are also able to continue strengthening their cash buffers.

Business insolvencies remain in check.

They fall in Western Europe (-3%), Central and Eastern Europe (-3%) and North America (-2%), decelerate in Latin America (+2%).

Asia Pacific significantly increases (+31%) due to forceful cleaning of 'zombie' companies in China.

Table 1 Key Euler Hermes/Allianz Research assumptions and forecasts for 2018 and 2019

Our Macroeconomic Scenario at a Glance
ERD forecasts a **benchmark Brent oil price of at USD63/bbl on average** throughout the year in 2018 and USD62/bbl in 2019, with upside risks from rising geopolitical risks.
Inflation steadily increases towards targets in major countries and regions (global forecasts: +2.5% in 2018 and +2.6% in 2019). Wage-price loops are expected to remain contained.
Expected slight USD appreciation in the next 6 months **(+2.5%):** EUR/USD to reach 1.15 at end-2018 and 1.18 at end-2019.
One to two years of additional growth globally as a result of supportive fiscal policy in the US fostering GDP growth; above-potential growth in Europe despite political vulnerabilities; and continued acceleration in Emerging markets.
Market volatility is set to increase as liquidity conditions tighten gradually; rates increase progressively.
Allianz Research's core scenario is **mild protectionism** in the next two years, with global trade expected to grow by +4.4% this year and +3.8% in 2019.

Source: Euler Hermes, Allianz Research

.How are politics factored into the equation? 2018 should not be short of political hurdles, with important milestones ahead: Brexit negotiations with the EU, NAFTA (North American Free Trade Agreement) renegotiation and mid-term elections in the US make the top of the list. Yet our baseline scenario does not consider a full-fledged crisis from the identified political obstacles, whether it could be the trade games between US and China, the tensions between US and Iran or a US withdrawal from NAFTA.

Table 2 Real GDP growth forecasts and revisions since last quarter

	2016	2017	2018		2019	
			Latest forecast	Revision (pps)	Latest forecast	Revision (pps)
World GDP growth	**2.6**	**3.2**	**3.3**	0.1	**3.1**	=
United States	1.5	2.3	2.9	0.3	2.4	0.2
Latin America	**-1.0**	**1.2**	**2.3**	=	**2.8**	=
Brazil	-3.5	1.0	2.5	=	3.0	=
United Kingdom	1.9	1.7	1.5	0.5	1.2	0.4
Eurozone members	**1.7**	**2.5**	**2.3**	0.1	**2.0**	=
Germany	1.9	2.5	2.5	=	1.9	0.1
France	1.1	2.0	2.1	0.2	1.9	=
Italy	1.0	1.5	1.4	0.1	1.2	=
Spain	3.3	3.1	2.5	0.1	2.3	0.1
Russia	-0.2	1.5	1.9	=	1.8	=
Turkey	3.2	7.4	4.6	0.6	4.0	0.3
Asia	**4.9**	**5.2**	**5.0**	=	**4.9**	=
China	6.7	6.9	6.5	0.1	6.2	=
Japan	0.9	1.7	1.2	=	1.0	=
India	7.1	6.7	7.3	=	7.3	=
Middle East	**4.3**	**1.7**	**2.7**	=	**3.0**	=
Saudi Arabia	1.7	-0.7	1.7	=	2.0	=
Africa	**1.3**	**3.2**	**3.7**	0.2	**3.8**	0.3
South Africa	0.6	1.3	2.0	0.6	2.5	0.7

** Weights in global GDP at market price, 2017*

NB: The revisions refer to the changes in our forecasts since the last quarter
Fiscal year for India

Source: IHS, Allianz Research

Getting tense in a late phase of the cycle increases risks

Late growth cycles coincide with increasing economic and financial tensions.

First, global liquidity is expected to progressively tighten, justifying the upcoming deceleration of growth forecasted in 2019. Monetary and financial conditions reflect the ease of getting credit and funding; after the 2008-2009 crisis, they significantly eased as a result of unconventional monetary policies. An announced global tapering – of the Federal Reserve (Fed), then European Central Bank (ECB) – would hence gradually tighten global financial conditions. We already see that the growth of money supply (M2) has significantly decelerated in the US, opening the way for other developed economies.

As a result of this, interest rates will increase steadily but slowly, in a context where inflation will be stable in the Eurozone (+1.5% in 2018) but accelerate in the US (+2.3%). Two more Fed hikes are expected in 2018 and two other in 2019. The ECB is expected to reduce the pace of its monthly asset purchases to EUR15bn between October 2018 and January 2019, and continue reinvesting the principals from the maturing bonds until at least 2020. A first rate hike by the ECB is not expected before Q3 2019. Alongside monetary policy normalizations, further bouts of market volatility are expected, similar to the ones witnessed late February.

Separately, tensions are arising from a trade war, or more precisely a trade game, between the US and China. In spite of the protectionist rhetoric, trade accelerated in 2017 (+9.3% in value terms, +4.8% in volume i.e. correcting for price and currency movements). We expect a scenario of mild protectionism in 2018. By the end of 2018, global trade will have recovered the USD2tn in value terms it had lost between 2015 and 2016. The slight deceleration of trade expected this year to +8.4% in value terms and +4.4% in volume terms, should prolong over 2019. Price effects should abate, with value and volume growth converging.

New types of risks make this cycle unique

Will economic history stutter? Not exactly. New risks have emerged; they have become distinctive features of our current economic cycle, the second longest since World War II.

First, fragmentation in financial markets has increased; blame it on a patchy financial architecture. Disintermediation did not spare the financial sector: new actors have taken excessive risks as they were not as regulated as traditional financial institutions.

New risks have also emerged in the real economy. Governments, companies and households have growingly and disproportionately relied on debt. Growth has become more credit intensive, hence more sensitive to interest rates fluctuations. We use a measure of credit intensity (units of additional credit needed to generate one additional unit ofnominal GDP, see Chart 1); compared to 2011, it has increased inFrance (4.8) Japan (4.3), China (3.1), and Brazil (2.0) and remains above 1 in the US (1.6). As a consequence, any shock on interest rates will spread to the real economy.

Another distinctive feature of the current cycle is the prominent role of China. An innovative policy toolbox makes China heterodox by European or US standards. As it carefully manages its "soft landing", gradually opens its financial account and extends its influence, China could be the next stabilizer rather than the country from which the crisis originates. However, there are still persisting risks of a disorderly adjustment if the reining in policy targeting credit starts to impact domestic and global demand too severely.

One question then remains: where will the next crisis come from this time? Think data privacy and security; what if a confidence crisis arose from a massive data breach, and targeted Tech giants rather than actors in financial services? The likelihood of such an event rises every day.

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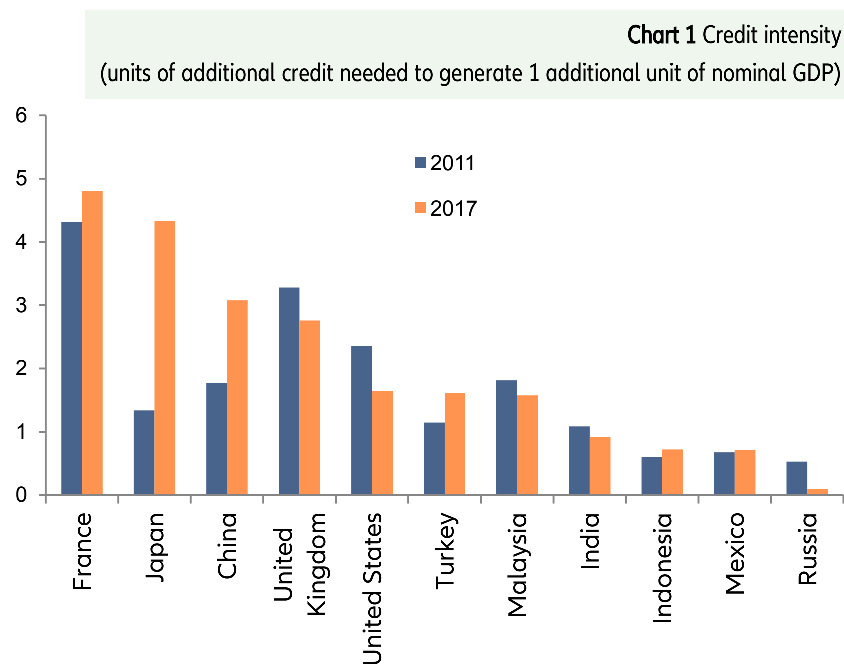
Chart 1 Credit intensity
(units of additional credit needed to generate 1 additional unit of nominal GDP)



2017 – average of the first three quarters

Source: IHS, Allianz Research

Country risk in line with the economic cycle

Over the past years, country risk has broadly developed in line with the global business cycle. In 2015, the net change in our Country Ratings (upgrades minus downgrades) was -8, followed by -2 in 2016 (see Chart 2).

As global growth picked up to +3.2% in 2017, country risk reversed its trend and clearly improved, posting a net upgrade of +5. The uptrend continued in Q1 2018 with a net change of +2.

The cyclicality in the overall Country Ratings was mostly driven by changes in our Short-Term (ST) Rating – which shifted from net downgrades of -2 in 2016 to net upgrades of +2 in 2017 – and here in many cases reflecting changes in the CRI (Cyclical Risk Indicator) sub-component which is determined by trends in real GDP growth and insolvencies.

Our less volatile Medium-Term (MT) Rating was balanced in 2017, after net downgrades of -3 in 2016, and recorded one downgrade in Q1 2018. In a typical late phase of the cycle, some downgrades reflect a risk of overheating.

The early stage of the recovery in most of the emerging markets feed into further country rating upgrades

Advanced Economies (AE) have been ahead in the country risk cycle, with 2 upgrades in 2015 and 5 in 2016. It entirely reflects Eurozone's recovery, embodied by a progressive decline of fiscal deficits among other improving fundamentals.

Looking ahead, we expect a few more upgrades in 2018-2019. However, increasing protectionist tendencies pose a downside risk to our scenario.

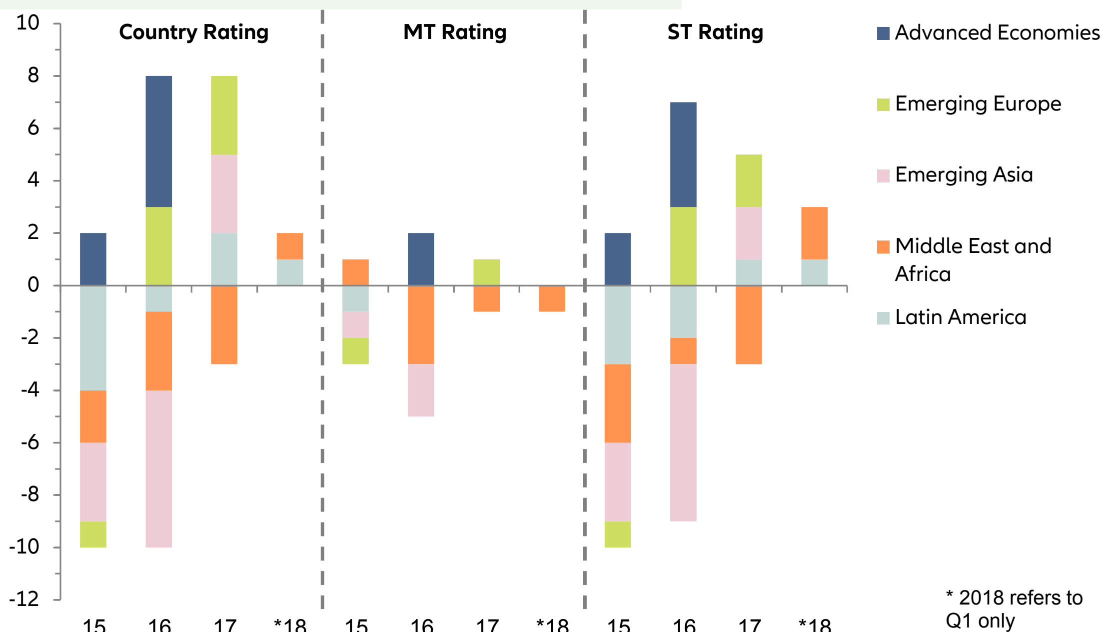
Emerging Europe has followed the AE in the country risk cycle with a lag of one year or so. Following -1 net downgrade in 2015, the region registered +3 net upgrades in both 2016 and 2017, as robust domestic demand and rising exports resulted in strong regional growth.

In Q1 2018, Eastern Europe registered one upgrade and one downgrade. *Russia* was upgraded from C4 to C3, thanks to the end of the recession in 2017, the stabilization of the RUB, which led to record low inflation, a narrowing of the fiscal deficit and an export's recovery. Concerns about continued and stepped-up Western sanctions are well reflected in the C3 rating. *Romania* was downgraded from B1 to B2 due to mounting overheating concerns. The +7% GDP growth achieved in 2017 was not healthy as it was fueled by strong pro-cyclical fiscal stimulus and high wage growth, that caused a significant rise in macroeconomic im-balances, notably widening twin deficits and rapidly rising inflation. Moreover, insolvencies rose by +9% in 2017 and are expected at +12% in 2018. Elsewhere in the region, *Turkey* is also overheating, with related risks already reflected in the current C3 rating. Going forward, we expect net rating changes to be neutral in 2018-2019, though complacency (postponement of necessary policy tightening) could lead to a deterioration of the risk environment.

Emerging Asia and *Latin America* followed next in the country risk cycle, with a reversal to net upgrades in 2017 (+3 and +2 respectively).

In Asia, it reflected a strengthening of growth and better fundamentals in the *ASEAN region*.

Chart 2 Net changes in Country Ratings by region, from 2015 to Q1 2018



Source: Euler Hermes

The reversal in Latin America was triggered by an exit from recession for both Argentina and Brazil amid recovering commodity prices.

In Q1 2018, there was no rating change in Asia and one upgrade in Latin America.

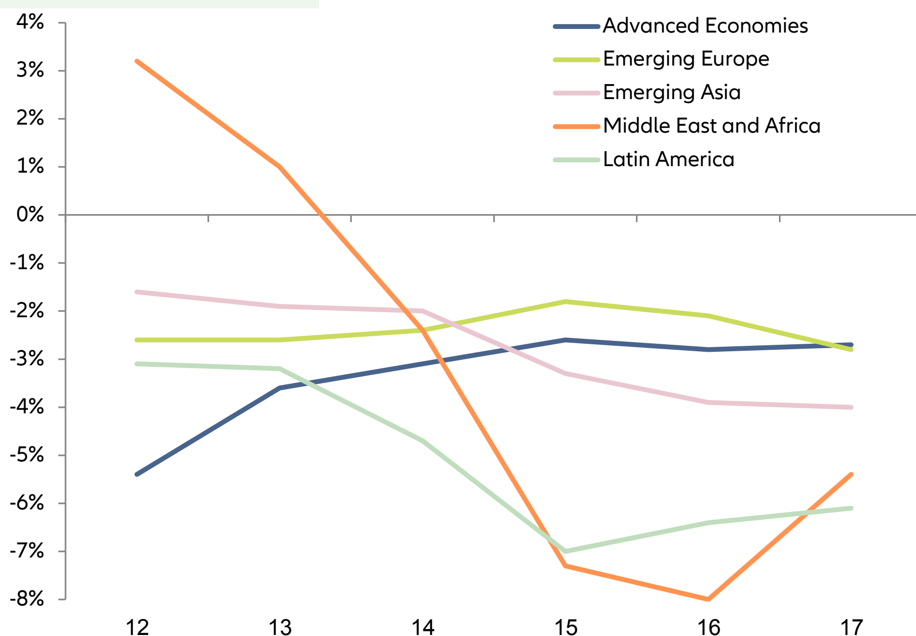
Chile improved from A2 to A1, thanks to a rebound of growth in H2 2017 and an improved growth outlook for 2018.

Looking ahead, a few more upgrades are possible in these regions in 2018-2019 despite lingering risks related to US protectionist initiatives.

In the *Middle East and Africa*, country risk continued to deteriorate until the end of 2017, with -8 net downgrades in 2015-2017, reflecting mainly the adverse effects of persistently low commodity prices (notably oil), deteriorating public finances and external accounts, and in some cases also increased political risk (including hidden public debt).

However, Q1 2018 saw 3 upgrades overtrumping 2 downgrades in the region. *Algeria* was downgraded from C2 to C3 due to ongoing lax fiscal policy and surging credit.

Chart 3 Regional fiscal balances



Sources: IMF, Allianz Research

Tunisia was downgraded from B3 to C3 due to continued large external deficits and rising debt levels.

Egypt (from C3 to C2), *Ghana* (from B2 to B1) and *Côte d'Ivoire* (from C3 to C2) were upgraded thanks to low levels of inflation and improved fiscal as well as external imbalances. Yet, against the backdrop of high political risk and weak economic fundamentals in many countries, it remains to be seen if Q1 may have heralded a tentative reversal in country risk profiles of the region.

Companies are reaping the benefits of an extended phase of expansion

The improvement of macro fundamentals continued to translate into a reduction of risk at sector level. In line with the previous quarters, a large number of industries reported a stronger demand in Q1 2018 and presented a positive outlook (76). This by far exceeded the number of industries with a worsening demand outlook (32).

A positive momentum has prevailed throughout the past 4 quarters (276 industries with stronger demand as opposed to 157 with weaker underlying top line fundamentals). Moreover, positive reports on profitability (69) and liquidity (52) outnumbered negative ones.

In this context, our sector risk ratings show a net positive change for the third consecutive quarter with twice as many grades upwards (21) than downwards (10). Even though there is still disparity amongst region and sectors, this is confirmation of the turnaround that began mid-2017.

The sector outlook remains strong in the developed world ex UK, while improving in Asia and Latin America

Sector risk ratings in *Western Europe* continued improving albeit at a slower pace, with a net balance of 3 upgrades in Q1 and 23 over the last 4 quarters. The momentum persisted in Q1 2018 with 6 new upgrades after 14 in Q4 2017 and 32 upgrades over the last 4 quarters. Yet, there is one important exception: *UK* retail sector's downgrade from 'Medium risk' to 'Sensitive'. It marks our first downgrade for the UK since the Brexit vote. A strong deceleration of private consumption, intensifying price competition and some disruption from e-sales all contributed to this downgrade.

We observed a trend reversal in *Latin America*, after waves of downgrades from 2015 onward. Argentina's and Brazil's exit of recession is now feeding through into sector upgrades, notably on the consumer side.

There were 7 net upgrades in the region in Q1 2018, out of which 5 in *Brazil* (including Retail and Household equipment).

The vast majority of upgrades, though, are from 'High risk' to 'Sensitive', which still indicates an elevated level of risk.

Separately, we observed that (i) there were no additional upgrades in *North America* – the region being in advance in the economic cycle; (ii) there were more upgrades than downgrades for the second quarter in a row in *Asia*, confirming a continuing improvement in the region; and (iii) Concerns over overheating in *Eastern Europe* have no impact on sector risk ratings at this stage.

Chart 4 Summary of Q1 2018 rating changes (new grades)

	Upgrades	Downgrades
Automotive manufacturers	Australia The Netherlands New Zealand	
Construction		Russia South Africa
Transportation	Brazil	
Chemicals	Greece	
Pharmaceuticals	Autralia Kuwait The Netherlands	
Agrifood		Philippines
Textiles		Spain
Paper	Peru	Spain
Electronics	Brazil Thailand	
Metals	Australia Spain Poland	
Retail	Brazil The Netherlands	UK Estonia Latvia Lithuania
Machinery & Equipment	Brazil	
Transport equipment	Ecuador	
Software & IT Services		Poland
Household equipment	Brazil Russia	
Energy	Norway	

Source: Euler Hermes

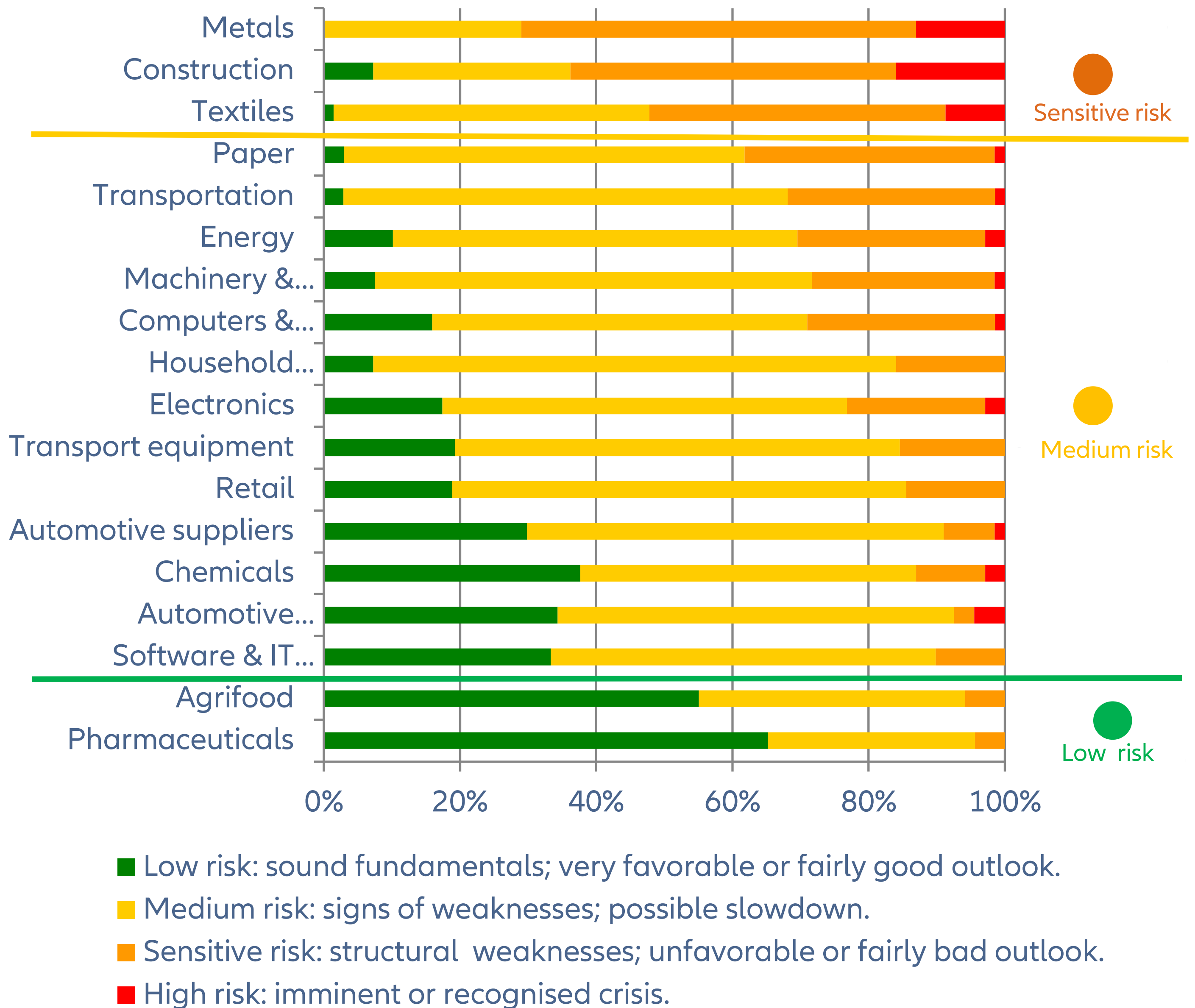
A broad-based and well balanced improvement in the sector outlook

The distribution of our *upgrades,* was very balanced (7 from high to sensitive, 7 from sensitive to medium and 7 from medium to low risk), with some concentration on cyclically sensitive sectors (Metals, Automotive and Household equipment). Rising commodity prices have led us to upgrade the *Metals* sector in 3 countries (Australia, Poland, and Spain) as global demand is strong. While we see a clear and sustainable recovery in base metals and mining, we continue to have concerns with regards to Steel. In a number of countries, stronger earnings are driven by protectionist measures, while global overcapacity persists - about 25-30% overcapacity globally, most of which concentrated in Asia (China). US tariffs will have a limited direct impact on the sector, as numerous exemptions were granted. Nevertheless, Japan remains largely exposed to tariffs and protectionist measures might accelerate capacity closures in Asia.

Downgrades appeared notably at the safer end of the risk range, with 3 out of 4 downgrades from 'Low' to 'Medium risk' in the *Retail* sector in the Baltics. This sector, with 8 downgrades over the last 4 quarters including the UK case, remains on the watch list as challenged by structural change. Downgrades in the *Construction* sector to 'High risk' were isolated and in our view represent idiosyncratic factors in Russia and South Africa.

Metals, Construction and Textiles remain the *riskiest* sectors, all rated 'Sensitive' on average. We consider Pharmaceuticals and Agrifood as the *safest* sectors. Note that both of the latter are entirely deprived of 'High risk' ratings. Also, Chemicals, Automotive manufacturers and IT services, on average rated 'Medium risk', contain a significant share of countries at 'Low risk' grades (respectively 38%, 34% and 33%). Conversely, there are pockets of higher risk within Energy and Transportation, where we rate 31% of countries as 'Sensitive' or 'High risk'.

Chart 5 Q1 ratings by sector (global average) and risk distribution of sectors (number of countries in %)



Source: Euler Hermes

Ana Boata, Maxime Lemerle, Georges Dib, Alexis Garatti

REDISTRIBUTION BY MONETARY POLICY

- **Net interest income of different economic sectors fluctuates wildly since the start of monetary loosening**
- **Corporates and households in the South are among the big winners**
- **French and Finish economies find themselves on the losing side**

Monetary policy has distributional effects. Extreme monetary policy has extreme distributional effects.

That's the lesson learned during the last nine years in the Eurozone when the ECB constantly eased its policy, up to the point of the introduction of negative interest rates and asset purchase programs, worth several trillions of euros.

The fluctuations of net interest incomes of economic sectors in different euro countries bear impressive witness to that.

Although the concept of net interest income is easy to understand – the balance of interest income and expenses –, there are many ways to calculate it. The ECB, for example, uses interest payments after FISIM (see box) and only looks at the pure price/interest effect i.e. leaving changes in stock out of the equation.

Things are further complicated if so-called "opportunity costs or gains" are calculated by comparing the real development with a hypothetical "normal" trend development.

Such a contra-factual approach might be better suited than a simple comparison with the past to identify "winners" and "losers" of low interest rates.

The problem is that nobody can say with certainty how things would have played out under "normal" circumstances.

We, therefore, use a different approach: We look at the real development, i.e. we use interest rate before FISIM (see box) and take volume changes into account.

That's because the sometimes huge changes in volume – reduction of debt, disposal of bonds or increase in bank deposits – should be seen as deliberate reactions to falling interest rates.

Furthermore, we compare the fluctuations with the base year of 2008, the start of monetary easing.

Having said this, our calculation is nothing more – but also nothing less – than a straight illustration of what really happened in recent years.[1]

And in some cases, these changes in net interest incomes are nothing less than dramatic.

Even more so if annual changes against the base year 2008 are cumulated: that way, the changes of the net interest income, as percentage of GDP, often reach double digit numbers.

[1] Italy already showcased a notable reduction in banking sector risk where NPL stocks have been reduced by EUR104bn since 2014.

What is FISIM?

The national accounts refer to two forms of interest income and expense: before and after "FISIM", which stands for "Financial Intermediation Services, Indirectly Measured". This is calculated by adding/deducting the indirect fees charged by banks as part of their lending and deposit business, calculated using models, to/from the interest payments actually made.

In other words: the national accounts assume that interest payments consist of two components: the "pure" interest and the price for the banking service (e.g. loan processing, deposit management, etc.). This is why, for example, the interest income of private households is much higher with FISIM – after all, this income also settles any service fees relating to account management which the banks, however, conveniently withhold right away (which is why they are referred to as indirect fees). Interest expenses, on the other hand, are much lower, because part of the interest payments "actually" refers to the service fees for loan processing (which, however, are not directly reported by the banks).

The differences between the interest measurement before and after FISIM are by no means trivial, as a look for example at the German national accounts for 2016 reveals: according to these statistics, private households were faced with interest expenses of EUR 59.5 billion and earned interest income of EUR 15.9 billion in that year. By contrast, the figures after taking indirect bank fees into account are as follows: interest expense of EUR 26 billion and interest income of EUR 37.6 billion. This means that FISIM turns net interest income that is well in the red (EUR -43.6 billion) into a sizeable surplus (EUR +11.7 billion). This shows that the method used to calculate interest has a considerable impact on the result of the calculations.

In general, we do not believe that it makes much sense to look at interest income and expenses after the allocation of financial intermediation services indirectly measured for the purposes of our analysis – namely to assess the impact that the low interest rates have had on household finances. After all, while this sort of break-down might be consistent with the logic behind the national accounts, in the sense that it facilitates an estimate of the contribution to added value made by the banking sector, it does not reflect the reality of life for savers. After all, savers do not live in a theoretical world; they are not interested in what could have been credited to their account at the end of the year if the indirect banking services had been taken into account – rather, they are only interested in the funds that actually end up in their account. The same applies to their interest expenses, which no saver is likely to break down into pure interest payments and fees in his head (after all, what formula would he use?); what is relevant is the amount that has to be paid to the bank every month.

Net interest income of households: Monetary fault lines

For households, the income gains or losses resulting from the change in net interest income in the years of the low interest rates are very high in a number of EMU countries (see figure 1).

Spain and Portugal, for example, are ranked among the "winners" of the low interest rate policy.

As far as Spain is concerned, the changes in volume are also likely to have contributed to the substantial interest rate gains: the marked increase in deposits put a damper on the drop in interest income, while the reduction in loans accelerated the drop in interest expenses. Developments in Portugal followed a similar trajectory to those in its neighboring country: rising assets and declining liabilities turned a negative net interest result at the start of the low interest rate period into a positive one.

On the other hand, for some households, notably in the Netherlands and France, the low interest rates were something of a non-event; net interest income remained virtually unchanged because interest income and expense fell more or less in tandem with each other. This is due to a more or less parallel development in volumes (rising in each case) and interest (falling in each case).

The biggest "interest rate losers" are Italy and Belgium. As far as Italian households are concerned, this is due largely to the dramatic slump in interest income, a trend that was fueled not least by the drastic reduction in the bond portfolio, which was slashed from around EUR 800 billion (end of 2008) to EUR 360 billion (2016). As a result – despite an increase in bank deposits – interest-bearing assets have fallen by a good 10%. In Belgium's case, it is primarily the (slight) increase in interest expenses that is responsible for the drop in the net interest result. This development, which bucked the trend, is due to rising debt levels and what has been only a very slow drop in interest rates in this area.

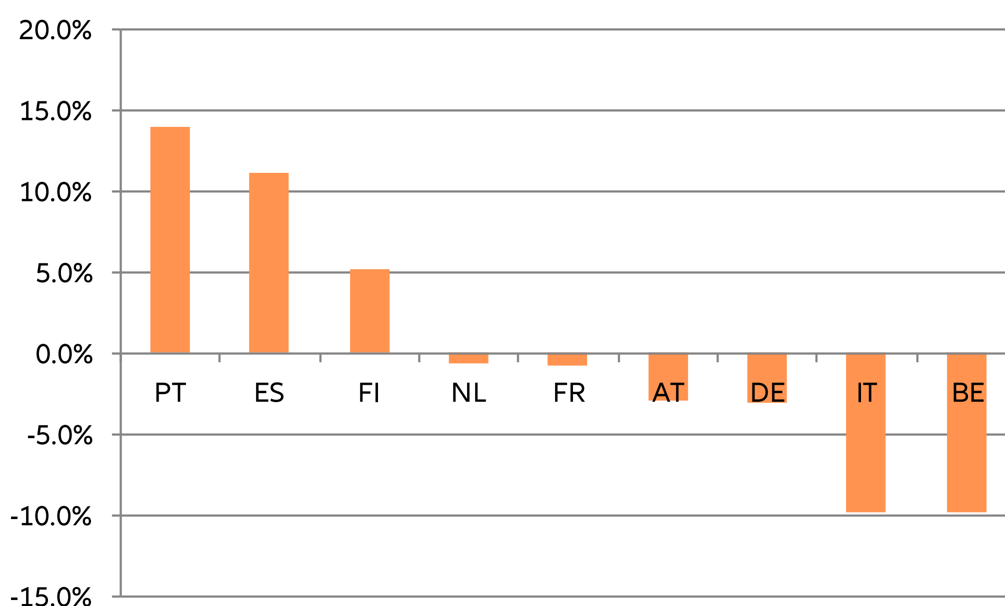
In addition to households in these two countries, German and Austrian households also have to be counted among the losers, with cumulative interest losses corresponding to roughly three percent of GDP.

One reason is the widening interest differential between the asset and liabilities side: whereas deposit interest rates are adjusted to reflect the key monetary policy rate fairly quickly, it takes some time for lending rates to adjust, not least due to the long fixed-interest periods that are common practice for mortgage loans in Germany.

The upshot: Although German savers have stepped up their bank deposits by just under 40% since 2008, interest income plunged by more than 70%. Interest income plays a decisive role in Austria, too, plummeting by almost 80% during the period under review, despite the fact that assets have grown by 20%.

To sum up: the main winners of the low interest rates have been the households in the southern euro crisis countries, such as Portugal and Spain, whereas "countries of savers" like Germany, Austria and Belgium have lost out.

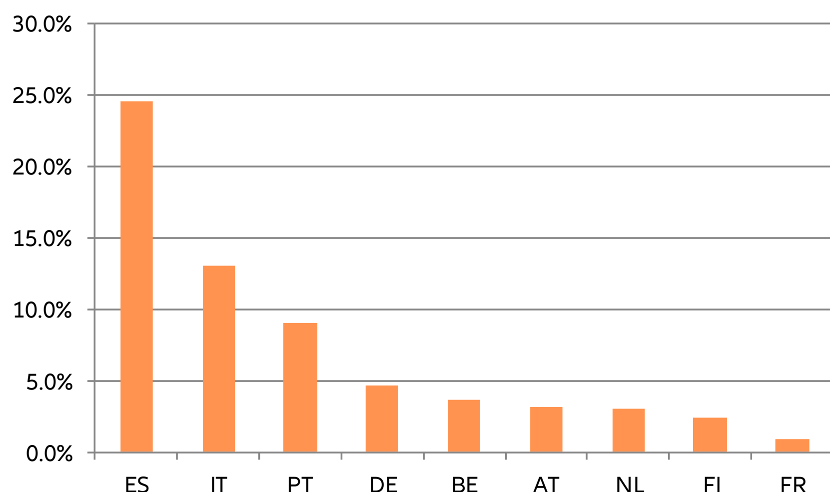
Figure 1 Cumulated changes in net interest income of households between 2008 and 2016 (% of GDP)*



*Interest payments before FISIM.

Sources: Eurostat, Allianz SE

Figure 2: Cumulated changes in net interest income of non-financial corporations between 2008 and 2016 (% of GDP)*



*Interest payments before FISIM.

Sources: Eurostat, Allianz SE

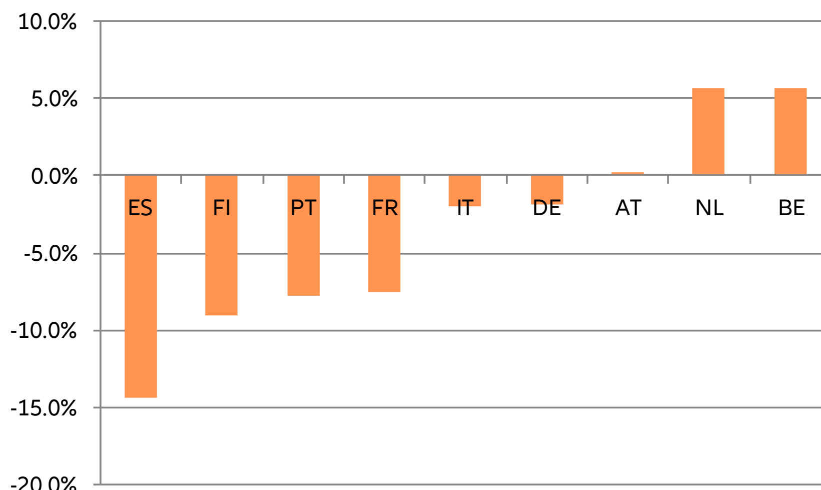
Net interest income of non-financial corporations: Benefiting nicely

In general, non-financial corporations benefited nicely because their liabilities are much bigger than their assets. But not all companies are equal: Spanish companies, for example, profited the most because not only rates fell but debt was also reduced (by 18% between 2008 and 2016). In contrast, French companies increased their debt load by one third and consequently saw a much smaller rise in their net interest income (see figure 2).

Net interest income of financial corporations: Margin squeezing

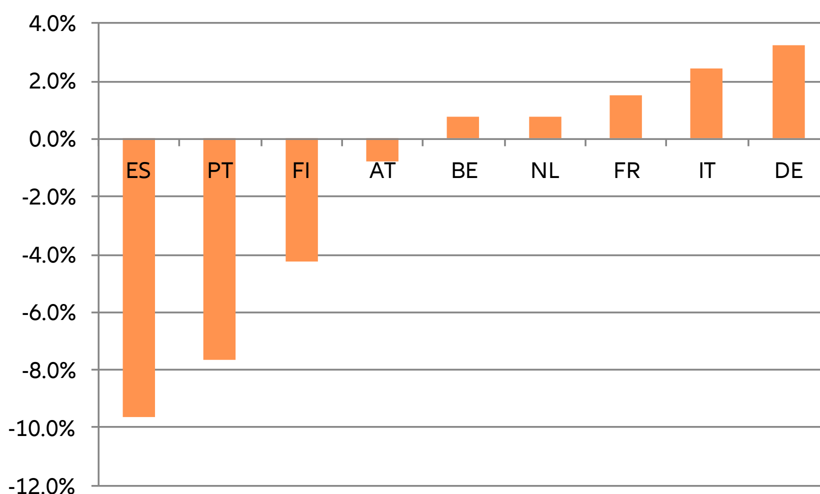
Most Eurozone banks suffered from low interest rates as their interest margins were squeezed. In the case of Spanish banks, shrunk balance sheets came on top. On the other hand, Belgian and Dutch banks – somehow surprisingly – bucked the trend: They managed to widen their margins. But this might be mainly due to the choice of the base year, 2008: Both the Dutch and Belgian banking systems were early victims of the escalating banking crisis and many banks were forced at that time to offer rather high deposits rates to attract funds.

Figure 3 Cumulated changes in net interest income of financial corporations between 2008 and 2016 (% of GDP)*



*Interest payments before FISIM.

Figure 4 Cumulated changes in net interest income of governments between 2008 and 2016 (% of GDP)*



*Interest payments before FISIM.

Sources: Eurostat, Allianz SE

Net interest income of governments: Debts without regret

All Governments benefited hugely form falling interest rates. However, even under these circumstances governments in Spain and Portugal had to pay more interest – because public debt soared since 2008: by more than 200% in the case of Spain and more than 100% in the case of Portugal. Finland, too, saw a doubling of its debt pile during that period. On the other end of the spectrum are Italy and Germany where debt increased only "moderately" by around 40%. Consequently, both countries could improve their net interest income as the (implicit) rates for government debt dropped by around 2 percentage points, lowering the interest bill by 36% respectively 15%. In the case of Germany, this drop is the main driver behind its recent achievement to balance the public budget.

Net interest income: French blues

In the Eurozone as a whole, these changes in net interest income of different sectors more or less cancel each other out. However, because of extensive economic integration, this is not the case for each and every economy in the monetary union.

"Big winners" are the economies of Spain, the Netherlands and Portugal. For both the Southern economies the pattern is very similar: Lower net interest incomes of banks and the government are more than offset by improvements on the side of companies and households. In the Netherlands, the story is slightly different:

Net interest incomes of the government and households barely changed but financial as well as non-financial corporations improved.

On the other hand, the economies of France and Finland had to cope with a negative development.

In both cases, the lower net interest income of banks is mainly to blame for the overall dismal performance.

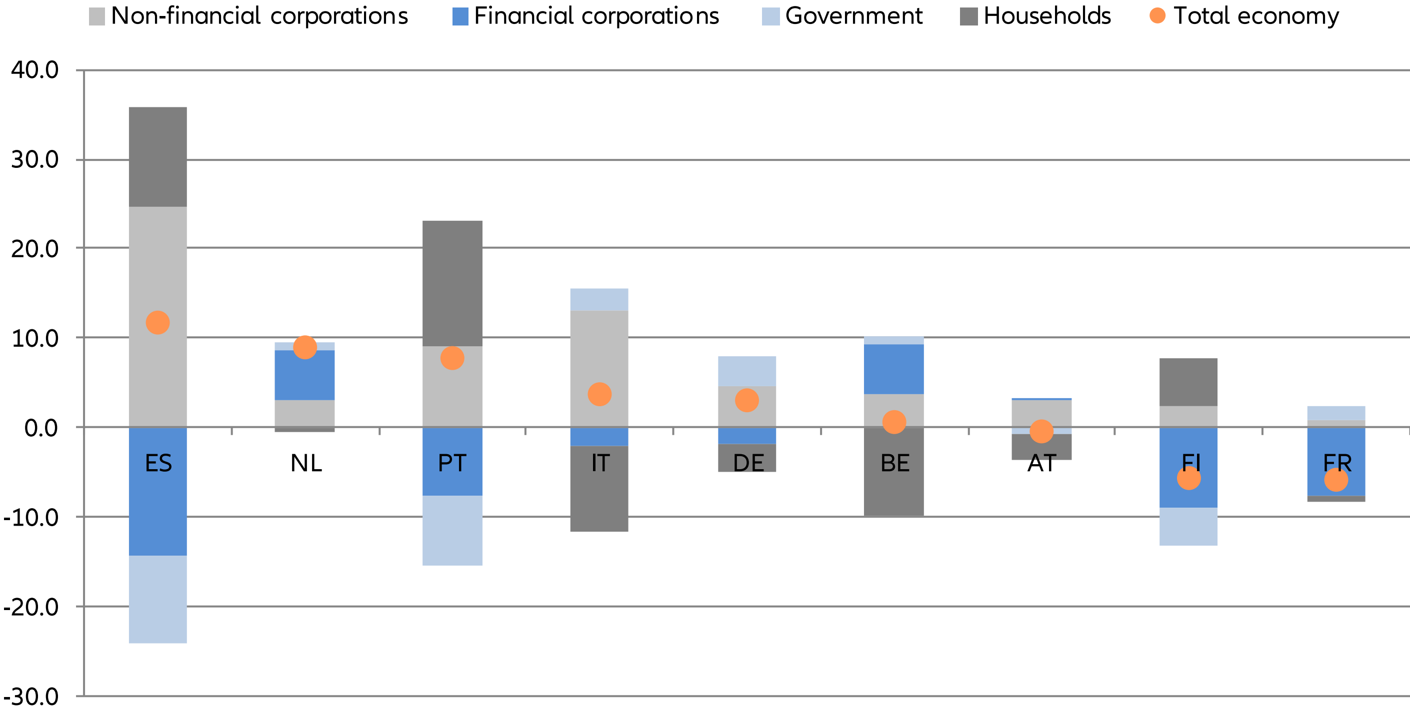
For the other countries in focus, the overall impact was rather marginal as "losses" of some sectors are compensated by "gains" of other sectors. Germany, too, belongs to this group:

Altogether, the German economy comes off rather well. However, the distribution of "winners" and "losers" is quite different to the Southern economies.

In Germany, the biggest profiteer of extremely low interest rates is – besides non-financial corporations – the government; on the other hand, not only banks but also households find themselves on the losing side.

Kathrin Brandmeir, Arne Holzhausen

Figure 5 Cumulated changes in net interest income between 2008 and 2016 (% of GDP)*



*Interest payments before FISIM.

Sources: Eurostat, Allianz SE

PAYMENT BEHAVIOR

PAYMENT DELAYS UP 2 DAYS GLOBALLY: DON'T LOWER YOUR GUARD TOO EARLY!

- **In 2017, the average DSO increased by +2 days in 2017 to 66 days. It should increase by +1 day in 2018**
- **The US, part of the Eurozone and China experience the highest increase in DSO**
- **Upstream industrial sectors such as Electronics, Machinery and Construction have the highest DSO**

The return of growth and trust distract attention from payment discipline

As shown in chart 1 , there is a clear correlation between DSO and global economic activity as measured by GDP growth. The economic and financial crisis of 2007-2008 had led companies to closely monitor or accelerate debt collection, reflected in the sharp fall in DSO (-5 days, to 60 days in 2008 on average). The return of growth then allowed DSO to rise to 64 days where it stayed constant from 2012 to 2016 before the backdrop of +2.8% p.a. average GDP growth. We interpret the latest increase in DSO as a certain lowering of the guards and greater trust as a result of stronger growth and optimistic short-term macroeconomic forecasts: GDP growth reached +3.2% in 2017, after +2.6% in 2016. We expect a similar dynamic in 2018, with global DSO rising by one more day, to 67 days.

Widespread lengthening of payment periods

Across our sample of 25,000 listed companies across 20 sectors and 36 countries, DSO rose by +2 days on average globally, reaching 66 days at the end of 2017. After five years of stability at 64 days, DSO reached a ten-year high. Moreover, the spread of DSO around its mean increased in 2017, with one company out of four being paid by its clients within less than 31 days, but one out of four being paid after 90 days. This compares to one out of four companies achieving payment within 88 days in 2016.

The lengthening of DSO reflects a relaxation of payment standards between companies. As global economic health is improving (see chart 1), companies tend to trust their clients to pay them - despite the increase in insolvencies of large companies.

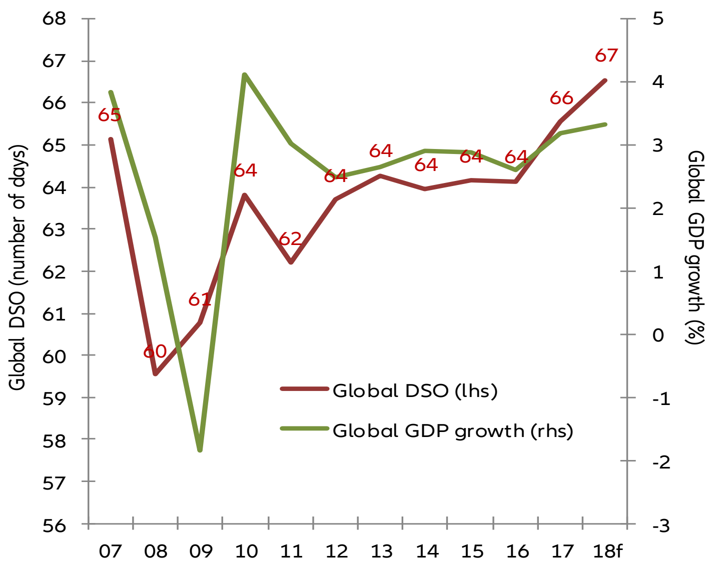
The increase in average DSO in 2017 stems from a global trend observed in most countries. As shown in chart 2, DSO increased in 2017 in two thirds of the countries in our universe. For the most part, they are developed countries, but some are large emerging economies, such as China and other Asian countries, but also Turkey (+3 days) and Brazil (+1 day). In China where the average DSO already by far exceed the global average, DSO rose by a further +3 days in 2017. By early 2018, it reached 92 days. It is worth noting that DSO increased in twelve sectors out of eighteen in China, compounded by the share of Chinese companies with DSO that exceeded 90 or even 120 days.

In light of relative levels of DSO (see chart 3), three main groups of countries emerge with respect to the global average:

1) The seven strongest countries have an average DSO inferior or equal to 51 days, the country with the lowest DSO globally being New-Zealand with 43 days. Other countries with short averages are the Nordic countries (Denmark and Finland), Austria and Switzerland, the US and eventually the Netherlands despite the four-day rise due to the strong increases in the telecom, technologies and support services sectors.

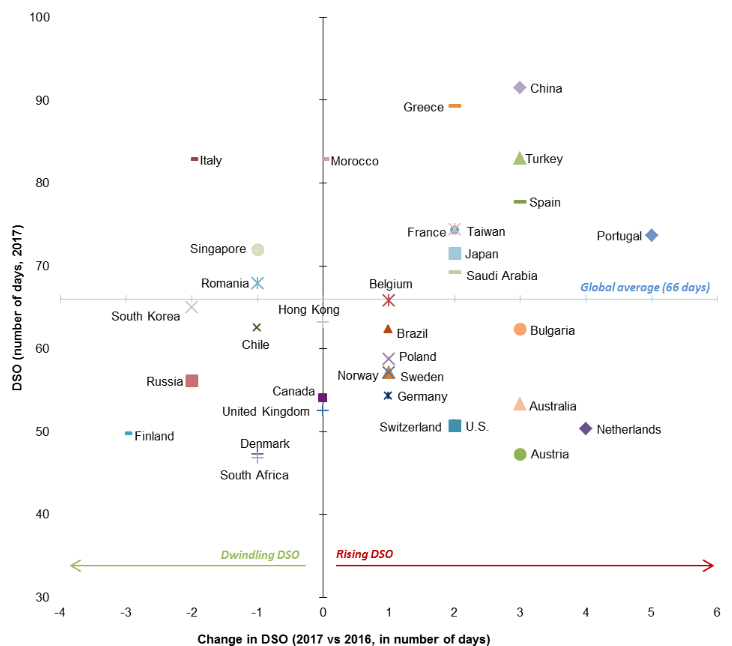
Photo by Nik MacMillan on Unsplash

Chart 1 Change in Global DSO and Global GDP growth



Sources: Bloomberg, Euler Hermes, Allianz Research

Chart 2 DSO and change in DSO by country



Sources: Bloomberg, Euler Hermes, Allianz Research

2) The group of 7 other countries for which DSO stays below the global average, comprises amongst others Germany (54 days), Canada (54), Brazil (62), and the UK (53) in which it is stable despite uncertainties due to Brexit. We find it noteworthy that Russia is part of the group, with DSO decreasing by +2 days to 56 days, with one quarter of companies being paid under 22 days.

3) Finally, the remaining group of 12 countries with an average DSO superior to the global average of 66 days, such as France (74), Italy (83). China has the highest average DSO (92 days). With respective average DSO of 74 days and 83 days, Portugal and Turkey should be closely monitored as almost one company out of four is paid after four months in these two countries.

The average DSO grew in two-thirds of the countries, being above average in both construction and upstream industrial sectors

We note increasing DSO in almost all sectors while four sectors particularly stand out: Aeronautics (+4 days in 2017, +12 days since 2012), Automotive (respectively +3 and +7), Construction (+3) and Electronics (+3), the sector with the highest a DSO in our universe. There are only four sectors with stable DSO (Food, Household equipment, Machinery, Recreational goods) and two with decreasing DSO y/y (Pharmaceuticals and support Services). DSO is once again far higher in B2B than B2C activities.

The longest DSOs are in sectors with long manufacturing processes, i.e. Aeronautics (72), Automotive (72), Machinery (87) and Electronics (91). DSO in all of these sectors exceeds the global average of 66 days by +6 days or more.

This is also the case for Chemicals, with a DSO of 73 days on average. It is no surprise, as it is a supplier to all industrial activities.

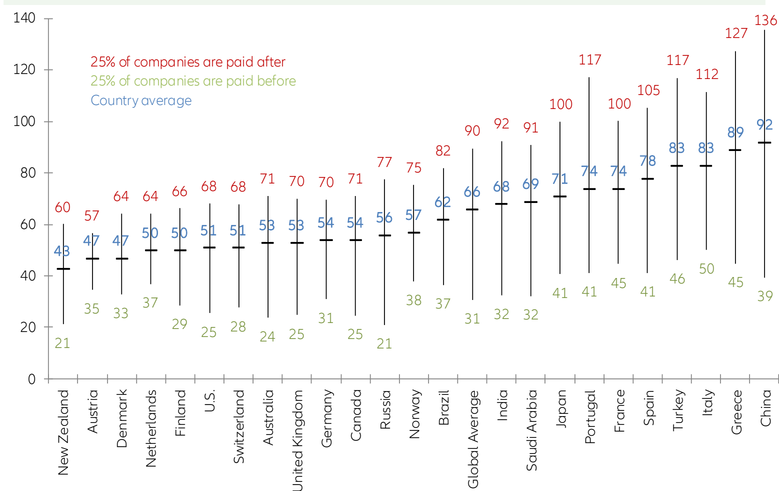
Construction is one of the three sectors with the highest DSO with 85 days: this stems from public works and infrastructures, but also from increasing delays in real estate programs. Not overly surprising given the heterogeneous nature of the sector, there is great divergence around the mean. DSO in the Energy (63 days), Metals (58) and Paper (62) sectors stand below our global average. However, the metric for the two former ones increased by +3 and +2 days in 2017, respectively, as a consequence of the increase in commodity prices. As for the Paper industry, the +1 day increase to 62 days can be explained by the rise in online sale

Finally, Pharmaceuticals is the only B2B sector with a decreasing DSO (-2 days) in 2017, albeit still with (78 days), linked to its particular customer base – mainly public health insurance systems.

At the other end of the spectrum are sectors closer to the end consumer, with DSO far lower than the global average of 66 days, such as Food (46 days), Transportation (49) and Household equipment (49).

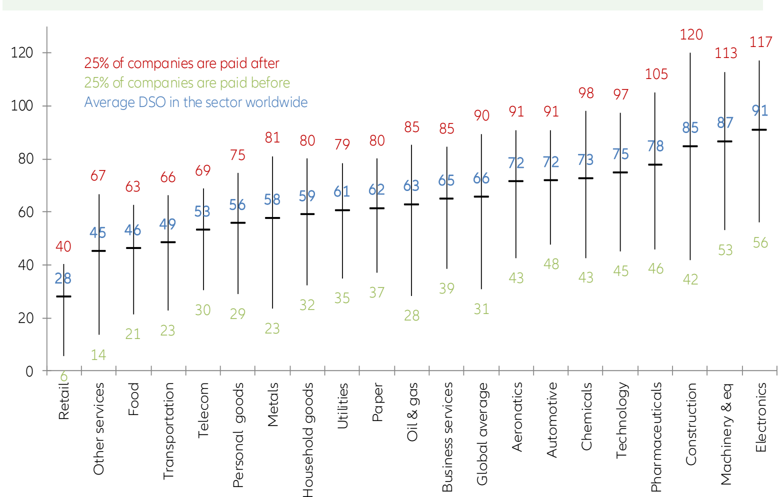
Marc Livinec

Chart 3 DSO level and dispersion by country in 2017 (number of days)



Sources: Bloomberg, Euler Hermes, Alllianz Research

Chart 4 DSO level and dispersion by sector in 2017 (number of days)



Sources: Bloomberg, Euler Hermes, Alllianz Research

Chart 5 Global DSO Heat Map 2017

	Retail	Other services	Food	Transportation	Telecom	Personal & recreational goods	Metals	Household goods	Utilities	Paper	Oil & gas	Business services	Aero	Auto	Chemicals	Technology	Pharma	Construction	Machinery & eq	Electronics	**Country average**
New Zealand	16	20	47	32	37	40	-	-	41	-	33	54	-	-	-	63	67	55	61	95	43
South Africa	28	33	42	39	44	-	34	-	-	45	17	62	-	-	59	70	77	52	54	67	47
Denmark	23	32	36	41	-	39	-	34	83	-	55	54	-	-	-	58	50	55	64	51	47
Austria	-	38	61	47	-	32	43	-	31	-	73	-	-	27	-	-	-	52	49	-	47
Finland	11	28	29	40	73	43	47	38	-	42	-	54	-	-	-	85	-	37	58	51	50
Netherlands	9	72	44	35	51	35	-	42	-	-	52	60	-	-	57	70	-	42	49	55	50
Switzerland	19	27	39	27	-	47	49	101	67	30	-	62	-	-	74	70	63	49	61	64	51
U.S.	21	40	36	36	43	41	48	40	51	41	57	57	57	57	57	61	62	57	60	62	51
United Kingdom	14	43	48	42	51	42	34	33	58	56	57	56	53	63	75	76	72	42	75	65	53
Australia	28	48	51	44	40	50	47	57	53	49	58	60	93	45	83	62	75	59	62	60	53
Canada	18	40	34	52	50	42	34	57	44	35	85	54	51	-	38	63	68	56	69	83	54
Germany	29	48	39	49	42	41	60	38	48	-	53	69	-	68	45	62	77	51	62	66	54
Russia	26	23	39	26	-	37	60	72	63	43	50	34	75	61	23	68	118	68	65	75	56
Sweden	23	41	51	20	35	48	33	51	15	47	40	66	59	38	92	77	56	67	63	71	57
Norway	8	31	39	46	31	61	51	-	-	-	73	72	-	-	53	60	48	52	62	71	57
Poland	36	44	54	44	46	47	38	55	35	55	40	67	60	43	48	69	71	69	87	80	59
Brazil	60	37	42	39	82	97	44	74	66	67	62	78	58	55	53	71	91	81	56	-	62
Bulgaria	64	28	59	-	-	66	42	72	89	60	63	22	-	58	72	134	85	79	75	41	62
Chile	64	33	55	61	-	77	53	84	63	-	-	57	-	-	103	-	-	74	115	-	63
Hong Kong	29	43	42	54	41	55	53	63	54	65	81	72	-	82	68	74	102	73	99	82	63
South Korea	34	50	46	45	55	57	74	52	73	67	54	52	76	69	64	68	94	63	76	62	65
Belgium	42	56	52	67	62	45	29	-	107	-	-	68	-	-	45	105	67	66	81	71	66
India	46	62	39	58	37	56	58	58	73	44	58	87	92	58	76	93	76	85	77	101	68
Romania	26	22	86	64	-	34	45	52	66	53	67	90	55	92	56	-	149	81	81	75	68
Saudi Arabia	37	45	48	96	105	74	59	92	-	-	-	111	-	-	73	-	-	80	67	154	69
Japan	23	37	52	51	69	63	89	67	47	88	56	60	117	70	99	72	95	111	108	100	71
Singapore	44	35	52	65	42	74	72	72	89	64	98	70	89	65	80	77	57	85	92	85	72
Portugal	17	59	66	99	-	-	-	-	48	46	-	120	-	-	-	113	-	96	-	-	74
France	35	80	63	55	56	49	49	64	79	55	96	92	74	53	60	99	63	75	97	78	74
Taiwan	36	36	48	40	39	57	57	58	42	58	61	71	97	78	74	71	78	71	93	99	74
Spain	20	68	75	46	51	79	54	55	69	49	131	88	-	54	-	109	69	111	93	-	78
Morocco	43	75	62	114	-	-	71	-	79	-	46	-	-	-	-	140	95	85	-	-	83
Italy	41	96	58	73	75	64	-	86	105	-	93	103	55	41	88	98	76	80	91	74	83
Turkey	28	77	70	31	109	75	57	78	42	87	73	56	-	74	83	134	120	123	107	140	83
Greece	48	65	92	44	-	71	110	108	68	-	20	99	-	-	85	121	-	110	109	-	89
China	22	57	37	54	67	61	75	68	56	94	113	91	125	112	84	113	93	123	126	139	92
Sector average	28	45	46	49	53	56	58	59	61	62	63	65	72	72	73	75	78	85	87	91	**66**

Reading notes:

A greener color indicates a lower average country or sector DSO; hence a customer base paying faster, consolidating one's cash balance.

Conversely, a more red color indicates a lengthening country or sector DSO that usually brings on problems, especially in case of poor cash balance.

DSO data are available on our Web App MindYourReceivables

US FISCAL POLICY
GHOSTS OF THE PAST

- **Over the last five months, President Trump has initiated an ambitious program of tax cuts and higher fiscal spending, with the promise that positive dynamic effects on growth will be strong enough to avoid any increase of the public debt**
- **We estimate that the impact on GDP growth should be moderate with a 0.7 pp boost in 2018 and 0.6 pp in 2019**
- **The rapid worsening of the fiscal situation, embodied by a public deficit at 4.5% of GDP in 2019 compared with 3.4% in 2017, will evidence rather weak multiplier effects in a late phase of the cycle and call for rapid changes in the orientation of the US economic policy**

The US economic policy at a crossroad

Over the last five months, President Trump has initiated an ambitious program of tax cuts and higher fiscal spending, with the promise that positive dynamic effects on growth will be strong enough to avoid any increase of the public debt. Taking into account the specificities of these fiscal packages, we estimate that the impact on GDP growth should be moderate with a 0.7 pp boost in 2018 and 0.6% pp in 2019. The rapid worsening of the fiscal situation, embodied by a public deficit at 4.5% of GDP in 2019 compared with 3.4% in 2017, is evidence of rather weak multiplier effects in a late phase of the cycle.

History can tell us a lot, especially the smell of the 80s, concerning the fiscal actions. In this paper, we will look at the three building blocks of President Trump's fiscal policy, i.e. a radical program of tax cuts (USD 1.4 trillion over ten years), a tax holiday on foreign profits (targeting a pool of USD 2.4 trillion of funds detained abroad) and a significant acceleration of public spending (USD440bn over 2 years).

Similarities and differences from the past suggest that the bet of higher growth and stable debt may not materialize. Mid-term elections will probably play the role of a wake-up call as debt sustainability will come back at the forefront of concerns among conservative leaders.

A sizeable tax bill with limited effects, especially if/when the fiscal hawks are back

Donald Trump has announced one of the largest tax cut programs ever in the US.

Losses on fiscal revenues, without taking account of macroeconomic positive feedback effects, are estimated at USD 1.45 trillion over ten years.

It represents an average stimulus of USD140bn per year. The estimated size of the tax cut boost ranks fourth in the hierarchy of past tax cut programs, behind 1981 Reagan's program (Table 1).

Table 1 Revenue effects of major US bills enacted since 1968 (Constant 2012 USD bn)

Tax bill	year 1	year 2	year 3	year 4	first 2-Y average	first 4-year average
Revenue and Expenditure Control Act of 1968	80	22.3	N/A	51.1	N/A	N/A
Tax Reform Act of 1969	18	10.9	N/A	N/A	14.4	N/A
Revenue Act of 1971	-19.1	-28.3	N/A	N/A	-23.7	N/A
Tax Reduction Act of 1975	-31.8	1.2	N/A	N/A	-15.3	N/A
Tax Reform Act of 1976	-47	-34.5	-19.5	N/A	-40.7	N/A
Tax Reduction and Simplification Act of 1977	-51.5	-37.3	-14.9	N/A	-44.4	N/A
Revenue Act of 1978	-30.4	-56.5	-62.6	-68.7	-43.5	-54.6
Crude Oil Windfall Profit Tax Act of 1980	28.8	37.2	35.1	36.4	33	34.4
Economic Recovery Tax Act of 1981	-79.5	-179.4	-259.3	-314.9	-129.4	-208.3
Tax Equity and Fiscal Responsibility Act of 1982	34.4	72.4	76.1	89.8	53.4	68.2
Social Security Amendments of 1983	11.9	16.2	16.3	19.2	14	15.9
Deficit Reduction Act of 1984	17.4	28.5	37.2	40.7	22.9	30.9
Tax Reform Act of 1986	32.7	1.5	-19.2	-14.3	17.1	0.2
Omnibus Budget Reconciliation Act of 1987	15.6	23.6	25.9	24.1	19.6	22.3
Omnibus Budget Reconciliation Act of 1990	35.2	51.1	44.9	49.6	43.1	45.2
Omnibus Budget Reconciliation Act of 1993	34	61.7	69.5	84.6	47.8	62.4
Tax Relief Act of 1997	-12.3	-4.9	-23.5	-25.8	-8.6	-16.7
Economic Growth and Tax Relief Reconciliation Act of 2001	-93.7	-42.8	-104.6	-125	-68.3	-91.5
Job Creation and Worker Assistance Act of 2002	-53.5	-57	-33.4	4.5	-55.3	-34.9
Jobs and Growth Tax Relief Reconciliation Act of 2003	-65.7	-166.9	-94.1	-10.6	-116.3	-84.3
Working Familes Tax Relief Act of 2004	-32.1	-46.7	-23.2	-17.5	-39.4	-29.9
Tax Increase Prevention and Reconciliation Act of 2005 (enacted in 2006)	-12	-38.8	-5.1	-41.4	-25.4	-24.3
Economic Stimulus Act of 2008	-119.4	-47.9	14.6	9.1	-83.6	-35.9
Bank Bailout Bill of 2008	-105.4	-2.5	-3.1	-0.8	-53.9	-27.9
American Recovery and Reinvestment Tax Act of 2009	-88.9	-198.5	-41.6	6.7	-143.7	-80.6
Patient Protection and Affordable Health Care Act of 2010	8.4	12.2	30.1	75.5	10.3	31.5
Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010	-420.2	-345.6	-88.1	12.9	-382.9	-210.2
American Taxpayer Relief Act of 2012 (enacted in 2013)	-279.7	-331.6	-319.7	-351.6	-305.7	-320.6

Sources: Office of Tax Analysis, Allianz, Euler Hermes

The TCJA mainly deals with tax cuts and reduction of tax loopholes, which aim at simplifying the US tax system (see the details in Table 2).

Besides the size of the stimulus, the composition and targets of the "Tax Cuts and Jobs Act" point toward limited impact on growth.

In order to calculate the impact of the US fiscal reform on US GDP growth, we adopt a differentiated approach of multipliers by categories of agents and by categories of measures.

Table 2 What is TCJA about?

Comparing Current Law and "Tax Cuts and Jobs Act"										
	Current Law					Tax Cuts and Jobs Act (Conference Committee)				
	Taxable Income (USD)					Taxable Income (USD)				
	Single Filers		Married Coupled Filling Joint		Tax rate	Single Filers		Married Coupled Filling Joint		Tax rate
	Over	But not over	Over	But not over	%	Over	But not over	Over	But not over	%
Individual tax rates	0	9525	0	19050	10	0	9525	0	19050	10
	9525	38700	19050	77400	15	9525	38700	19050	77400	12
	38700	93700	77400	156150	25	38700	93700	77400	156150	22
	93700	195450	156150	237950	28	93700	195450	156150	237950	24
	195450	424950	237950	424950	33	195450	424950	237950	424950	32
	424950	426700	424950	480050	35	424950	426700	424950	480050	35
	426700	and over	480050	and over	39.6	426700	and over	480050	and over	37
Individual alternative minimum tax	AMT exemptions equal to USD55400 (single), USD86200 (joint); Phases out above USD123100(single), USD164100 (joint)					AMT exemptions equal to USD70300 (single), USD109400 (joint); Phases out above USD500000 (single), USD1000000 (joint); Individual AMT changes sunset after 2025				
Standard deduction	USD 6500 (single), USD13000 (joint), USD9550 (head of household); indexed for inflation					USD 12000 (single), USD24000 (joint), USD18000 (head of household); indexed for inflation; sunsets after 2025				
Personal and dependent exemptions	USD 4150; Indexed for inflation					Repealed; Sunsets after 2025				
Child tax credit	Credit equal to USD 1000 per qualifying child under 17; Phases out above USD 75000 (single), USD 110000 (joint); Refundable portion equals 15% of earnings in excess of USD 3000					Credit equal to USD 2000 per qualifying child under 17, USD 500 for other dependents; Phases out beginning at USD 400000 for joint filers; Refundable portion equals 15% of earnings in excess of USD 2500 up to USD 1400 per qualifying child; Maximu refundable portion indexed for inflation; Requires Social Security number to claim nonrefundable and refundable portion of USDD 2000 child credit; Sunsets after 2025				
Higher education	American Opportunity Tax Credit; Lifetime Learnings Credit; Tuition and Fees Deduction (expired after 2016); Student Loan Interest Deduction					Unchanged				
State and local tax itemized deduction	Real estate, personal property, and either income or sales taxes are deductible; Applicable to principal and one other residence					Real estate, personal property, and either income or sales taxes up to USD 10000 (single and joint filers) are deductible; Sunsets after 2025				
Mortgage interest itemized deduction	Interest payments on up to USD 1,1 million of debt (including USD 100000 of home equity debt) are deductible); Applicable to principal and one other residence					Interest payments on up to USD 750000 of new acquisition debt are deductible; Applicable to principal and one other residence; Sunsets after 2025				
Medical expense itelized deduction	Out-of-pocket medical expenses in excess of 10% of AGI are deductible					Out-of-pocket medical expenses in excess of 7,5% of AGI are deductible in 2017 and 2018; Reverts to current law in 2019				
Overall limit on itemized deductions	Itemized deduction phases out starting at AGI of USD 266700 (single), USD320000 (joint); Amounts indexed for inflation					Repealed; Sunsets after 2025				
Top capital gains tax rate	23,8% (20% plus 3,8% Net Investment Income Tax)					Unchanged				
Inflation index	Consumer Price Index (CPI)					Chain-weighted consumer price index (C-CPI)				
Income from pass-through business	Taxed at ordinary income rates (maximum rate of 39,6%)					Provides 20% deduction (maximum rate of 29,6%); Deduction limited above USD 157500 (single), USD 315000 (joint) for personal service income and based on compensation paid or investment property; Sunsets after 2025;				
Top corporate income tax rate	35%					21%				
Corporate alternative minimum tax	Yes					Repealed				
New investment purchases	2018: 40% "bonus" depreciation for qualified property; 2019: 30% "bonus" depreciation for qualified property; 2020: 20% "bonus" depreciation for qualified property; Small business (section 179) expensing up to USD 500000					100% "bonus" depreciation for qualified property; Phases down from 100% by 20% per year starting in 2023; Small business (section 179) expensing up to USD 1000000				
Business interest deduction	Fully deductible (generally)					Disallowed for net interest in excess of 30% of business inome (excluding depreciation after 2022); Exemption for business with gross receipts of USD 25 millions or less				
Taxation of US multinational companies	Worlwide system with deferral and foreign tax credit					Modified territorial system with base erosion provisions; "anti-abuse" tax on certain payments to foreign corporations; one-time tax on unrepatriated foreign earnings at 8% (15,5% for liquid assets)				
Estate tax	Top rate of 40% on estates above USD 5,6 millions; USD 11,2 millions (couples); Amounts indexed for inflation					Top rate of 40% on estates above USD 11,2 millions; USD 22,4 millions (couples); Amounts indexed for inflation; Sunsets after 2025				
ACA individual mandate penalty	Individuals without adequate health insurance coverage must pay a tax penalty or claim a coverage exemption					Repealed				

Sources: Tax Policy Center, Allianz, Euler Hermes

CBO research has provided a low and high estimate of different categories of multipliers. We adopt a middle range in order to get a reasonable estimate of the total multiplier impact.

We therefore assume an average multiplier of 0.9 for tax cuts benefitting to lower income households and a multiplier of 0.35 for higher income households. Regarding tax cuts on profits, the average estimated size of the multiplier reaches 0.2.

These types of multipliers are somewhat lower compared with other types of stimulus measures such as infrastructure spending or direct purchase of goods and services by the government with estimated values of 1.3 and 1.5 respectively.

Individuals of the lower income group, that we define as those perceiving less than USD 100K per year, will benefit from USD39.2bn of cuts in income taxes in 2019 (28% of total individual tax cuts), while those winning more than USD 100K will benefit from the bulk of the tax cuts (72% representing USD102.8bn).

Households in the highest categories of revenues have a lower propensity to spend when observing a rise of their disposable income. Applying the CBO's multiplier to those tax cuts sharing by income categories and assuming that the effects take place within one year, we obtain an impulse of 0.4 pp on GDP growth in 2018 and 0.3 pp in 2019. On the business side, we can estimate that USD112bn of tax cuts will occur in 2018 and USD118bn in 2019. By applying a multiplier of 0.2 we obtain an impact amounting 0.1 pp of domestic aggregate demand in both 2018 and 2019.

In total, cumulating the impact of individual tax cuts and corporate tax cuts, we reach a positive outcome representing a boost of 0.5% of GDP in 2018 and 0.4% of GDP in 2019.

Table 3 Near-term output increase associated with tax cuts

Policy	Tax cuts in 2018 USD bn	Tax cuts in 2019 USD bn	Multiplier	Impact in 2018 as % of GDP	Impact in 2019 as % of GDP
Net cuts individual taxes					
Lower- and Middle-Income Groups	39.2	35.1	0.9	0.18	0.16
Higher-Income Groups	102.8	91.9	0.35	0.18	0.16
Corporate tax provisions	112	118	0.2	0.11	0.12
Total	254	245		0.5	0.4

Sources: CBO, Allianz, Euler Hermes

Photo by Luke Stackpoole on Unsplash

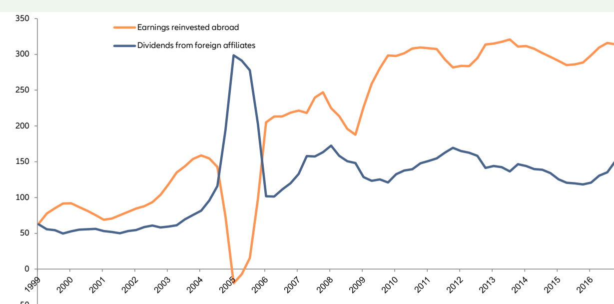
Ghost of the Past: President Trump's fiscal reform produces a sense of déjà vu when compared with President Reagan's Economic Recovery Tax Act of 1981 and the Tax Reform Act of 1986

The net increase of public debt should reach a level of USD 1 trillion over ten years as dynamic effects on growth are generally estimated at USD 400bn, less than offsetting the USD 1.4 trillion of losses in terms of fiscal revenues. In fact, this expected surge in public debt is a common feature with Reagan's era as it increased from 31% of GDP to 51% of GDP between 1980 and 1988 following the implementation of different tax cut programs. President Reagan proposed two series of tax cuts: the Economic Recovery Tax Act of 1981 (Enacted reduction in marginal income tax rates by 25% over 3 years, with the top rate falling from 70% to 50% and the bottom rate dropping from 14% to 11%, reduced maximum capital gains to 20%, trimmed taxes paid by corporations by USD150bn over a five year period) and the Tax Reform Act of 1986 (Top individual tax rate was reduced to 28.5% from 50%, increased home mortgage deductions, reduced tax loopholes). President Reagan slightly increased public expenditure, notably defense spending, from 29% of GDP to 31% of GDP between 1980 and 1988. However, the double dip recession of 1982 had eroded fiscal revenues and required some support in terms of public expenditures. As a result, public debt ballooned, inciting the Congress to push for tax hikes in order to restore its sustainability. The Tax Equity and Fiscal Responsibility Act (TEFRA), then significantly counterbalanced the tax cuts decided in 1981 with the ERTA. President Reagan raised taxes 11 times over the course of his presidency thereafter.

November 2018 mid-term elections could be a turning point for fiscal policy

As a symbol of a lack of confidence in winning the next Mid-Term Elections, and gradual division among Republicans, the House Speaker Paul Ryan announced on April 11th, 2018 that he would retire from January 2019. This announcement is first of all an obstacle to the current campaign of fund raising as he is a prominent figure of the GOP counterbalancing the image of President Trump. It brings to 38 the number of Republicans not seeking re-election, embodying a form of discouragement in the Republican side. It is now estimated that Democrats have a chance to win back the House (they need 23 seats). The current rate of approval of President Trump is currently significantly lower compared with all prior US Presidents. At last, the Republican Chairman of the Senate Judiciary Committee proposed a bill to protect Special Counsel Robert Mueller from being dismissed after President Trump's communication suggested that this possibility was real. A growing division is clearly visible meaning that fiscal hawks, those advocating for prioritizing the stabilization of public debt, could re-take the lead after November 2018. Similarly with President Reagan's era, in the case of no rapid success of the fiscal policy in boosting growth, the current US President could be pushed to backpedal in order to stabilize debt.

Chart 1 Repatriated earnings rose sharply during the HIA tax holiday



Sources: CBO, Allianz, Euler Hermes

Earnings repatriation suggests small boon for investment

Above calculations of the multiplier takes into account repatriated foreign profits flowing into investment. One of the highlights of President Trump's tax plan is the reform of taxation of income perceived by foreign affiliates of US companies. As it stands the US taxes foreign corporate income at a rate of 35% if/when earnings are repatriated. The latest iteration of President Trump's tax plan has two key features: (i) foreign income would be subject to a 0% territorial regime with a minimum rate for intangible income and (ii) a one-time tax on untaxed foreign profits of 15.5% for assets held in cash and liquid assets and 8% for the rest. With respect to growth, estimating how much of these earnings will be distributed in the form of dividends versus being re-invested is key.

Ghost of the past: The 2004 Homeland Investment Act (HIA) which revised section 965 of the internal revenue code (IRC) such that US corporations with foreign subsidiaries could bring overseas profits at a reduced tax rate of 5.25%.

In the immediate aftermath of the HIA, US corporations repatriated 25% of their total estimated overseas earning or USD300bn in 2005 alone, up from USD82bn in 2004 (see figure 1). Researchers have shown that this tax holiday did not result in increased domestic investment, employment or R&D. Instead, a $1 increase in repatriations was associated with nearly as much an increase in payouts to shareholders. According to analysts, S&P 500 companies account for USD2.5 of USD2.9 trillion in earnings reinvested overseas including USD920bn is in the form of cash. Assuming firms fund their tax burden from overseas cash that leaves USD652bn dollars available. Assuming that the magnitude of tax repatriation is the same as in the wake of the HIA, S&P 500 firms could repatriate (net of taxes) as much as USD163bn in 2018 with the rest remaining overseas to fund international operations.

Table 4 Scenario analysis of Repatriated US earnings

S&P 500 overseas holdings	$ USD	Tax Rate	Tax Paid	Post-tax Value
Total Permanently reinvested earnings	$2.5 trillion			
Untaxed earnings	$1.6 trillion	7.5%	$118 trillon	
Untaxed cash	$920 billion	14.5%	$133 billion	
Cash Available for repatriation	$920 billion		$251 billion	$668 billion
2018 Repatriation estimate (assuming 25% HIA share)				**$167 billion**
Share for investment				
Low Range: 80% buybacks (post HIA levels)				~$ 33 billion
Central Scenario: 50/50 split w ith shareholder				~$ 84 billion
High Range: 60% investment (recent trend)				~$ 100 billion

Sources: Allianz, Euler Hermes

US corporates which repatriate foreign earnings will have the choice of returning it to shareholders via (i) share buybacks and dividends or (ii) investing for growth in the form of capital expenditure, research and development and cash backed merger and acquisitions. Based on history, we could assume that 80% of the USD167bn will fund share buybacks and dividends, the other USD 33bn remaining could be used for investment. Nevertheless, US companies have already announced USD 151bn of share buybacks YTD (more than doubling the level of 2017 at this stage) with the prospect that this amount will exceed total 2017 level by far (USD 800bn expected compared with USD530bn in 2017). That's why we can reasonably estimate that the general impact on investment will finally be negligible.

Bi-partisan budget and Omnibus bill: USD430bn of additional spending over two years but 2000bn of additional debt

The "Bipartisan Budget Act of 2018" budget deal that finally emanated from the negotiations on February 9, 2018 and the subsequent adoption of the Omnibus Bill on March 23, 2018 have the following elements:

- It once again lifts the Budget Control Act's spending caps , increasing them by about USD320bn over the next two years and devoting about 55 percent of that increase to defence spending,
- Democrats also obtained an increase in natural disaster spending, as the package contains USD84bn in disaster relief for communities affected by recent hurricanes and wildfires.
- It retroactively extends a number of tax provisions, none of them particularly significant, which had expired at the beginning of 2018 for a total cost to Treasury of USD17bn.
- The legislation suspends the debt ceiling until March 2019.
- Last, the recently voted Omnibus spending bill which determines discretionary spending levels of programs funded by the federal government, added USD 110bn above these caps.

Overall, it is estimated that the package will add another USD 430bn to federal budget deficits over the next two years.

From a macroeconomic perspective, the most important aspect is the boost to demand coming from the lifting of budget caps for defence and non-defence spending.

With regard to the effects of the decided increases in public sector expenditure on economic activity, it should be noted first of all that the expenditure increases authorized by the budget for the next two years will be spent over a longer period of time. In fact, the corresponding estimates of the Congressional Budget Office for outlays show that by the end of the fiscal year 2019 only a good 2/3 of the budgeted authority will be spent and the remainder will be expended in successively reduced amounts by the fiscal year 2023. A similar pattern, but over a 10-year horizon, is evident in the spending of disaster relief.

The second and probably more difficult aspect is the magnitude of government spending multiplier, taking account of the fact that the US economy is in a mature stage of the business cycle. Empirical studies commonly suggest that fiscal multipliers are lower if the economy is close to or above its potential output than when there is a large negative output gap. The effectiveness of additional public spending is limited in times of high overall economic capacity utilization as it crowds out private demand, in part because the central bank is reacting to rising demand pressure. Concretely, a CBO study finds that a dollar increase

(decrease) in demand will have effects over eight quarters, instead of four in a situation when output is below potential. Importantly, the cumulative effect on GDP over eight quarters is clearly below 1, ranging from 0.2 ("low estimate") to 0.8 ("high estimate"), because output in quarters five through eight moves in in the opposite direction of its initial path. Using the low estimate value of the CBO's multiplier estimate and making the simplifying assumption that USD 130 bn of the additional outlays are spent in 2018 and USD 300 bn in 2019, we have attempted to determine the impact on aggregate demand over time.

All in all, GDP growth is expected to increase by around 0.2 percentage points in 2018 and by 0.2 in 2019 as a result of the higher fiscal spending.

Ghost of the past: Debt to markedly increase amid partisanship, low growth and low inflation

As a result of lower fiscal revenues, higher public spending and a muted reaction of activity to these different impulses, we expect the US deficit to reach 4.5% of GDP at the horizon of 2019 compared with 3.4% of GDP in 2017. Between October 2017 and March 2018, the US deficit has already reached USD599.7bn, representing a 14% increase compared with the same period last year. The CBO expects the level of public debt held by the public to reach 100% of GDP approaching 2030 if the current law is maintained until this time.

The drawbacks of partisanship

The recent budget deal in Congress quite clearly documents how overcoming a partisan standoff eventually contributes to piling up public debt. Since fiscal year 2017 ended last September, the federal government has been operating under a series of continuing resolutions to fund the government. Negotiations have been complicated as – in addition to issues related to immigration policy – Republicans, in particular, desired a large increase in defense spending without the commensurate increase in nondefense spending. Partisan discussions on immigration issues blocked the voting of a continuing resolution (temporary fix of public finances) on budget in the US Congress.

As a result, a government shutdown (closure of non-essential federal offices) took place from January 20, 2018, and then was temporary fixed until February 8, 2018. A government shutdown, observed several times in the past, represents a negative shock to annualized quarterly real GDP growth of 0.1-0.15 %-point per week.

Partisanship has reached a record high level during first year of Donald Trump's Presidency. In order to overcome these difficulties, many concessions have been done in terms of tax cuts and increase of public spending to satisfy the Republican and Democratic side. Yet the IMF has demonstrated a positive relation between political fragmentation and the level of public debt.

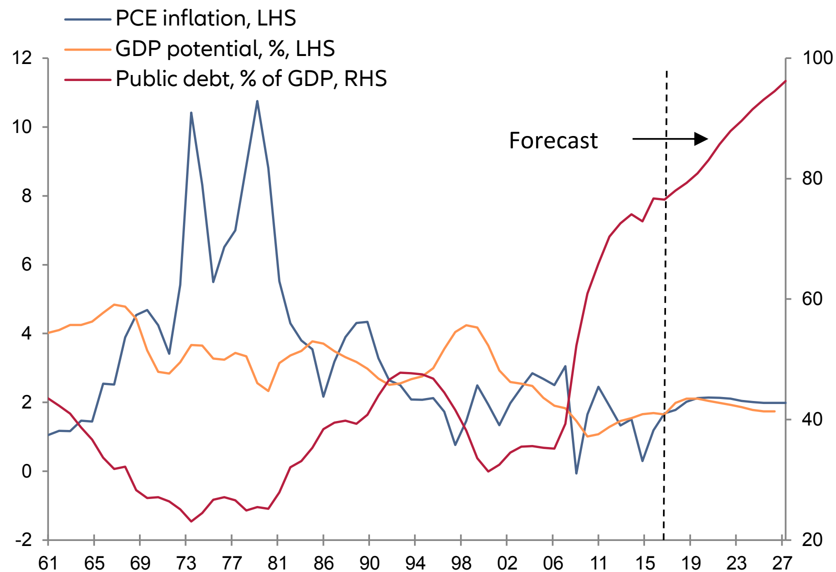
Typically, countries with highly partisan political systems (Japan, Greece, Spain, Italy, France, US) have higher public debt compared with countries capable of bipartisanship in public affairs via a tradition of broad coalition governments (Germany, Netherlands, Finland, Sweden, Denmark).

Table 5 Impact of US fiscal initiatives (pp)

	2018	2019
US GDP estimate prior to policy announcement	2.2	1.9
Estimated impact of TCJA	0.50	0.40
Upward revision due to Bipartisan Budget Act (BBA) of 2018	0.20	0.20
Total TCJA & BBA	**0.70**	**0.60**
Impact protectionism		**-0.10**
Revised GDP forecast	**2.90**	**2.40**

Sources: Allianz, Euler Hermes

Chart 2 US public debt outstanding and CPI inflation



Sources: CBO, Euler Hermes, Allianz research

A regime of lower growth and lower inflation

By implementing a pro-cyclical policy in a context of already tight labor market conditions, one could assume that the implicit goal of the US government consists of reaching a higher level of inflation and a higher level of growth. Historically, generating higher inflation has represented an indirect albeit disorderly way to reduce the level of debt expressed as a % of GDP as it boosts fiscal revenues via higher tax income revenues if a wage – inflation loop is at work. In the present environment however, even with fiscal expansion, it is unlikely that a regime of higher inflation will emerge. In modern economies, characterized by independent central banks, the materialization of higher inflation in a late phase of the cycle usually triggers a tightening of the monetary policy. In the current context, where inflation remains under control, and where the new FOMC aims at consolidating its credibility, the normalization in rates policy is likely to be gradual, probably contributing to prolong the current upswing. Indeed, we estimate that US wage acceleration should be limited with a range of 3% y/y – 3.5% y/y in 2018 and expect a muted reaction of prices to salaries

(CPI inflation at 2.3% y/y in 2018 and 2.4% y/y in 2019). The same is true for the regime of growth. Tax cuts will have positive effects on supply. However, the impact of the tax cuts on the US potential of growth is expected to be positive albeit being limited. Indeed, we evolve now in a regime of low productivity growth and the demographic dynamism has been significantly impaired

(productivity and growth of active population are the main determinants of the potential of growth of an economy).

These significant differences, compared with past administrations having similar fiscal initiatives, are visible in the Table 6. In this radically different environment, marked by a lower potential of growth and a regime of lower inflation, there is a higher probability to observe a rapid increase of public debt (Figure 2).

Conclusion

(1) The growth and inflation impact of fiscal expansion will be quite moderate, hopes for extended self-financing of fiscal expansion will be disappointed, debt will rise (as was observed in former fiscal expansions). The corporate tax cuts besides the holiday on repatriated profits will have positive supply side effects, albeit moderate and temporary ones.

(2) Despite strong fiscal expansion, the US economy will not enter an inflationary boom in 2018 and 2019 and the Fed can remain gradual in its tightening approach. Growth will be dampened beginning in 2019 and thereafter as post mid-term election measures are likely to reign in high public borrowing.

(3) Financial markets will not have to correct the basic view that inflation and interest rates will remain relatively low. The analysis of fiscal policy is compatible with our baseline scenario. Although volatility will rise for various reasons in the late stage of the cycle, we do not expect interest rate shocks as a result of massive overheating.

Thomas Hofmann, Alexis Garatti

NORTH AMERICA
CRACKS OF DRYING LIQUIDITY

A few segments of the US economy show some signs of fragility amid higher rates

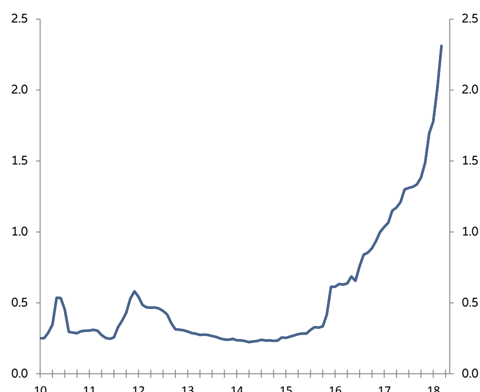
A significant increase of the Libor rate

The recent announcements made by the White House on trade protectionism have triggered a sudden surge in the level of uncertainty, harshly penalizing equity markets and increasing the demand for safe haven assets. As a result of this, US long-term interest rates have markedly declined over the last month from 1.9% to 1.8%. In the opposite way, and despite rising uncertainties, US short-term interest rates have continued increasing, in particular the LIBOR rate, which today reaches 2.35%. This trend reflects above all the confidence of the market in the Fed's capacity to continue its monetary policy normalization with a gradual increase of official rates. We still expect two more hikes in 2018.

More worryingly, the LIBOR – OIS spread currently reveals increasing difficulties of banks in accessing short-term liquidities on the money market. During the subprime crisis, this indicator played the role of a bell-weather on the health of US banks as sudden reversal of confidence in any financial conditions could lead to a market freezing, with strongly negative impacts on banks' credit conditions and on the real side of the economy. Today, this indicator has lost of its relevancy because of regulatory changes, which have transformed the way money market funds interact with banks. Despite this new element, the widening of the LIBOR – OIS spread still contains some information in terms of liquidity conditions, as evidenced by our proprietary indicator of excess supply of money.

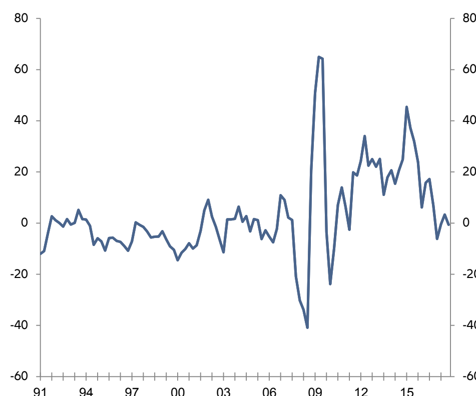
In order to identify the impact of the Fed's tightening policy (progressive increase of official rates and reduction of the Fed's balance sheet), we estimate a theoretical money de mand based on M0 and quantity theory of money, i.e. we calculate a theoretical M0 (transactional money demand), which is determined by the relation MV = PT with M corresponding to M0, V indicating the velocity of M0, P the level of prices and T the level of transactions or nominal GDP. We study this relation in variation and compare the observed evolution of M0 and the theoretical one justified by activity and speed of money circulation. To this regard, it appears that we are currently at an interesting juncture, where the excess of liquidity is now close to 0 after long years of money excess supply, during which debt and therefore investment financing were particularly cheap. Our indicators therefore points toward an end of the cheap money, which could have a significant impact on the real side of the company, for those economic actors which rely the most on debt.

Chart 1 Libor rate



Sources: Bloomberg, BLS, Euler Hermes, Allianz

Chart2 US excess liquidity (based on M0)



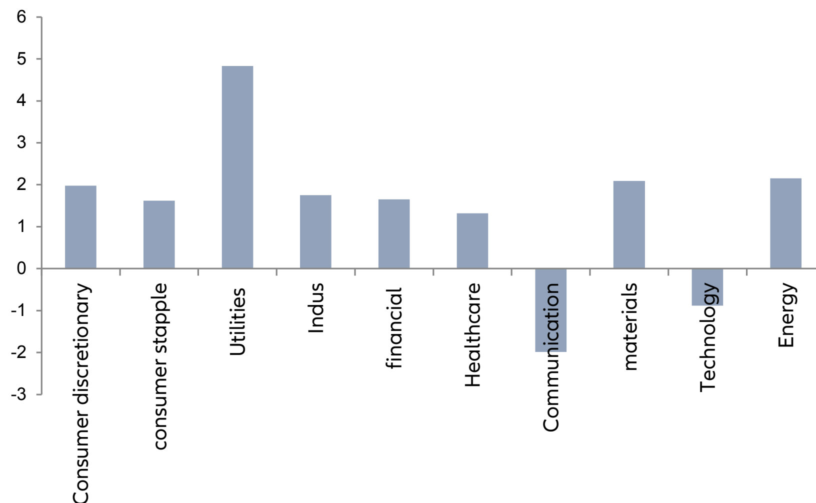
Sources: Sources: Bloomberg, BLS, Euler Hermes, Allianz

Photo by Glen McC on Unsplash

The high yield sector is probably one of the most exposed segments of the US economy to an interest rate shocks as it benefitted from exceptionally advantageous interest rate conditions. On the basis of a bottom up process using financial data from companies listed in the S&P500, we can have a view on the relative level of leverage of sectors calculated as the ratio of net debt to ebitda. To this regard, the utilities sector is the most leveraged, followed by materials and energy, confirming the existence of high indebtedness in sectors which are relatively more capital intensive.

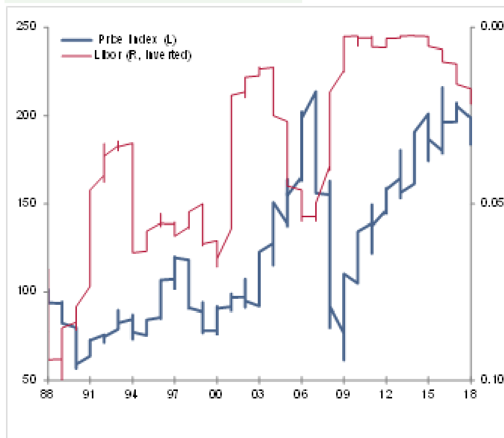
We study the sensitiveness of CDS spreads by sector to LIBOR rates and find that indeed a context of higher rates leads to an increase of the probability of default in only two sectors, i.e. consumer discretionary and utilities, while energy sector is likely to suffer as well. Our data basis confirms than energy and retail registered the highest number of major insolvencies (with services, which is a collection of disparate activities), respectively 5 and 16 in 2017.

Chart3 US S&P 500 net debt to ebitda



Sources: Bloomberg, Euler Hermes, Allianz

Chart 4 LIBOR vs. REIT Prices



Sources: Bloomberg, Euler Hermes, Allianz

REIT prices falling

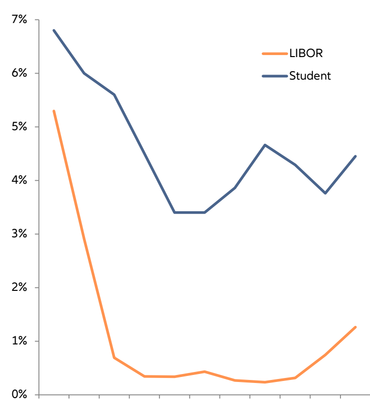
Because of their exposure to retail activities and their sensitiveness to rates, REITs (Real Estate Investment Trusts) could be exposed to interest rate shocks. They are similar to mutual funds although they invest primarily in commercial real estate. REITs yield an income stream from the rents on the properties. This income stream, which is paid in the form of a dividend, is highly correlated with LIBOR. Dividends tend to rise as LIBOR rises. Over the past six months, LIBOR has risen by approximately +80 basis points (0.8%) while REIT prices have fallen -6.2%. The market value of all REITs is approximately $1T, whereas the market value of the S&P 500 index is approximately $25T.

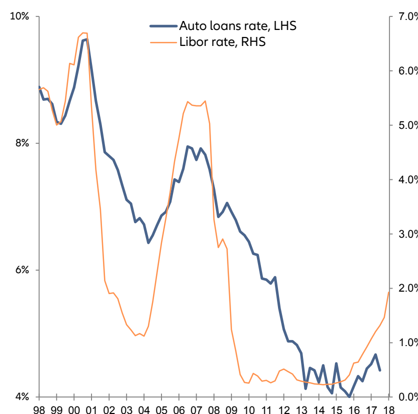
Delinquencies on Consumer Debt Rising

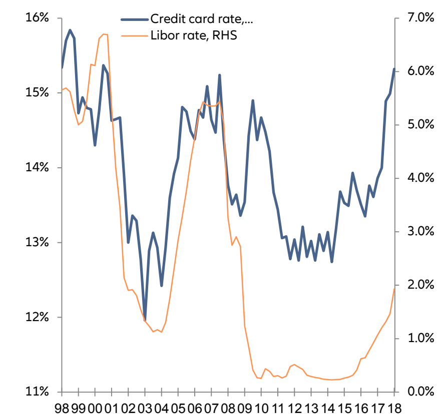
Student, auto and credit card debt

Consumer debt has been growing at an average rate of 4.4% y/y since 2003, outpacing nominal GDP growth of about 4.0% y/y over the same period. This faster growth rate implies that the economy is now somewhat more exposed to consumer debt than before. Credit card debt has grown on average 1.3% y/y since 2003, auto loans have grown 4.0% annually, but student loan debt has soared at an annual rate of 12.9% from $0.25T to $1.4T in just 14 years. More to the point, despite the fact that the outstanding debts are similar in magnitude to student debt, the delinquency rate is something completely different. Chart 5 a, b, c shows the amount of debt outstanding which is delinquent by 30 days. Clearly student debt is by far the worst performer with an 8% delinquency rate, resulting in $106B of delinquent debt outstanding. The credit card debt delinquency rate is only 2.5%, although it is worth noting that the amount of delinquent debt has risen sharply over the past four years from $16B to $20B. Auto loans have a delinquency rate of only 1%, but again have almost doubled in four years from $10B to $18B. And while delinquencies are increasing in all three categories of consumer debt, they are all exposed to variations in short-term interest rates as well. Credit card rates are perhaps the most sensitive to LIBOR. And as LIBOR has risen around 0.85% over the past year, credit card rates have used the excuse to skyrocket about 1.5% to almost 15.5%.

Chart 5 a, b, c: Consumer rates and LIBOR





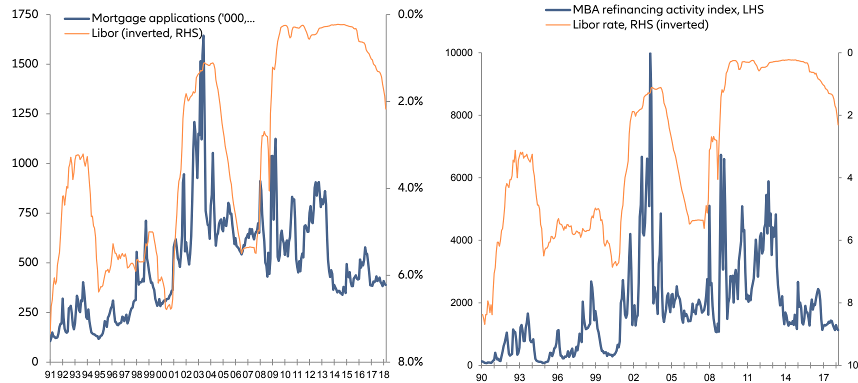


Sources: Bloomberg, Euler Hermes, Allianz

Mortgages

Residential mortgages are by far the largest portion of total consumer debt. Currently there is $12T of consumer, residential mortgage debt outstanding, which is about three quarters of the total $16T in consumer debt outstanding. Mortgage activity is highly sensitive to LIBOR rates as shown in Chart 6; the LIBOR rate is shown inverted demonstrating that when rates go up (the red line goes down), mortgage applications go down. Mortgage refinancings are particularly sensitive to LIBOR variations.

Chart 6 a, b: loans demand and Libor



Sources: Bloomberg, Euler Hermes, Allianz

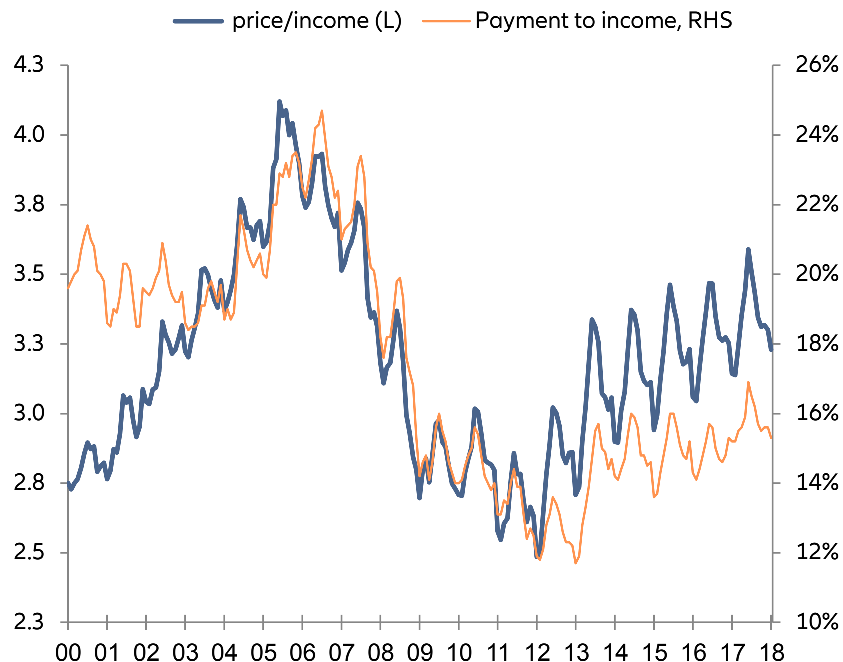
An increase in LIBOR will raise mortgage rates, increasing the monthly payment borrowers must make, effectively shutting some borrowers out of the market. The median price of an existing home over the last year was approximately $250,000. An increase in the 30 year fixed rate from 4% to 5% would increase the monthly payment from $1,194 to $1,342, or a sharp 12.4%. The median price of a new home (the new home market is about one-tenth the size of the existing home market) has been about $325,000. That same increase in the 30 year fixed rate from 4% to 5% would increase the monthly payment from $1,552 to $1,745, again a sharp 12.4% increase. Clearly monthly mortgage payments are very sensitive to movements in the 30 year fixed rate, which is highly correlated to LIBOR. Rising LIBOR rates will have a significant negative impact on the mortgage market.

In addition to rising rates, there are other signs of stress in the mortgage market as well. First, median home prices have been rising much faster than median incomes as shown by the tan line in chart 7. In fact since 2012 the price of a median existing home has risen at an average annual rate of 7.7%, whereas the median family income has risen at less than half that rate, 3.1%. Prices have been driven up by a lack of homes for sale and a strong job market.

As a result, buyers are having to stretch for houses, and their monthly payment as a percentage of their income is rising sharply as well. And while the payment/income ratio has risen from about 2.5 to 3.5, that ratio will continue to go up with rising interest rates; the data shown here only goes through January and does not reflect the rapid rise in LIBOR since then.

This lack of affordability has caused participants in the mortgage market to lower standards to make it easier for potential buyers to get a mortgage. While the goal of making housing more accessible may be a virtuous one, it does create increased risks in the mortgage market.

Chart 7 Declining affordability



Sources: Bloomberg, Euler Hermes, Allianz

For example, the two largest participants in the mortgage market, the government sponsored entities (GSEs) Fannie Mae and Freddy Mac recently raised the allowable debt-to-income ratio from 45% to 50%. The result according to CoreLogic is that around 20% of mortgages recently issued had debt-to-income ratios greater than 45%, three times as much as in 2016 and early 2017. And the Urban Institute reports that the share of mortgages which had both higher debt-to-income ratios and lower credit scores rose from 19% a year ago to 25% in the first two months of this year.

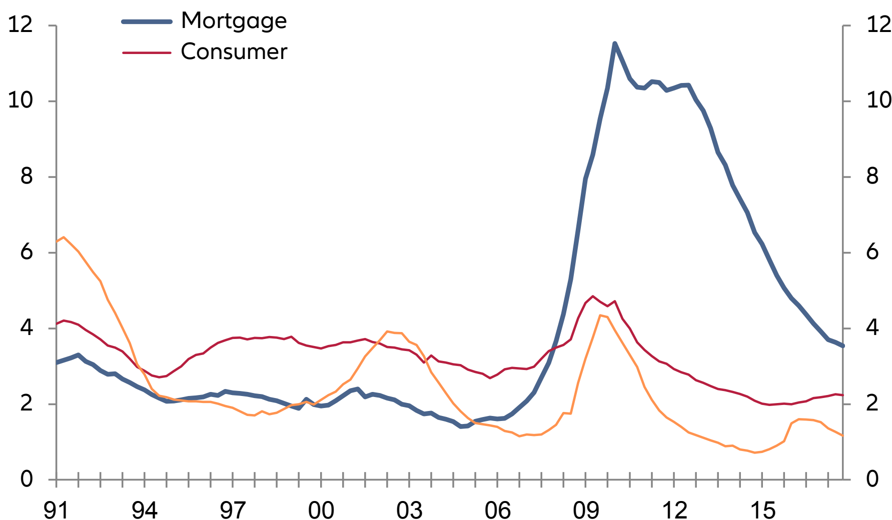
Other risky practices are emerging. Fannie and Freddie are now backing lenders who will help pay a borrowing student, and guaranteeing loans with down payments as low as 3% - the standard used to be 20%. And one of the most dangerous products which sparked the housing meltdown of the 2000s, sub-prime loans, has returned with a new name: non-prime loans.

These loans are being made by "non-bank" lenders who are in fact getting their funds from the largest U.S. banks such as Wells Fargo, Citigroup, and virtually all of the other major banks who needed to be bailed out from the risks of this very type of loan in the 2000s. Loans to non-bank firms are now among the largest items on some banks' balance sheets. Remarkably some of these loans are being made on very poor risks with histories of foreclosures, bankruptcies, bad payment, and credit scores as low as 500. And they are being issued in amounts of up to $1.5 million, including cash outs of $500 million. Disturbingly, for the first time in 30 years, the majority of mortgage loans in dollars are being made by non-bank lenders.

Clearly, demand in the mortgage markets is very high, and lenders are taking on imprudent levels of risk just ten years after the mortgage meltdown of the 2000s. With the higher risks on outstanding mortgages, an increase in mortgage rates based on LIBOR could put a significant strain on the market. As rates rise, fewer potential borrowers will qualify for mortgages, but lenders seem likely to keep lowering standards. Adjustable Rate Mortgages (ARMs) could see a significant, even damaging, increase in defaults. The era of improving credit quality seems to be over in the US.

Dan North, Alexis Garatti

Chart 9 US delinquency rates (%)



Sources: Euler Hermes, Allianz Research

WESTERN EUROPE BELGIAN CORPORATES FLEX THEIR MUSCLES

Fast growing turnovers coupled with high margins and strong cash buffers would help Belgian indebted corporates withstand the rise of interest rates once the ECB start to tighten its monetary policy in 2019

Stars remain aligned for Belgian corporates in 2018

Strongest export gains in 6 years in 2017 (EUR21bn) have boosted turnover growth in the manufacturing sector (+9.9%), registering the highest growth in the Eurozone. High margins supported by past reforms (freeze of wage indexation, lower social contributions) coupled with high equity, low financing costs and high business confidence have allowed to close the investment gap compared to the crisis much ahead peers. However, over the past years corporate debt increased more than in the Eurozone as a whole. Fortunately, companies continue to enjoy strong cash buffers and high margins which will help them withstand the rise of interest rates after the ECB starts to tighten the monetary policy from H2 2019. But vulnerability stands above the Eurozone average.

Strong export growth in 2018, for the third consecutive year

GDP increased by +1.7% in 2017, the highest level in 6 years and growth should accelerate to +1.8% in 2018. Private consumption has been the strongest contributor to GDP growth (+0.6pp), albeit registering a slower growth (+1.1% vs +1.7% in 2016). Real export growth has been strong (+4.5% in real terms after +7.5% in 2016), while export gains reached EUR21bn, the highest level since 2011. The Belgian trade balance is the 5th highest in the Eurozone and SMEs make 50% of the total exported amount. In total, 10% of the total Belgian companies export, almost as much as in Germany (13%). A sound performance of the Eurozone economy (+2.3% of growth in 2018), accelerating activity in the US (+2.9%) and a well-managed soft landing in China (+6.5%) should support Belgian export growth in 2018 (+3.0% in real terms). We expect export gains to reach EUR25bn in 2018 mainly in the US (EUR5.1bn), Germany (EUR3.5bn), France (EUR2.8bn), China (EUR1.9bn) and the Netherlands (EUR1.4bn). The sectors expected to drive this export performance are expected to be: chemicals (EUR7.2bn), automotive (EUR2.5bn), agri-food (EUR2.3bn), machinery and equipment (EUR1.8bn) and energy (EUR1.5bn).

Five key drivers for corporate investment growth: strong turnover growth, high margins, high equity ratios, low financing costs and high business confidence

The corporate investment gap has closed since 2014, much ahead of the other Eurozone countries and fixed investment in real terms stands +10.5% above the 2007 level.

Belgian companies enjoy high equity which allowed for self-financed investments. Equity in % of total balance sheet stands at around 46% on average (49% for SMEs) which is relatively high compared to France and Italy (32%), Germany (34%) and even Spain (44%).

Furthermore, bank financing costs remain low, supporting the demand for loans (+6% y/y in February 2018).

Thirdly, after four years of contraction, corporate turnover growth in the manufacturing sector (+9.9%) ranked the second highest in the Eurozone in 2017 thanks to the recovery in value of global exports (+9.3%) and improved domestic pricing power.

Furthermore, non-financial corporations' margins continued to strengthen in 2017, reaching their highest level since 2000, at 43.4% of the value added.

The gap with the Eurozone hasn't stopped widening since 2015 as they currently stand +2pp above the Eurozone's average.

Part of the explanation comes from the freeze of the automatic wage indexation launched in 2015 – terminated in 2017, lower employer social contributions (from 30.75% in 2014 to 25% in 2018).

This positive support should continue thanks to the corporate tax reform (from 33% to 29% in 2018 - 20% for SMEs - and to 25% by 2020).

More interestingly, Belgium managed to increase the domestic activity but also exports in sectors with high margins like Chemicals, Pharmaceuticals and Agri-food.

All of this, coupled with positive demand perspectives, strong business confidence (at the highest in 6 years) and high capacity utilization rates (79.2%, above the long-term average) should continue to support business investment growth in 2018 (+2.1%).

image courtesy of igor ovsyannykov pixabay

Moderate downside risks from the corporate debt accumulation thanks to high cash holdings and margins

Non-financial corporate debt has increased by close to +70% since 2007 against a +40% increase in the Eurozone as a whole. In value terms, the increase in non-financial corporate debt stood close to EUR300bn since the start of 2007, around 9% of the total increase in debt in the Eurozone, compared to nearly EUR400bn in Germany.

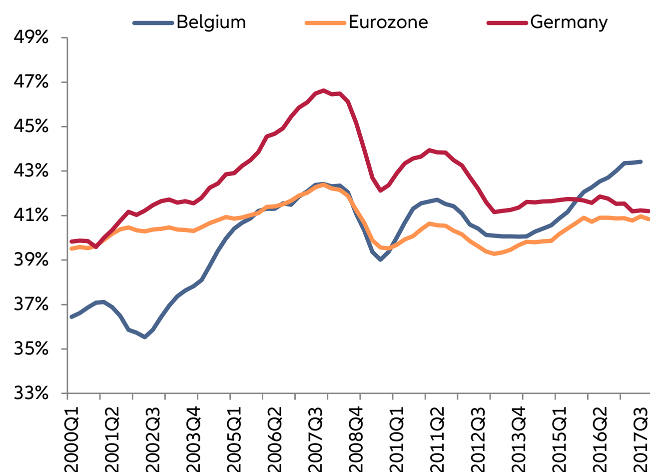
Despite the high level of corporate debt, at 157% of GDP, 3rd highest in the Eurozone after Luxembourg and Ireland, and compared to 102% for the Eurozone as a whole, we see the vulnerability to a rise in interest rates as relatively contained thanks to higher corporate margins and cash buffers (14% of total balance sheet, the 4th highest in the Eurozone after France, Germany and Finland).

We have computed that an increase of +1pp in ECB key interest rates by 2022 would increase corporate bank loan interest rates by +0.9pp to close to +2.5%.

This would bring financing costs back to their 2012-13 levels and would translate into an increase in interest expenditures of close to +6pp of the operating surplus to 16% of the operating surplus (against 22% in France and 15% for the Eurozone as a whole).

Ana Boata

Chart 1: Non-financial corporates margins (% of value added)



Source: Euler Hermes

ASIA ASEAN: SOLID GROWTH BUT NO SMOOTH SAILING

Asean-6 economy is set to grow by 5.0% in 2018. Trade, policies and politics will shape the outlook in the near term

A story of trade, policies and politics

ASEAN-6 economy is expected to grow by a solid +5.0% in 2018 (after +5.1% in 2017). Three themes - trade, policies and politics - will likely shape the outlook in the near term. Firstly, trade related risks are rising with slower economic growth in China and a rising protectionist stance in the US. In that context, countries will have to either rely on their domestic demand or find ways to keep exports growth in-check (through alliances, or improved competitiveness).

Upside risks could stem from: (i) further regional integration (as part of the Belt and Road Initiative, e.g.) or (ii) the entry into force of a mega-trade agreement (Comprehensive and Progressive Agreement for Trans-Pacific Partnership) for the country involved (Singapore, Malaysia, and Vietnam). Secondly, the global environment is getting less supportive on the credit and the financial sides with tighter monetary policy in the US and a rise in commodity prices. Thus, having strong policy buffers (sound public finances, low external debt, e.g.) and credible policies will be key to keep economic growth in check and preserve financial stability. Thirdly, we see pockets of political uncertainties in the region with elections in Malaysia, Indonesia, and continued postponements of elections in Thailand.

Singapore: after the peak

In Singapore, economic growth is set to slow to +2.9% in 2018 after +3.6% in 2017. Exports growth will likely decelerate but remain firm. The economy is not specifically targeted by the US for now but it would be adversely affected by trade frictions between China and the US due to the nature of its growth model (heavily reliant on global trade and global financial flows). Domestic demand shows signs of strength. Private consumption accelerated by +3.1% in 2017 and fundamentals are well oriented. Citizen unemployment rate decreased to 3% in Q4 2017 (from 3.5% in Q1 2017). Investment recovered in Q4 (+2.4% y/y) and a solid business sentiment (manufacturing PMI above 50) points to continued expansion. Fiscal policy is generally supportive with the 2018 budget including measures to boost both private consumption and business investment (active support to employment; extension of the Wage Credit Scheme).

This should help to compensate for a gradual tightening of monetary policy. In April 2016, the Monetary Authority of Singapore flattened the slope for the SGDNEER policy band, on the back of low economic growth and increased deflationary pressures.

With economic growth rising at a firmer pace (clearly above +2%) and inflationary pressures rising, the MAS increased the slope for the SGDNEER band in April.

Thailand: a light at the end of the tunnel?

We expect the Thai economy to slow to +3.6% in 2018 (from +3.9% in 2017). Exports growth should moderate; domestic demand should gain some traction. We expect public consumption and investment to pick up speed supported by a favorable policy mix. Monetary policy is accommodative and considering the low level of inflation (+0.8% y/y in March 2018 compared to target band of +1% to 4%), it is unlikely that the central bank will change its stance soon. Fiscal policy will likely become more supportive this year on the back of public infrastructure projects especially in the Eastern Economic Corridor.

We expect a limited improvement for household's consumption. A rise of consumer confidence and an increase of the daily minimum wage (+2% to 7%) will be supportive. Yet, a still high household's debt (77.5% GDP) may limit the momentum.

Yet, risks to the outlook are elevated. It includes a tougher protectionist stance from the Trump administration as Thailand has an elevated trade deficit with the US (USD20.4bn in 2017 according to the US Census Bureau); a weaker than expected growth of private investment due to ongoing political uncertainties. General elections have been postponed several times since the military took power in 2014.

Malaysia: keeping the balance

Economic growth is set to slow to 5% in 2018 after +5.9% in 2017. Firstly, we expect monetary policy to tighten. Bank Negara Malaysia raised its policy rate by 25bp to 3.25% in January on the back of rising inflation.

Photo by chuttersnap on Unsplash

Moreover, authorities will likely continue to sustain a strong ringgit due to high external debt (nearly 70% GDP). Secondly, we expect fiscal consolidation to continue as the government expects to bring fiscal deficit to -2.8% GDP in 2018 (from -3% GDP in 2017). Thirdly, private consumption will likely remain constrained by a still high household's debt (84.3% GDP). Fourthly, trade related risks remain elevated as Malaysia has a significant surplus with the United States (USD25.6bn in 2017).

Indonesia: improving slowly but surely

Economic growth is set to pick up speed to +5.3% in 2018 (from +5.1% in 2017) led by a positive investment cycle. Easier rules on foreign investment and less macro-imbalances (controlled inflation and lower current account deficit) help boost investors' confidence and foreign direct investment. This has been reinforced recently by a rise in risk appetite globally. Infrastructure investment is rising supported by public investment. We expect the central bank to keep policy rate unchanged at a low level in 2018 (4.25) as inflation remains under control (at 4% against a target band of 2.5% to 4.5%). Private consumption is expected to gather speed gradually driven by stronger job creation.

Risk relates to a busy political agenda this year and next that could weigh on investors' confidence. This includes regional elections in June 2018 and the presidential election in April 2019. President Jokowi is still popular within the country, yet the opposition's victory in Djakarta gubernatorial election points to a risk of changing majority. On the external front, pocket of vulnerability could stem from a tighter than expected monetary stance in the US.

Philippines and Vietnam: prudent policies will be key

Philippines (+6.8%) and Vietnam (+6.7% in 2018) will likely be the growth champions among largest ASEAN economies. Competitive cost advantages help the two markets to leverage on exports, but also to benefit from a rise in investment as companies look for alternatives to China. Domestic consumption is also strong supported by positive demographics and solid job markets. While the growth outlook is strong for now, economic policy risks are elevated for both markets. In Vietnam, risk stems from public finances management as debt is high (61.3% GDP) and critical external vulnerabilities especially poor import cover (below 3 months). For the Philippines, public debt is safe for now but one should pay attention to a strong rise of credit and a rise of inflation.

Mahamoud Islam

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LATIN AMERICA STILL VULNERABLE?

Argentina's current account deficit is a source of vulnerability. Long-term investment, curbing the trade deficit and boosting public savings could help

The story of a rapid deterioration

Argentina's current account deficit rapidly deteriorated in 2017. It reached a historical high of -4.8% of GDP (see figure 1) at the end of 2017, or USD30.7bn (over 4 quarters), from -2.7% of GDP in 2016.

What caused this deterioration? First, a steep import bill: in 2017, the recovery saw imports rising by +14.7% while exports lagged behind at just +0.4%. Hence net exports subtracted -3.8pp from GDP growth over the year. This widening of the trade deficit resulted from a significant rebound of domestic demand. Second, an investment-savings mismatch: by its national accounting definition, the current account balance amounts to the difference between national savings and total domestic investment. A widening current-account deficit signals the need for a country to finance its investment abroad. Argentina's saving rate stood at 0.42% in 2017, up from 0.17% in 2016 but much lower than 6.89% in Brazil and 2.64% in Mexico (2016 data).

At the same time, investment is rushing back

In 2017, Argentina emerged from a year of recession growing at a strong +2.9% after -2.2% in 2016. While private consumption contributed the most to this performance (+2.6pp), the most impressive recovery is that of investment, which grew +11% in 2017 after contracting -4.9% in 2016. Investment should continue to grow in 2018. Indeed, estimates of total investment as a share of GDP for 2017 (IMF, IDB) show that Argentina has the fifth lowest share in Latin America, c. 17%, behind Brazil (c. 18%), Mexico (c. 22%) and Colombia (c. 25%). Under the impulse of President Macri's economic policy, Argentina is currently catching up after many years of underinvestment in infrastructures. This momentum is therefore likely to persist in 2018, on the back of a supportive global economic context and ongoing infrastructure policy.

Reasons to worry

First, this deficit is now financed up to 113% by portfolio flows, which soared since Macri's election. But those are short-term investment flows, subject to capital swings triggered by potential confidence shocks. Besides, Argentina came back to bond markets, yet bonds are also sensitive to confidence shocks through interest rate movements. Finally, longer-term flows, i.e. foreign direct investments, only cover 35% of the current account deficit.

Second, national data point to a strong acceleration in domestic credit growth, in parallel to investment's ongoing recovery. Although credit to corporates only account for 14% of GDP (7% for households and 56% for government), excessive credit growth threatens the current recovery's sustainability, as real y/y credit growth rate has reached 22% in 2017's last quarter, a level unseen since 2012.

What could be next?

The Argentinian Peso has depreciated by –14.7% year to date. We expect a dual effect in the medium run of (i) moderating imports, along with the fiscal tightening and still high inflation, which would curtail private consumption; (ii) slightly boosting exports through enhanced competitiveness, helped by the acceleration of Argentina's two main trade partners in 2018 (Brazil and the US, which jointly receive almost a fourth of Argentina's total exports). However, as Argentina is gradually converging toward a more open economic model, progress in reducing the trade account deficit could be relatively slow. For instance, by the end of 2017, Argentina has signed new trade agreements with Mexico and Chile, while agreeing to ratify the WTO Trade Facilitation Agreement in the wake of 2018. Moreover, the EU-Mercosur Trade Agreement, in negotiations since 2000, could be successfully signed this year. In the absence of rapid progress in terms of competitiveness, this strategy of trade opening could easily lead to a widening of the trade balance.

The USD26bn infrastructure plan, based on Public-Private-Partnerships, will help attract foreign direct investment and hence ensure a more sustainable financing of the current account deficit, despite endangering the government's capacity to meet its fiscal deficit target of 3.2% of GDP in 2018. Finally, more clarity in the monetary policy and alignment with the government are needed: after the government eased inflation targets, the central bank cut rates early 2018. Rate increases along with a renewed government commitment to curbing the deficit and fighting inflation (still at +25%) would partially restore confidence and encourage investors to commit over the longer term.

Georges Dib

EMERGING EUROPE
FAST AND RISKY

Turkey: Pro-cyclical economic policies have caused an overheating of the economy and rising country risk

Strong growth in 2017...

Real GDP grew by +7.4% in 2017, up from +3.2% in 2016. The sharp acceleration was in part a result of base effects since 2016 output was disrupted by the failed coup attempt in July, but the main drivers were strong wage increases in 2016 (+30%) and 2017 (+12%) as well as substantial pro-cyclical fiscal stimulus – including tax breaks for consumers and firms, a significant credit impulse from the government's enlarged Credit Guarantee Fund, and publicly (co-)financed construction investment (+26% nominal growth in 2017) – which boosted domestic demand in 2017. Inventories added +0.8pp to growth in 2017. External trade activity was dynamic as well last year, with real exports rising by +12% and imports by +10.3% so that the contribution of net exports to full-year growth was marginal (+0.1pp). Noteworthy, while export expansion peaked in Q3 2017 and has since softened somewhat, imports have continued to gain momentum until early 2018.

...was accompanied by rising imbalances

However, the growth acceleration in 2017 came along with expanding macroeconomic imbalances. Fiscal stimulus has widened the fiscal deficit to an estimated -3% or so of GDP and private sector credit growth surged by more than +20% last year (compared to an EM median of around +5%). Moreover, as strong domestic demand has fueled import expansion, the current account deficit rose sharply from -USD33bn in 2016 (-3.8% of GDP) to -USD47bn (-5.5%) in 2017 and further to -USD52bn in the 12 months ending in January 2018. Furthermore, since the Central Bank of Turkey implemented only timid monetary tightening, annual consumer price inflation increased to 11.9% (core inflation 12.3%) at end-2017 before easing slightly to 10.3% (11.9%) in February 2018. Altogether, these indicators strongly indicate an overheating of the Turkish economy, driven by policy mistakes (pro-cyclical fiscal stimulus and insufficient monetary tightening).

Soft landing in 2018?

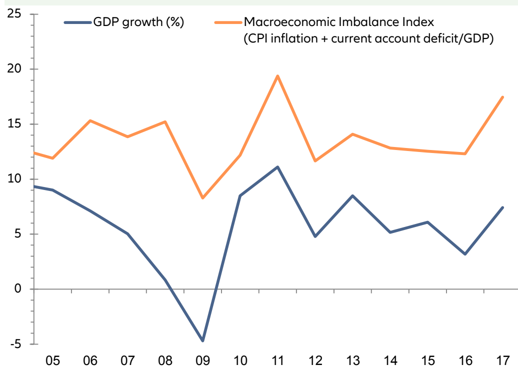
In our central scenario, we forecast GDP growth to slow down to +4.6% in 2018, as a result of a neutral impact of inventories this year, an expected negative impact of net exports and the absence of base effects. However, the balance of risk to the forecast is more to the downside, as Turkey is now among the most vulnerable EM in the event of an external shock.

Corporate debt poses high risk

As persistent large annual current account deficits have been mostly financed through new short-term external debt, the debt burden of NFCs in Turkey has continued to rise and reached 69% of GDP in Q3 2017, a 29pp increase since end-2010, and is forecast to grow further in 2018. About 54% of that debt is FX-denominated, the second highest share among major EM. Even in the soft landing scenario, rolling over that FX-denominated debt is increasingly challenging amidst the current global liquidity tightening, and all the more if investor confidence in Turkey weakens and the lira slides.

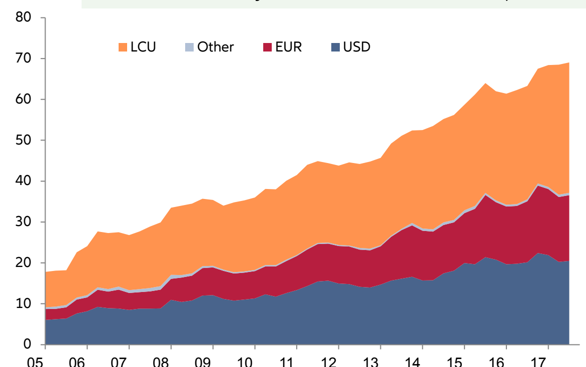
Manfred Stamer

Chart1 Rising GDP growth is accompanied by increasing imbalances



Sources: National statistics, Allianz Research

Chart 2: Currency breakdown of NFC debt (% of GDP)



Sources: National statistics, Allianz Research

AFRICA UNITED

Photo by Marcelo Novais on Unsplash

Africa attracts flows from foreign investors and announced a free trade area. This would imply significant export gains for manufacturers and food exporters

Trade liberalization in context

44 African economies signed in March an ambitious treaty in order to form the African Continental Free Trade Area (AfCFTA). The goal is to eliminate tariffs on 90% of goods. The rationale behind more regional integration is to trade between equals and limit the share of vertical trade (exports of commodities and imports of capital). It should help ascend the value chain and increase the share of manufactured goods in African exports, since manufactured goods represent 43% of intra-African exports and less than 20% of African exports to other regions (75% is driven by commodities). The current predominance of commodity exports makes growth procyclical to commodity prices. Sizeable output volatility deters economic development.

More trade openness should imply some economies of scale, through the relocation of production activities in regional hubs, although with some limitations explained by remaining capital controls. One may easily infer some welfare gains for the consumer. However, such economies of scale will also imply some losers. The recent period of low commodity prices was abruptly felt by countries with fixed exchange rates, as they lost competitiveness after other currencies depreciated (like the Nigerian Naira or the Ghanaian Cedi). In economies with low labor productivity, the likely impact of lower import tariffs is worrying trade unions. It explains why Nigeria and South Africa did not sign the free trade agreement yet, since these organizations are directly involved in political parties in these countries.

A free trade area will increase intra-African exports

We expect African exports to increase by a wide margin, based on two different scenarios. The first one is without AfCFTA and is driven by current development trends and foreign investor appetite for Africa. After China, Turkey developed a strategic partnership with African economies, and India is about to do so. In this first scenario, African exports would grow but trade would remain quite vertical, as commodity exports would keep the lion share of total exports. Based on our country scenario (on nominal GDP growth, exports and exchange rates), we estimate that African exports of goods and services would increase by +7% per year and reach USD 1275bn by 2030. But, intra-African exports would stick with their 19% share of the total.

The second scenario adds an AfCFTA impact on exports. Continental exports would grow by about +8% per year and reach USD 1415bn by 2030. This scenario yields also to very different structures of trade. Intra-African exports would reach 27% of the total, about the current ASEAN intra-regional trade share. Under this second scenario, intra-African exports would grow by about +11% per year (+7% with the first scenario). Manufactured goods would also represent a higher share of total exports in this second scenario, jumping to 28% (USD 398bn) from 24% (USD 308bn) in the first scenario. It also means that the trade impact of an AfCFTA would be asymmetric. Manufactured goods and service exporters will make the bulk of additional export gains (South Africa, East Africa), while many oil exporters would not see key differences, as e.g. Nigeria, Algeria or Gabon. Additionally, food exporters will also be big winners (Ghana, Zambia, and Côte d'Ivoire), since current barriers to food exports are among the biggest barriers to trade in Africa.

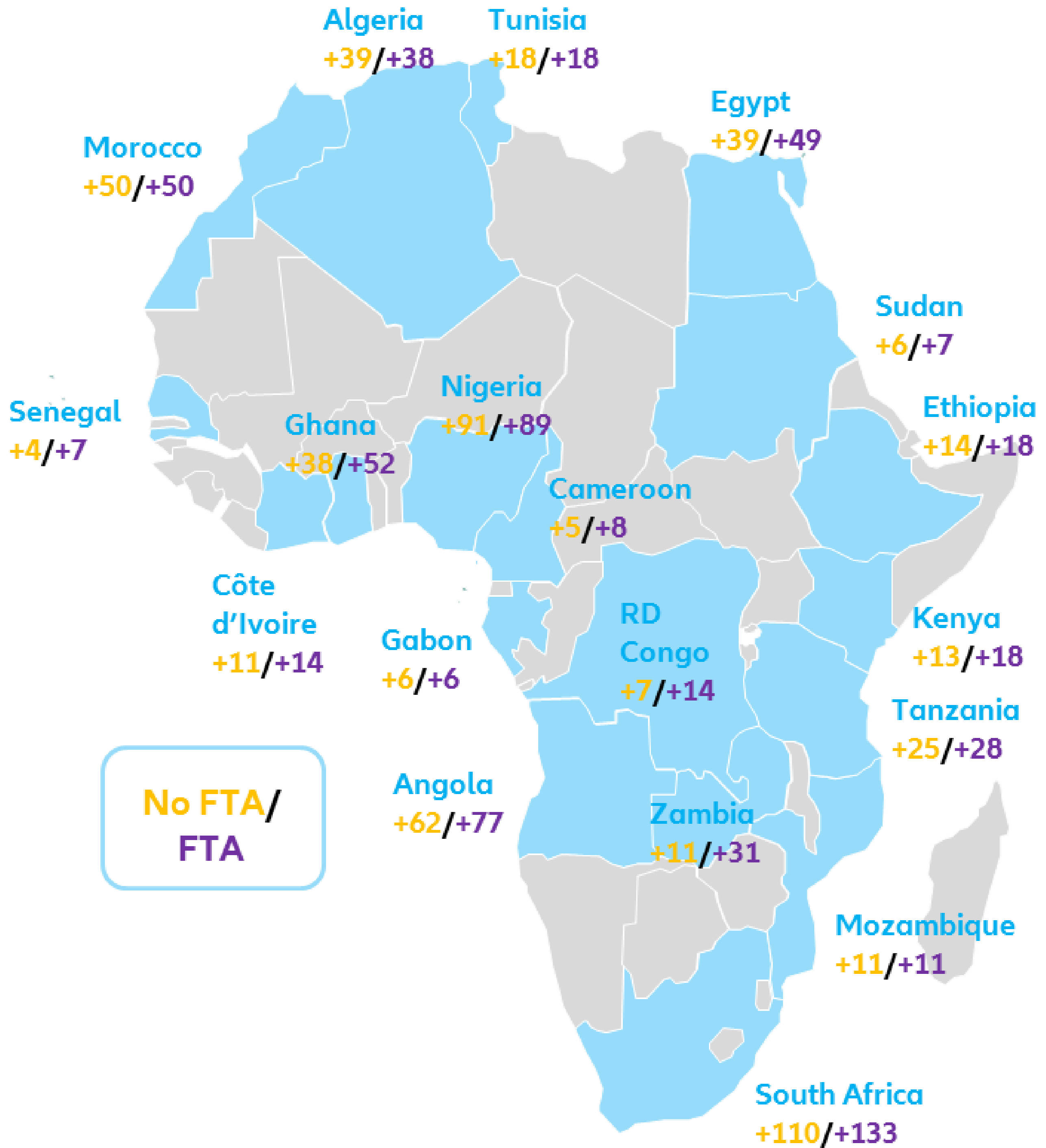
Issues for implementation

Infrastructure development is among preconditions to a stronger intra-African trade. Export logistics are frequently organized in order to trade with other regions. Physical integration is increasing in East Africa, but is still in its infancy. Upgrading it would mean key infrastructure investment. E.g. Kenya would need USD 117bn investment in roads and railways (76.5% of its actual GDP) to close by 2030 its transportation infrastructure gap with Thailand. Moreover, this development would imply other basic needs (investment in the digital economy, water, sanitation, power). Power generation would make the bulk of it: USD 84bn (55% of actual Kenya GDP).

Attracting the right kind of financing would be another issue. Increasing foreign direct investment from the current USD 50bn would require many reforms since the current business climate is still detrimental, despite some progresses made. Fiscal revenues will also have to be increased in order to channel more funds to infrastructure financing. It means that new taxes will have to be raised (VAT, income tax) to replace old ones, as import tariffs currently represents 9% of fiscal revenues in Africa according to the UNCTAD.

Stéphane Colliac

Chart 1: Additional exports of goods & services in 2030, compared to 2017 (USD billion)



Sources: Euler Hermes, Allianz Research

dubai. Photo by Craig Whitehead on Unsplash

MIDDLE EAST SLOW REBALANCING

Saudi Arabia: Higher oil prices and fiscal measures support recovery in growth and improvement in macroeconomic imbalances

Full-blown recession in 2017...

Official data released at the end of March show that the downturn intensified at the end of 2017 – real GDP contracted by -1.2% y/y in Q4 – and confirmed an earlier flash estimate that full-year GDP declined by -0.7% last year. Details indicate that the November 2016 OPEC agreement to cut oil output was the main trigger for the recession in 2017. On the supply side, the non-oil sector grew by +1% while the oil sector shrank by -3%, in which oil extraction dropped by -3.5% while oil refining increased by +2.4%. On the expenditure side, the oil output cut caused a sharp drop in capital formation, with fixed investment falling by -7% and inventories subtracting -0.3pp from 2017 growth, and declining external trade activity. Real exports fell by -3.2% last year and imports by -4.5%, so that net exports made a small positive contribution of +0.2pp to growth. Meanwhile, consumer and public spending both grew modestly by +2% and +0.8% last year, respectively. Note that Q4 real GDP increased by +0.4% in q/q seasonally-adjusted terms which is pointing to a tentative recovery this year.

...to be followed by a moderate recovery in 2018

Looking ahead, opposite forces will affect the economic momentum in 2018. The non-oil private sector PMI fell to an average 53.0 points in Q1 from 56.8 in Q4. This seems to reflect the introduction of a 5% VAT and administered price hikes at the start of the year which have pushed up inflation to +3% y/y in January-February (from -1.1% in December) and possibly affected consumer spending.

But the situation is likely to improve in the next quarters as the government has announced a number of public sector bonuses and higher public infrastructure spending to come. Moreover, the negative impact of the OPEC oil output cut has now waned. Thus oil output should be stable this year and with a higher average oil price than in 2017 this should help to achieve turnarounds in investment and exports. Overall, we forecast real GDP growth of +1.7% in 2018.

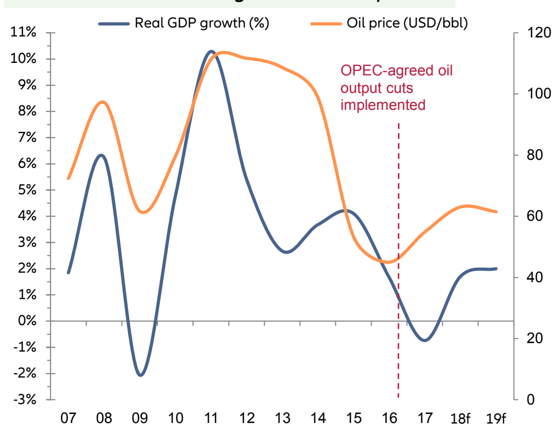
Step-by-step rebalancing

The current account balance shifted back to a surplus of +2.2% of GDP in 2017, after two years of deficits, mainly thanks to a rebound in the value of oil exports (+25%). As a consequence, total FX reserves held at SAMA (central bank) have stabilized at around USD490bn since mid-2017, after having fallen from a peak of USD745bn in August 2014 (these reserves include financial assets managed by the SAMA Foreign Holdings SWF). Current foreign assets are still sufficient to cover around 30 months of imports. We forecast the current account surplus to widen to 3% of GDP in 2018.

The rebound in oil revenues combined with austerity measures also helped to reduce the fiscal deficit from -17% of GDP in 2016, however, it remained large at around -9% in 2017 and is forecast at -7% this year. Nonetheless, related risks remain moderate as total public debt is still low at about 20% of GDP and huge financial assets held in two SWFs provide for a substantial cushion.

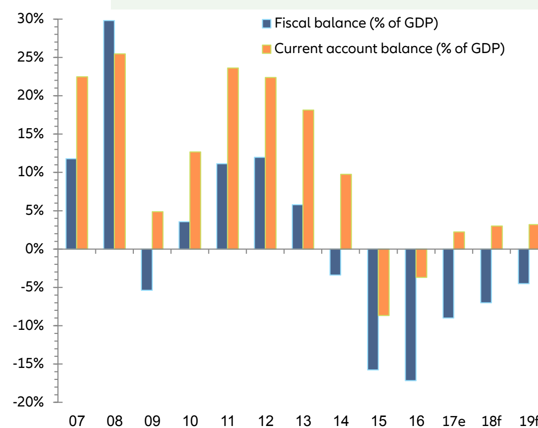
Manfred Stamer

Chart 1 Saudi real GDP growth and oil price



Sources: National statistics, IMF, IHS Markit, Allianz Research

Chart 2 Fiscal and current account balances



Sources: National statistics, IMF, Allianz Research

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