

THE VIEW

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THE PERILS OF A TRUMPED WORLD

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"I think Trump may be one of those figures in history who appears from time to time to mark the end of an era and to force it to give up its old pretenses. It doesn't necessarily mean that he knows this, or that he is considering any great alternative. It could just be an accident."

When Henry Kissinger, the grand *consigliere* of American diplomacy, 95 years old, said those words, he had me wonder. What if what I thought to be a four-year pause for America as the most-respected benevolent hegemon in history could as well be the beginning of a grave new world without any? What if the US continued to disengage from supplying the world with pivotal public goods and rules of the game for the greater good?

Almost thirty years after the Washington Consensus became the norm for international policy-making, and ten years after the global financial crisis, it looks like we're going back in time. History- and science-proof policy benchmarks (and sheer common sense) are being overruled or blatantly questioned tweet after tweet. Six months ago, the benefits of free trade and the ensuing trade war; five months ago those of smart financial regulation, then came net neutrality and attacks against the press, threats to withdraw from a range of global platforms including those for security and defense, and just a week ago, the independence of the Federal Reserve – the only reason the dollar became the epitome of trust it is today.

Where will it (he) stop? It's hard to say as chain reactions are ignited. First lose canons and new cowboys of economic policy-making are multiplying faster than ideas to solve global issues. Disrespectful diplomacy, once an oxymoron, is now "a thing". Secondly cronyism and identity economics –just like identity politics– cater to short-term instinctive needs, thus hard to rationalize or prove wrong. Third, risks are piling up faster than we think. There is a higher likelihood of policy mistakes to offset negative externalities of previous ones. The divestment from long-term stabilizers and innovation and structural wedges between nations will make coordination harder when the next crisis strikes.

We may have missed an opportunity to reconcile free-trade and full employment, entrepreneurship and safety nets, innovation and regulation, growth and equity. International institutions and globalists alike may have underestimated how urgent and pivotal the need for a new paradigm was. President Trump does offer an alternative and a new style - for the US only. Is anyone ready to take the baton for issues beyond the American border? Not really. The Chinese model is difficult to replicate and Europe is busy once again with very domestic decisions to make. Re-incentivizing the creation of common goods (maybe with a European twist to it?) is essential. It is not too late, never.



Photo by David Kovalenko on Unsplash

China monthly trade surplus with
the US at a record high in June
2018*

**USD 29
billion**

*Source: China Customs General Administration

THE DE-SYNCHRONIZATION OF THE GLOBAL CYCLE

The global economy is expected to continue to grow at a healthy pace in 2018 and 2019 albeit mirroring more diversity in an asymmetric reaction to a series of shocks on energy prices, political uncertainty and interest rates

The global economy has probably passed the peak of its current cycle

Global economic growth is set to accelerate further in 2018 to +3.3% y/y, after growing by +3.2% in 2017. The global economic landscape remains good, despite the emergence of cycle de-synchronization. Without a doubt, this phenomenon is crucial to both understand and anticipate the economic momentum. This de-synchronization will result in asymmetric answers from national economies to three global-scaled shocks.

First come commodity prices, in particular oil prices, which surged faster than expected. The Brent price reached the USD 79/bbl mark during May 2018. This general increase may favor exporting countries in the short term. It will also increase input prices and lead to a noticeable rise of global inflation in the upcoming months. However this hike should be temporary, and will not destabilize the global economy – we are forecasting stable oil prices around USD 69/bbl in 2019 – given that central banks are not likely to over-react to heightened inflation.

Then is the interest rate shock, fol-

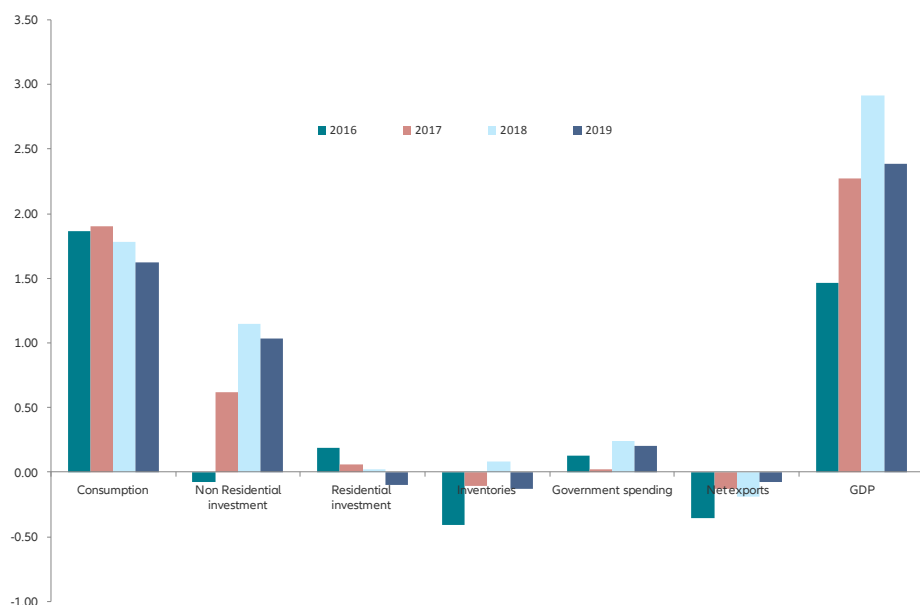
lowing a faster than expected monetary policy tightening in the US. Indeed, the fiscal stimulus initiated in the US in 2017 appears to be more powerful than previously thought, while recent measures of financial deregulation will stimulate further the economy.

In this context increasingly resembling overheating, added to riskier behavior around corporate debt and financial activity at large, the Fed will toughen its line. We expect two more rate hikes in 2018 and two additional ones in 2019.

The normalization of the American monetary policy will inevitably result in unstable volatility and increased Dollar value – we are expecting a +5% appreciation in the Dollar index in the next six months. As a consequence, it will put most fragile economies under pressure, i.e. those characterized by persistent fiscal, commercial or price disequilibria. This will lead to a mounting discrepancy between weak economies – those showing high debt stocks or insufficient record of reducing imbalances in the last two years, despite a very favorable climate and stronger ones.

Finally, there is a global perturba-

tion due to a shock of economic policy uncertainty, following protectionist moves and a historical overhaul of America's foreign policy. The "America First" policy already had, and will continue to have deep consequences. One needs to analyze this new paradigm from a historical perspective, taking into account the traditional role played by the US as a supplier of public goods at the global level. It has long been a purveyor of security through NATO and the UN, of free trade through multilateral rules under the WTO and an economic power with a big influence within the G7 and G20. At every level, one can foresee a disengagement from the US, thus redefining international talks. The divide between economic and military rationales has blurred, with the Trump administration no longer hesitating to ask for commercial and financial compensation for its geostrategic contribution. Global multilateralism is clearly on the decline, triggering a negative shock of uncertainty around economic policy. The rise of populist regimes and their reaction to de-synchronized economic momenta will be the last source of asymmetries in the months to come.

Figure 1 Contribution to US GDP growth (% y/y)

Source: IHS, Euler Hermes Allianz Research

The American economic policy will be a victim of its own success

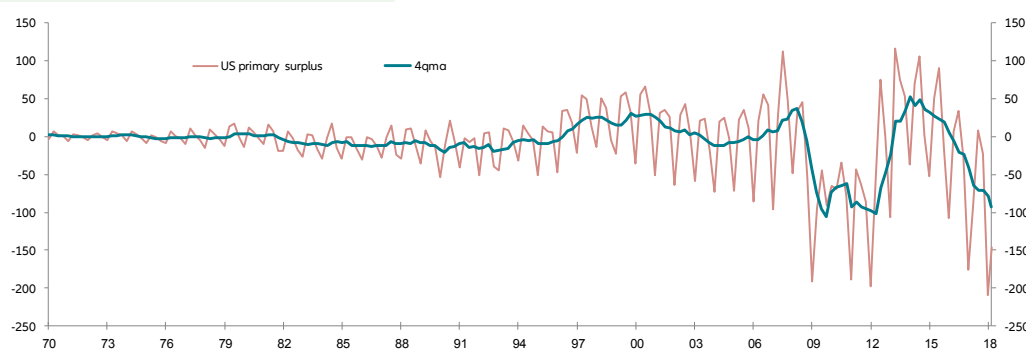
The American economy should see an acceleration in growth in 2018, with production expected to increase by +2.9% y/y, after growing by +2.3% y/y in 2017. This can be explained by the ambitious fiscal reform which significantly reduced taxes for both companies and households. After this budgetary stimulus, American companies positively reacted with upward revision of both hiring and investment intentions. We estimate that Trump's economic policy will contribute to further accelerate US GDP growth by +0.5pp in 2018.

This economic voluntarism, on which the mantra "America First" is based,

has hampered political discussions both in the US and abroad. Domestically, it led to an extreme political polarization of both parties' stances and strategies in Congress. This is likely to lead to tensions around budgetary negotiations – the Congress is the final decision maker regarding American budgetary policy. In this context, Paul Ryan's decision not to run for another term as President of the House of Representatives will contribute to weaken the American political debate – given his relentless efforts to bring around the table Trump, the GOP and the Democratic Party. As the Republican Party is divided, November mid-term elections may rebalance the forces in Congress. The latest polls show an important turnout among Democrat

voters, along with higher financial contributions to the campaign. In such circumstances, combined with a rapid deterioration of the fiscal balance, the Trump administration may be forced to withdraw some of its most recent tax cuts if the House of Representatives, or even the Senate, became Democrat. This scenario would imply a less accommodating budgetary policy, accompanying a monetary policy tightening from the Fed.

These two factors are the main driver of an expected slowdown of US economic growth in 2019, to +2.4% y/y. In this case, the American foreign policy - in particular its trade policy - could have its most polemical aspects tamed.

Figure 2 Fiscal primary surplus (USD bn)

Source: IHS, Euler Hermes Allianz Research

Despite the political uncertainty, Europe will continue to grow above potential

After strong growth in 2017 (+ 2.6%, the highest in 10 years), the Eurozone economy should slow down in 2018 and 2019 to + 2.1% and + 1.9% respectively. However, growth will remain above potential. Intra-zone trade and more generally domestic demand will offset the external slowdown. In 2019, domestic demand will contribute more to GDP growth (+1.8pp after +1.4pp in

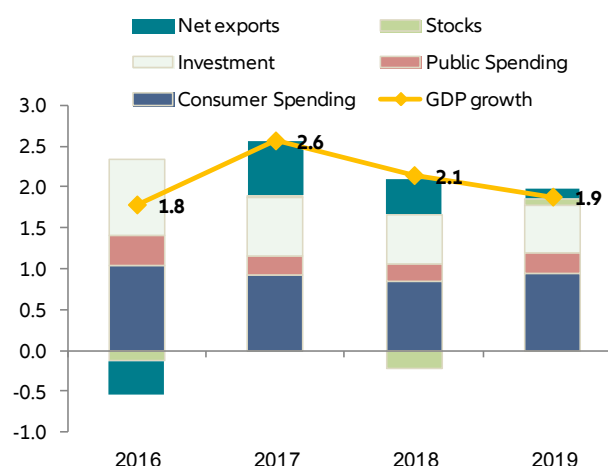
2017). But the resurgence of protectionism, even if it is currently under control (expected export losses of EUR12bn if import tariffs are expanded to the car industry in addition to steel and aluminum products), weighs on business confidence. Internally, the political uncertainties (Italy, Brexit, German coalition, rise in populism) announce a high volatility regime.

Indeed, over the past few years global liquidity and the broad-based cyclical upswing in the Euro-

zone helped drown out concerns about the underlying structural weaknesses in the economy as well as political discontents.

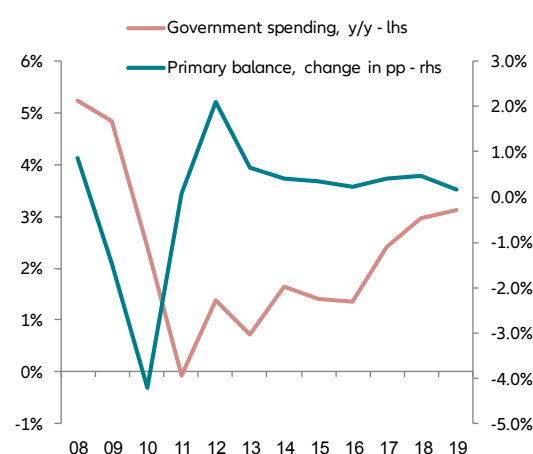
Going forward, with the economic upswing in Europe likely to have passed its peak and global central banks gradually normalizing their policy stance, markets are bound to become increasingly more sensitive to political risks – and this is visible in the higher Italian-German 10-year bond spreads – which we expect around 180 to 250bp for the remainder of the year.

Figure 3 Eurozone GDP growth and components



Source: IHS, Euler Hermes Allianz Research

Figure 4 Eurozone government spending vs primary balance



Source: IHS, Euler Hermes Allianz Research

The ECB will start to progressively normalize its monetary policy but we expect the tone to remain rather dovish, keeping the rise in long-term interest rates rather contained. The Quantitative Easing program should end in December 2018 as recently announced, while a first increase in the deposit rate should not come before September 2019.

We estimate that a rise of + 50bp in the key interest rate will increase the interest charge by EUR60bn for companies in the Eurozone.

Hence, the acceleration of European institutional reforms will be key to

reassure on Europe's capacity to integrate further, especially in the current context of a decreasing multilateralism led by the America First policy and supported by a certain surge of growing European populism – we estimate the first parties to win the European elections in 2019 to be anti-establishment.

The balance on the European reform agenda looks delicate despite the Macron pivot.

However, the region benefits from important safety mattresses, which protect growth from the negative impact on business confidence: (1)

fiscal policy that will become expansionary in 2019, particularly in Germany, Italy and to a lesser extent in Spain; (2) private consumption, supported by the acceleration of wages (to +2.3% in 2018 from +1.6% in 2017) coupled with contained inflation (1.7%), means greater real purchasing power, notably in the second half of 2018; (3) companies' margins remain high, notably in Italy and Spain; (4) turnover growth around +6% on an annual basis and above pre-crisis levels; and (5) companies enjoy high cash holdings (above EUR890bn).

Eastern European countries benefited from the Eurozone recovery and a rebound in investment activity thanks to better absorption of EU funds, reaching GDP growth above +4% in 2017. However, over the past two years, this has favored the accumulation of imbalances and in-

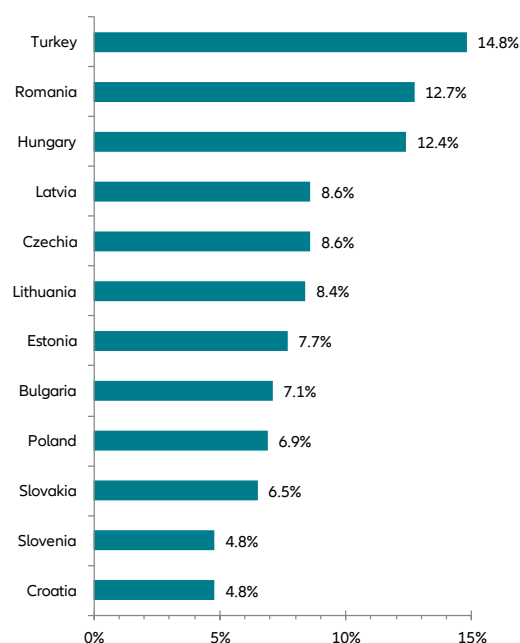
creased the risk of overheating.

This has been the case for Turkey and Romania, and more recently for Hungary.

Turkey and Romania will experience a sharp slowdown which will reduce growth in the Eastern European re-

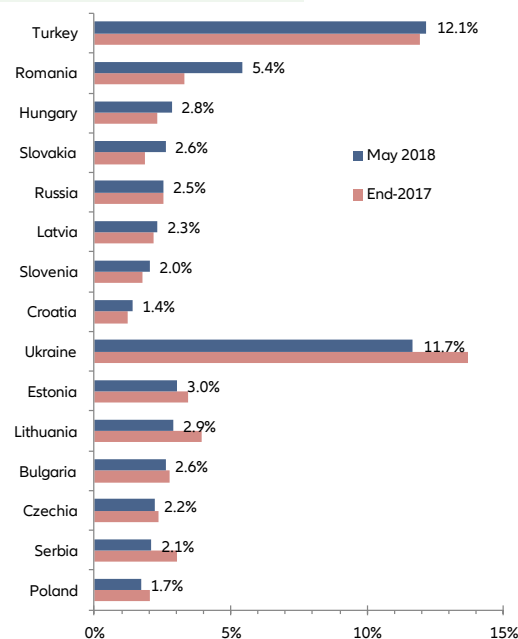
gion to +3% in 2018 and +2.7% in 2019. In Russia, higher oil prices will more than offset any impact from the new US sanctions that were implemented in April. Still, growth will pick up only moderately from +1.5% in 2017 to +1.8% in both 2018 and 2019 as structural rigidities persist.

Figure 5 Nominal wage growth 1Q18 (% y/y)



Sources: National statistics, IHS Markit, Allianz Research

Figure 6 CPI inflation (% y/y)



Sources: National statistics, IHS Markit, Allianz Research

In Asia, resilience will stem from China

Asia-Pacific economic growth will depend on China's ability to respond to the US and to keep domestic demand growth in check.

We expect a gradual and measured response to the US protectionist measures (see regional outlook for Asia) consisting in many small policy moves ranging from tighter regulation against US companies, strategic partnerships with key allies to pressure the Trump administration and currency depreciation.

On the domestic side, we expect private expenditures to stay firm, supported by rising income and solid profitability.

The policy mix is expected to be relatively balanced, supporting growth on the one hand (e.g. through fiscal stimulus and targeted liquidity support) and keeping risks in check on the other (with stricter regulation to maintain deleveraging efforts).

This supportive policy mix will be associated with a gradual opening of the economy with (i) tariff cuts for consumer related sectors and (ii) continued progress on financial liberalization. Against this background, China's economic growth is expected to stand at +6.6%.

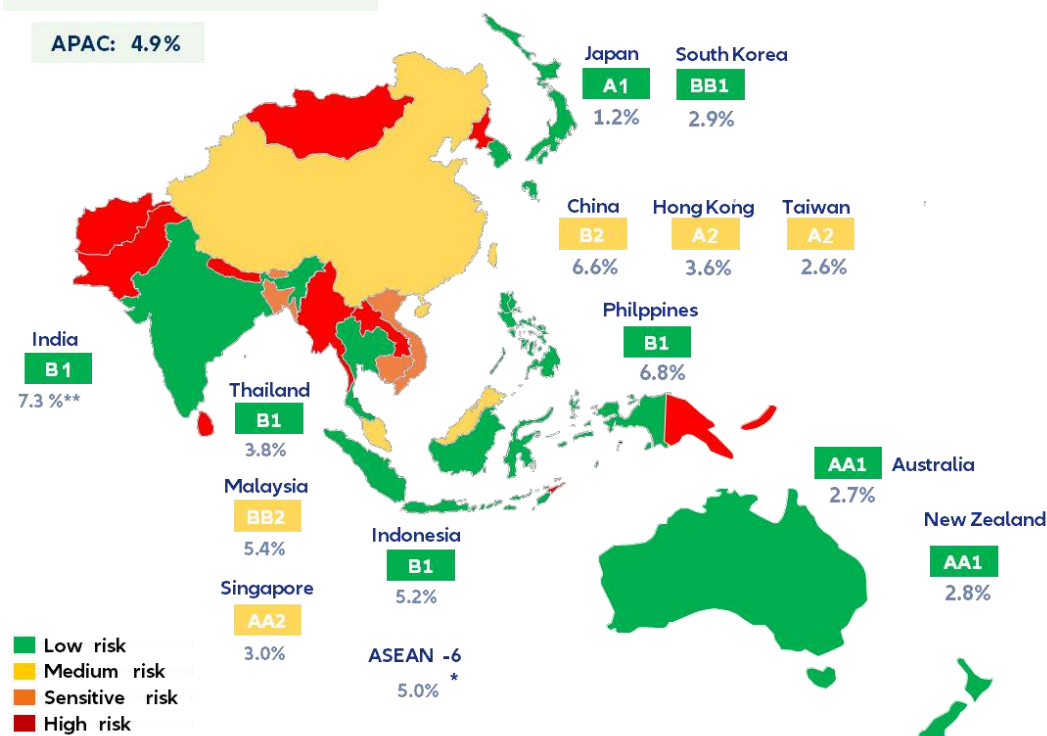
This resilience of China will act as a buffer for the region. Regional economic growth is expected at around +5% in 2018 and 2019. India is expected to pick up speed as proactive

policies (capital injections for banks, pre-emptive rate hikes) improve confidence, reforms (bankruptcy law, GST, e.g.) start to bear fruit and the adverse effects of demonetization fade away.

In Japan, economic growth is expected to slow as the impact of the previous fiscal stimulus recedes. Yet growth would remain above potential supported by a still accommodative monetary policy, and a resilience of private demand.

In ASEAN, a still firm rise of global trade and an increase in foreign direct investment will help keep growth in a solid range: Vietnam could grow by +7%, Philippines by +6.8% and Indonesia by +5.2% especially.

Figure 7 Asia-Pacific growth forecasts



Sources: IHS, Allianz Research

In the short run, we see currency turbulences as the main risk especially for countries with twin deficits (India, Indonesia), in countries where investors could perceive a risk of policy mistakes (Malaysia on fiscal consolidation, Philippines on credit management).

In the medium term, we do not expect this risk to derail economic growth.

The first reason stems from the proactivity of the central banks that have raised policy rate preemptively to reduce pressures on the currency.

Secondly, most of the large economies of the region have sufficient buffers to keep growth in-check.

Latin America: the BAM (Brazil, Argentina and Mexico) under political and financial pressure

In Latin America, the takeoff expected at the end of last year is delayed. We have revised downwards growth prospects of the region (+2.0% in 2018 after +1.2% in 2017,

and +2.4% in 2019) mainly due to revisions in Brazil and Argentina.

Why? Because the late cycle market stress has exposed regional vulnerabilities. Argentina, with its twin deficits and high inflation (+25%) was sanctioned by markets (-45% depreciation of the ARS peso ytd).

The situation is now under control with the IMF support until 2020; yet the tight fiscal adjustment will cut growth (+ 1.4% in 2018 and + 1.7% in 2019 down from + 2.9% in 2017).

In Mexico, despite a resilient economy (+ 2.5% growth in 2018 after + 2% in 2017), financial pressures will continue. The overhaul of NAFTA probably delayed to 2019 and the future of the energy sector - a possible target of the new Mexican president - will be a source of prolonged volatility.

Although we don't expect a major fiscal slippage, public spending could also increase going forward.

In Brazil, the recovery will be slower than expected, but the country

should resist volatility thanks to a favorable external position, with growth expected at + 1.9% in 2018 (+1% in 2017) and +2.5% next year.

The medium-term outlook remains degraded due to drifting public finances, especially as the outcome of the presidential election remains uncertain.

Middle East: recover and rebalance

In the Middle East, annual growth will pick up from just +0.8% in 2017 to over +2% in 2018-2019 as the GCC region recovers at last from the recession, thanks to higher oil prices and the fading impact of OPEC-agreed oil production cuts at the end of 2016.

Higher oil prices will also support the rebalancing of large fiscal and current account deficits in the GCC economies that evolved in 2014-2017.

However, Oman and Bahrain remain the weaker spots in the region as they have fiscal breakeven oil prices of more than 80 USD/bbl.

Africa: a growth driven by commodities

In Africa, the recent rise in commodity prices should have a stabilizing influence for the entire region; specifically a consolidation is awaited in Nigeria (+2.5% in 2018).

Euler Hermes expects an acceleration of the African growth at +3.9% and +4.3% in 2018 and 2019 (after +3.4% in 2017).

The question is not the growth in itself. The infrastructural projects are still numerous, in particular in Eastern Africa (Ethiopia, Kenya) or in Western Africa (Côte d'Ivoire, Senegal).

But the way those projects are funded can be an issue and lead to situations of excessive debts.

Accordingly, the examples of Mozambique and of the Republic of Congo could become more than isolated incidents.

Insolvencies in 2018 and 2019 to mirror de-synchronized cycles

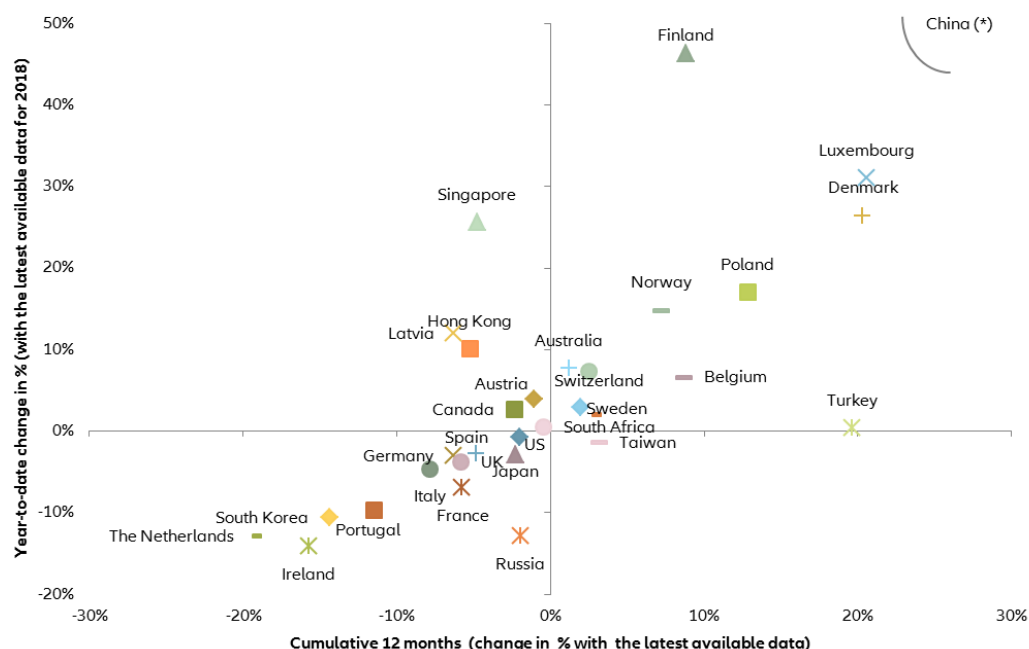
The diversity of trajectories in this adjustment to the threefold series of shocks will require skills of discrimination for investors and risk managers. The significant complexification of the global political environment coupled with a historical phase of monetary policy normalization is likely to generate some decoupling in the pattern of global insolvencies. To this regard, the first half of 2018 has been illustrative of this idea of a transition between a synchronized global economic cycle and more heterogeneity to come:

- In the first months of 2018, corporate insolvencies increased in more than half of the countries monitored compare to the same period of 2017
- The surge in insolvencies continues in China, notably re 'zombie companies', and insolvencies

rebounded in Hong-Kong and Singapore.

- The downside trend remains on track in the US, but paused in Canada.
- The downside trend also remains on track in Germany and in most Southern Europe countries, notably France.
- Yet, many other European countries posted a rebound in insolvencies the first months of 2018: Belgium, Switzerland, Poland, Romania and the Nordics
- The improvement in Brazil marked a (temporary) pause.
- We expect our Global Insolvency Index to remain on the upside for a second consecutive year in a row in 2018 (to +8% from +6% in 2017) and to keep on increasing in 2019 (+4%). However, this global trend will reflect different trends by regions and countries.

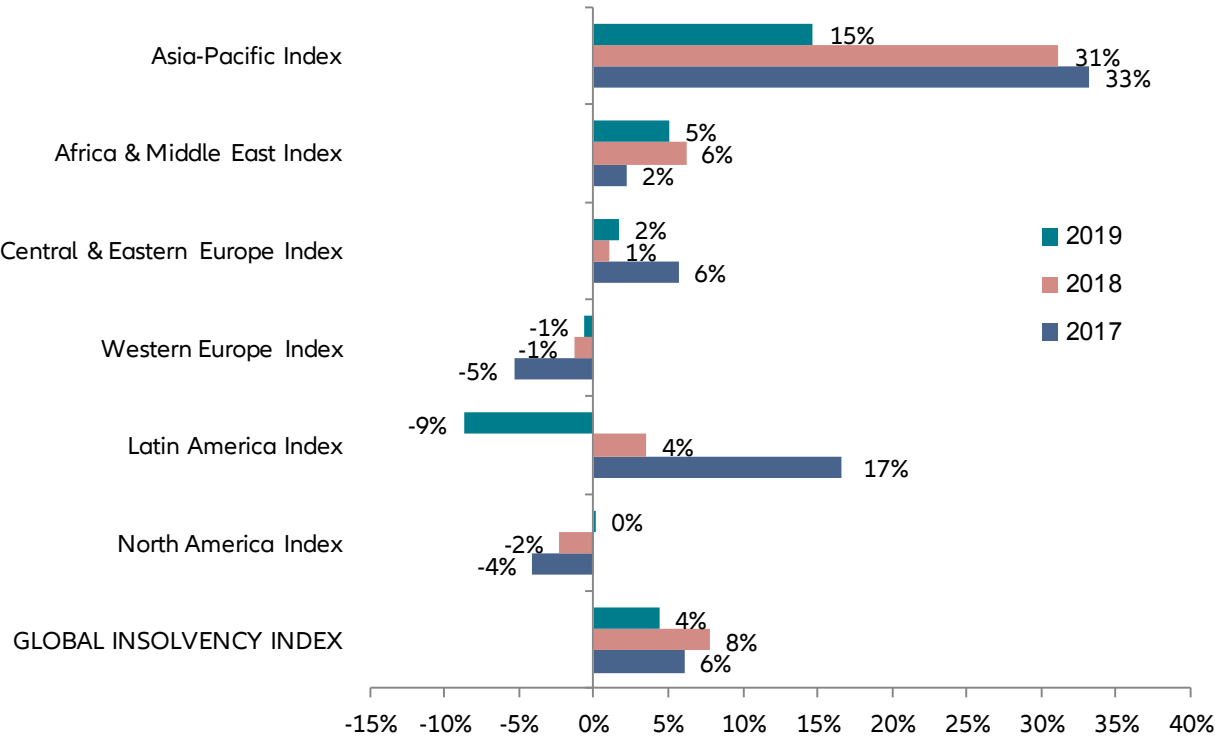
Figure 8 Trend in insolvencies in the first months of 2018



(*) Figures for China: +64% YTD and +90% for the latest 12 months

Sources: National statistics, Euler Hermes, Allianz Research

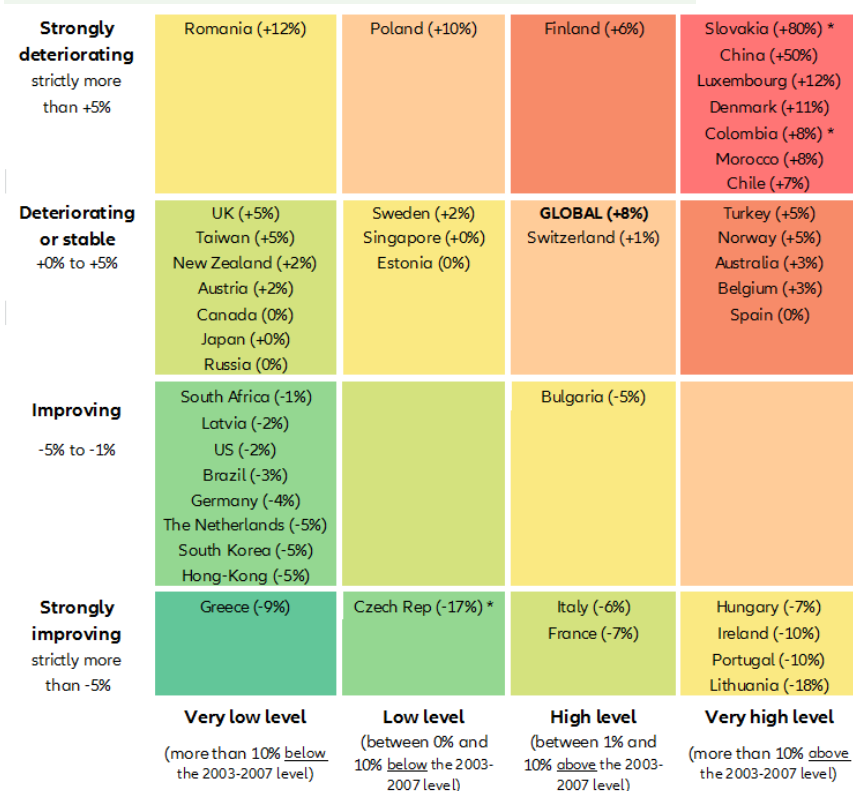
Figure 9 EH global and regional insolvency indices (yearly change in %)



Sources: National statistics, Euler Hermes, Allianz Research



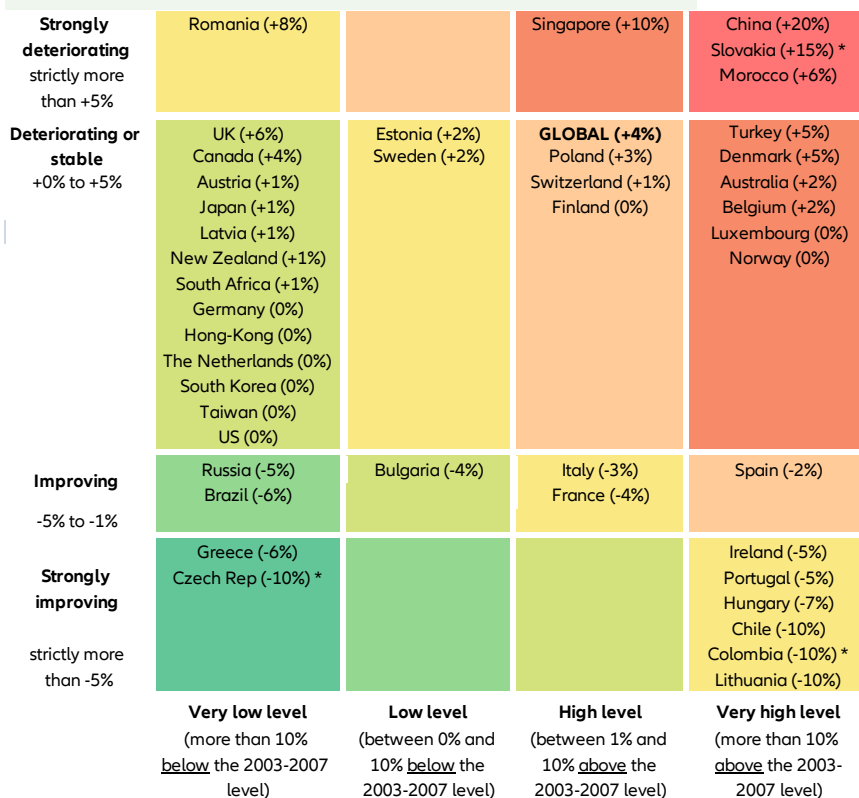
Figure 10 Insolvency heat map 2018



(*) Historical data are not fully consistent because of changes in law or national figures

Sources: National statistics, Euler Hermes, Allianz Research

Figure 11 Insolvency heat map 2019



(*) Historical data are not fully consistent because of changes in law or national figures

Sources: National statistics, Euler Hermes, Allianz Research

LET AFRICA ENTER ITS BELLE EPOQUE

FINANCING ON THE A-LIST

Africa's attractiveness is strong since the continent's growth is driven by capital intensive needs, particularly infrastructure. Therefore financing (both levels and sources) is among the key questions that need to be answered in order to properly channel funds to the right projects. Let's make it work through a mix of formal solutions (FDI, fiscal resources) and innovative ones (mobile banking).

Is Africa still following the same financing model?

Financing needs have increased and are financed differently

Back in 2015, Africa experienced a common financial stress, as a result of a commodity price slump and falling exports. It triggered a USD -141 billion (bn) current account deficit, with the -86bn not covered by workers remittances financed mainly through debt (bilateral and IMF loans).

The drop in exports led to lower private capital flows to the region. However, this symmetric liquidity shock is now over and the landscape has changed quite a bit. Growth is on again, but the overall current account deficit still prevails, mirroring remaining deficits in key oil exporters (Algeria, Angola mainly). These persistent deficits mean that the main African economies avoid growth collapses. The adjustment was less severe than in the eighties. Yet, since domestic demand kept growing, the current account deficit is still present following the market shock. Financing has changed as well, since debt and equity flows should top Foreign Direct Investment (FDI) in 2018 and reach an all-time high, as a result of growing bond issuance.

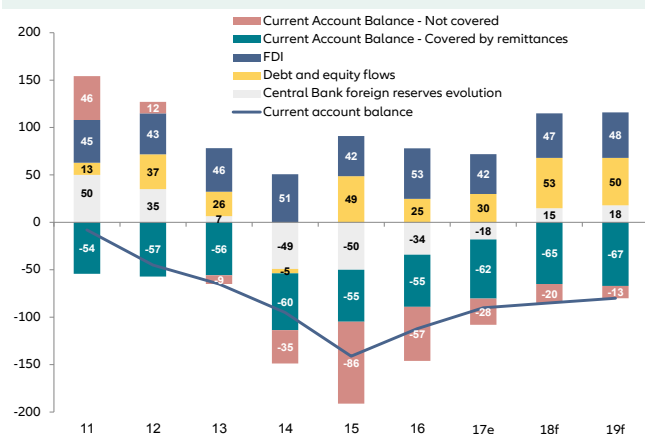
Weakening FDI inflows mirror regional divergence with Central and Southern Africa still growing less than before the crisis and exhibiting attractiveness problems, whereas North, West and East Africa are not experiencing similar difficulties.

I've got the Power: A USD 1000bn issue? No, no, but one third is still big

Financing through FDI, bilateral loans and Eurobonds is not neutral given the current investment pattern in the region. Current expenditure is one key aspect, since many African economies fell in a deficit trap as a result of decreasing commodity prices. Moreover, infrastructure projects were put under scrutiny particularly in economies with the poorest governance scorecard.

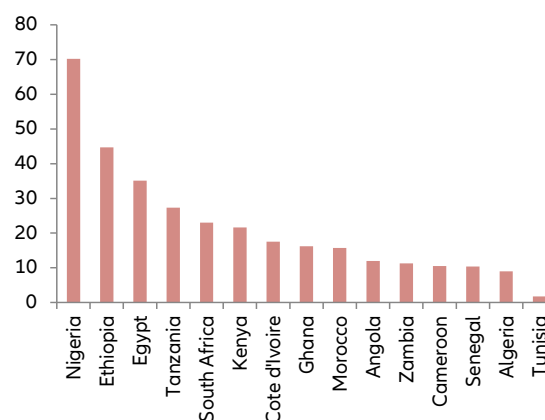
Power generation is one of the key infrastructure areas needed in order to fuel a catch-up process. Countries unable to close their resources gap often fall in to the so-called "middle income trap". A common pattern is electricity blackouts nurturing premature deindustrialization, a phenomenon well-known in South Africa.

Figure 1 Aggregate current account financing excl. offshore centers, per source, (USD bn)



Sources: IMF, World Bank, UNCTAD, Euler Hermes Forecasts

Figure 2 Likely spending through 2030 for power generation infrastructure in the main 15 African economies (USD bn)



Sources: World Bank, Euler Hermes

East Asian economies did not fall prey to this particular problem, since they managed to reach their potential. Comparing African economies with an Asian one (Thailand) shows that African economies would need to spend about 20% of their current GDP to close their power generation gap by 2030. In dollar terms, the 15 key African economies would need about USD 1000bn in order to finance it.

However, countries with poor institutions (Angola, Nigeria) or already high debt levels (Angola, Tunisia, Ethiopia, Kenya...) will likely inhibit infrastructure financing. This is particularly true in large economies with difficult relationship between sovereign and sub-sovereigns (Nigeria, Ethiopia mainly). Despite these bottlenecks, Nigeria would still rank 1st given the size of its economy, but the missed opportunity to improve its

infrastructure will see a potential loss (about USD 200bn) to its overall growth potential.

Is there enough FDI to cope with financing needs?

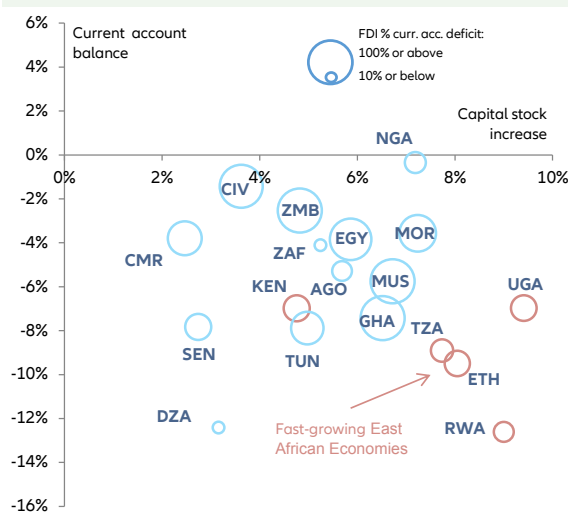
Better infrastructure adds to the capital stock of a given economy and some economies have begun to improve it quickly, particularly in the East African Community. It means a sizeable current account deficit since imported capital goods have much higher value added than a country's exports.

Definitely, African economies need long-term financing in order to improve their infrastructure. However, FDI covers a limited fraction of the current account deficit, particularly in fast growing East Africa. Ethiopia ranked second in 2017 in Sub-Saharan Africa, attracting USD 3.2bn in terms of FDI inflows, but it merely covered 32% of its current

account deficit. This mismatch between deficits and long-term financing can be interpreted in two ways. Building new plants or additional infrastructure will make the output (exports) of the economy greater in the future, and the current account deficit is transitory in some way.

However, financing it through loans creates vulnerabilities depending on the duration of these loans. It exposes the countries to sudden stops of capital flows, with a risk of debt distress for some entities, particularly those with the most fickle access to credit, like sub-sovereigns and state-owned enterprises. In an adverse environment delayed payment becomes the norm (e.g. in Angola), thereby reducing a country's overall attractiveness. Obviously, living with structural financing needs makes the case for defaults likely.

Figure 3 Capital stock increase (annual average growth, last 10 years), current account balance (% of GDP, 5-year average), and share of the deficit financed through FDI



Sources: Penn World Tables, IHS, Euler Hermes

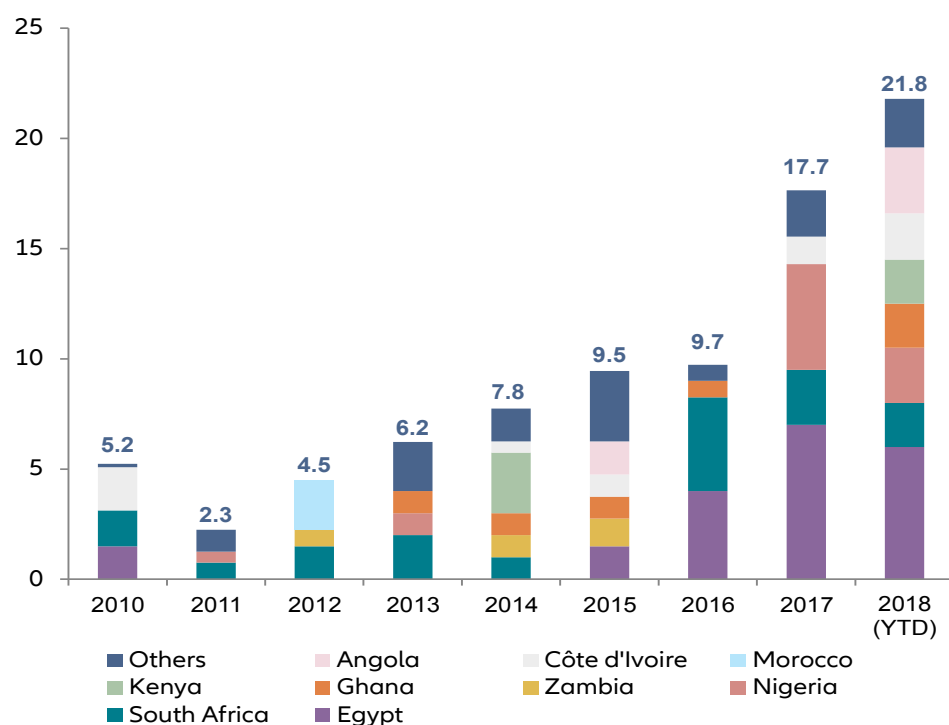
Financing Africa: Fashionable issues

African Eurobonds: The new frontier
African economies made their best start in 2018 in terms of overall Eurobond issuance, with about USD 22bn issuance. There is one good reason behind that: Some African economies did a good job in terms of poli-

cy choices during the low commodity price period and now see their perceived creditworthiness improved. No surprise, given that our four country risk upgrades decided in 2018 (Egypt, Ghana, Côte d'Ivoire and Senegal) all issued a Eurobond in 2018H1.

The overall trend was not affected by bouts of financial volatility

(Italian risk) and higher interest rates in the US. Only the most vulnerable economies did feel the shock, those with low foreign reserves: E.g. Tunisia had to delay an issuance given a low appetite triggered by its high external debt (84.5% of GDP) and low import cover of foreign reserves (2.5 months of imports).

Figure 4 Eurobonds issuance, USD bn

Sources: Bloomberg, Euler Hermes

This is the first set of problems: only some economies in Africa have access to this sort of financing and shutdowns are likely. South Africa was the only key sovereign to keep continuous access to the market during the commodity price shock.

When available, Eurobond issuance is a welcomed fix for countries with low import covers, since its size is large enough to upgrade the import cover to the safe zone, as e.g. in Egypt. But it increases the reliance of the country on foreign currencies, making repayment quite expensive when the country suffers from exchange rate depreciation. Moreover, there can be a maturity mismatch between financing and expenditure: Eurobonds are not the best way to finance infrastructure or social spending needs. The bottom line is obvious: this kind of inflow will reverse itself sooner or later depending on investors' risk appetite.

Sons-in-law, rather than Chinese children

The region is the first Chinese outward investment destination outside of Asia, following two distinct goals. From the Republic of Congo to Mozambique and

Angola, the access to commodity resources is still the main rationale. As is the case on the Mainland, China delivered many loans in order to secure its access to these commodities. Part of these loans were used to finance new investments, and part was used in crony financing of current spending, allowing a narrowing link between fiscal revenues and expenditures.

Debt has increased in many economies and decreased access to overall credit has put some of these economies in a credit crunch. China may extend the maturity of the loans... or not. But, obviously a public debt restructuring (rescheduling) plan that works for Mozambique (117% of GDP), Republic of Congo (115% of GDP) or Angola (76% of GDP) would involve Chinese bilateral loans.

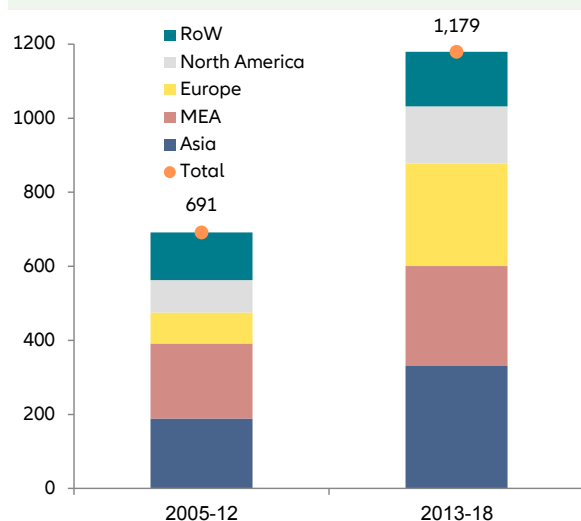
The second kind of relationship is driven by One Belt One Road (OBOR) motives and channels funds mainly to East Africa in order to increase and improve production with the goal of re-exporting the output. As a result, Chinese corporates are also financing infrastructure development (road, railway, ports, power gen-

eration...) in order to improve countries' ability to re-export through the development of a new trade route from Djibouti to Mozambique.

From being a world leader in infrastructure building to using low cost / improving countries' logistics in order to raise low-valued output (textile), the growing Chinese presence is driven by several rationales, but is not unbiased. As a result, social discontent may eventually materialize and Chinese financing in countries with far worse governance may not be as smooth as it was in Mainland China.

Obviously, some projects were financed since China was in the country, including when Chinese investors were not involved in the project. But, overall, there is no explicit Chinese guarantee on African sovereigns, sub-sovereigns or State-owned Enterprises debt (SOEs). Also, there is no proof that China will roll-over its bilateral loans as it was done in the past for Chinese mainland corporates.

Go one step beyond to overcome fundamental African bottlenecks

Figure 5 China's overseas investment and construction activity by region (USD bn)


Source: AEI. China global investment tracker

Public sector enhancement

African economies have the twin goal of developing planning capabilities to follow a sustainable development path while also improving their infrastructure and raising living standards within their countries. This kind of spending needs to be more insourced. The need to raise fiscal income levels is obvious in Africa, particularly in the biggest economies, where sub-sovereigns may lack the resources needed to finance it. In Nigeria, the governorate of Imo State lost its access to power after unpaid bills.

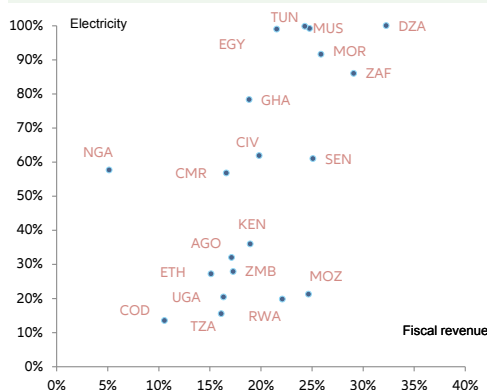
Resources are low and are often not spent in timely fashion, since policy-making processes are too slow, e.g. again in Nigeria where H1 usually does not see many projects imple-

mented because of late financing and H2 benefits from more funding. More generally, a plan that works needs to provide the young labor force with enough skills and jobs in order to have a peaceful transition to a higher income level. In a nutshell, the risk is that inequalities create protests and division and therefore pose a risk to the overall developmental momentum, as e.g. in Ethiopia.

Based on the Chinese example, a plan that works sets goals and priorities for two distinct time periods: In the very long-term (30-40 years) with final targets, and the medium-term with intermediate objectives based on 5-year planning. That is exactly the approach developed in the

Emerging Senegal Plan launched in 2014. The overarching goal is urbanization and focuses a set of priorities on construction (output grew by +11.2% in 2017), as well as on health and education (+9.7%).

Along with soft governance skills (e-government as e.g. in Rwanda, government effectiveness...), it supposes a growing share of taxes in % of GDP in order to match rising expenditure. Spending growth has to be matched with recurrent revenue growth in order to limit sustainability issues. The imbalance between the two is the main weakness observed in Nigeria where fiscal revenues remain too marginal to sustain the effort, as opposed to the situation in Senegal where fiscal revenues

Figure 6 Fiscal revenue (% of GDP) and access to electricity (% of population)


Sources: World Bank, IMF, Euler Hermes

should reach 25% of GDP quite rapidly.

Africa's corporate DSOs: Let it be!

In many places, economies are suffering from too long Days Sales Outstanding (DSO). Big players are often bad payers, whereas small players have no opportunity to pay late. There is a paradox when observing key SOEs able to postpone their payments by several years (e.g. in Angola or in the past in Egypt) and others with no choice but cash payment. E.g. Moroccan main corporates have 84 days of DSOs

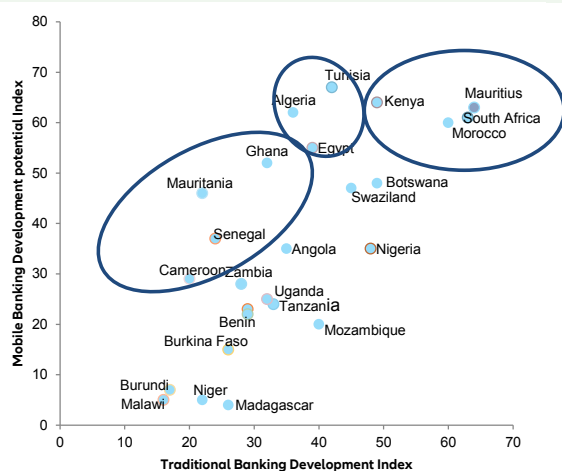
In 2015, Euler Hermes estimated that if a payment term of 30 days were granted on the share of imports paid in cash (cash in advance), then it would free up over USD 40bn dollars of working capital for companies. The commodity shock that hit resource-rich countries sliced their export revenues reducing further their capacity to finance imports.

This contributed to the 22% fall in African import values from USD 800bn in 2014 to USD 623bn in 2016. Taking into account the new trade picture, our new estimate stands at USD 33.5bn for 2018. This

still represents large amounts that could be used to support growth. Decreased imports combined with lower payment terms (64% of imports paid in advance) lead to this result.

As we expect imports to grow at an 8% annual rate, if suppliers were to lengthen their payment term by 30 days, this would free about USD 45bn in 2020. This is a non-negligible opportunity cost for Africa. This huge amount of money wasted each year is a clear argument to develop a domestic capacity to produce the necessary inputs, since imports

Figure 7 Banking development indices, traditional¹ vs. mobile²



Sources: World Bank, GSM Association, Euler Hermes

come with a cost related to low DSOs.

- Oil exporters (Algeria, Nigeria, Angola, Libya...) account for USD 14bn wasted in cash vaults as a result of poor DSOs, with Algeria (5bn, 3% of GDP) at the top of this ranking. Republic of Congo for instance would free up the equivalent of 11% of its GDP (USD 0.9bn) with longer DSOs.

- More DSOs should also be a non-negligible growth factor in fast growing East African economies. In Kenya, it would free USD 1.6bn (2% of GDP), and about the same amount in Ethiopia.
- Potential gains are weaker in value in West Africa (USD 0.4bn in Senegal, 0.7bn in Côte d'Ivoire) but range from 2 to 2.5% of GDP. These gains are weaker in relative terms in countries with

the highest income level: South Africa (0.4% of GDP), Morocco (1% of GDP).

Leapfrogging: Make growth more inclusive through mobile banking

Financial depth and financial literacy are among the bottlenecks impeding Africans access to credit, a key inhibiting factor on growth.

¹ Traditional Banking development index: the index evaluates the state of traditional banking development in 32 African countries according to 3 dimensions (equally weighted): Penetration (Bank accounts per 1000 adults, Account at a formal financial institution (% age 15+), ATMs per 100000 adults), Depth (Bank deposits to GDP, Liquid liabilities to GDP, Domestic credit to private sector) and Competition (Lerner Index, Boone indicator). The data used are taken from the World Bank Global Financial Development database.

² Mobile Banking Development potential index: the index tries to capture the development potential of mobile banking in 36 African countries according to 3 dimensions (equally weighted): Infrastructure (Access to Electricity) Mobile banking current popularity (Mobile phone used to pay bill, Mobile phone used to send money (% age 15 +), Mobile penetration rate. The data used are taken from the World Bank database for the first two dimensions and the GSM Association reports for the third (The Mobile Economy Sub-Saharan Africa 2017 and 2016).

Southern and North Africa have the most developed banking systems, but less than 30 % of the sub-Saharan (excl. High income countries) adult population has a formal bank account.

Informality is quite present in the region and mobile banking appears to be well suited since it reduces the distance between people and banks to zero, and limits both management costs and administrative requirements. Large penetration rate

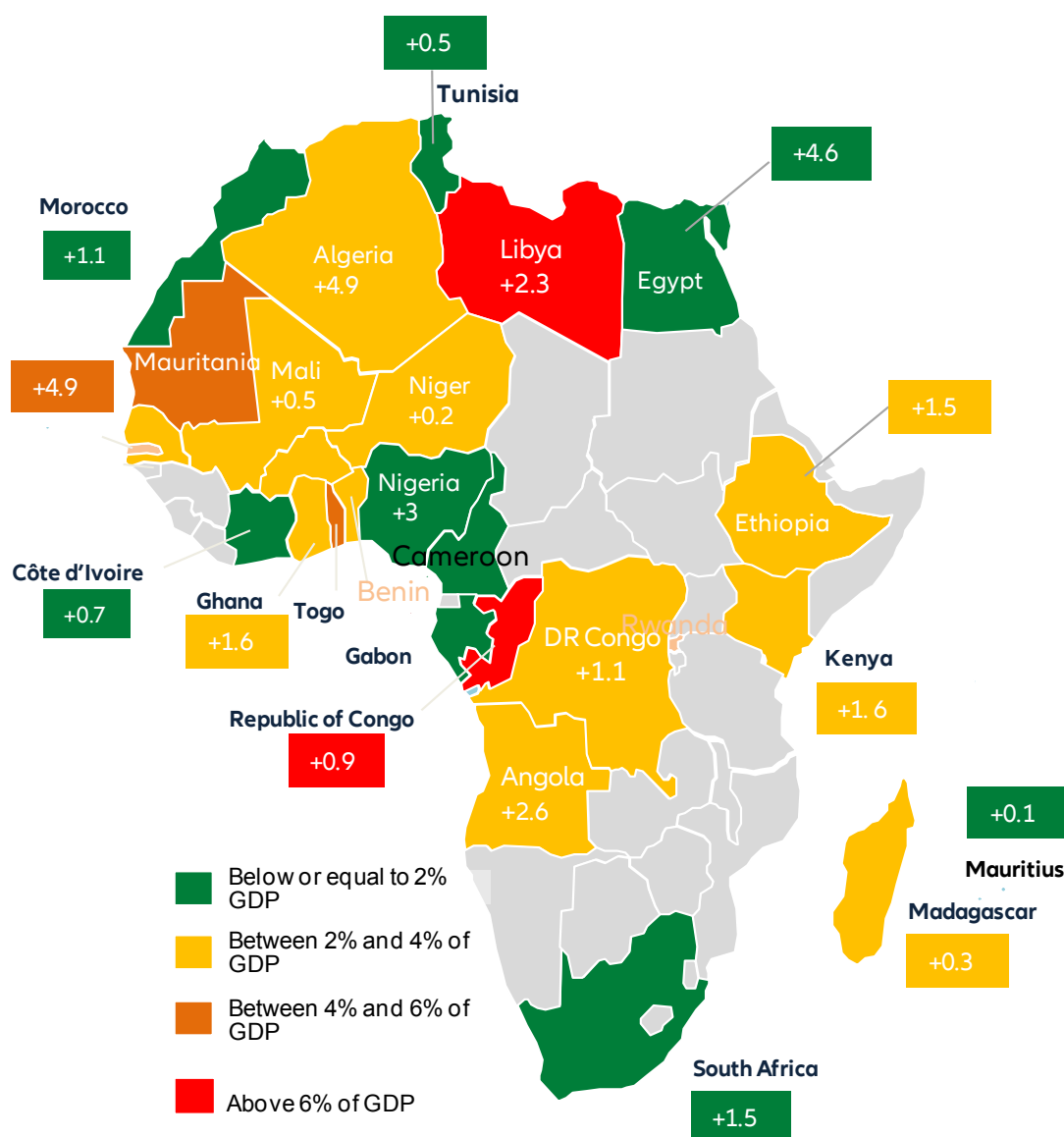
of mobile phones in Africa is an opportunity to include households and give them access to insurance services.

Following the success of the M-PESA experiment, launched in Kenya in 2007 and led by the operator Safaricom, many new initiatives emerged across the continent. Banks and insurance companies developed new strategies to tap into this huge market.

Ecobank for instance, which covers 36 countries in West, Central, and East Africa, reoriented its strategy through the development of mobile tools created for people without bank accounts. In September 2017, it launched Xpress Cash, which allows users to retrieve cash thanks to a mobile app, without the need for opening a traditional bank account.

Stéphane Colliac

Figure 8 Additional Free Cash Flow with higher DSOs (USD bn)



Source: Euler Hermes

NORTH AMERICA

US MID-TERM ELECTIONS TAKE ON EXTRA IMPORTANCE

A rebalancing of power could occur after US mid-term elections with a significant economic impact

President Trump has led an extraordinarily stormy first year and a half which has created unprecedented political vitriol. He has failed to fulfill some campaign promises such as repealing and replacing Obamacare (although he has weakened it) and thus far has not built "the wall". Yet he has also had significant political victories as well, including passing the tax package, deregulation, increased military spending, bringing North Korea to the negotiating table, appointing a conservative Supreme Court justice, and nominating another, the collapse of ISIS, and most importantly, a strong economy. He doesn't talk about the almost doubling of the US budget deficit over the last three years, but you can't blame him, as Republicans - who used to be budget hawks - have become largely indifferent to it now that President Obama has left office. Someday, but not now, this might change.

However, the mid-term elections are approaching in November, giving the Democrats an opening to counter or even reverse some of Trump's policies. Indeed Trump is loved by about 40 percent of the electorate but intensely reviled by another 40 percent. Up for grabs in this election are the twenty percent of the voters who may not have made up their minds, or whose views are more nuanced. A good economy and the feeling that the majority of people in the country believe it is moving in the

right direction gives the Republicans comfort. On the other hand, the President's popularity is only in the mid 40's and this is a particularly bad omen when the country is almost at full employment. Public opinion polls give the Democrats a 7 percent edge against the Republicans on a national basis. Should this remain or increase, it is likely that the Democrats would take control of the House of Representatives, and stand a 50/50 chance of reclaiming the Senate. Because of how the Congressional Districts are composed Republicans can still maintain control of the House of Representatives if they lose the national aggregated vote by less than 4 percent. Anything in between makes it anybody's guess.

The outcome of these elections could have more importance than any mid-term elections in recent memory as with a new Democratic Majority, the Congress can not only stop the Trump legislative agenda at its roots, but could use the next two years to engage in all sorts of investigations designed to make the White House and the Government agencies a miserable place to work for Trump political appointees and probably the President as well.

Historically, the President's party has lost ground in the mid-terms elections. On average, over the past 21 midterm elections, the President's party has lost 30 seats in the House

and 4 seats in the Senate. If that were to happen this time, it would give the Democrats a slim majority of between three and five votes in the House. In the Senate, Democrats (including independents) would hold a 53-47 vote margin over the Republicans.

Republicans are blessed by an excellent Senate map in which there are 33 seats up for a vote, with 23 being held by the Democrats. Five of them (North Dakota, Missouri, Indiana, Montana and West Virginia) are held by Democrats, but were carried by President Trump by more than 20 percent in 2016, making them promising targets for the Republicans. Still, these five Democratic Senators have won before and with deep local ties, and fully warned, each of them has a fairly decent fighting chance to hang on and win again.

There are therefore three possible scenarios:

1. Democrats take the House but not the Senate. This is the most likely case with a probability estimated of around 60%
2. Democrats take both the House and the Senate, with a probability of 25%
3. Republicans maintain the majority in both the House and the Senate, with a probability of only 15%



Photo by Noah Grezlak on Unsplash

In the third case, Donald Trump . could be energized by a popular validation of his policy and complete his own personal domination of the Republican Party, which until he came along, was a strong supporter of NATO and Free Trade and an ardent foe of deficits. Much of this has already changed as the President has put his own unique brand on the party. A lot of Republicans are unhappy about this and have hesitantly fought back. Should the Republicans maintain complete control of Congress, expect President Trump to reign supreme.

A Republican win could lead to a reinforcement of recent policies. An extension of tariffs on larger amounts of imports (our trade feud scenario) and further de-regulation in the financial market is conceivable.

In either the first or second cases with the Democrats winning at least one House of Congress, the Democrats will have the ability, if they stick to party lines, to stop the Trump agenda in its tracks, or even roll back some of its achievements. To get some idea of what to expect, you could just look at the Obama administration which was una-

ble, after its first two years in office, to secure any major legislation when the Republicans took control of the House of Representatives. President Trump was legislatively blocked in had to resort to using his regulatory authority to get things done which he wanted. However, a significant portion of this was later overturned by the Courts decisions affirming that the President lacked the legal authority for his actions.

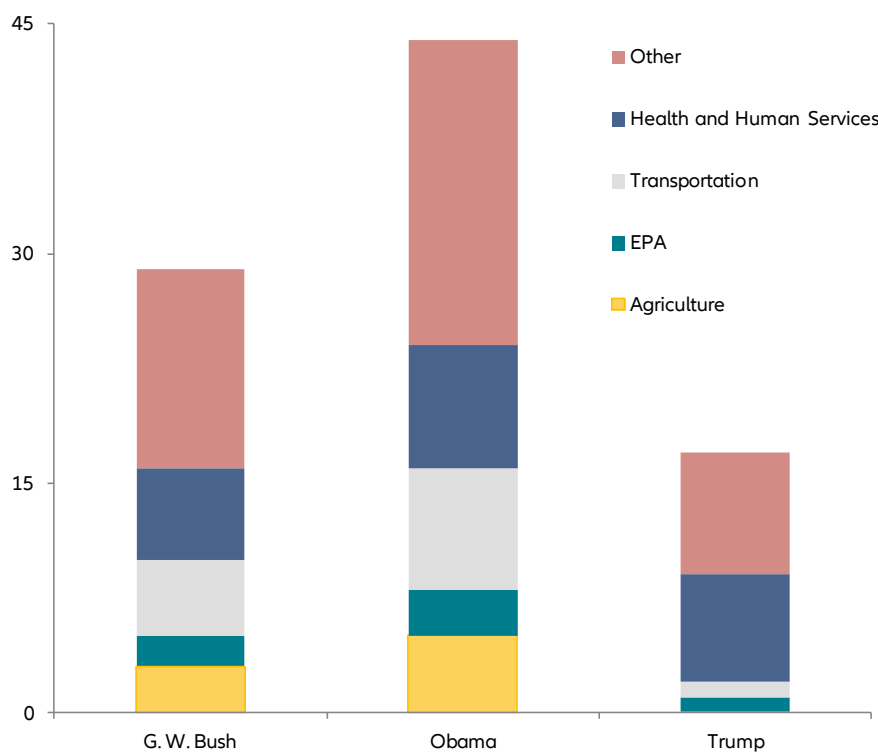
Reversal of tax cuts

The Tax Cuts and Jobs Act has been Trump's most significant victory so far, and it has become his signature legislation. Democrats however opposed the bill en masse, and not a single one voted for it. Former (and potentially the next) Speaker of the House Nancy Pelosi, a Democrat, has actually vowed to reverse the tax cuts. Even though the plan is only very vague at the moment, if it were to succeed, it would surely create a drag on the economy and push it into recession sooner than it otherwise would. One of the reasons the Democrats opposed the measure was that it the tax cuts flow disproportionately to the wealth and that it would add to the national debt. However it is almost certain that reversing the tax cuts would

not alleviate the debt because a faster, deeper recession would produce less revenue, and Congress has no interest at all in curbing spending. This scenario is implicitly contained in our macro-economic scenario as we consider that mid-term elections are likely to increase pressure on President Trump regarding the debt sustainability issue, triggering a deceleration of growth in 2019 to 2.4% y/y compared with 2.9% y/y in 2018. Indeed, in the wake of recent tax cuts, the degradation of public finances in the US is currently taking place at the same pace as during the subprime crisis. In the end, it is likely to take President Trump leaving office and the emergence of high interest rates to force the US Government to take action on deficit spending. As long as the party is still going on, there is no appetite to deal with this difficult issue even though delaying action makes the problem bigger **and harder to solve in the future**

More instability in budgetary issues with repercussions on the equity market

The government is currently funded through the end of September, but if no spending bill is passed by then, the government will shut down, undermining business and consumer confidence.

Figure 1 Published Economically Significant Final Rules within 1st year of a Presidential Term

Source: RegInfo, Office of Management and Budget

It could also temporarily slow the economy as government employees would go unpaid (they are usually paid retroactively afterwards). In addition, the debt ceiling, which is currently suspended, will in theory be reached on March 1st, 2019 (i.e. the day it is to be reinstated). Typically, the Treasury will be able to avoid the ceiling for some period of time, but eventually it will have to be raised, or the government will have to default on its debt obligations. Normally this results in last minute theatrics and finger pointing with a solution being found minutes before the deadline. However Trump is unpredictable and could do the unthinkable and default on the debt, which would be disastrous for the global economy. A shift of power in Congress, including the influence it could exert on a rebalancing of fiscal policies, is likely to increase uncertainty even more and feed volatility in the equity market. Potential revisions to earnings expectations, in the wake of fiscal back pedaling, is likely to trigger a severe correction of the equity market and a signifi-

cant depreciation of the Dollar.

Republican Members of Congress will do everything possible to keep the government open and prevent the default on the debt. Deep in their hearts they know that the public would hate this occurring, and would blame them, as the party which controls both houses of Congress and the Presidency, and not the Democrats for the damage. Reigning in President Trump has always been a challenge for Congressional Republicans. Their magic political card is to tell the President that a government shutdown and a debt default would cost the Republicans their Congressional majority and this would mean that the next and possibly the last two years of the Trump Presidency would be miserable for everyone, especially the Commander in Chief.

Re-regulation

One of Trump's campaign promises was to repeal two existing regulations for every new one created. Although it's not at all clear if this goal has been achieved, it is true that the

administration has stopped some Obama-era regulations that had not yet been implemented. And in the first year the administration approved only 156 regulations compared to over 400 for Bush and over 500 for Obama. In a rare bipartisan move, Congress in 2018 did change part of the Dodd-Frank act to ease restrictions on small and regional banks, and it did so in a bi-partisan effort. Yet again some Democrats are now announcing plans to put back the Dodd-Frank restrictions on some of the larger regional and national banks. That would hurt the economy because those banks would again be constrained in making loans, particularly to small and medium sized business.

Impeachment

Some progressive Democrats have vowed that if they win the House, they will vote to impeach Trump, which would amount to charging him with a "high crime or misdemeanor". Others in the party counsel restraint, saying that as evidenced by the Clinton Impeachment



Photo by Joseph Barrientos on Unsplash

proceeding in 1998, the American people don't like to have their President removed even if they don't particularly like him.

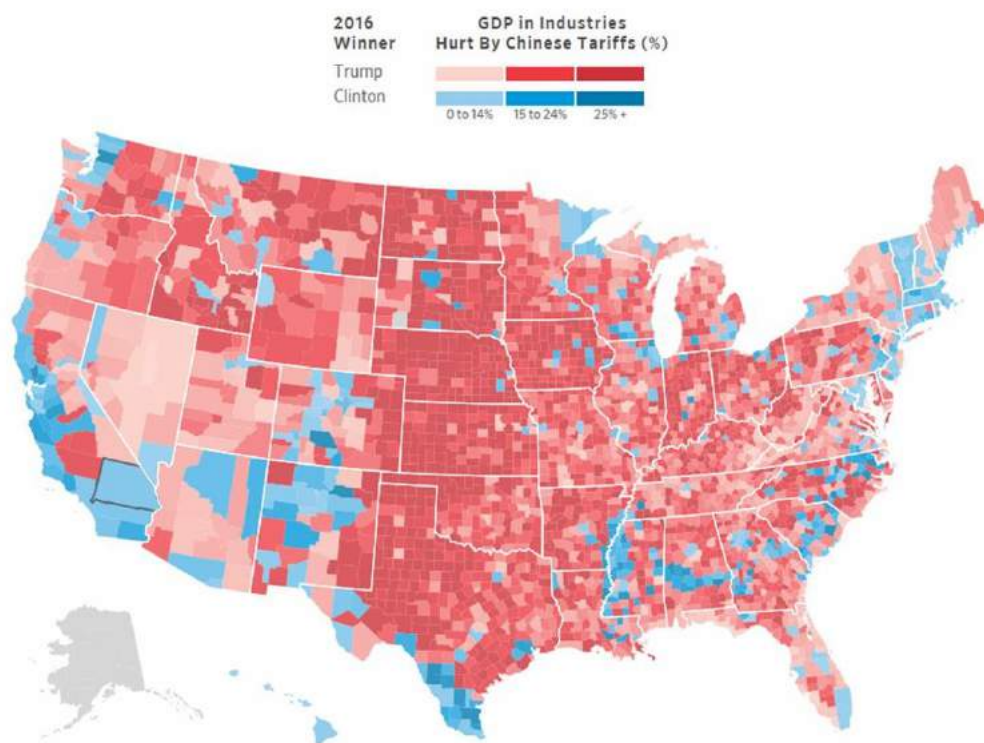
An impeachment only takes a simple majority vote in the House of Representatives. But the next step in the process is to actually hold a trial in the Senate, where a 2/3rds majority, or 67 votes, would be required to remove him from office. That would imply that the Democrats might need around 13-16 Republicans to vote along with them. This seems unlikely, though not impossible and if history is any guide, it would take an extraordinarily serious crime to have occurred to get a conviction, and more likely than not, as seen by President Nixon in 1974, the easier path is just to quit and leave office. No President has ever been removed from office through impeachment and conviction. However the uncertainty caused by the proceedings and the accompanying vitriol could easily derail consumer confidence and spending,

possibly creating enough of a headwind to slow the economy and push it faster into recession. It should be noted however that the economy was largely unaffected by President Clinton's impeachment and trial and in fact it was precisely the good economy that not only allowed President Clinton to escape judgement, but which permitted the Democrats to gain rather than lose seats in the House of Representatives, a year in which the Republicans thought they would be the winners.

Immigration reform

The immigration situation and debate is currently highly explosive. If the Democrats take over, immigration reform of some sort could well be their very first priority, and the resulting clash with the Republicans and Trump could turn even uglier than it already is. Once again that could undermine consumer and business confidence and put a drag on the economy. Immigration is one of the few issues

where a public bipartisan consensus is emerging that involves: 1) border security; 2) limitations on the number of people allowed to come to the United States, and 3) the establishment of legal status for those people who have come without documentation, but have lived without significant legal blemishes during their lives. Right now the far left and the far right is preventing compromises from occurring but this could possibly change, particularly if both political parties believe it is in their interests to do so. Many Republicans were prepared to make a deal with the Democrats on immigration reform in 2018, but backed off when it became clear that support from President Trump, which was intermittently promised, was permanently withdrawn. Many fear Republican primary voters and need political cover from the President to get to an agreement which deep in their hearts they support.

Figure 2 US Counties Industry GDP hurt by retaliatory tariffs

Source: Wall-Street Journal, Moody's Analytics (industries impacted); Dave Leip's Atlas of U.S. Presidential Elections (2016 winners); U.S. Census Bureau (population). Note: The percentage of gross domestic product in each county is weighted based on the industry share of GDP.

Executive orders and vetoes

If the Democrats take over, the rest of the Trump administration's plans will be totally de-railed. As a result he will have to borrow from the gamebook of President Obama and other Presidents to use Executive Orders and regulations to achieve his goals, and he will clearly not hesitate to do so. However, even Executive Orders still need funding approval from Congress, providing yet another roadblock. On the other hand the President retains the power to veto any legislation put forth by Congress. That veto can only be over-ridden by a 2/3rds majority vote in both the Senate and the House. The U.S. Constitution does provide an excellent set of checks and balances, but the result could be a completely stagnant government. For example, try as they might during the time when Republicans were in control of one or both houses of Congress during the Obama administration, (2011-2017) they had only modest success in blocking the President. During the Obama years, State Republican Attorney

Generals got very good at developing strategies to block regulations once they were adopted. Democrats seemed to have learned from this lesson very well and are doing the same. "I will see you in Court" is a very American way to deal with things you find annoying.

Trade policies

Under the US Constitution, Congress is responsible for deciding on trade agreements, which need to be passed into law. The setting of individual tariffs normally depends on the approval of both the House and the Senate. These kinds of initiatives (trade agreements or tariffs) have traditionally been delegated to the US President, but the Congress keeps its prerogative of accepting or refusing them.

In the current situation, President Trump's imposition of new tariffs bypassed this approval by utilizing Section 232 of the Trade Act of 1962, which allows the usage of tariffs without Congressional approval on the grounds of national security. Several lawsuits will challenge the

President's authority saying it was designed to deal with real national security issues, and not the importation of expensive German cars. It is possible the Trump administration might be forced to retreat. That being said, the decision to impose tariffs has direct implications on the electorate as evidenced by the map below, which shows that retaliation by China and the EU target President Trump's voters. In these circumstances, Republican political leaders of these states (often with an important agriculture sector) have recently been less vocal in supporting his protectionist initiatives. In the case of a rebalancing of power in Congress in favor of the Democrats, there could be more support for initiatives which aim at reducing the role of the President in deciding trade policy. In fact on the 11th of July 2018, 39 Republicans and 49 Democrats in the Senate voted for a resolution re-affirming Congress' role in trade issues. Already the Europeans have threatened tariff retaliations, and the Chinese are not only doing this but are subjecting



Photo by Brandon Mowinkel on Unsplash

all types of US products, including agricultural produce with a short life span, to enhanced inspections which is causing misery for US exporters.

Other considerations

The immigration situation could continue to deteriorate, which would probably favor the Democrats as they are seen to be more humane, particularly in light of the administration's former policy of separating families caught at the border. A few Republicans could back away from Trump if his immigration and trade policies have even more negative consequences than they already have had. Business and agriculture groups are already complaining about their inability to secure workers.

The fight over the next Supreme Court nominee is likely to be extraordinarily heated and bitter. Ultimately all that's needed is the 51 votes the Republicans currently have in the Senate, but the Democrats could use the fight to make

significant inroads in the election. Trump has already appointed one conservative Judge to the Supreme Court, and another one would give the Court a decidedly conservative orientation for many years to come. Republicans hope that the appointment of conservative Judges will serve as a rallying cry for business owners, and well educated and affluent voters who have been put off by the perceived chaos of the Trump Presidency. They think this issue will bring these less than enthusiastic Republicans back into the party fold.

The Democrats could the issue of Supreme Court Judicial nominations to create fear in the voters that their civil liberties would become under attack. In particular, many Democrats are concerned that the Court could re-visit the landmark *Roe vs. Wade* decision which legalized abortion in the U.S. Well educated suburban women voters, who usually lean slightly Republican, might be put off by all of this. This was already seen in the

Gubernatorial and State legislative elections in Virginia in 2017, where Republicans did much worse than anyone expected. In these elections, Democrats, perhaps motivated by their disdain of the President, came out in much larger numbers than normal, and the important Independent vote, also swung their way.

The Mueller probe into Russia – Trump collusion during the campaign, or possibly rumored reports of his personal financial connection to Russian oligarchs could turn up damning evidence. Thus far the Trump base has stayed with him, but nothing in politics is forever.

Democrats will have to be cautioned about the tendency, for at least of some of them, to move far left on a number of issues where the general electorate disagrees with them. Prominent among them are Medicare for all, the closing down of the Immigration and Customs Enforcement office, and maybe going just a little too far on legalizing, Marijuana and abortion rights.

Dan North and Peter Lefkin

WESTERN EUROPE REFORMS RELOADED

Europe will enjoy above potential GDP growth for two more years. This should be a good reason to boost reform momentum. Despite high expectations, the institutional breakthrough has been delayed to late 2018

Exogenous factors (i.e. US policy), but also endogenous (i.e. Brexit) call for a speed-up in European institutional reforms

Europe is likely to experience still above potential GDP growth for at least the next two years, at +2.1% in 2018 and +1.9% in 2019 respectively. The recovery, truly visible since 2017, has not yet sufficiently morphed into higher household purchasing power and significantly lower unemployment rate in a widespread manner across all Eurozone economies. In Italy for example, the unemployment rate reached 10.7% in May, the lowest since 2012, but remains around 4pp above the 2007 level.

Despite a speed-up in the national reform momentum since 2014, Italian GDP growth has lagged peers. Insufficient progress on the economic front has probably contributed to the rise of anti-establishment parties. This trend is visible across the Eurozone countries. Our simulations suggest that 38% of the seats of the next European Parliament could be held by “populist” parties against 30% in 2014. This suggests that both the European Parliament and the European Commission would be governed by a “grand-coalition” between traditional parties, but it also shows a high risk of polarization in the European political landscape. This could represent a significant

obstacle to reform.

The 28-29 June European Summit was a step in the right direction, but the outcome remains below expectations

The Meseberg joint French-German statement on Europe on June 19th revealed the projects on which there is a consensus and willingness to progress on both sides. Its content has increased expectations in terms of reform speed in the Eurozone as the statement outlined several initiatives looking at strengthening and reforming topics such as security, migration, competitiveness, taxation, EMU integration, climate and innovation.

Despite this, the June Summit brought a consensus on controlling the migration flow into the EU (the most pressing issue for the German and Italian government), security and trade policies (reforming the WTO, notably the dispute settlement mechanism) while it disappointed on the economic reform.

Europe is indeed in a tough situation: the German coalition is weak, the Brexit-related deadlines approach fast with no major progress and increased political uncertainty, Italy is governed by an anti-establishment coalition and the US foreign policy goes for decreasing multilateralism and a lower role as a

provider of world public goods (security, trade, protection of environment...). In the wake of the European elections, and the rise of populist forces, progress on the European reform agenda seems to have been delayed.

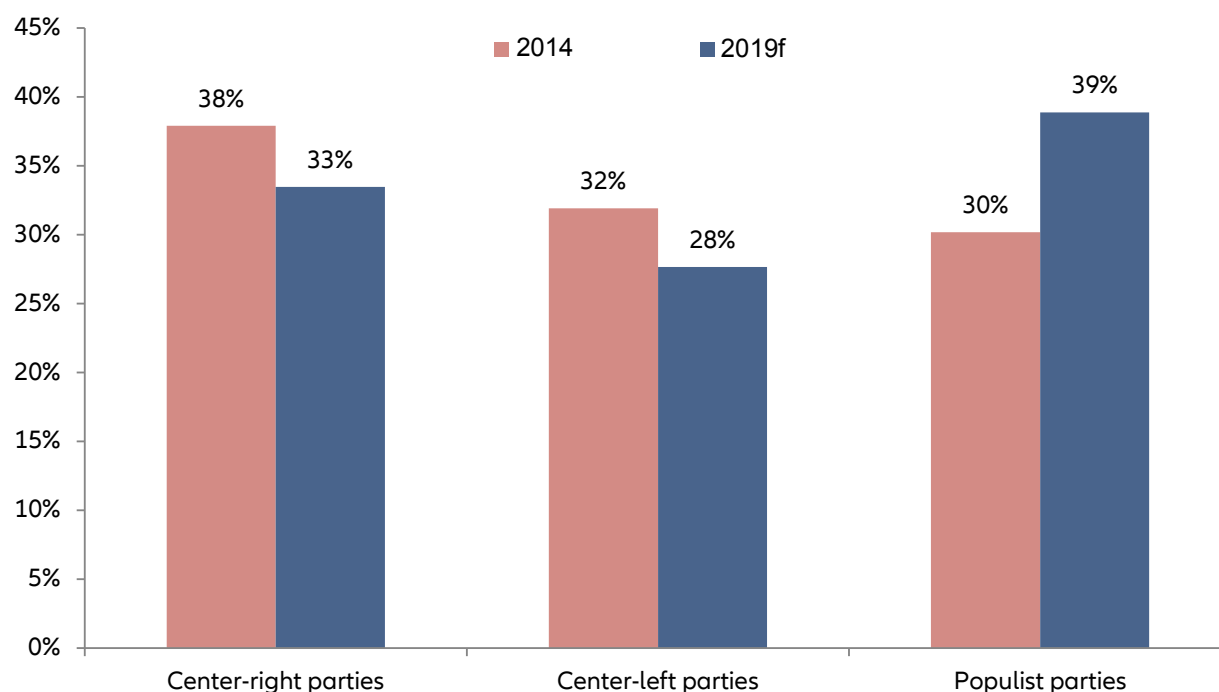
On the economic side, the revamp of the European Stability Mechanism, to be most probably called European Monetary Fund (EMF) is good news.

However, it will remain an inter-governmental tool (and not a European Institution) while a lot of details are still to be given in December.

The only concrete agreement was that the EMF provides a credit line (around EUR55bn to be confirmed) to the Single Resolution Mechanism (second pillar of the banking union and the last resort backstop for distressed banks) by the time it becomes fully operational in 2023.

Awaited details at the December Summit – which would be considered as positive – are: (i) greater responsibility for the development and monitoring of financial assistance programs, (ii) a debt restructuring option post debt sustainability analysis, and (iii) a more efficient usage of the precautionary lines.

European Parliament, share of total seats 2014 vs 2019



Sources: polls, Allianz Research

Next steps on European reforms: a clear roadmap for completing the Banking Union and agreement on setting a Eurozone budget for targeted investments as the next steps for the 14-15 December Summit

The European reform goes beyond France and Germany. To understand what can come next, we looked at the common denominator between the tandem France-Germany and the Group of 8 EU countries¹ that have been vocal on the matter. We have found 4 main common objectives: (i) the transformation of the ESM into a European Monetary Fund, (ii) the finalization of the Banking Union, (iii) the reinforcement of the post 2020 Multi-annual Financial Framework, and (iv) progress on the Capital Markets Union in order to foster cross border private risk sharing.

Completing the Banking Union means reinforcing the common backstop for the SRF (already announced in June) and implementing the European Deposit Insurance

Scheme (EDIS), the third pillar. This last point is very much dependent on the risk reduction in the banking system and the legacy issues post crisis (i.e. remaining close to EUR300bn of non-performing loans in Italy for example). The November European Banking Authority (EBA) stress tests would comfort the banking risk reduction since the 2016 stress tests, in particular for Italy. Thus, we would expect an agreement on a concrete roadmap implementation in December.

We would also expect an agreement on a Eurozone Budget as part of the Multi-annual Financial Framework as announced by the Meseberg joint French-German statement. Resources would come from both national contributions, allocation of tax revenues and European resources (financial tax, digital tax). The Budget focus would be on investments targeting innovation, technology and human capital. Setting up a Eurozone unemployment reinsurance fund as part of the Euro-

zone budget would come as a second step, most probably in H2 2019, once the size of the Budget would have been decided (President Macron called for several points of GDP while President Merkel spoke about tens of billions).

Finally, more decisive progress on the Capital Market Union (CMU) would not be announced in our view before Brexit is finalized and that the EMF and the banking union are close to finalization (which we see as pre-conditions to the CMU) – which would take at least until end-2020 in our view.

Ana Boata

¹ Denmark, Estonia, Finland, Ireland, Latvia, Lithuania, the Netherlands and Sweden

ASIA CHINA: A MULTIFACETED STRATEGY IN RESPONSE TO THE US

China's economic responses to US protectionist measures will range from economic patriotism policies to currency depreciation. Regarding domestic demand, rising income and a fine tuned policy mix would provide some buffers

It's all about policies

China started the year on a strong footing despite a rise in oil prices, an increase in protectionist rhetoric and a tighter monetary policy in the US. Economic growth rose by an estimated +6.8% in the first semester, the RMB was strong with an average of 6.3 per USD.

The remainder of the year and 2019 are set to be more challenging. First, monetary tightening in the US is expected to pick up speed (two hikes expected by the end of this year) and this could lead to downward pressures on the RMB. Secondly, the Trump administration could intensify protectionist measures and this could hinder China's export performance. The US recently announced that it considers additional tariffs of 10% on USD200bn Chinese exports.

Against this background, our scenario envisions an economic growth of +6.6% in 2018. Policymakers are expected to: (i) adopt a multifaceted strategy to respond to US protectionist measures, (ii) adopt a more supportive policy mix in order to keep economic growth in check.

A multifaceted strategy in response to the US

China will likely adopt a gradual and measured approach to respond to US protectionist measures consisting in five types of policies. The objectives would be to force the US to negotiate and limit the impacts of the newly implemented protectionist measures on the Chinese economy.

1. The country could set a soft economic patriotism policy

This could include: (i) non-regulatory measures such as an anti-US campaign, a boycott of some US products; (ii) regulatory measures that affect American companies operations in China. The latter could consist in tighter regulation at the customs, more difficult rules for basic and routine procedures (set up of a company, revenues repatriation to the US, e.g.). China has already employed this strategy in the past when South Korea decided to install a US made Terminal High Altitude Area Defense anti-missile system (THAAD). At that time the Chinese government started a boycott against South Korea. This resulted in a drop of -48% of Chinese tourist arrival in South Korea in 2017 (after +35% in 2016). Bank of Korea estimated that the THAAD backlash shaved -0.4 pp off growth in 2017.

2. Chinese authorities could increase strategic partnerships with economic heavyweights such as Japan, ASEAN, India or the EU. This could kill two birds with one stone. A coordinated response could give more leverage against the US. Partnerships could open new avenues for trade especially when they result in mega free trade agreements.

China has already started to move on that front.

- It presses the EU for greater cooperation and anti-US coalition on trade. The last talks between China and Germany suggest that the two blocks could move towards that direction. The two countries signed deals worth USD23.6bn and announced further cooperation between government agencies.
- It is stepping up measures to accelerate the negotiation of the Regional Comprehensive Economic Partnership which should gather all major economic blocks of Asia (China, Japan, ASEAN, India, South Korea, Australia and New Zealand).



Photo by Aaron Greenwood on Unsplash

3. The Mainland could implement protectionist measures on the balance of services.

The country has a deficit with the US (-38bn). Both travel and financial services could be the target. This could be a huge blow to US corporates that are looking to tap into the growing (financial) needs of the new Chinese middle class.

4. China could use the RMB as a tool of retaliation.

We expect the RMB to depreciate by -4% against the dollar in the second semester compared with the first semester. The recent depreciation of the currency and limited reaction of the PBoC suggest that the authorities are comfortable with a weaker RMB. This would help corporates to absorb the rise of tariff through an improvement of their price competitiveness.

5. Lastly, we could see turbulences on the holding of US treasuries but not a major sell-off, as it could considerably hinder investor confidence and be in contradiction with the stability of the RMB. The objective could be to trigger a temporary rise in US yields in order to force the US to negotiate.

A more supportive policy mix

In parallel, measures to support domestic demand will likely be implemented. In the short term, increasing incomes (nearly +8% y/y growth for nominal disposable income) and rising industrial profits (up to +16.5% YTD y/y in Jan-May) should support private expenditures.

In the medium term, fine tuning macro-policies will be pivotal to keep growth in a decent range. First, we expect fiscal policy to be expansionary. Public infrastructure spending could pick up speed as part of the Belt and Road Initiative. On the tax side, cut in tariffs for some consumer goods (automotive, agri-food, e.g.), cut in income tax would likely boost consumption growth.

Secondly, we expect the ongoing financial tightening to pause. Deleveraging efforts would be maintained though via stricter regulation. Authorities would keep the benchmark lending rate at 4.35% until the end of this year. Yet, they would step up targeted liquidity measures (RRR cut, liquidity injections) in order to support the most fragile entities of the economy (corporates at a risk of default, SMEs, e.g.). The last 50bp cut in Reserves Requirement Ratios

goes to that direction. It is expected to unleash RMB700bn of cash in the bank system, and this liquidity should be directed to viable companies that are at risk of default and to SMEs.

Last, more structurally, we expect authorities to keep up their efforts of financial liberalization. On inflows, easier regulation on FDI and the opening of the financial sectors are set to be key drivers. On outflows, we expect a more gradual approach with still strict regulation: (i) on large amount of capital flowing out of the countries and (ii) outward flows that are not tied to authorities' strategy (e.g. non-Belt and Road).

Mahamoud Islam

LATIN AMERICA

AMLO'S MEXICO

Photo by Omar G. Garnica on Unsplash

President-elect Obrador inherits a resilient economy and is given a strong mandate for reform. Yet, we expect only partial implementation of his proposals

AMLO inherits a resilient but underwhelming economy

On Sunday July 1st, Andrés Manuel López Obrador (AMLO) won the Mexican presidential election by a landslide (53% of the vote share) and his coalition *Together We Will Make History* now holds a majority of seats in both chambers of Congress. What Mexico does he inherit?

Mexico's economy should continue showing resilience. The election of Donald Trump in the US brought the currency to an all-time low in January 2017 (MXN 21.9 per USD), and caused business confidence to drop to its lowest level in 8 years. Yet, the economy grew +2.0% in 2017 after +2.9% in 2016 and is on track for a strong performance this year (+2.5%). This is attributable to (i) an accelerating US cycle driving industrial production and exports (80% of which go to the US); indeed despite a bleak investment cycle, industrial production remains at a high level. (ii) Tight labor market, with unemployment at a record low (3.40%) and wages picking up.

Mexico's macroeconomic policy management boasts a sound track record: Fiscal policy is constrained by the 2006 Fiscal Responsibility Rule and its enriched framework (fiscal deficit hovers around -1% of GDP). Monetary policy has been proactive. Since the Fed's first hike, the Central Bank hiked the official rate 13 times to tame inflation (now at +4.5% down from +6.8% in Dec.2017) and avoid a wave of capital outflow.

On the other hand, the economy is held back by an inhibited consumer, in a context of still high inflation and tight monetary policy conditions (policy rate at 7.75%). In addition, Mexico exhibits **structural vulnerabilities**. The business environment worsens as the country has fallen more than 30 ranks in Transparency International's Corruption Perception Index in the last two years, and the number of homicides in 2018 is expected to be double that of 2014. Poverty (44% of the population) and inequality between the North and South remain persistent issues.

Partial policy implementation, and continued volatility in sight

The immediate aftermath of the election has been comforting for companies, with reassuring messages sent by AMLO's nominations of pro-business figures to key posts. The MXN peso even erased its losses is now up +3% year to date. We do not expect a major fiscal drift, but our 2019 growth figure (+2.1%) is subject to an upside risk, as we learn more about the

projected fiscal stimulus. AMLO indeed intends to remediate to the atony of investment by increasing public investment from 2.6% to 5% of GDP, and boost private consumption through social spending (2% of GDP). It is less likely that he maintains fiscal accounts balanced (see table below), as financing fiscal spending only through better allocation of public funds and fighting corruption is unrealistic. Going forward, two main risks and sources of volatility remain: the renegotiation of NAFTA and the future of the energy sector, a target of the new Mexican president.

AMLO's economic policy measures and expected implementation

ECONOMIC POLICY	TO WHAT EXTENT COULD IT BE IMPLEMENTED?
Institutions, economic values and principles	
Respect the independence of the central bank, and principles of the market economy. Increase competition in the financial sector (deregulate in favor of small banks, strengthen existing supervisory agencies)	
Support NAFTA and adopt a constructive stance in negotiations	
Corruption: zero tolerance, elimination of privileges and abusive government contracts. Retrieve up to 2% of GDP in public money from corruption. (the IMF estimates Mexico loses 2% of GDP because of corruption)	 <i>Not as easily said as done. Government austerity measures overestimate room for maneuver as AMLO will not be able to reduce pensions, wages, transfers to states</i>
Fiscal policy	
Maintain a stable budget deficit and avoid increasing debt, without increasing taxes to finance public spending until spending efficiency has been achieved (i.e. eliminating corruption, overspending, etc.)	 <i>No excessive fiscal drift in sight, but hard to imagine spending financed only with public savings retrieved from corruption, without increasing deficit or taxes. Mexico's tax revenues-to-GDP ratio (17%) is the lowest in the OECD and lower than Brazil or Colombia</i>
Infrastructure: implement an ambitious program worth 4% of GDP (including refineries see structural reform section). Create an infrastructure fund (joint public-private participation) <ul style="list-style-type: none"> 2 high-velocity trains Improve infrastructures in the South Put the New Mexico City international airport project in standby, submit it to public consultation 	 <i>Program ambitions will likely be revised down. We expect partial implementation</i>
Increase social spending (2% of GDP plan) and investment (to reach 5% of GDP up from 2.6% currently) <ul style="list-style-type: none"> Increase spending on healthcare and education: universal pension for the elderly and disabled, scholarships for poor students. Increase minimum wage by 11.6% annually until 2024 (until it reaches MXN 171) 	 <i>Likely to implement most of the measures which appeal to his ideological base.</i>
Structural reforms	
Overturn the energy sector reform	 <i>AMLO has backed down, and securing a 2/3 majority to amend a constitutional reform could prove difficult in this case</i>
Support the domestic oil/energy sector <ul style="list-style-type: none"> Build 2 refineries and develop the 6 existing ones in order to stop importing fuel within three years. Index gasoline prices to inflation (=freeze real prices) for at least three years. This threatens tax revenues and inflation expectations 	 <i>Revising oil contracts is possible, and restricting foreign investment in energy sector as well, to support PEMEX and CFE. Yet freezing gasoline prices and building refineries would have huge cost implications</i>
Overturn the education reform	

Sources: "Andrés Manuel López Obrador: Equipo de trabajo y agenda", Euler Hermes



Georges Dib

EMERGING EUROPE HUNGARY CHECK-UP



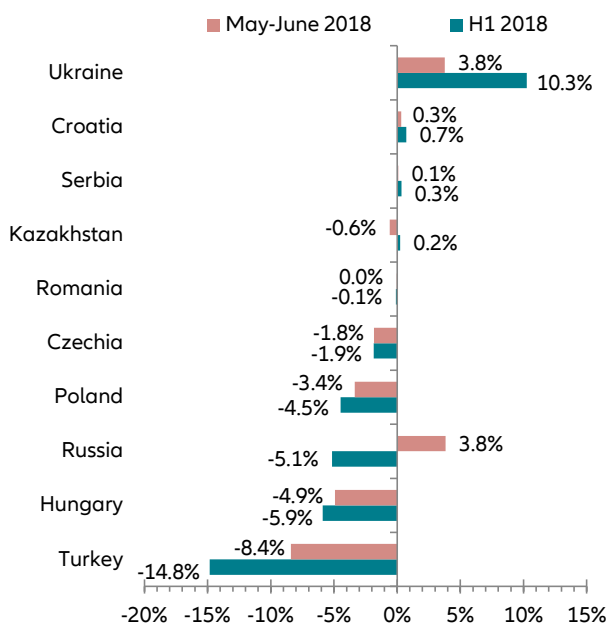
Photo by Daniel Olah on Unsplash

The labor market is overheating, the wider economy not yet

Strong growth...

The economy continued to boom in Q1 2018. Real GDP grew by +4.4% y/y, the same pace as in the previous quarter and stronger than in 2017 as a whole (+4%). Growth in Q1 was driven by domestic demand, notably fixed investment which surged by +17.1% y/y, fueled by a strong absorption of EU investment funds, which we expect to continue in the coming quarters. Consumer and public spending also rose rapidly by +5.1% and +4.6% y/y, respectively. In contrast, external trade activity weakened markedly on softening demand from the Eurozone. Exports expanded by just +3.5% y/y and imports by +3.8% in Q1, less than half the paces reached in 2017. Advanced indicators suggest that the momentum has eased slightly but remained overall robust in Q2. In April-May, industrial production growth slowed to +3.3% y/y, reflecting the cooling external demand, while retail sales growth (+6.8%) remained buoyant, indicating continued sound consumer spending. Overall, we forecast +3.8% GDP growth in 2018 as a whole.

Chart 1 Currencies – changes versus



Sources: IHS Markit, Allianz Research

...but weakening currency

Despite the strong economic activity, the Hungarian forint (HUF) has weakened markedly in the first half of 2018. The HUF reached an all-time low of 330 per EUR at the end of June, having lost -5.9% in value in H1, most of that in May-June (-4.9%). This made it the second-worst performing currency in the Emerging Europe region – only the Turkish lira lost more in value (see Chart 1). In 2017 as a whole, the HUF had still slightly appreciated by +0.7% against the EUR. How is the recent weakening to be explained?

Fiscal stimulus should be offset by monetary tightening

The strong economic impetus since mid-2017 in particular has been fueled in part by pro-cyclical fiscal stimulus. VAT rates on various products were lowered while public sector wages were raised. The latter combined with a tightening labor market (unemployment fell to 3.9% in Q1) has pushed up overall wage growth (+12.4% y/y in Q1) and accelerated consumer spending. Corporate taxes were also cut which has mitigated the impact of wage growth on corporates as well as inflationary pressures until early 2018. However, the recently proposed 2019 budget proposes cuts in social contributions as well as more hikes in public sector wages. This has raised concerns about a further overheating of the labor market and adverse effects for the wider economy, explaining the loss of confidence in the HUF. Moreover, monetary policy has remained very loose for now. The key policy interest rate was again kept at 0.9% in June, even though CPI inflation rose to 2.8% y/y in May and 3.1% in June (up from 1.9% in February).

That said, other macroeconomic fundamentals have remained in check so far. Private sector credit growth has remained modest at +3.3% y/y in April. The current account balance posted a solid surplus of +EUR1.4bn in the first four months of 2018. The fiscal deficit is expected to widen as a result of the fiscal stimulus measures but should remain well below -3% of GDP in 2018.

Summarizing, the overheating labor market and the depreciating HUF need close monitoring. However, the Central Bank has the tools to rein in the risk of a full-blown overheating and recent comments suggest that it is ready to tighten policy if needed. We expect the first interest rate hike to come in early 2019, at the latest.

Manfred Stamer

MIDDLE EAST UNDER PRESSURE

Bahrain: A large and credible support package is needed

Concerns on the rise again

At the end of June, Bahrain returned into the spotlight as yields on its government bonds and credit default swaps surged within a few days, putting pressure on the peg of the Bahraini dinar (BHD) to the USD. Previously, the smallest GCC country had come under scrutiny in November 2017 on reports that it had asked Saudi Arabia and the UAE for financial support in order to replenish its foreign exchange (FX) reserves and avert a currency devaluation. The latest sell-off had no specific new trigger. It appeared to reflect investor concerns over Bahrain's precarious public finances and external debt sustainability while there was still no credible support commitment from the richer GCC countries.

Against the backdrop of falling oil prices, the fiscal deficit surged to around -18% of GDP in 2015-2016. With the gradual recovery in oil prices, the shortfall moderated to -15% in 2017 and is forecast at a still large -11% in 2018 as Bahrain has the highest fiscal breakeven oil price in the region, estimated at 95 USD/bbl (see Chart 1). External debt sustainability is threatened as FX reserves fell again at the start of the year and were estimated at just USD2.4bn in April. This is equivalent to just one month of import cover (see Chart 2). In other terms it is even more critical: it covers only a meagre 10% of the external debt payments falling due in the next 12 months, much below an adequate ratio of 100%. Adding Bahrain's assets held in its

SWF – which amount to USD11bn (the smallest in the GCC) – to the FX reserves, that ratio remains modest at just over 50%.

Support to come?

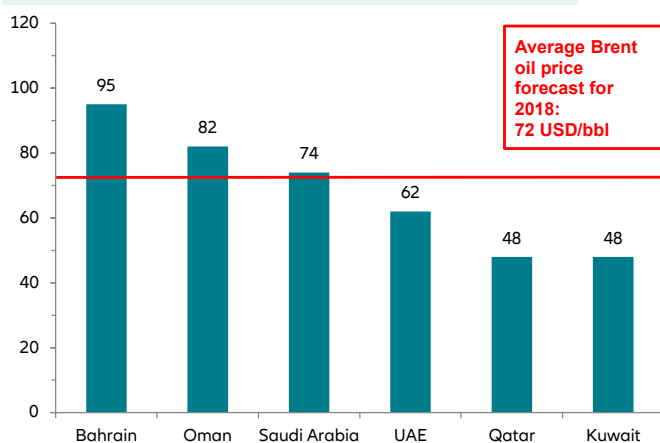
In the meantime, Saudi Arabia, the UAE and Kuwait have delivered a firmer statement that they will provide a financial support program. Details have to be disclosed yet, but any aid is likely to be conditional on strict fiscal consolidation. Ultimately, we expect a policy package to come as the neighbors will want to avoid a currency devaluation in Bahrain which could spill over to the region. We expect the program to include the introduction of a 5% VAT, which was already planned but postponed at the start of this year, in 2019.

Impact on growth

Bahrain posted healthy growth of +3.9% in 2017 – the highest rate in the GCC region – despite the fiscal woes. This was thanks to a strong +4.9% expansion in the non-oil sector, which accounts for 80% of GDP, hereby offsetting the effect of a -0.4% decline in the oil sector. In 2018, we expect the oil sector to grow again since oil prices are higher and the impact of OPEC-agreed oil production cuts at the end of 2016 is fading. On the other hand, fiscal consolidation measures will slow down the non-oil sector in 2018-2019. As a result, we forecast GDP growth to decelerate to +2.4% in 2018 and +2% in 2019.

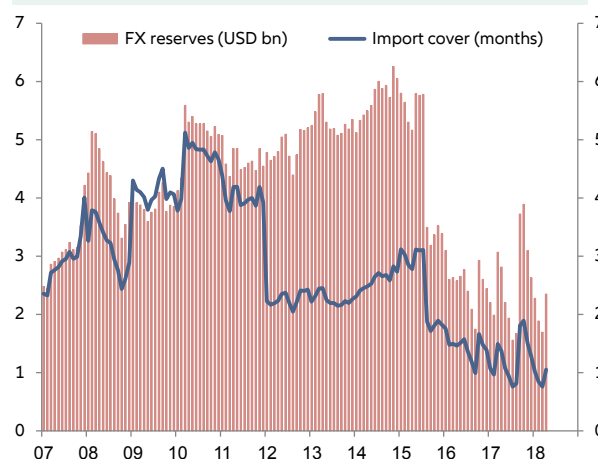
Manfred Stamer

Chart 1 Fiscal breakeven oil price forecasts 2018 (USD/bbl)



Sources: IMF, Allianz Research forecasts

Chart 2 Bahrain - FX reserves and import cover



Sources: IMF, Allianz Research calculations and estimates



Photo by Annie Spratt on Unsplash

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