

THE VIEW

Economic Research

June 2018



THE HOT SEASON

- 04 Oil: The Price of Geopolitics?
- 12 US Financial Deregulation: Higher Growth and Risk
- 24 Financial Liberalization in China: A Turning Point
- 30 The Global Insurance Market: 80% of Growth Comes from Emerging Markets
- 36 Updates by Region

DON'T POKE THE PANDA BEAR

LUDOVIC SUBRAN



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

From the Beijing Olympics, to comic books, to the World Wildlife Fund (WWF), panda bears are known for being both the symbol of China and the quietest animal on earth – granted they have some bamboo handy.

Back in the 1970s, gifts of giant pandas to American and Japanese zoos formed an important part of the diplomacy of the People's Republic of China (PRC). This practice has been termed "panda diplomacy". Forty years later, China is recognized for much more than panda bears, being the second largest economy only to the US.

Forty years later, it looks like President Trump has decided to launch the bull-in-a-China-shop diplomacy. From the campaign trail to his latest announcements, China has been, echoed by polls, the number one target of America First policies. All the world looks in awe as defiance and volatility come from the threat of protectionism. Could this lose-lose game jeopardize China's economic success story?

In our June issue of The View, we try to unveil how China has changed, and more importantly how fast it keeps transforming, making it hard to catch up. Over the past ten years, Xi Jinping and Li Keqiang have succeeded in transitioning China from an investment- and export-driven economy to a consumer-driven superpower, with rapid industrialization and servitization. Secondly, China continues to surprise the rest of the world with innovative policy-making, aligning public and private sectors' incentives for stability and long-term growth. Quick fixes and international worst practices are not welcome. If I had to point to three super policies, I would mention: rapid financial liberalization, combined with taming credit risks through macro prudential policies; the Belt and Road Initiative, which will create unprecedented soft power opportunities; and a fascinating innovation and industrial policies embedded in China 2025, which already brought to life the famous BATX (Baidu, Alibaba, Tencent and Xiaomi, the acronym for the Chinese GAFAs). It is important to note that this innovation policy came at the expense of numerous zombie state-owned enterprises which went belly up in the past years.

China's strengths do not make it less vulnerable to a full-fledged trade war. The recent depreciation of the renminbi to the dollar – allegedly good for Chinese competitiveness – makes it difficult for Chinese authorities to rely on private savings to finance growth domestically and abroad. It also reduces profitability and disposable income. In addition, credit risk, though receding, is still high in China. Authorities need more time to deflate the real estate bubble, increase financial literacy, boost governance and regulation, and develop safety nets.

Yet, retaliation cannot be ruled out. "Only one eye for one eye" says the law of talion. But limited bilateral trade deficits with the US require imagination to make it even. From longer time to clear customs, to playing hard to get for international investors to repatriate their dividends (especially in financial services), to calling up economic patriotism to curb entire markets, the tool box that China has to dent global trade, growth, and liquidity should not be underestimated.

How cute is a giant panda? Peaceful, unconcerned, stolid. Have you seen Kung Fu Panda by DreamWorks? Just don't poke the China bear.



Photo by Gonard Fluit on Unsplash

Global Foreign Direct Investment (FDI) declined by –23% in 2017, mirroring a fall in M&A activities and greenfield investments

–23 %

OIL: THE PRICE OF GEOPOLITICS?

This paper attempts to rationalize recent oil price strength and perspectives for the remainder of the year. Post-trough recovery and demand-led strength have been substituted by geopolitics as prime oil price driver since early Q2 18

After the broad based commodities recovery of 2016/17, oil price strength has persisted in an almost unabated fashion. At currently USD 74/bbl, Brent Crude is now up more than 150% from the 2016 trough of USD 29/bbl.

In order to gage a better view on these latest movements, we try to disentangle the influence of diverse factors on oil prices. We first estimate the log of Brent oil prices in function of the log of a world GDP

now index (based on Goldman Sachs world GDP now-casting index), the log of world oil supply (data from the US Department of Energy), the log of net long positions on the Brent futures and the log of the Dollar index (DXY), plus one constant, all on a monthly frequency (from January 2001 to January 2018, data on world oil supply beyond that date are still missing).

We use an error-correction model¹ allowing the identification of a long-

term and short-term equation. We can interpret coefficients in the long-term equation as elasticities.

It means that 1% increase in the world GDP triggers a 1.7% increase of oil prices, while an increase of the same extent of world oil supply triggers a decline by -2.6% of this price. An increase of 1% of net long positions in Brent futures triggers an increase by 0.7% of oil prices, while an appreciation by 1% of the Dollar index induces a decline by 2.4% of oil prices.

Figure 1 Econometric model of oil price drivers

Long-term equation

Dependent Variable: LOG(OIL_PRICE)

Method: Least Squares

Date: 05/16/18 Time: 21:17

Sample (adjusted): 2001M01 2018M01

Included observations: 205 after adjustments

$\text{LOG(OIL_PRICE)} = C(1) + C(2) * \text{LOG(GDP)} + C(3) * \text{LOG(SUPPLY)} + C(4) * \text{LOG(OPEN)} + C(5) * \text{LOG(DXY)}$

	Coefficient	Std. Error	t-Statistic	Prob.
C(1)	26.70136	5.984961	4.461409	0.0000
C(2)	1.680083	0.644937	2.605033	0.0099
C(3)	-2.596134	0.693527	-3.743377	0.0002
C(4)	0.693518	0.084369	8.220094	0.0000
C(5)	-2.439942	0.151916	-16.06108	0.0000

Sources: Euler Hermes, Allianz Research

Short-term equation

Dependent Variable: DLOG(OIL_PRICE)

Method: Least Squares

Date: 05/16/18 Time: 21:18

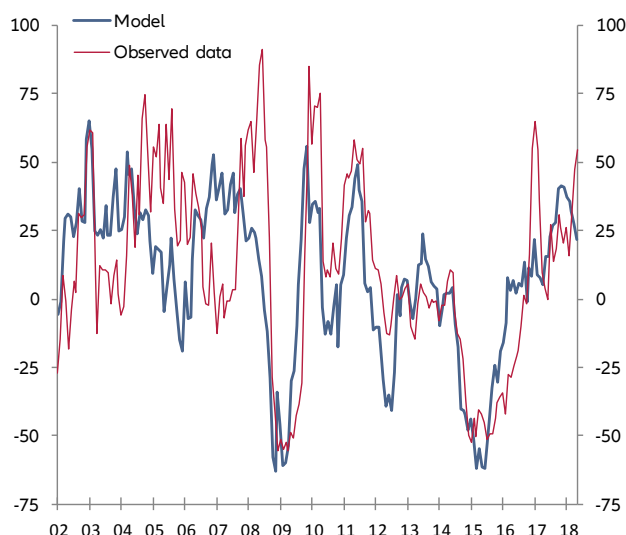
Sample (adjusted): 2001M02 2018M01

Included observations: 204 after adjustments

$\text{DLOG(OIL_PRICE)} = C(1) * \text{RESID01}(-1) + C(2) * \text{DLOG(GDPINV)} + C(3) * \text{DLOG(SUPPLY)} + C(4) * \text{DLOG(DXY)} + C(5) * \text{DLOG(OPEN)}$

	Coefficient	Std. Error	t-Statistic	Prob.
C(1)	-0.121468	0.028782	-4.220294	0.0000
C(2)	2.265475	0.747078	3.032447	0.0027
C(3)	-1.012688	0.717374	-1.411659	0.1596
C(4)	-1.174087	0.241694	-4.857733	0.0000
C(5)	0.347840	0.105300	3.303334	0.0011

¹ The existence of a co-integration relation (or long-term equation) is proven by the fact that the coefficient attached to the lag of the residual of this long-term equation is significant in a short-term equation.

Figure 2 Brent oil prices (y/y, %)

Sources: Euler Hermes, Allianz Research

We compare our theoretical model with observed data and get a satisfying result ($R^2 = 0.85$) and extend our estimate to May 2018 by assuming that the m/m variation of the world oil supply is the same in 2018 as in 2017 for the missing data (February to May 2018).

The residual of the long-term equation could be associated with the geopolitical factor, which we tried to put in this equation via the inclusion of a weighted average of a geopolitical risk index (Saudi Arabia, Russia, Mexico, Malaysia, Indonesia...) but it was not significant.

Looking at the contribution of each of our factors to the fluctuations of modeled oil prices we can see that fluctuations of the Dollar and speculative (or momentum) factor contribute the most to the variations observed in oil prices. The contribution of real demand embodied by world GDP growth and the contribution of world supply growth seems to be marginal. However, the momentum or speculative factors and the currency factors seem to be amplificatory of shocks in demand and supply in the real side of the economy.

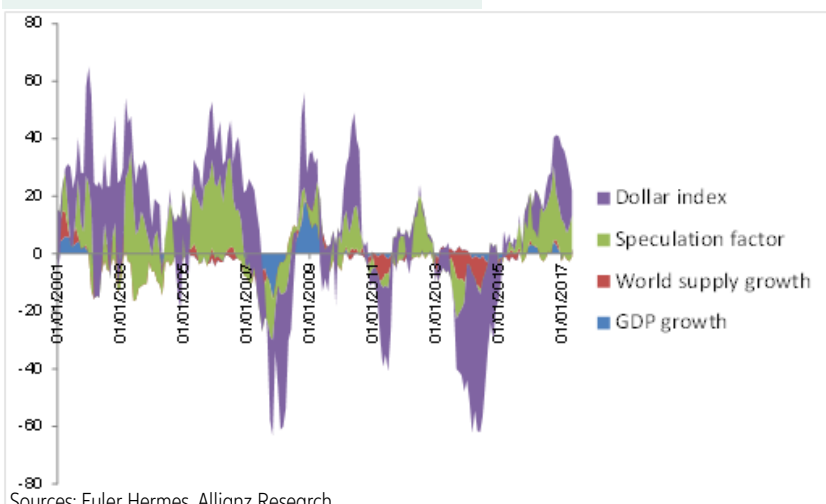
At this stage, the market has moved

from demand driven to possibly supply constrained.

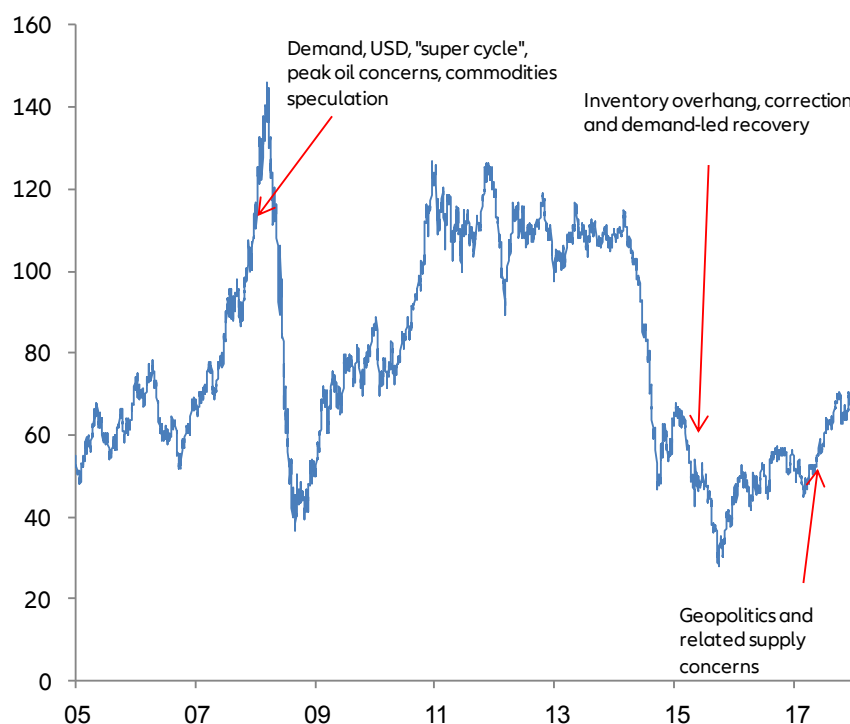
Post first trough (USD 50/bbl 01/16), the recovery from H2 2017 was driven by stronger than expected demand on the back of synchronized global economic growth.

Earlier this year, we upgraded our global GDP forecast by 10bps to 3.3% for 2018.

Despite our expectation of a Q2 18 soft patch, our full year view in terms of growth is unchanged, for sustained strength of demand.

Figure 3 Brent oil prices (contributions, y/y, %)

Sources: Euler Hermes, Allianz Research

Figure 4 Brent Crude (USD/bbl)

Source: Bloomberg

We have envisaged the possibility that the residual of our long-term equation represents geopolitical risk as this is the only important factor influencing oil prices, which is not included in it. It seems that this factor has played a bigger role over the last year.

To verify this assumption, we estimate another equation between January 2007 and May 2018 with the world GDP, the geopolitical risk indicator and the Dollar index.

The performance of the model is satisfying and sign of coefficients as theoretically expected (see Figure 5). Over this period, the geopolitical risk index is significant and more visible especially in a more recent time.

We can see that a lower contribution of fluctuations of the Dollar (i.e. the recent re-appreciation of the USD) is probably one the main driver of increase in oil prices, beside the rebound of world growth and the

rise of geopolitical risk (see figure 6).

Oil price strength in Q2 to date has indeed been driven by geopolitics, in particular heightened tension in Syria and in the Middle East, and subsequently the US withdrawal from the Iran nuclear deal.

While there was no direct supply impact on supply from Syria, the possible loss of production from Iran could range from 0.2m to 1mbpd.

Figure 5 Econometric model of oil price drivers**Long-term equation**

Dependent Variable: LOG(OIL_PRICE)

Method: Least Squares

Date: 05/16/18 Time: 17:19

Sample: 2007M01 2018M05

Included observations: 137

$$\text{LOG(OIL_PRICE)} = C(1) + C(2) * \text{LOG(GEOPOL)} + C(3) * \text{LOG(GDP)} + C(4) * \text{LOG(DXY)}$$

	Coefficient	Std. Error	t-Statistic	Prob.
C(1)	-2.485200	2.606676	-0.953398	0.3421
C(2)	0.333927	0.089215	3.742948	0.0003
C(3)	4.480843	0.575534	7.785537	0.0000
C(4)	-3.481377	0.165950	-20.97850	0.0000

Sources: Euler Hermes, Allianz Research

Short-term equation

Dependent Variable: DLOG(OIL_PRICE)

Method: Least Squares

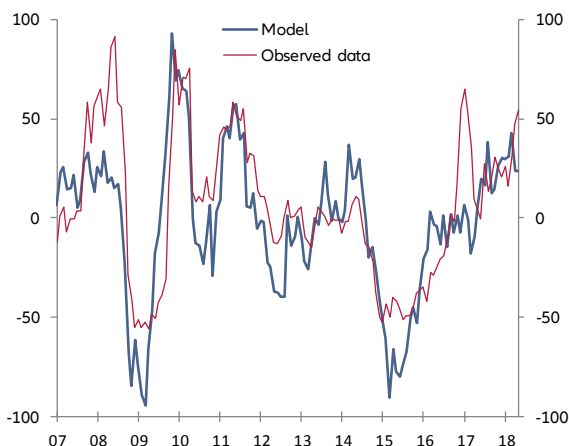
Date: 05/16/18 Time: 17:18

Sample (adjusted): 2007M02 2018M05

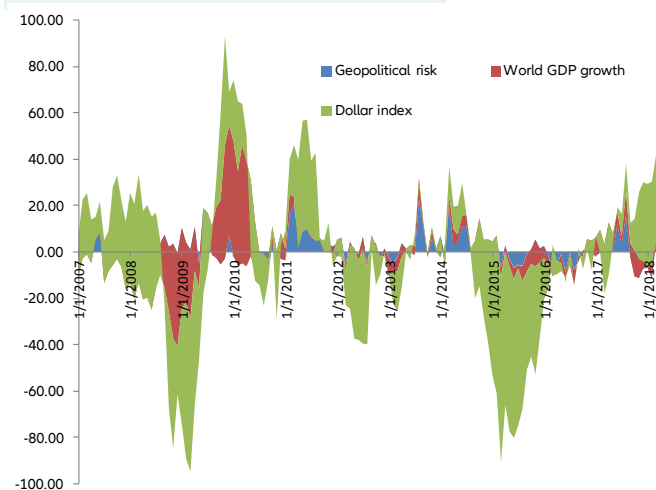
Included observations: 136 after adjustments

$$\text{DLOG(OIL_PRICE)} = C(1) * \text{RESID01}(-1) + C(2) * \text{DLOG(GDP)} + C(3) * \text{DLOG(DXY)} + C(4) * \text{DLOG(GEOPOL)}$$

	Coefficient	Std. Error	t-Statistic	Prob.
C(1)	-0.181685	0.041613	-4.366015	0.0000
C(2)	2.518827	0.851239	2.959014	0.0037
C(3)	-1.618915	0.272178	-5.948010	0.0000
C(4)	0.012527	0.042518	0.294632	0.7687

Figure 6 Brent oil prices (y/y, %)

Sources: Euler Hermes, Allianz Research

Figure 7 Brent oil prices (contributions, y/y, %)

Sources: Euler Hermes, Allianz Research

Oil price strength in Q2 to date has indeed been driven by geopolitics, in particular heightened tension in Syria and in the Middle East, and subsequently the US withdrawal from the Iran nuclear deal. While there was no direct supply impact on supply from Syria, the possible loss of production from Iran could range from 0.2m to 1mbpd. There is unlikely to be a full loss of production from Iran: Over the short term, exemptions will mitigate to a degree. There is stiff opposition to the US withdrawal from the agreement.

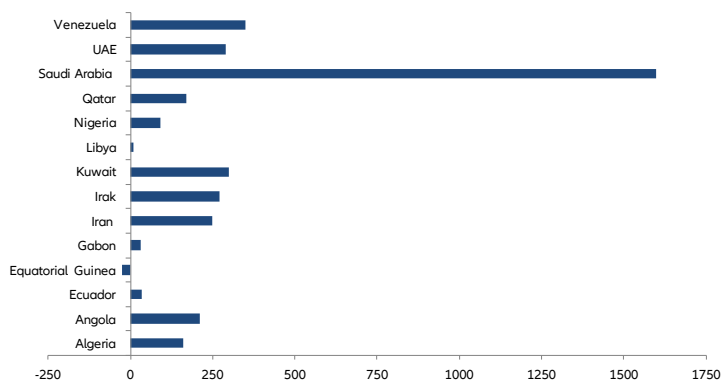
An at least partial upholding of the deal is not outside the scope of possibilities. Compliance levels with sanctions might be lower this time than previously where there was multi-lateral buy-in. However, the shortfall from Iran comes at the

same time as prospects for further shortfalls from the Venezuelan economic and political crisis, likely in the region of 0.5mbpd. Altogether, in a realistic scenario, the market could lose about 1mbpd of oil supplies going forward.

There is potential mitigation to the loss of supply. OPEC could step up production, notably Saudi Arabia. After the supply cut agreement, there are about 2mbpd of spare capacity. Saudi ministers have confirmed that there is available capacity. But Saudi Arabia is unlikely to act on its own; any increase in production would have to be agreed within OPEC and with Russia. The question is whether Saudi Arabia is confident enough with regards to supply cuts having achieved a balanced market in a persistent manner.

Saudi Arabia denies having a target oil price. Yet, it – and other oil producing nations – clearly have a choice of long term optionality in relation to their resource, according to optimization occurs. And rhetoric, such as debate over new measures of inventory averages, suggest that supply cuts may remain in place over the short term.

We will be watching the run up to the June meeting where a revision to the supply cut agreement could occur, closely. We further believe that the Saudi Aramco IPO, albeit uncertain in terms of timing, should not be entirely ignored when it comes to considering oil prices and a possible step up of Saudi production volumes. A higher oil price will have a greater impact on pricing than temporarily higher volumes.

Figure 8 OPEC spare capacity (thousands of bbl/day)

Source: Bloomberg

The US government has entered into talks with international oil majors in order to gauge scope for them to increase production. Sanctions coming into place gradually may allow other producers to increase output. This concerns conventional resources and shale oil.

Furthermore, higher oil prices incite natural mitigation through increased production. Certain companies in the shale sector claim profitability for their best projects at USD 25/bbl. While this is certainly the very low end, tier one share projects are now profitable around the USD 45/bbl level. Second and third tier projects can be justified around the USD 65/bbl level.

This leaves ample margin for production to be stepped up in response to price signals. US shale production would likely be the first to increase. Note, though, that the shale industry is encountering capacity constraints which will limit production increases. The most important issue is pipeline capacity in Mid Texas. As production from the Permian Basin, the most important production region in the US with 55% of all active rigs in the country, has increased by 60% over the past two

years, pipeline capacity expansion has not kept up. There are also reports of tightness in the supply chain for production, notably sand, needed for fracking. However, there is probably room for about 0.3-0.5mbpd of additional production for 2018 in our view. Additional pipeline capacities of 1.9mbpd are due to get commissioned in H2 19. That will lift US shale production solidly above 11mbpd.

Other fundamental data has been soft. While the inventory overhang has mostly cleared and demand remains strong at likely just short of 100mbpd in 2018 – inventories currently stand 10mb below the five year average – recent data has shown surprise increases at some occasions.

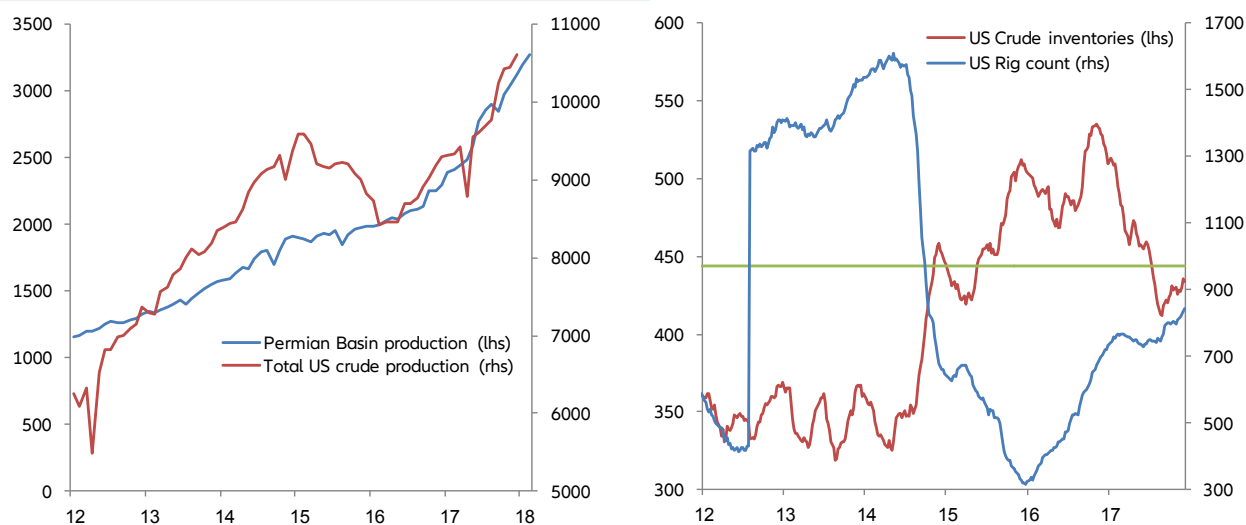
At the same time, US production continues to increase. The EIA has recently increased its production forecast to 10.72mpd for 2018. Rig count is up 11% ytd. The great earnings recovery – earnings by the oil majors have grown 42% y/y on average in Q1 18 – increases the potential for investment into new projects by virtue of greater availability of cash. The industry is more disciplined than in the previous cycle as far as

capex is concerned, but we do think that pressure for volume growth will mount.

There is also risk of a negative demand effect as a result of much increased oil prices. Demand elasticity tends to be highest in emerging markets. We note the IEA's 40kbpd reduction in its 2018 oil demand growth forecast. We note that financial markets' views on the oil price are mixed. In particular, managed money net long positions have decreased since early 2018. The historic correlation between oil futures and net long positions and has been broken since early Q2 18. We calculate an average oil Brent price of USD 68/bbl ytd. Based on GDP growth of 3.3% for 2018, about 0.5mbpd supply reduction and a 2.5% USD appreciation, our econometric model suggests a Brent price of USD 72 on average for the whole of 2018.

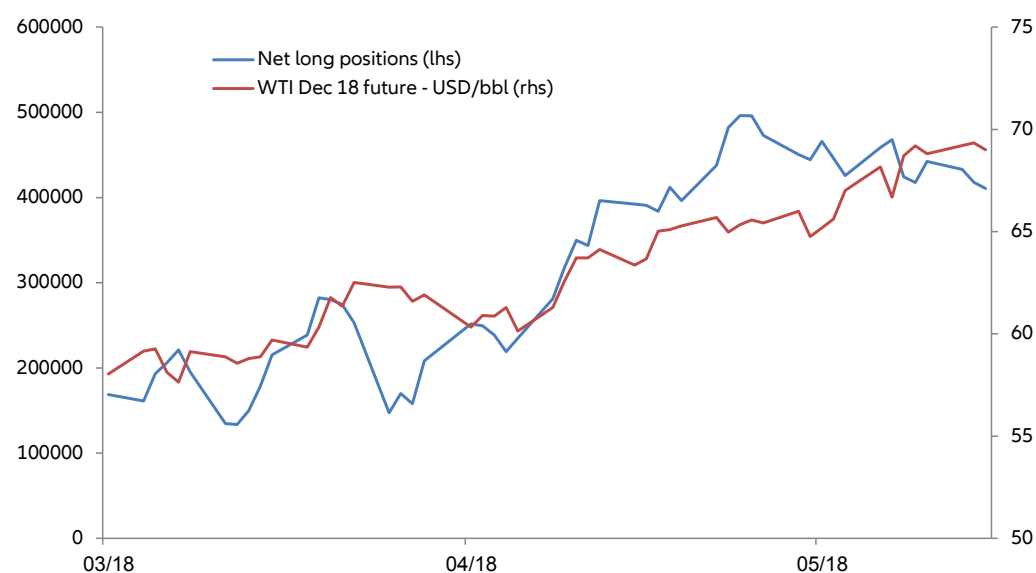
However, we are very aware of the bulk of this being driven by the strong increase in net long positions on a 12 months average basis and us being only part into the year 2018, while such positions have in fact decreased since early 2018 as mentioned above.

Figure 9 US crude production and inventories (thousands of bbl/day)



Sources: Baker Hughes, DOE, Bloomberg

Figure 10 TWTI futures vs. net long positions



Source: Bloomberg

For our central case, we assume a return to the 24 months average as far as net long positions are concerned. Interestingly, when taking into account only the increase in net long positions over Q2 18, which we believe to be the quarter where oil prices are predominantly being driven by geopolitics, our model fully explains the current price of Brent Crude.

All the while we are not in any way akin to suggest that speculators or managed money move the oil price, we believe the conclusions from our model confirm that the market is being driven by concerns over geopolitically induced supply shortages (that may or not materialize).

Assuming a base case of stabiliza-

tion around current levels for the remainder of this quarter, followed by normal seasonal pattern would also imply an oil price of USD 72/bbl on average for 2018. We rationalize this by a sustained high price level on the basis of uncertainty over the impact of the Iran issue and the actual impact hitting the market later in H2.

Should markets correct to the mid USD60/bbl levels in Q3 on the basis of fundamental data and/or pull-back after the very rapid recent increase –possibly driven by reducing net long positions after strong performance - this would bring the average for 2018 to USD 67/bbl.

We have included a bull and a bear scenario in order to account for vari-

ability in our underlying assumptions: 3.3% GDP growth along with 2% USD depreciation y/y and greater supply loss than in our base case – 2mpb from Iran and Venezuela combined – would yield a Crude price of USD 80/bbl.

Conversely, our bear scenario assumes 30bps of loss of GDP growth, possibly from a negative oil price impact, along with 5% USD appreciation y/y.

It further assumes that the industry would be able to fully make up for the loss of supply from Iran and Venezuela and that the US shale industry could bring an incremental 0.5mpbd to market, i.e. total supply increasing by 0.5mpbd y/y. This results in USD 67/bbl Brent.

Figure 11 Econometric model based 2018 Brent Crude average

	Chge y/y	Implied oil price USD
GDP	3.30%	58.09
Net long positions	43%	71.56
USD	2.50%	51.70
Supply	-0.5%	55.71
Oil price post cumulated impact		72.05

Sources: Euler Hermes, Allianz Research

Figure 12 Assumptions for bullish oil price scenario

	Chge y/y	Implied oil price USD
GDP	3.30%	58.09
Net long positions	43%	71.56
USD	-2.00%	57.64
Supply	-2.0%	57.86
Oil price post cumulated impact		80.14

Sources: Euler Hermes, Allianz Research

Figure 13 Assumptions for bearish oil price scenario

	Chge y/y	Implied oil price USD
GDP	3.00%	57.81
Net long positions	43%	71.56
USD	5.00%	48.40
Supply	0.5%	54.29
Oil price post cumulated impact		67.05

Sources: Euler Hermes, Allianz Research

For 2019 we assume 3.1% World GDP growth and 2.5% dollar appreciation. However, significant new supplies will come into the market as the US Permian Basin gets de-bottlenecked. Furthermore, oil prices topping USD 70/bbl will incentivize other new production. We have baked 1mpd of incremental production into our forecast, which we think is conservative. On this basis, our central estimate is for an oil price of USD 69/bbl. Companies in certain sectors are now finding themselves with materially increased input costs. Given the speed of the rise in the oil price, most likely, there will be little hedge in place. The sectors most concerned are sectors that transform crude oil, such as specialty chemicals, but also energy intensive industries such as heavy industry, manufacturing, and certain segments within machinery. Airlines, road transport and shipping will see their fuel cost increase. There will also be an impact on the automotive sector. Increasing oil prices can lead to an acceleration of substitution of vehicles, e.g. towards EVs.

For that to happen, the increase needs to be seen as persistent. Mining, a very energy intensive sector, particularly for open pit resources, faces higher fuel costs for diesel used in trucks and digging equipment. Iron ore and bauxite which feed into steel and aluminum, are particularly exposed. Most of the B2B sectors at this stage are able to pass the increased input costs from higher oil prices on to customers. This is the case for specialty chemicals and certain machinery manufacturers at the high end.

As long as pricing power persists, margins will be protected. It is the end consumer who pays for the increase in oil prices through inflation in a broader basket of goods and services. Other sectors and businesses in segments with intense competition will see their margins contract.

Several mining companies have stated they are looking for greater operational efficiencies as the sector. However, during the week commodities cycle, a lot of potential for efficiencies has been exploited and

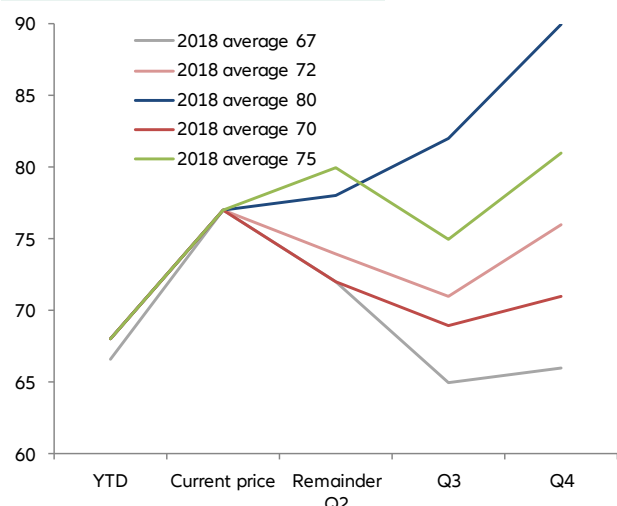
further cost reductions will be more challenging. Pricing power in the mining sector very much depends on the tightness of the market for the commodity in question. There are segments where high cost producers will need to close down operations. Steel and iron ore are sectors of particular concern in that context.

Importantly, higher oil prices encourage substitution. Alternative processes, clean energy technologies and renewables will benefit as they become more competitive. A number of alternative processes become competitive with hydrocarbons based technologies around the USD 70/bbl level. The mature power generation technologies are already now at levels where they are competitive with fossil fuels on a stand-alone basis. Still, adoption rates tend to increase whenever oil prices rise.

Last not least, the oil and utilities sectors are seeing a significant earnings recovery and return to growth on the back of high oil prices.

Catharina Hillenbrand-Saponar and Alexis Garatti

Figure 14 Oil price scenarios (USD/bbl)



Sources: Bloomberg, Euler Hermes

Figure 15 Oil price central scenario 2019

	Chge y/y	Implied oil price USD
GDP	3.10%	75.79
Net long positions		
USD	2.50%	67.68
Supply	1.0%	70.13
Oil price post cumulated impact		69.61

Sources: Euler Hermes, Allianz Research

Figure 16 Sector impact

Sector	Impact
Specialty chemicals	<ul style="list-style-type: none"> Input cost pressure – mitigated through pricing pressure; watch commoditized segments
Manufacturing & heavy industry	<ul style="list-style-type: none"> Input cost inflation – high end mitigates through pricing pressure
Airlines	<ul style="list-style-type: none"> Margin pressure through rising fuel cost with little scope for pricing power in very competitive environment
Road transport	<ul style="list-style-type: none"> Pass through of fuel costs in function of end market
Shipping	<ul style="list-style-type: none"> Margin pressure due to fuel costs in function of competitive intensity by route/merchandise Possibly positive impact for industries exposed to low cost imports
Automotive	<ul style="list-style-type: none"> Acceleration of EV adoption if expectation for long term increase in oil price
Mining	<ul style="list-style-type: none"> Cost pressure, offset in commodities with tight markets (nickel, possibly copper), margin contraction in markets with overcapacity (e.g. steel)
Oil and gas	<ul style="list-style-type: none"> Positive earnings and cash flow impact across the value chain; particularly E&P Recovery of energy services as result of increased investment spend Positive repercussion on gas industry through price and substitution linkages
Alternative energy & new technologies	<ul style="list-style-type: none"> Much increased viability of oil substitution technologies Acceleration of adoption of mature technologies Greater development and fund raising ability for early stage technology under expectation of persistent high oil price

Source: Euler Hermes and Allianz Research

US FINANCIAL DEREGULATION

HIGHER GROWTH AND RISK

- President Trump obtained a radical overhaul of the US financial system, including watering down prudential standards and Dodd-Frank
- US financial deregulation will push community banks to win back credit market shares, help US SMEs and foster growth — it will also boost the general level of risk through cycle positioning and increased complacency

President Trump's policy represents a turning point in the US as well as global economic history. It is characterized by a strong contrast between a doctrine of laissez-faire on the internal side and a maximum of interventionism on the external side embodied by protectionist measures. We consider here the domestic aspect with the reform of financial regulation, a primary objective of Mister Trump since the Presidential campaign, which was signed into law after a bipartisan support in the Congress on May 24th 2018. We present here the different elements of this new legislation via a chronological approach, which mainly aims at undoing the so-called Dodd-Frank law signed in the aftermath of the subprime crisis to put the U.S.

financial system on a stronger footing.

Actual legislation and orientation by the Trump administration

President Trump's EOs and the House's Financial Choice Act

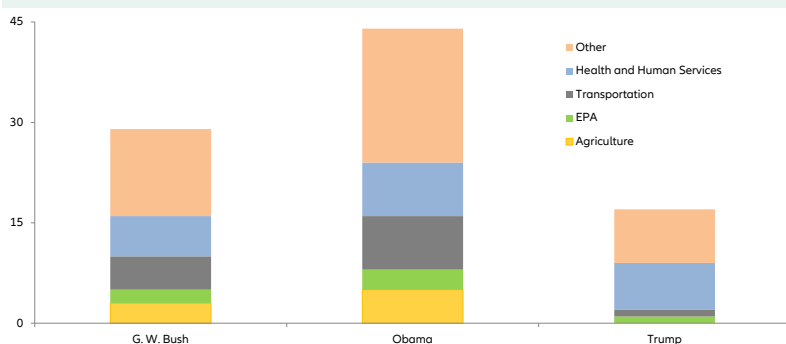
Since his election, President Trump and his administration have been determined to consequently reduce the regulatory burden on the U.S. economy through the elimination of supposedly inefficient, useless or obsolete regulations.

Toward this end, President Trump issued four Executive Orders (EOs) in 2017 directing federal agencies to repeal two regulations for every new regulation; to review every existing regulation so as to highlight any

case of excessive regulation as well as giving council on how both the financial and energy sectors should be deregulated. This first stance of the newly elected administration on regulatory issues was followed during the summer 2017 of the Financial Choice Act.

This bill aimed at rolling back most Dodd-Frank provisions, as well as improving consumer protection. It had for ambition to grant healthy banks significant regulatory relief and subject banks to stress tests every other year instead of every year as well as repealing a Dodd-Frank provision allowing the government to take over a failing financial firm, known as Orderly Liquidation Authority (OLA), and create new bankruptcy laws instead.

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



Source: RegInfo, Office of Management and Budget

Economic Growth, Regulatory Relief, and Consumer Protection Act

On March 15, 2018, the U.S. Senate passed a very significant regulatory relief bill, the Economic Growth, Regulatory Relief, and Consumer Protection Act, thanks to a rare bipartisan vote of 67-31.

a. Enhanced Prudential Standards (EPS)

EPS include liquidity and risk management standards and heightened capital but also mandatory and frequent stress testing for large BHCs. Firstly, the bill will significantly increase the asset threshold for subjecting BHCs to EPS, from USD 50bn to 250bn, with staggered implementation dates depending on the institution's size.

However, the "too big to fail" BHCs, also known as Global Systemically Important Banks (G-SIBs), will be exempted from such regulatory relief, regardless of their asset size.

Concerning supervisory stress tests, BHCs with over USD 250bn in total consolidated assets (TCA) will still be subject to annual supervisory stress tests, but twice rather than thrice. BHCs with TCA comprised between USD 100bn and 250bn would still be subject to periodic supervisory stress tests but their new frequency has not yet been revealed.

Finally, for the smaller BHCs (under USD 100bn in TCA), there would be no more capital stress testing, which is a considerable relief.

Concerning company-run stress tests, the new legislation would exempt all banking organizations with less than USD 250bn in TCA from having to conduct any company-run stress test.

b. Regulatory Capital and Liquidity Requirements

The Senate Bill plans to enforce various capital and liquidity require-

ments for most banking companies across the country. Nevertheless, the bill requires federal banking agencies to revise their supplementary leverage ratio (SLR) rules for custodial banks to exclude funds that are placed with the Federal Reserve Banks or the ECB. This amendment intends to address recurrent criticisms that the Federal Reserve Board's enhanced SLR rule imposes an unnecessary burden on BHCs. Bank of New-York Mellon, State Street and Northern Trust, who manage trillions of assets for mutual funds, would be the main beneficiaries. They will be able to exclude some deposits they hold in central banks from their total assets when calculating their leverage ratio.

c. Volcker Rule

The Volcker Rule was implemented within the Dodd-Frank framework in 2010 and had for main goal to restrict U.S. banks from engaging in certain types of trading which do not benefit their customers. This proposal specifically restricts banks and BHCs from engaging in proprietary trading, and from owning or investing in a hedge fund or private equity fund. The new bill exempts from the Volcker Rule all banks and BHCs with USD 10bn or less in TCA and liabilities of 5% or less of TCA, which means it concerns nearly all community banks throughout the country.

d. Community Banks

Republican Congressmen have long been complaining that the Dodd-Frank Act of 2010 was mostly detrimental to the smaller and state-based banks. The Economic Growth Act is not the first attempt to bring relief to smaller banks and to the average consumer by overhauling Dodd-Frank. For such reasons, Title II targets notably capital rules and risk committees for community banks. For instance, banks and BHCs with less than USD 10bn in TCA who also guarantee a "community bank lever-

age ratio" of at least 8-10% would now be exempt from the general U.S. capital rules originating from the Basel III accords.

e Real Estate and Mortgage Lending

Following the same logic which underlies the amendments brought to the community banks regulation, this bill tries to encourage banks' capacity to lend money. The bill would strongly increase the number of mortgage loans deemed to satisfy the Truth in Lending Act's "ability to repay" requirements so as to be treated as "qualified mortgages". "Qualified mortgage" follow stringent guidelines defined by Dodd-Frank, as the following example shows: a borrower's loan payment must represent less than 43% percent of their income.

Moreover, it will allow certain mortgage loans of less than USD 400k to be exempted from appraisal requirements under the Financial Institutions Reform. The bill will also revisit recent dispositions taken by the Consumer Financial Protection Bureau under the Home Mortgage Disclosure Act, which requires many financial institutions to maintain, report and publicly dispose loan-level information about mortgages. The goal here is to increase small community lenders' competitiveness in extending mortgage credit.

Federal Reserve proposals and future outcomes

The Fed aims to revise main ratio requirements and stress tests

Banks with assets being lower than USD 100bn will not be subject to stress tests. For banks with assets between USD 100bn and USD 250bn, regulators will have the possibility to stop testing every year and rather control banks on a “periodic basis”. The frequency of controls will be subject to the discretion of the regulator. After several nominations at the top of the FOMC, there is no doubt that its members are now in favor of a lighter approach in terms of regulation.

On April 10-11, the Federal Reserve released two important proposals detailing the first major changes to capital rules under Fed Chair Jerome Powell.

The first proposition, released on April 10, aims to introduce a “stress capital buffer”, to replace the fixed 2.5% portion of the capital conservation buffer, and a new stress leverage buffer within the current CET1 requirement framework. Figure 2 below illustrates how the minimum CET1 capital ratio requirement could be concerned by these proposals.

The additional stress capital buffer would take into account a bank’s

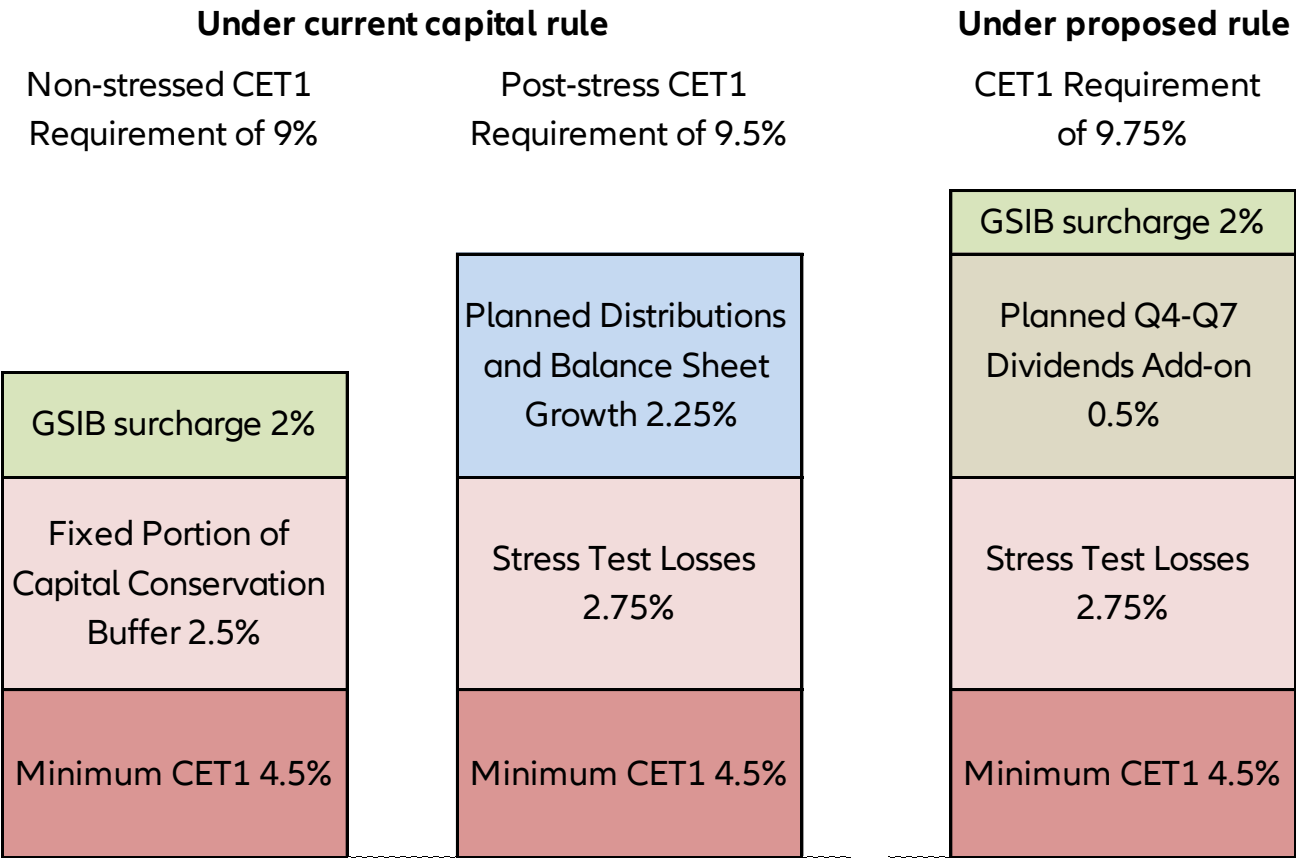
worst stress test results as well as its planned dividends.

The second proposition aims to revise the enhanced supplementary leverage ratio (eSLR), specifically designed for US G-SIBs.

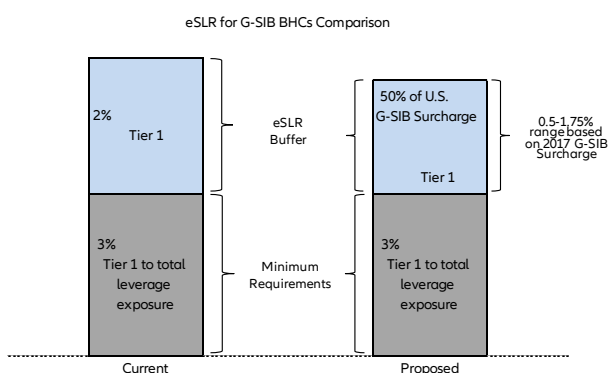
As seen below in Figure 3, the new ratio would correspond to 50% of the firm’s G-SIB surcharge from the preceding year and would therefore be both firm-specific and dynamic.

The Fed expects both proposals to slightly increase capital requirements for the largest systemic banks while reducing them considerably for all other banks, notably deposit institutions.

Figure 2 Change in minimum CET1 capital ratio requirement



Source: Federal Reserve Board

Figure 3 New Supplementary Leverage Ratio Architecture for G-SIBs

Source: Federal Reserve Board

These recent measures are a great encouragement for Fed officials which support a greater deregulating policy. These amendments would allow them to perform stress tests every two years or more, which comes with reduced risk assessment and control. Stress tests are also very important for banks to precisely calculate the level of capital that is mandatory to prevent losses. This means that under such provisions, banks with TCA between USD 100bn and 250bn could easily reduce their capital requirements, knowing they will not be tested. With more than USD 2tn in combined assets, the decrease in protection could end up with considerable losses in a future crisis.

Finally, recent changes within federal agencies' administration have been another way to see how the Trump administration has been diffusing its aggressive deregulatory dynamic. The first flagrant sign for this was Mick Mulvaney's appointment as head of the Consumer Financial Protection Bureau (CFPB).

More than his declarations about the CFPB being a "sick, sad" joke, the fact that he has not taken a single enforcement action against any institution more than 160 days after he took over the agency is very representative. Created under the Dodd-Frank Act, the agency is slowly being stripped of most of its powers despite Democrats having managed

to block particular amendments during the Economic Growth Act vote days ago. Moreover, last week also saw Jelena McWilliams, President Trump's candidate, be appointed as head of the Federal Deposit Insurance Corporation (FDIC), a key bank regulator. She is considered to be the final piece of Donald Trump's regulatory team reshuffling, helping the President's strongly deregulatory agenda. This sets us to believe that the FDIC should experience a similar future to the CFPB's recent times, with constant re-examination of past rules and amendments. Comparable momentum awaits the Financial Stability Oversight Council, which shows that even though Republicans have not yet managed to pass bills to entirely overhaul the majority of the Dodd-Frank and other post-crisis regulation, deregulation through law interpretation is already fully under way and efficient since last year

Interpretation of Basel IV shows "America First" spirit at work like in the (protectionist) interpretation of international trade rules

The new reforms brought to the Basel III accord, dubbed Basel IV by the financial industry, will progressively take effect between 2018 and 2027. They will impose limits to how much the biggest banks' bespoke models for calculating risk in areas such as mortgages can diverge from the regulators' most conservative calcu-

lations. Since the start of 2017, fear had risen that President Trump's global deregulatory agenda might prevent or slow down further agreement at the Basel Committee. Finally, the process was supported by the Treasury Department and the Trump-appointed Vice Chairman for Banking Supervision at the Fed, Randal Quarles. In a series of reports over the past year, the Treasury Department has recommended "recalibrating" bank capital and liquidity standards set by the Financial Stability Board. For instance, the provisions contained within Title IV of the Economic Growth, Regulatory Relief, and Consumer Protection Act would cause the U.S. supplementary leverage ratio to considerably diverge from the Basel leverage framework because of its treatment of central bank deposits. Since the Great Recession, the U.S. have had a history of diverging from the Basel leverage ratio towards a greater conservatism, with notably federal banking agencies imposing an "enhanced" SLR buffer requirement on U.S. G-SIBs and their subsidiary IDIs. However, it seems now that the U.S. administration is willing to re-work on international agreements by itself, just like what has been done with international trade laws. The interpretation of the Basel IV accord by the U.S. is a sign of increased banking competition and of a desire to decide unilaterally of international standards.



Photo by Nathan Dumlao on Unsplash

Additional measures to deregulate the banking industry are yet to come

The passing of such bill demonstrates how policy makers have decided to scale back their priorities in order to guarantee support for a bipartisan compromise vote.

The original inspiration bill for the Economic Growth Act, the Financial Choice Act, had been strongly watered down within a year to maintain a chance of passing through the Senate in March of this year.

The Senate bill then experienced numerous revisions between March 15 and May 22.

Indeed, when one takes a look precisely at which dispositions from the Dodd-Frank Act, it is evident that many overhauls were suspended and delayed. If most constraints on banks have been alleviated, especially for community “Main St” banks, it is undeniable that some dispositions were forgotten. For instance, Republican instigators of the bill decided to abandon trying to reorganize the Consumer Financial Protection Bureau, which was strongly opposed by Democrats.

Moreover, the Orderly Liquidation Authority (OLA) to take over failing financial firms stays in the 2010

Dodd-Frank Act, which means there will be no immediate overhaul of bankruptcy law in the U.S., despite strong support from most Republicans and the White House.

Many banking groups are known to have pressed such vote from the House, despite House Financial Services Committee chairman Jeb Hensarling (R-TX) trying to toughen the Senate bill. Mr. Hensarling seems to have emerged from this episode with a commitment from Senate Majority Leader Mitch McConnell (R-KY) to vote on a separate package before the midterm elections, so as to try and pass stronger deregulation measures.

Table 1 What was voted, what was not voted

Dodd-Frank Act Overhaul	
Voted measures	Refused measures
Relief from Dodd-Frank's core provisions for banks with < USD 250bn in assets: reduced stress tests, capital and liquidity requirements	The Orderly Liquidation Authority will continue to take over failing financial firms and the Bankruptcy code will not suffer any modification
Raised asset-threshold for Enhanced Prudential Standards	Consumer Financial Protection Bureau structure and powers remain untouched
Volcker Rule repeal for banks with < USD 10bn in assets	The Financial Stability Oversight Council powers are not diminished
Mortgage lending requirements are eased under the Home Mortgage Disclosure Act	
Safeguards for student loan borrowers	

Sources: Allianz, Euler Hermes

The positive aspects of deregulation

Community bank relief to liberate credit

Since the middle of the 2000s, community banks as a whole have lost significant market share regarding net loans and leases: their share of the total went from 27.8% in 2003Q1 to 20.7% in 2018Q1 as seen in Figure 4. However, the major part of the share loss happened since 2010 and the passing of major financial regulation bills such as the Dodd-Frank Act: this share was still of 26.4% in 2010Q1.

Moreover, community banks have seen their market shares in several lending markets decline heavily, for instance on private real estate or business loans (as shown in Figure 5), which has caused many complications for these banks.

This is why the Economic Growth, Regulatory Relief, and Consumer Protection Act has most strongly targeted the “Main St” banks. Its major amendments will bring relief to banks with less than USD 10bn in assets thanks to the watering down of most of the Dodd-Frank Act, newly accommodative prudential standards as well as lower requirements for mortgage standards and a repeal of the Volcker rule.

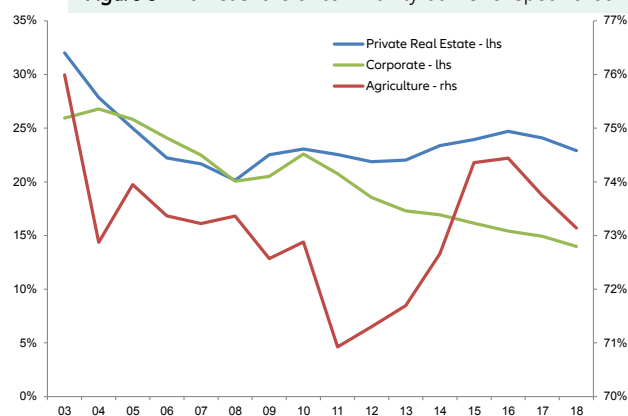
We now believe that these measures will strongly help community banks to find back their way towards better times. Indeed, as the qualified mortgage rule will disappear and capital requirements will be reduced overtime, we see community banks managing to regain their total market share on the U.S. lending market back to 2010 levels, right when post-crisis financial regulation was being implemented. We estimate that the return of community banks could strongly boost credit across the country. Indeed, rising from 20.7% to 26.4% of the loan market would liberate up to USD 500bn of additional credit for U.S. customers.

Figure 4 Market share of community banks for total net loans and leases



Source: FDIC Statistics on Depository Institutions

Figure 5 Market share of community banks for specific loans



Source: FDIC Statistics on Depository Institutions

Considering the rapid decline of community banks, it would take around eight years for these banks to regain their share, which is the time which has passed since the Dodd-Frank regulation bill was voted and signed. Therefore, we estimate the additional credit for one year at slightly over USD 60bn.

The current regulatory burden

The US government has had a very blunt stance on deregulation since President Trump's arrival in office: the main message is that deregulation burdens growth at all times, because it creates uncertainty and misallocates funding.

As part of a study for the National Association of Manufacturers (NAM), the total cost of Federal regulations to the U.S. economy was estimated in 2012 at ca. USD 2.03tn (or ~ 12% of GDP).

This calculation tries to take in consideration both direct and indirect costs of complying with regulations: performing mandatory operations, hiring compliance officers or alternative use of funds for instance.

We try to see here how government regulation may impact directly on costs and growth to understand how changing the regulatory stance

Decreased firm investment and policy uncertainty

Both existing regulation and policy uncertainty can be as damageable and dangerous for corporate investment. First, regulation in the product market can be of great help for incumbent producers because it allows them to raise their prices above competitive rates. Regulation and miring “red tape” can be such burdens that they discourage companies to increase their production capacity through investment. In that sense, regulation is dangerous because it can influence the capital-labor distribution by limiting a company’s return on particular inputs. OECD statistics between 1975 and 1998 contribute to the idea that least regulated countries have seen great growth of their investment as share of capital stock while aggressively regulated countries suffer conversely from drastic investment decreases. Finally, uncertainty about future regulations can also be very detrimental to companies. This is particularly significant when such uncertainty is associated with a threshold event – elections for instance. In such cases, firms will tend to delay investment decisions as empirical evidence suggests that both regulation and the prospect of regulation both act as a tax on firm investment.

Cost of Compliance

Regulations can also play a similar role to a tax on production. Indeed, in order to guarantee legal compliance, businesses need to spend additional resources and time on this administrative burden set to diminish production activities. The Council of Economic Advisors (CEA) has shown that US businesses have spent, in 2015 alone, USD 16.8bn on compliance officers’ wages (a +171% increase since 2000). The regulatory burden could also have notable consequences on global corporate financing. Companies

tend to abandon the more regulated public capital markets and rather find financing on private markets. Since 1996, the number of publicly listed firms has constantly been on the decline. Research papers tend to explain this continuous decline because of a mix of more important costs and the rise of new, more interesting sources of capital, such as private equity firms.

Regulations as barriers to entry

One of the greatest dangers for regulations, as well-intended as they may be, is how they can work as barriers to entry for other small and novice producers. These barriers generally encourage prices to rise, which in turn causes a decline in output and therefore of investment. Another way for regulation to work as a solid barrier to entry is to implicitly discourage companies through fixed costs. Indeed, strong regulations will prevent new small firms from managing to internalize fixed costs, by forcing them to file registration paperwork, acquire certification or even receive licensure. These practices lead to heavier costs, which are necessarily less bearable for young and small companies than for the already installed big players, which furthermore generally benefit from better and more diverse legal counsel. Such regulations will always tend to decrease competition and therefore increase mark-ups, which is inevitably detrimental to the average consumer.

Distributional Impact

Firstly, the regulatory burden tends to be stronger for low-income households, who spend a greater share of their disposable income on goods like transportation, gasoline, food and health care, which are strongly regulated goods. Another angle through which regulatory measures can also impact income inequalities is entry regulations. In-

deed, research has showed that entry regulations may increase the skill mismatch within the US economy, which results in lower wages for such individuals who have been lead to work in fields unrelated to their skills.

Regulatory Delays

Compliance uncertainty over existing and future regulation can considerably impact a business’ capacity to predict future needs. First, a firm may be uncertain as to whether one of its products will actually comply with existing regulation. This generally happens when the details of a current regulation measure are difficult to understand or interpret. Considerable uncertainty also comes from regulatory delay and can negatively impact the firm’s return on investment as well as its innovation programs.

The overall impact of deregulation on growth is ambiguous when taking into account risk

A complete review of literature has led us to understand both major perks to financial liberalization and how it can encourage serious vulnerabilities. Indeed, if financial liberalization will strengthen financial development and contributes to higher long-term growth, it will also encourage greater risk-taking and increase macro-financial volatility, which then tends to cause more frequent crises. This leads to the idea of a trade-off between higher growth and higher crisis risk. Indeed, there are some really consequent benefits to an increased liberalization, such as improved capital allocation and project investment, which in turn boost productive competition. Relaxing credit constraints and broadening global credit access also strongly encourages investment and consumption, as well as it fosters greater competition in industrial sectors, which can help reduce mark-ups and reduce bottlenecks.

However, this dynamic also brings risks which stem from the continuous boom-bust cyclicity which modern economies continue to experience. The boom phase sees rapid bank credit expansion and some credit risk, which then fosters a decline in bank portfolio quality that can slowly weaken the economy. Such events strongly increase the probability of seeing financial crises take place and correspond to the start of the bust phase, which conduce to a strong negative impact on GDP growth. Moreover, greater financial depth can also have a strong negative impact on income equality and distributional issues, notably in the US. Indeed, as income inequality rises, savings are concentrated at the top of the income distribution and lower income households become more indebted, which in turn increases the risk of financial instability. Globally, we see a rising share of economists questioning a risk of “too much finance” in advanced economies, while the trade-off between growth and financial crises is still positive for middle-income countries.

Financial deregulation will also boost global risk

Small banks are the big winners but they already take on more risks

Community banks (less than USD

10bn in assets) have undergone complicated times since the Great Recession. Indeed, the industry’s momentum is rather deceiving, with approximately 1500 fewer community banks in the U.S. since 2009.² Moreover, there are strong pressures and the market competition has been quickly increasing. Small banks have started to face enhanced competition from financial technology companies as well as from major banking companies. These institutions have been trying to develop more online and mobile banking services, in order to increase their deposit market share. The goal behind such moves is to create new consumer and commercial lending opportunities.

Moreover, stricter regulations imposed on banks since the Great Recession have strongly impacted community banks as well, despite targeting in priority globally systemic banks (G-SIBs). The Dodd-Frank Act and the most recent Basel accords have mostly been designated as the scapegoats to the small banks’ recent difficulties. The qualified mortgage rule in particular was created to engage banks in maintaining higher lending standards, with banks being asked to guarantee a borrower’s ability to repay the loan. The legal costs associated with more stringent regulation represent

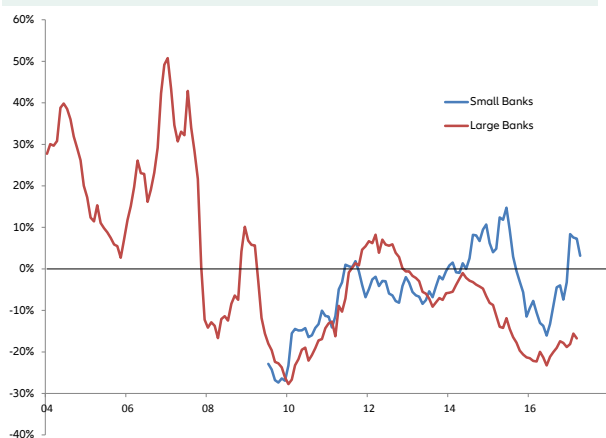
a larger share of revenue than for large institutions.

Resulting from these burdens which are difficult to tackle for small actors, the market share of community banks in the credit market has declined from 40 % in 1994 to 20% in 2015. Dodd-Frank has been an aggravating factor in this trend as their share in commercial banking assets has declined at a double rate compared with prior to 2Q10. Today, community banks have a total market share of 18%, 20% for real estate loans, 10% for corporate loans, 50% for loans to SMEs and 70% for agricultural loans.

The Economic Growth, Regulatory Relief, and Consumer Protection Act, despite being watered down compared to the original GOP-written version, represents very good news for small banks. One of the rare middle grounds between Democrats and Republicans over the bill was how the Dodd-Frank Act unfairly harmed small lenders – or community banks – when rather trying to solve systemic banks’ issues.

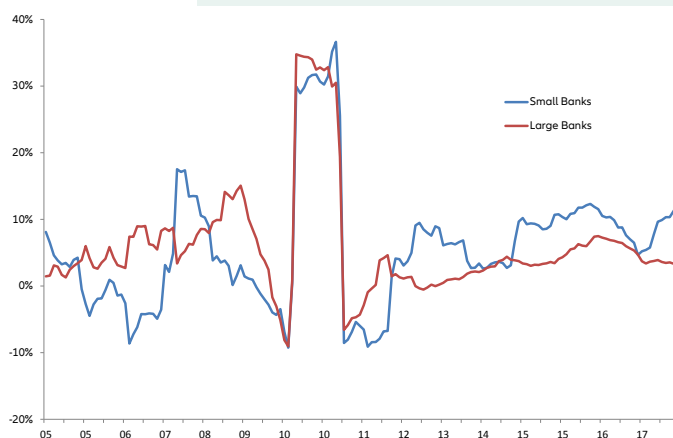
In this rare bi-partisan atmosphere, small banks have already anticipated an easing of regulation in their favor as they have distributed credits and securitized them at a quicker pace compared with large banks, as shown in Figures 6 & 7.

Figure 6 Mortgage-backed securities (12-mth average, % y/y)



Sources: Euler Hermes, Allianz Research

Figure 7 Consumer loans (12-month average, % y/y)



Source: Board of Governors of the Federal Reserve System

² Independent Community Bankers of America (2017)

The pace of credit distribution is rather high and risky segments where small banks have a leadership position, i.e. agricultural loans (see Figure 8) and commercial real estate could entail a significant amount of risk. The agricultural sector is a likely candidate to suffer retaliation by foreign countries following recent US protectionist initiatives.

More importantly, a high level of risk concentration is present in community banks in relation to commercial real estate.

The GAO (US Government Accountability Office) has estimated that while the commercial real estate (CRE) default rates are at record low, community banks have aggressively developed their activity in this area.

In 2017, close to 500 community banks had assets in commercial real estate representing more than 300% of their capital.

Numerous risk management practices were observed in a 41 banks sample of banks largely exposed to CRE. The GAO expects a rapid increase of charge-off rate in this segment over the two coming years.

Shadow banking, a hidden risk behind deregulation

Non-bank financing can provide an interesting alternative to bank lending as well as encourage economic activity. Indeed, it can provide a new source of credit supply and represent a healthy competition for the banking industry.

Nonetheless, this financing can also prefigure of increased systemic risk if it involves additional banking activities such as creating leverage and transforming maturity and liquidity, both directly and through its inter-connectedness with the traditional banking system.

We adopt the Financial Stability Board's (FSB) approach in defining shadow banking.

All measures of bank and non-bank credit used in this paper come from the publicly available BIS long series database on private non-financial sector credit; the measures cover all loans and debt securities to non-financial corporations, households and non-profit institutions serving households.

In order to successfully estimate non-bank credit and guarantee potential comparison between different countries, we subtract bank credit from total credit, with bank credit defined as all loans and debt securities held by domestic banks.

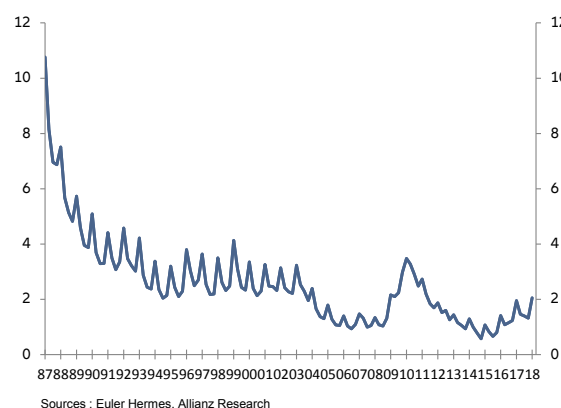
This allows us to consider a measure encompassing loans provided, and

debt securities held, by all other sectors of the economy, such as pension funds, investment funds, insurance companies or households.

This measure includes direct cross-border lending by foreign banks, which should be removed from the calculation.

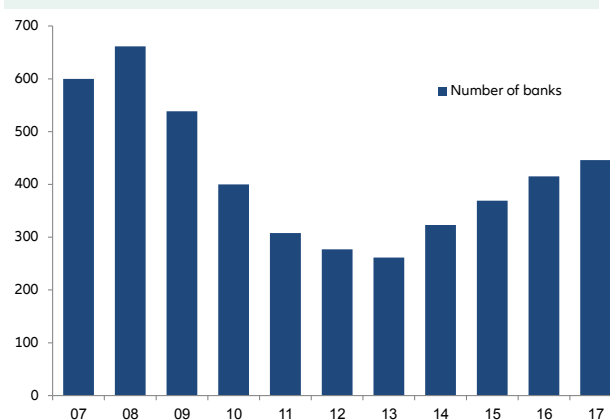
However, official non-resident bank credit figures are very small - less than 3% of GDP in average, with Luxembourg and Ireland strongly pushing the average up, at 103% and 30% respectively – and for such reasons we have decided to omit this component from our shadow banking data computing.

Figure 8 Agricultural loans (% y/y)



Sources: Euler Hermes, Allianz Research

Figure 9 Number of banks with Commercial Real Estate Loans representing 300% or more of their total capital



Source: Standard & Poor's

The U.S. situation

The size of non-bank credit is very different from one jurisdiction to another though some trends do come out when analyzing data: shadow banking is more important in advanced economies than in emerging market economies.

The large size of non-bank credit in certain advanced economies in comparison with emerging economies is in part due to captive financial institutions and money lenders.

Indeed, shadow banking in emerging economies generally does not involve complex and opaque chains of intermediation like it in advanced economies.

We can see strong similarities within advanced economies as seen in the following figure: major EU economies have all experienced a consequent surge of shadow banking activities since the 1980s.

However, there is a great difference between the UK and the three other countries.

The UK, a more strongly financialized economy like the U.S., has seen a strong peak of shadow banking activities as a share of GDP in 2008 (97.7% in 4Q08) and a decrease since, just like the American situation.

Separately, we have decided to

build a financial deregulation index so as to measure the evolution of this legal framework since the beginning of the 20th century. This index takes several components into account, including branching restrictions, the Glass-Steagall act, interest ceilings, the separation between banks and insurance companies, restrictions on investment opportunities or post-crisis regulations:

i. Branching:

To capture legislative evolution, we use as an indicator the share of the U.S. population who lives in states having removed branching restrictions via mergers and acquisitions. Interstate branching restrictions were first implemented through the McFadden Act in 1927, preventing branching of nationally chartered banks. Before this, the legal framework was vague so we set this component at 0.3 until 1926. The variable slowly increases until reaching 1 (or 100%) in 1999.

ii. Separation of commercial and investment banks:

The Glass-Steagall indicator is a continuous variable ranging from 0 to 1. It is 0 until 1932 and 1 from 1934 to 1986. As the Glass-Steagall Act was relaxed in 1987, 1989, 1997 and finally repealed in 1999 through the Gramm-Leach-Bliley Act, so that

the indicator comes back to 0 by 2000.

iii. Interest rate ceilings:

Ceilings first appeared in 1933 and were only fully removed after 1980. This means we set the variable at 0 until 1932 and at 1 from 1934 to 1980. Further deregulation came in the following years, at a progressive pace, so our index gradually moves back to 0 between 1980 and 1983.

iv. Separation of banks and insurance companies:

Since 1956 and the Bank Holding Company Act, BHCs are prohibited from engaging in most non-banking activities. It was only repealed in 1999.

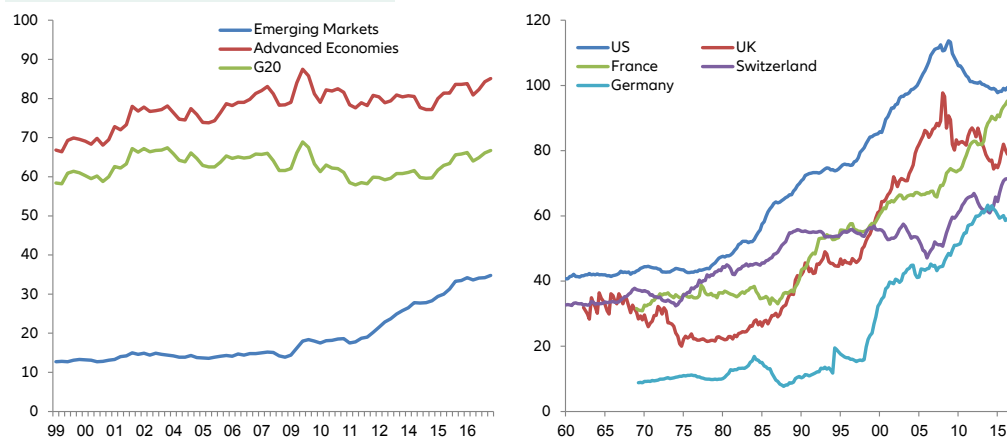
v. Post-crisis regulation:

The Great Recession put new financial excesses in the limelight, notably very lax lending conditions or proprietary trading. This fifth component tries to represent the impact of the Dodd-Frank Act and other banking regulation measures which were implemented post-2008.

Once these components have been computed, the U.S. financial deregulation index is given by:

$$\text{Deregulation} = (i) - (ii) - (iii) - (iv) + (v)$$

Figure 10 Non-bank credit, as % of GDP



Sources: BIS, Euler Hermes

The following figure shows how shadow banking and financial deregulation may possibly be linked, at least in the U.S. Indeed, there seems to be an interesting correlation between the development of non-bank credit in the U.S. and our freshly built financial deregulation index: simple regression analysis returns a coefficient of determination $R^2=0.90$. The more the financial system is being deregulated, the more funding and other various banking activities become, as intermediaries, easier and less expensive for such institutions. Shadow banking companies take advantage of these eased banking conditions and they thrive from the additional exchanges made. This figure shows well how there has barely been any slowing down for non-bank credit within the second half of the century, with the only remarkable decrease appearing since the Great Recession. Since the financial crisis and the considerable amendments which were brought to banking regulation, most importantly through the Dodd-Frank Act, it has been more difficult for almost all banks to maintain their flourishing activities.

The momentum had strongly decreased for a few years but now, especially with the last bill signed within the week, one can expect a new surge of shadow banking activities.

Risks and consequences of shadow banking

The rise in shadow banking activities could be a potential source of risk for the U.S. economy in such times. For instance, shadow banking institutions nearly doubled their share in the mortgage market from 2007 to 2015, up to 50% from 30%.³ This fast and unregulated growth could potentially expose the traditional financial sector to greater risk in the long-term. It stems from the Dodd-Frank Act because of how it restricted community banks' capacity to lend.

Moreover, most customers who borrow money from these firms have a tendency to be less creditworthy than conventional bank customers. For example, the use of bespoke tranche opportunities offered by shadow banks, which strongly resembles the notorious collateralized debt obligations – or CDOs –

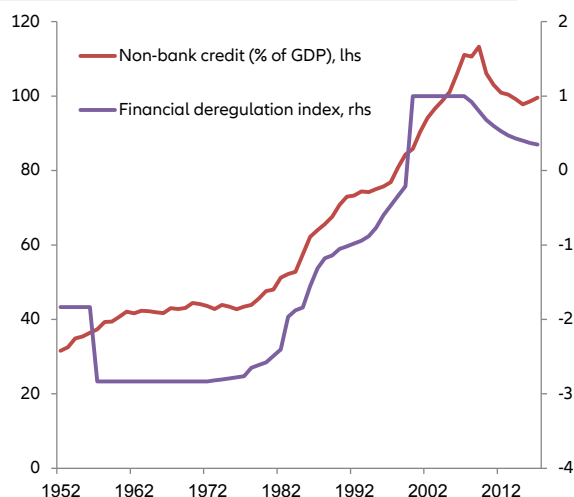
blamed for the last financial crisis, is a strong sign of a possible credit quality deterioration and must be supervised cautiously.

Economic Policy Uncertainty Indices

We also use various indices to try to measure policy-related economic uncertainty. Our goal here was to compare US overall regulation uncertainty with financial regulation uncertainty and see how the spread between them could help picture regulatory momentum in the U.S. These indices have been developed by independent researchers⁴ and are based on three precise components: the first one quantifies coverage in leading US newspapers of economic uncertainty, the second one indicates how many federal tax code provisions will expire in coming years and the third one reflects disagreement among economic forecasters. All indices are averaged and standardized homogeneously, which allows us to make direct comparisons between two indices or more.

We calculate the difference between both indices as seen below, analogous to a spread calculation as a yield differential between two bonds. The figure shows well how the recent regulatory atmosphere has been rather less concerned with financial regulation than all other types of regulation. The use of media coverage also gives an insight on the informal momentum surrounding legal and economic affairs. We can see that times during which regulation uncertainty has been lower in the financial sector (positive spreads) correspond with periods during which bubbles have inflated leading thereafter to severe crises. We can see that a similar trend has been already visible since at least 5 years prior to the voting of the Economic Growth, Regulatory Relief, and Consumer Protection Act, underlining the dangerousness of the current situation.

Figure 11 US shadow banking and deregulation index



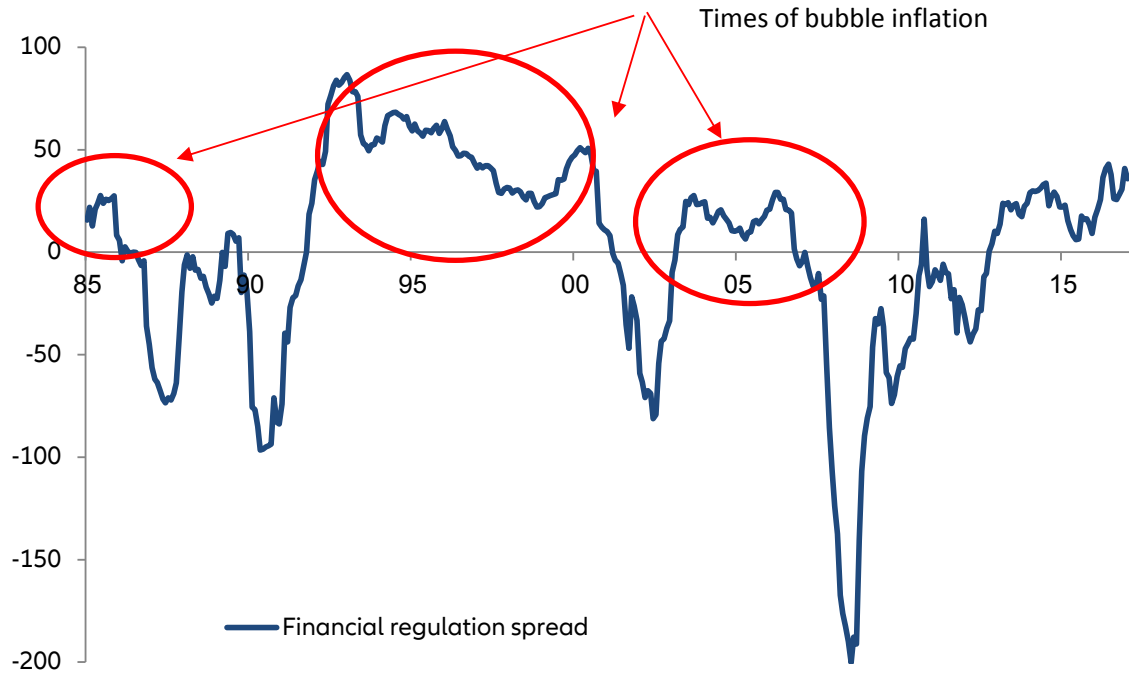
Sources: BIS, IHS Global Insight

Alexis Garatti and Arthur Laroche

³ Fintech, Regulatory Arbitrage, and the Rise of Shadow Banks, Buchak et al., 2017

⁴ More information is available on www.policyuncertainty.com

Figure 12 Financial regulation complacency index (US Financial regulation Uncertainty - US Global Regulation Uncertainty)



Source: Economic Policy Uncertainty Index



FINANCIAL LIBERALIZATION

IN CHINA: A TURNING POINT?

- **Unwelcome capital outflows forced China to take a break in its very gradual financial liberalization. New leadership have decided to accelerate efforts to modernize the financial sector**
- **Because of systemic importance, China must manage the trifecta of sustainable and balanced growth promotion, financial liberalization and financial stability**
- **Successful financial liberalization must include: Stronger institutions and Financial Literacy; A modern, integrated and innovative financial system; and State-of-the-art Asset and Liability Management**

Backwardness' advantages Step-by-step Financial Liberalization

Financial liberalization, or the deregulation of domestic financial markets and the liberalization of the capital account, is an engine of growth, for middle income countries. It also comes with risks that must, and can be minimized. Policy- and business-related lessons may be of relevance to successful financial liberalization in China.

Financial liberalization can lead to productive credit expansion and a better allocation of capital, both serving as growth boosters. But it can also aggravate boom and bust cycles and worsen inequality. This duality has played out in previous recent episodes of financial liberalization in East Asia, Latin America

and the Nordic countries, thereby providing insights for other countries, including China, to seize the opportunities of financial liberalization while minimizing key risks.

Firstly, financial literacy plays an important role in getting the balance right. Secondly, holistic regulation and supervision mechanisms are essential to success. Thirdly, relevant reform sequencing and a flexible approach to crisis management are needed.

China has adopted a gradual approach towards financial liberalization and this strategy has proven right so far. The economy has to manage the trifecta of sustainable growth promotion, financial stability strengthening and financial liberalization development.

Firstly, economic growth must be sustainable in order to move the country up from the middle-income category and keep social stability in check. A more balanced growth, based on private consumption will help achieve this goal. Secondly, maintaining financial stability will be essential to avoiding boom-bust cycles. Note that The Bank for International Settlements (BIS) data, points to a high leverage of 257% of GDP in Q3-2017 (compared to 146% of GDP in Q1 2006). Thirdly, financial liberalization has already begun and had results. Progress has been made, with policy makers showing considerable agility and willingness to learn from experience, theirs and others. Interest rate liberalization is formally completed and monetary policy is modernizing.



The authorities have been gradually moving towards the liberalization of the capital account, though efforts have slowed in 2015-17: risk-off mode led to strong capital outflows (USD647bn and USD646bn in 2015 and 2016 respectively) and authorities stepped up capital flow management measures (e.g. additional documentation for outward investment; caps on annual overseas withdrawal).

2018: A turning point?

At the end of 2017, China took steps to encourage capital inflows and its authorities announced plans that would ease limits on foreign ownership of banks and securities companies (November 2017).

The China Banking Regulatory Commission followed up on the promise with a revised regulation, facilitating administrative procedures for foreign banks conducting business and investing in China, beginning of this year.

In March 2018, financial markets welcomed some good news including the launch of oil crude oil futures in Shanghai Futures Exchange and

the internationalization of China's iron ore futures market. In June 2018, 233 A-shares has been added in MSCI's global benchmark. Concerning outflows, there has been little change; however, more favorable economic conditions (e.g. solid growth in private consumption, producer reflation) and a more stable RMB provide a window of opportunity for renewed progress and greater reform.

On the political and policy fronts, the nomination of Mr. Liu He as Vice Premier in charge of Economic Affairs, Mr. Yi Gang as the new People's Bank of China governor points to further pro-liberalization efforts. Early this year, Liu He provided a keynote speech at the World Economic Forum about China's Economic Policy for the next years. Key messages resonate with a cautious, holistic but gradual financial liberalization process:

The necessity to transition the Chinese economy from a phase of rapid growth to one of high-quality development; The necessity to prevent and resolve major financial risks, especially through decreasing shad-

ow banking and hidden debts for local government. The main goal is to effectively decrease overall leverage ratio in the next 3 years; and

The necessity to reform and open up at a faster pace. China will further integrate with international trade rules and ease market access, and will also substantially open up the services sector, the financial sector in particular, and create a more attractive investment environment.

Mr. Yi Gang in his first public speech as central bank governor also highlighted the importance of a gradual financial opening. The latter must continue as it leads to progress but should be associated with measures to reduce financial risks. He identified three critical tasks for his institutions: (i) the implementation of a prudent monetary policy; (ii) the opening of the financial sector; and (iii) the reduction of financial risks. These announcements were followed by a more detailed plan during the Boao forum. He announced six measures which should be implemented by June 2018, five others should be enacted by the end of this year (see table 1).

Table 1 Key measures announced in the Boao Forum (April 8-11, 2018)

By first half of 2018	By the end of 2018
<ol style="list-style-type: none"> 1. Remove foreign equity restriction on banks and financial asset management firms; treat domestic and foreign-funded institutions equally. Allow foreign banks to set up branches and subsidiaries at the same time in the country. 2. Lift foreign ownership limits to 51% in securities, fund management, futures and life insurance companies; limits to be removed after three years. 3. Remove the requirement that the domestic shareholder of a joint-venture broker needs to own at least one securities company. 4. Increase daily quota of the Hong Kong—Shanghai/Shenzhen Stock Connect by four times. (northbound quotas increase from RMB13 bn to RMB52 bn while southbound quotas increase from RMB10.5 bn to RMB42 bn) 5. Allow qualified foreign institutional investors to conduct insurance agencies and assessment businesses in the country. 6. Foreign-funded insurers will have same business scope as Chinese funded institutions. 	<ol style="list-style-type: none"> 1. Encourage foreign ownership in trust companies, financial leasing, auto finance, currency brokerage and consumer finance. 2. Remove cap limit of foreign ownership of financial asset investment companies and wealth management companies newly established by commercial banks. 3. Substantially expand the business scope of foreign banks. 4. Remove restrictions on the business scope of jointly-funded securities companies, treating domestic and foreign institutions equally. 5. Lift a requirement to have two-year representative office prior to establishing a fully-owned company in China for foreign insurance institutions.

Source: speech of Mr. Yi Gang, Governor of People's Bank of China at the Boao Forum



China must succeed

Success is of critical importance, for China and for the world, given the country's contribution to global demand; financing, liquidity and financial stability are unprecedented.

China accounts for one third of global economic growth, and is an important systemic influence on global trade in goods and services. More importantly, it aims at becoming a strong consumer market. For now, the US has the advantage, accounting for nearly 30% of global consumption. Yet, China is rising at a fast pace. While Chinese aggregate final consumption accounted for one tenth of that of the US in 2005, it rose to one third in 2016. Extrapolating this trend and assuming a gradual opening of the Chinese market for consumer goods, China's private consumption could match that of the US in 2040. This trend should go hand in hand with a liberalization of the currency. On top of higher incomes, the Chinese consumer will need to have a fully convertible and strong currency, in order to buy and borrow from abroad with reduced transaction risk.

The internationalization of the RMB has strong implications for the global financial system. Firstly, on global capital allocation, China accounts for 27% of global savings. Assuming that markets were to be liberalized, this would have an influence on asset prices, globally speaking. Gradual liberalization has already been associated in rising asset prices in high income markets such as Australia or Canada, including housing. Secondly, it effects global payment. For now, despite China's large economic size, the RMB share as international payment currency is small at 1.61% in December 2017. Easier access to RMB would help corporates to diversify their means of payment. Lastly, global monetary policy is affected as well. Being a reserve currency, central banks could diversify their foreign exchange reserves with further holdings of RMB. The PBC said that more than 60 countries have included the RMB in their foreign reserves.

Six lessons learnt for China's journey to financial liberalization

There are six building blocks (Figure 1) to support China's efforts to modernize its financial sector:

1. Stronger financial institutions that can assess, monitor, regulate and prevent financial risks in a predictable way.

China has already made important progress with tighter regulation to reduce financial risks, with the establishment of a Financial Stability and Development Committee that increases regulatory oversight. While there are few details on the operating framework, Mr Xu Zhong's (Director General, Research Bureau of the PBC) research explained that the new body could oversee the PBC, the China Banking Regulatory Commission (CBRC), the China Securities Regulatory Commission (CSRC), the China Insurance Regulatory Commission (CIRC) and the State Administration of Foreign Exchange (SAFE).

Regarding monitoring and prevention, more transparent balance sheets and data will help financial institutions react proactively to risks. Overestimated GDP numbers (e.g. Liaoning) as examples are a key concern for policy-reaction.

Concerning predictability, clarification and stronger enforcement of the institution's role will be crucial for improving policy efficiency, but, also for anchoring the market's expectations, which are a vital element of financial stability. For example, clarifying the role of the PBC and transparent communication on monetary policy will be important in the long term.

Currently, the institution has multiple objectives such as stabilizing the level of the exchange rate and domestic prices, supporting growth and ensuring financial stability with no explicit target.

This contrasts with other central bank peers that have a simpler framework (e.g. price stability for the ECB) and a more explicit target (2% inflation over the medium term). This

helps guide market expectations when there is a policy move.

2. Superior Financial literacy.

The ability to use knowledge and skills to manage financial resources effectively require investment in educational resources, but also on laws that promote transparency and awareness of financial corporations.

Financial corporations must ensure that their customers are aware of the risks of their financial products and services. China has already made strong efforts in terms of education investment.

Regarding transparency, financial institutions, such as, the PBC, CBRC, CIRC and CSRC are improving rules to create a more transparent system, even though diversification and the increasing complexity of Chinese financial products present a challenge. Strong moves include the new regulation on asset management issued in November last year.

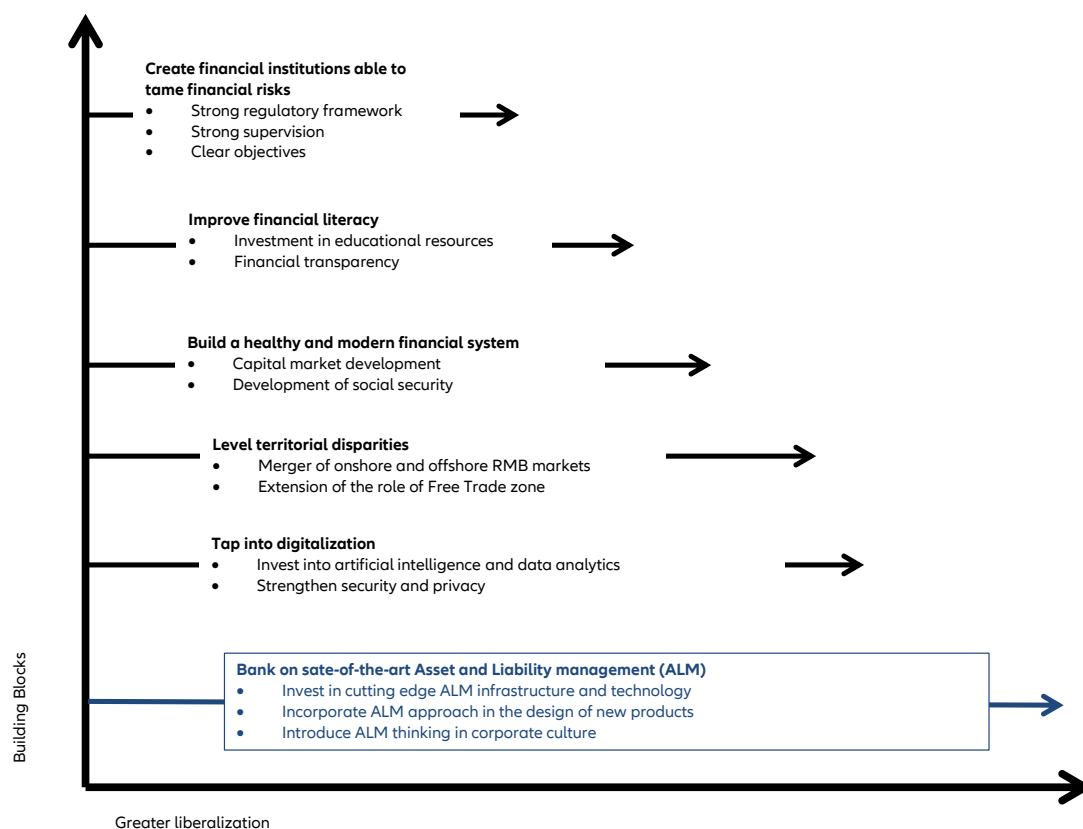
3. A healthy and modern financial system.

The reduction in financing risk has already started and should be backed by stronger financial institutions. Meanwhile, healthy financial deepening will be pivotal to ensure safe transactions.

There are two key areas of improvement: stronger efforts to improve social security and the modernization of China's financial markets with new institutional players.

The first, would help reduce inequality through efficient resource mobilization and help diminish precautionary saving (Feldstein, 1974) while the latter would allow for stronger mobilization of resources to finance growth and a stronger role given to market forces in order to avoid moral hazard.

While the interventions of China's authorities in the last market turbulence (2015-2016) were probably necessary to avoid financial and social panic, they also contributed to distorting risk pricing and encouraged risky behavior with implicit guarantees.

Figure 1 An augmented framework for financial liberalization

Source: Allianz Research

4. Regional integration.

This includes merging on- and off-shore currencies to eliminate opportunities for arbitrage and clarify RMB valuation, as well as the extension and the reinforcement of the free trade zones' role as springboards for financial liberalization and regional development. Existing free trade zones (Shanghai, Shenzhen) have already emerged as key global players. Shanghai's GDP accounts for USD469bn with a growth of +6.9%. Shenzhen rose to USD338bn, with a growth of 8.8% in 2017. This compares to a market size of USD340bn in Hong Kong. With no restrictions on the use of foreign currencies and favorable taxation, establishing free trade zones could help gradually move forward with financial liberalization, taking advantage of the lessons learned, but also creating regional driving forces.

5. Digital innovation.

The PBC decision to include big data and artificial intelligence in its monitoring process in order to detect and prevent financial risks is important. The recent announcement by Vice-Governor Fan Yifei from the PBC on the issuance of their own digital currency (digital cash) confirms China's pioneering position. New lending and payment methods offer opportunities but require a clear regulatory framework to avoid risks. China's financial authorities have generally been strong advocates of financial innovations, yet a loose regulatory framework was associated with a rise of risks. One example is the fast rise of online micro-lending over the past years, which was fueled by a lack of regulation. Financial authorities issued new rules clarifying loan originators and conditions for loans in

December 2017.

A cautious approach involving preliminary investigations and short-testing phases could be a key enabler for success.

6. State-of-the-art Asset and Liability Management (ALM).

With the introduction of the C-Ross capital regime and the new Asset and Liability Matching regulation in 2018, the Chinese regulators are moving in the right direction for establishing a more economic based steering framework for the insurance industry. However, there is still a way to go for the whole industry to improve ALM capability, from mentality and corporate governance to processes and system infrastructure.

Mahamoud Islam and Ludovic Subran



Photo by Marc-Olivier Jodoin on Unsplash

THE GLOBAL INSURANCE MARKET: 80% OF GROWTH COMES FROM EMERGING MARKETS

- Global insurance premiums increase in 2017 by 3.7% to EUR 3.66mn
- Property-casualty grows by 5.0%, almost twice as fast as life
- After a lost decade, premium growth should return to pre-crisis level – China is set to become the biggest market worldwide

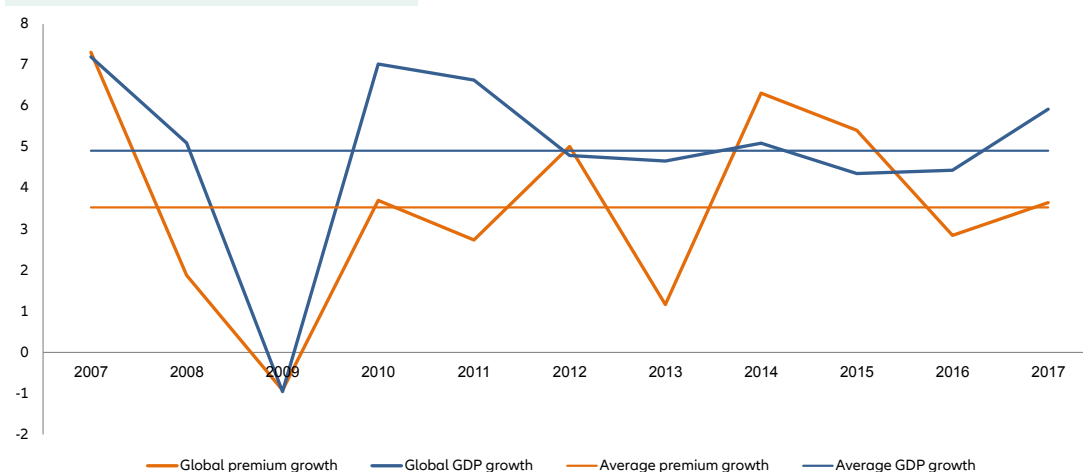
According to projections by Allianz Research, the global premium volume last year rose to a new record sum of 3.66 trillion euros (excluding health insurance). Compared to 2016, the nominal increase adjusted for exchange rate effects is 3.7%. Although the growth rate of premium income accelerated slightly compared to the previous year (+ 2.9%), it lagged behind the expansion of economic activity (+ 5.9% nominal growth) for the second year in a row (see figure 1).

A huge protection gap

Global insurance penetration (premiums as a percentage of GDP) has thus fallen to 5.5% – the lowest value in the last 30 years. Compared to the pre-crisis years, it dropped by almost one percentage point (life and p&c, w/o health). This drop translates into “lost” premiums of around EUR 330bn in 2017 alone (11% of total global premiums). Roughly 95 percent of this “loss” is attributable to the regions of West-

ern Europe and North America. Against the backdrop of increasing risks worldwide – climate and demographic change, increasing cyber incidents and geo-political tensions –, the fact that households, companies and investors are spending an ever smaller proportion of their income on protection is rather disturbing. This “protection gap” represents not only missed growth opportunities for the industry but also a less economically beneficial outcome for society as a whole.

Figure 1 5 Oil price central scenario 2019



Sources: AXCO, EIKON, national supervisory authorities, national insurance associations, national banks and statistical offices, Allianz Research

A huge protection gap

The term "protection gap" describes a situation of inadequate insurance cover. Insurance is "inadequate" in the sense that it does not cover the damage incurred either at all or in full (for example in the event of natural catastrophes), or in the sense that the benefits provided fall short of what is necessary or desired (for example in terms of health cover or retirement provision). Whether or not cover is deemed "adequate" obviously depends on a number of variables, including not only economic factors (income, inflation, interest rates, etc.) but also, and in particular, structural factors (the structure of state and private support systems) and individual preferences. As a result, adequate insurance cover cannot be reduced to a simple formula. This is also evident if we look at one parameter that is commonly taken as a guide: economic strength: Hong Kong, Germany and the UK have similar levels of per capita GDP, but British people spend an average of twice as much on insurance cover as their German counterparts do, and the Hong Kong Chinese in turn spend double what the British do. It just depends, and comparing individual markets makes little sense.

Assuming, however, that structural factors and individual preferences do not change overnight, intertemporal comparisons can at least provide some indication of the level of insurance cover that is adequate for the market in question. We have taken the pre-crisis years, a period of relative stability in which many households and companies were able to bring their spending on insurance cover into line with their actual requirements, as a benchmark. Specifically, we have assumed that the insurance penetration rate (premiums as a percentage of GDP) was more or less aligned with the overall structural conditions and individual preferences during this period (average for the years between 2003 and 2007). This means that any downward deviation from this level – i.e. a lower insurance penetration rate – flags up a "protection gap": people return to spending less on insurance cover than they actually deem necessary – based on their earlier decisions. This assumption is certainly plausible for the advanced economies; for the emerging markets, which have considerable catch-up work to do (i.e. rising insurance penetration rates in general), taking historical parameters as a guide is more problematic in comparison (and as a logical consequence, we can, in fact, barely detect any insurance gap in these countries).

Naturally, there might also be other reasons explaining lower demand for insurance. People might, for example, have less of a need for insurance cover – because the world has become safer overall. This is a nice idea, but hardly tallies up with reality in an environment characterized by global crises and increasingly frequent natural catastrophes. The idea that people might now have less of a need for retirement provision than they did prior to the crisis is also unrealistic given the record-high levels of government debt and populations that continue to get older and older; rather, the very opposite is true. Another alternative explanation would be that the same insurance cover is now available at a much lower price. This is a scenario that is at least within the realms of possibility. But first of all, the insurance industry is not exactly renowned for its ability to make huge productivity gains and second, the digital revolution is just about to begin, meaning that it will be some time before any resulting efficiency gains come to the fore. And as far as retirement provision – a major area – is concerned, it is once again the case that the prevailing low interest rates are making old-age provision more expensive as opposed to cheaper.

So only one theory is left as the most likely explanation for the drop in the demand for insurance in the recent crisis-ridden years: the majority of people have reduced their demand out of necessity and not because they consider a lower level of protection and provision to be sufficient. This is why the discrepancy between earlier and current spending levels can be interpreted as a "protection gap".

It goes without saying that any promising approach to narrowing such a huge protection gap requires a multi-stakeholder effort. The collaboration of private-sector insurers and governments is of particular importance. Governments could help by introducing compulsory schemes which create sufficiently large risk pools. They can also step in as insurers or reinsurers of last resort for certain risks which defy the most fundamental criteria of insurability. But first of all, insurers themselves have to step up their game. Digital and mobile technologies can go a long way in addressing protection gaps by simultaneously promoting affordability, awareness and product appeal.

Emerging and advance markets going into different directions

Property-casualty set the tone last year: At 5.0%, it not only grew almost twice as fast as life insurance in 2017, but also recorded the largest increase since 2012. Almost all regions contributed to the positive premium development; nevertheless, the growth discrepancy between emerging and industrialized countries remains striking: while premiums in the former soared by 11.6%, mature markets only managed an increase of 3.5%.

Western Europe, however, is also lagging significantly behind this figure: premium growth in 2017 reached only 2.0% – but still the second highest value since 2007; in the previous year, the Western European markets recorded zero growth. The French and German markets performed slightly better in 2017, achieving growth of 2.5% resp. 3%. The significantly lower global growth in life insurance premiums in 2017 (+2.8%) is primarily due to the still weak development in Western Europe, where almost 30% of global premium income is written. After a minus of 2.2% in 2016, there still is a red zero in 2017. At the end of last year, the regional premium volume was thus still almost 5% below the pre-crisis peak in 2007; insurance

penetration fell from 5.6% to 4.4% during this period. In France and Germany, the trend was equally dismal, in 2016 (-1.1% in France, -1.7% in Germany) and 2017 (-1.9% in France, -0.2% in Germany) premiums also fell in each case. However, whereas penetration has fallen by about two percentage points to 5.7% in France, in Germany, penetration has fallen in the last ten years by only about half a percentage point – because the level is much lower (2.6% in 2017).

Although the life insurance markets have become significantly more volatile in recent years, the downward trend is clear. Against the backdrop of unrelenting demographic change and the necessity of private provision, the decrease of long-term savings efforts is quite alarming. The severe economic crisis in many European countries is certainly one reason for this.

But the ECB's low-interest policy also plays an inglorious role here, discouraging savings efforts. For the interest of the younger generation, which will be much more dependent on private reserves in old age than the current generation of pensioners, the sooner monetary policy is normalized the better.

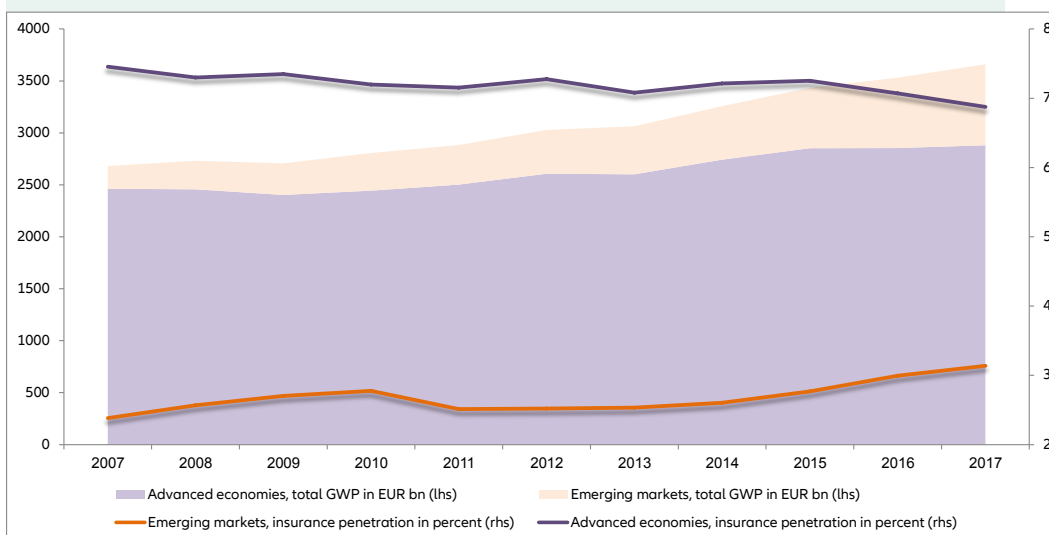
Some other developed economies also experienced declines in premiums in 2017, for example, Australia

(-18.2%), Japan (-11.3%) or South Korea (-4.9%). Overall, therefore, premium income in life insurance in industrialized countries shrank by 0.5% in 2017. The emerging markets, on the other hand, increased their premiums by a total of 17.2%. In particular, one country stood out: China. Of the approximately 60 billion euros in additional premiums in life, around 80% were attributable to the Chinese market. In both lines combined, last year's global premium growth totaled just under 130 billion euros. Emerging markets accounted for almost 80% of the increase, with China accounting for two-thirds of this.

As a consequence, insurance penetration, too, kept on rising in the emerging markets (see figure 2).

Looking at the drivers for insurance premium growth, it becomes clear that emerging insurance markets benefitted from all three relevant factors: economic activity increased strongly, inflation remained elevated and last but not least households and companies spend on average an increasing share of their incomes / revenues on protection (insurance deepening). In advanced markets, on the contrary, economic growth and inflation were lackluster – and on top of that, households and companies scaled back expenditures on protection (see figure 3).

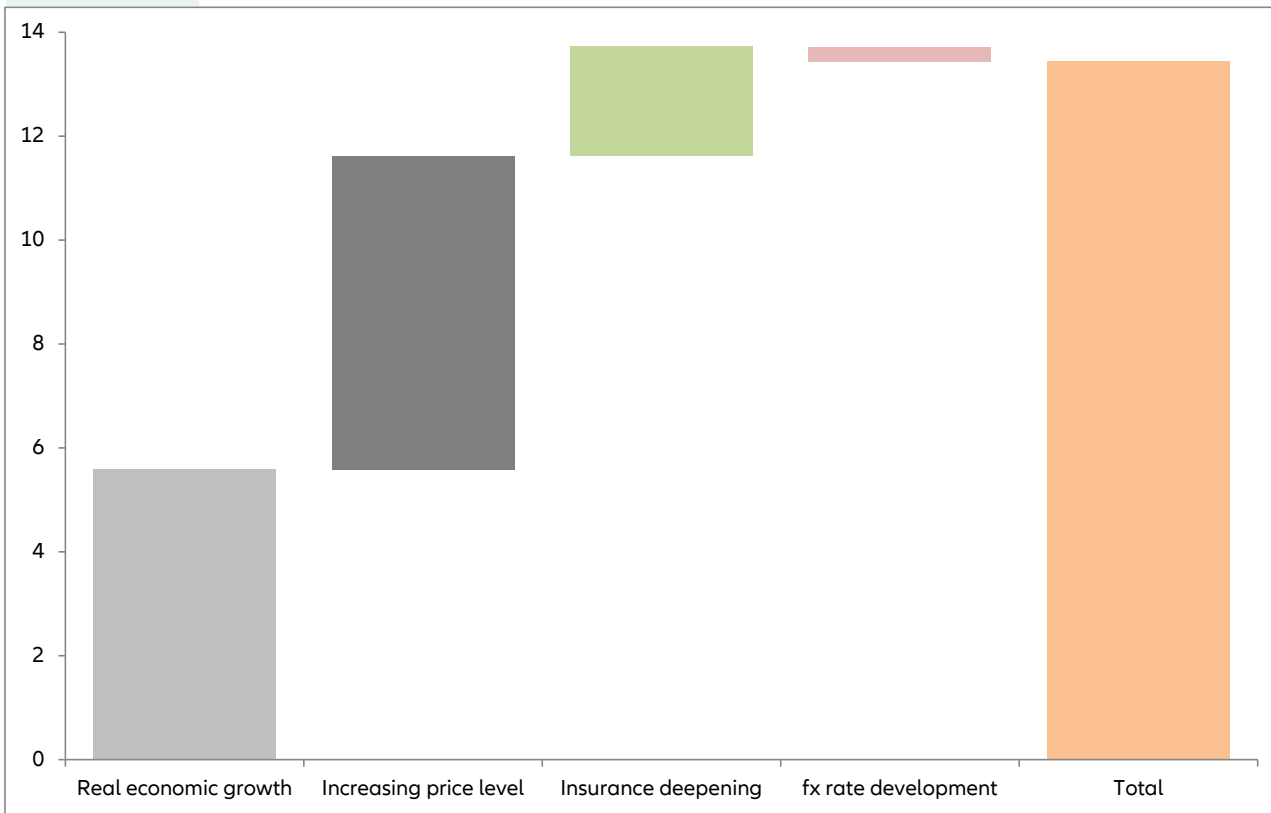
Figure 2 Total GWP in EUR bn and insurance penetration in %, emerging and advanced markets grades)



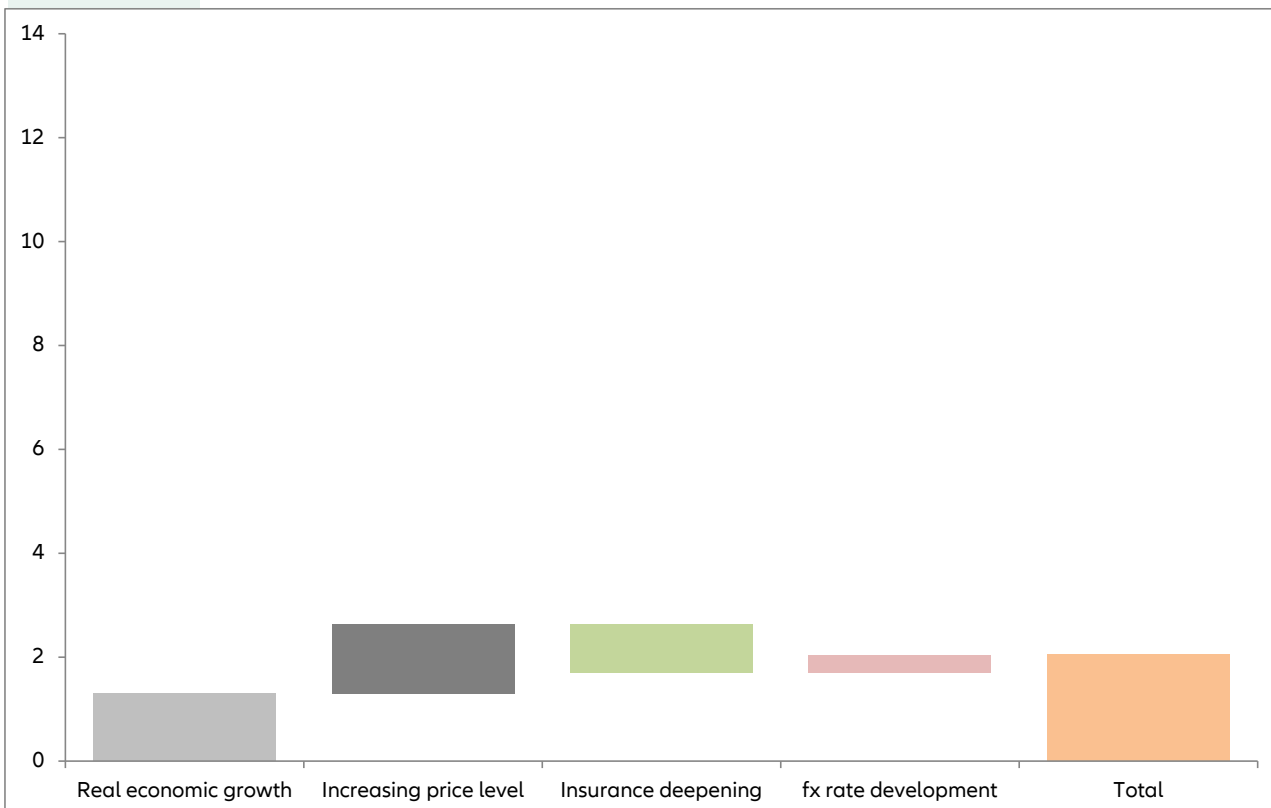
Sources: AXCO, EIKON, national supervisory authorities, national insurance associations, national banks and statistical offices, Allianz Research

Figure 3 Growth components in %, emerging and advanced markets, 2007 - 2017

Emerging markets



Advanced markets



Sources: AXCO, EIKON, national supervisory authorities, national insurance associations, national banks and statistical offices, Allianz Research

Outlook: Return to pre-crisis growth

Allianz Research expects the insurance markets to continue to recover in the future. After global premium growth disappointed since the financial crisis with a nominal rate of just over 3% p.a., growth should accelerate to around 6% in the next decade – almost reaching the pre-crisis pace.

This upturn reflects more stable economic growth as well as higher inflation and interest rates. This development is particularly pronounced in industrialized countries, not least in Western Europe: after zero growth of the last ten years, insurance premiums should increase again in the future by an average of just under 3% per year. This is also in line with growth expectations for the French and German markets.

However, this growth will only slow but not stop the downward trend in insurance penetration in advanced markets. In future, primarily structural reasons, as opposed to economic trends, will be responsible for the continuation of this subdued development: first, there is the demographic trend, with the baby boomer generation gradually starting to transition to retirement over the coming years. Second, achieving

further increases in premium income will prove to be more and more of a challenge for the old “bread-and-butter” business of the P&C segment, auto insurance. Various changes could cast a shadow over this branch of insurance in the future: in addition to hotter competition from digital players, new technologies (autonomous driving) could help to reduce the number of accidents and claims in the future, while rates based on driver behavior (telematics) could push average prices down and general changes in behavior could limit the number of users who have their own cars (car sharing and Uber). Although these paradigm shifts in individual mobility will most certainly take more than ten years to come to fruition in full, insurers are likely to start feeling the brunt of the change.

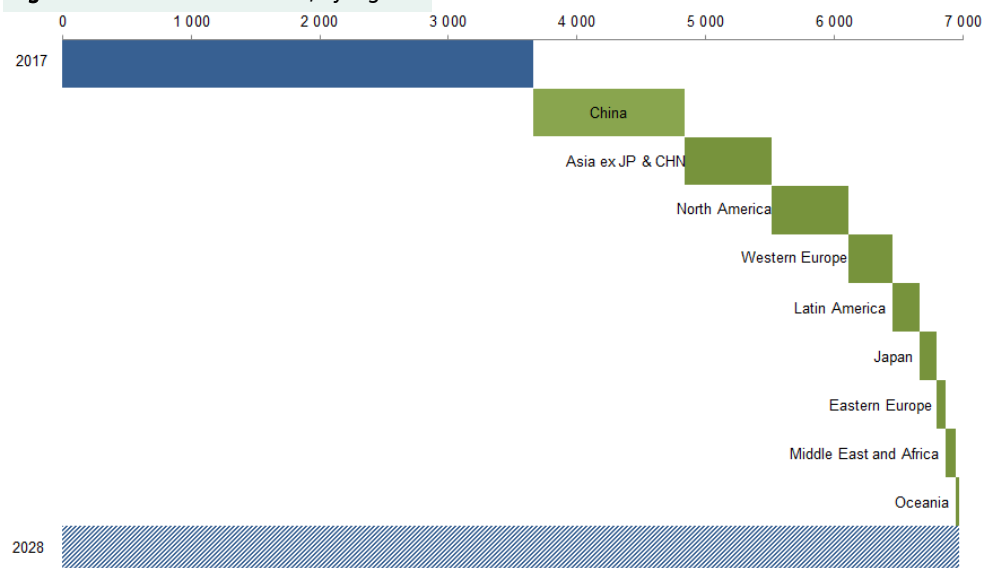
On the other hand, the shift in weight towards the emerging markets will continue unabated in the coming years. At the end of the 2020s, around 40% of global premium income should be written in this country group; 10 years ago, this figure was still below 10%. Of the 3.3 trillion euros of new premiums expected to be written in the next decade, more than one third will be generated in China alone (see figure

4).

As a consequence, there will be a historic change of guard at the top: China will overtake the USA as the largest insurance market. Today, the USA still dominates without restriction: With 1.1 trillion euros or just over 30% of global premium income, it is still the largest insurance market worldwide, far ahead of the number two, China, with around 420 billion euros. As usual, long-term forecasts have to be taken with a pinch of salt, in particular at these times where the insurance markets are undergoing fundamental change. But this disruption offers also great opportunities. With new technologies, insurance cover can be made accessible and tangible for more people, and insurance products can become more attractive. If the industry succeeds in getting customers so enthusiastic about insurance that they again spend as much of their income on insurance cover as they did before the crisis, global premiums could be about 1 trillion euros higher at the end of the next decade than in the baseline scenario. So, the upside of digitalization, big data and AI is enormous – as will be the competition for it.

Kathrin Brandmeir, Michaela Grimm and Arne Holzhausen

Figure 4 Global GWP in EUR bn, by regions



Sources: AXCO, national supervisory authorities, national insurance associations, national banks and statistical offices, Allianz Research



Photo by Arturo Castaneyra on Unsplash

NORTH AMERICA

INFLATION EMERGING IN THE US

Inflation and inflationary pressures are emerging in the U.S. economy. A plethora of measures from the real economy, the financial markets, and numerous surveys all show inflation starting to bubble up. While it is unlikely that broad-based inflation rates will rise significantly above 3% for an extended period of time, it is likely that the economy this year will break out of the less than 2% range experienced since the end of the recession. We are now factoring in new information (the recent increase of oil prices in particular) to revise on the upside our US inflation scenario to 2.8% y/y on average compared with 2.3% y/y before

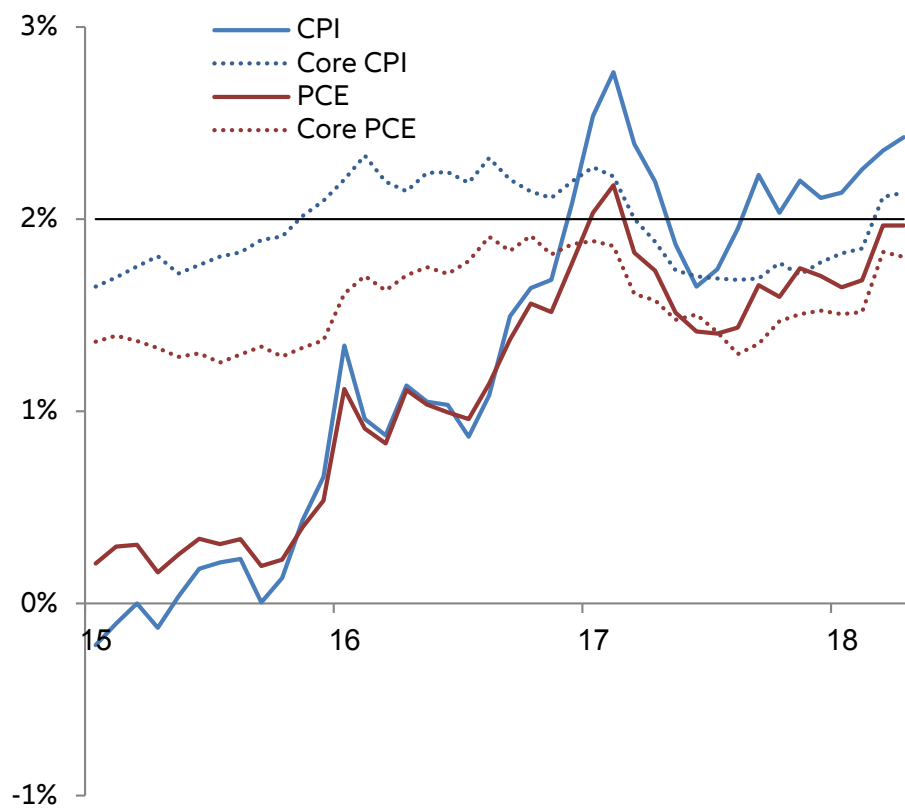
Real economy points toward higher prices alongside higher capacity utilization

Measures of inflation in the real economy have recently risen significantly.

No single measure will rise in a straight line every month of course, but the number of measures indicating rising prices is striking:

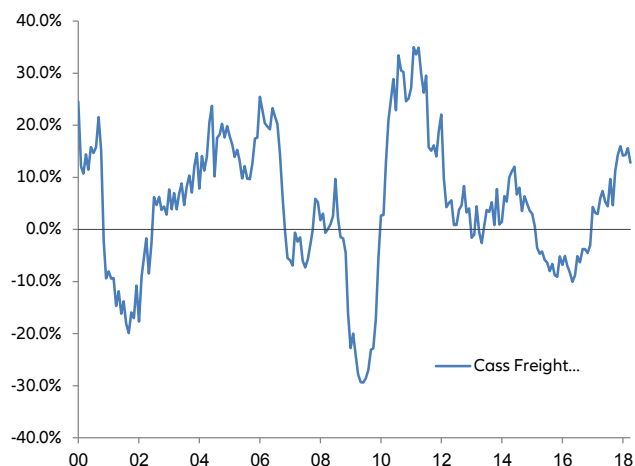
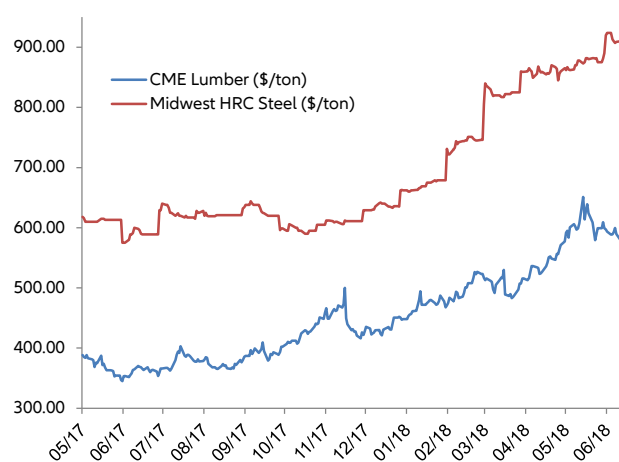
- The Personal Consumption Expenditures (PCE) Price Index and the PCE core index, which excludes the volatile food and energy components, have both risen 60 basis points (bps) since August including a 30 bps increase from February to March. Perhaps more importantly the PCE core is now rising at 1.8% y/y, bumping up right next to the Fed's target of 2% for this measure.
- Consumer and Producer Prices, including their core components, have also risen sharply over the past year, and all four measures are now above 2% y/y.
- Housing prices in the past 12 months have risen at an average y/y rate between 5.6% (NAR existing median sales price) and 6.1% (Case-Shiller, 20 cities SA). And since the end of the recession, 6.9% and 6.2% respectively, far outpacing wage gains of only 2.3% over the same period.
- Some essential commodity prices are on the rise. Lumber prices have risen 60% since last August when it became clear that the administration was about to impose a 21% tariff on Canadian softwood. Steel prices, such as those on Midwest Hot-Rolled Coil, have been pressured by tariffs and have risen 35% since January. Commodity indexes such as the S&P GSCI Commodity Index have risen 18.7% y/y.
- US retail gasoline prices have almost increased by 20% y/y in June.
- Freight rates, which lead other prices and the economy in general have risen a steep 12.8% y/y as measured by the Cass Freight Expenditures Index
- Wages are being pressured by a number of indicators in the tight labor market, including a job openings/unemployed ratio of 1, a high quits rate, and aggressive hiring plans expressed in the National Federation of Independent Business (NFIB) survey. As a result the Employment Cost Index (ECI) Wages and Salary component rose at an annualized rate of 3.7% in Q1-18, the most in 11 years.

Chart 1 CPI and PCE headline and core rate



Source: BLS, Euler Hermes

Chart2 Lumber and Steel prices, Cass Freight Expenditures Index



Source: NYMEX, CME, Cass Info, Euler Hermes

Surveys point toward higher inflationary pressures as well

Surveys across a range of industries are also reporting inflationary pressures

- The Institute of Supply Management's (ISM) manufacturing survey, which indicates expansion when it is over 50, has ten components, one of which measures prices paid for inputs. That measure reached a seven year high of 79.3 in April. The same measure for the non-manufacturing survey reached a five year high last September and remains at an elevated 61.8. A separate semi-annual survey noted that in December, manufacturing respondents forecasted that prices would rise 1.3% in the first four months of 2018, but in actuality prices rose at a much faster 4.8%. Respondents are currently forecasting price increases of 5% for all of 2018. On the non-manufacturing side, the current forecast for all of 2018 is 2.1%.
- Regional Fed surveys are showing rapid price increases in the manufacturing sector. The Philadelphia Fed's "prices received" index reached a 29 year high in May. The "prices paid" index reached a seven year high, and the New York Fed's prices received and prices paid indexes reached seven and six year

highs respectively.

- The National Federation of Independent Business (NFIB) survey of smaller businesses reports pricing pressures across a wide range of industries. The net percentage of respondents raising prices rose to the highest in almost 10 years in May.

Financial Markets

Inflationary pressures and expectations have been emerging in financial markets.

Long-term interest rates reflect both inflationary expectations, and the "real" interest rate which is driven by current supply and demand.

The yield on the benchmark 10 year U.S. Treasury note recently rose above the 3% psychological barrier, and reached 3.11% on May 17th, the highest in almost seven years.

The real rate, as represented by a Treasury Inflation Protected 10 year security reached a seven year high on the same day.

Inflationary expectations as represented by the spread between a regular 10 year and a TIP reached the highest in almost four years

What does our model tell us?

In order to factor in the recent evolution of macroeconomic variables (in particular higher energy prices), we have updated our US inflation model.

This initiative is important given our belief that the Federal Reserve could be more aggressive than previously expected in tightening US monetary policy. Our methodology consists of decomposing the headline CPI index into its main subcomponents (core commodities, medical services, shelter services, transportation services, education, food and energy), building a forecast for each of them, and then re-combining them to create a forecast for the headline index. Other explanatory variables used in our model include oil prices, the unemployment rate, the Dollar Index, average hourly earnings, real GDP growth, the Fed Funds target rate, and the budget deficit. We assume a forecast for the price of Brent crude oil of USD 76 per barrel at the end of 2018, and an average price for all of 2019 of USD 69 per barrel. Taking into account all these elements, we obtain a scenario where US CPI inflation reaches a peak of 3.3% y/y in July 2018, followed by a rapid decline thereafter. For all of 2018 we expect CPI to average 2.8% y/y, and for all of 2019, 2.1% y/y. By comparison our previous forecast was for 2.3% y/y and 2.4% y/y, respectively. Despite the upward revision for 2018, we are not changing our assumption about Fed monetary policy, because the surge in prices will only be temporary. In addition, a simple Taylor rule supports our scenario for 2 more rate hikes in both 2018 and 2019.

Alexis Garatti and Dan North



Photo by Alvaro Reyes on Unsplash

WESTERN EUROPE

ITALY: STRESS IS HERE TO STAY

- 88 days after the Italian parliamentary election, and an episode of exceptional financial market stress later, the Five Star Movement (M5S) and the Lega have sealed their governing alliance. Significant uncertainty remains however regarding the political and economic outlook. We defined four key political scenarios based on the fiscal measures implemented by the government and their relationship to the European institutions
- **Baseline scenario (50%)** assumes that the government implements only a portion of announced fiscal stimulus and finds a conciliatory approach with Europe. Italian 10-year spreads to the Bund will remain between 180bps and 250bps. GDP growth would more than halve by 2020 to 0.6% with debt-to-GDP embarking on an upward trend to 134% by 2020
- **Upside scenario (30%)** foresees the implementation of limited fiscal measures while the government maintains a constructive approach towards Europe. Spreads would still be elevated with less volatility, GDP growth would moderate to 1% in 2019/2020 while public debt stabilizes at 132% of GDP
- **Downside scenario (15%)** assumes a sharp rise in fiscal spending with the coalition embarking on a collision course with the EU. Spreads would rise by an additional +200bps compared to the baseline; Italy could slip in a shallow multi-year recession with debt rising above 140% by 2020.



- Italexit (<5%) assumes that a political event or a market default, combined with a confrontational stance causes substantial financial stress (spreads up by +500bps to the baseline). Italy would undergo a very deep recession with debt-to-GDP rising towards 160% by 2020. Contagion would follow.
- In its relation with Italy the European Union will have to strike a delicate balance between upholding its own rules while at the same working constructively with the new government with a view on making more tangible progress on EU reform

What's next for Italy? Four scenarios for 2018-20

88 days after the Italian parliamentary election on March 4, and after one failed attempt to form a governing coalition that triggered an episode of exceptional financial market stress, the Five Star Movement (M5S) and the Lega parties sealed their governing alliance.

Nevertheless significant uncertainty remains regarding the political and economic outlook for Italy particularly given the M5S/Lega government's ultra-expansive fiscal policy which includes tax cuts and higher spending to the tune of EUR126bn (about 7% of GDP). There are significant doubts regarding the government's ability to implement the proposed fiscal plans given institutional curbs. In addition, further financial stress may as well as limit appetite for Italian government bonds.

There are four key scenarios depending on the new government's policy choices. .

1. Baseline: Policy U-turn after Significant Fiscal Expansion combined with Moderately Confrontational EU Approach

Our base case considers significant fiscal expansion coupled with Euro-sceptic rhetoric to trigger a notable increase in market tensions. Substantial financial stress will prevail fueled by the downgrade of Italy's sovereign rating by one notch following the presentation of the government's 2019 budget plans in October. This help explains the expected U-turn in fiscal profligacy (30% of the proposed measures in 2019; 10% additional in 2020), and in the confrontational posture with the EU.

Such assumptions lead to a fiscal multiplier boost of +0.4pp to GDP growth as soon as 2019 but the deterioration of the fiscal deficit from -2.3% of GDP to -3.5% is expected to keep sovereign bond spreads relatively elevated (above +200bp over the 10-year compared to the Bund). In addition, fickle confidence will be a drag on the private sector. Overall, we expect GDP growth to reach +0.8% in 2019 after +1.2% in 2018. Keeping a positive primary balance initially helps avoid a more significant deterioration in market sentiment towards Italy. We estimate the fiscal primary surplus to fall from +1.5% of GDP to +0.3% before turn-

ing negative in 2020 – for the first time since 2009. Italian public debt will rise to 134% by 2020 up from 132% of GDP in 2019. The fiscal deficit is expected to be greater than -4% of GDP in 2020.

The spillover to other peripheral countries is expected to remain contained. The ECB will stay on course by extending its QE program until end-2018 and increase interest rates for the first time in H2 2019.

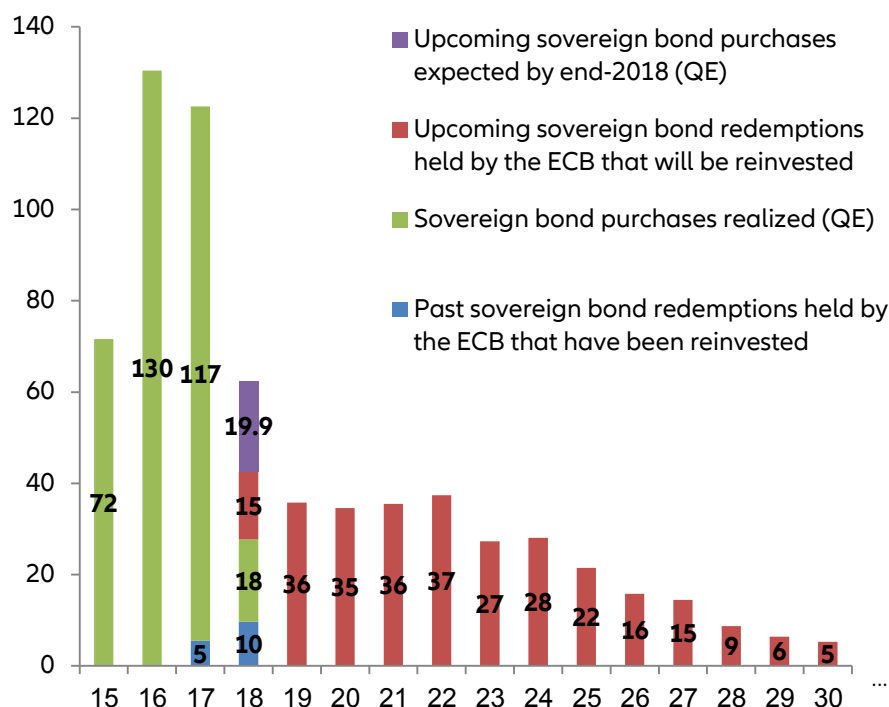
For the ECB to do more, financial stress would have to be more tangible: (i) a broad flattening of yield curves endangering banking system liquidity access; (ii) a significant loss of confidence among Eurozone banks (Euribor-Eonia spread above 1%; and (iii) peripheral spreads durably above +400bp.

Overall, the ECB holds EUR345bn of Italian public debt (around 18% of total bonds outstanding). Starting in 2019 we expect the ECB to buy Italian bonds as part of the reinvestment of principal only following its QE exit. The average monthly amount of ECB purchases of Italian bonds will be EUR3bn compared to almost EUR4bn since the start of 2018 or around EUR10bn in 2017.

Figure 1 Economics and Policy-Making



Source: speech of Mr. Yi Gang, Governor of People's Bank of China at the Boao Forum

Figure 2 ECB purchases of Italian sovereign debt (Gross sovereign bond purchases + reinvestment of principal), EUR bn

Sources: Bloomberg, Euler Hermes

2. Upside: Mild Fiscal Expansion & Conciliatory EU Approach

Our upside scenario sees the Italian government adopt a constructive stance towards Europe and abandon the vast majority of its fiscal plans, implementing only 20% of the proposed measures. This will reassure financial markets. The mild fiscal expansion props up economic activity in the short-run while triggering only a slight increase in refinancing costs.

In this scenario Italian GDP growth is expected to average +1% in 2019-20 after +1.3% in 2018. Given an increase of the fiscal deficit to above -3% of GDP by 2019, debt-to-GDP ratio would hover around 131% over the forecast horizon down from 132% in 2017. The impact on the Eurozone is likely to stay negligible as contagion to the periphery would remain low.

3. Downside: Considerable Fiscal Expansion & Confrontational EU Approach

Our downside scenario includes the governing alliance's pushing ahead its expansive fiscal spending plans while maintaining a persistent confrontational attitude towards its EU partners. This would in turn fuel rising concerns about the sustainability of Italian debt, the stability of its banking sector as well as its euro-membership. The sharp adverse market reaction eventually raises heightened concerns about Italy's ability to access financial markets. A revival of the 2012 episodes would follow.

The deterioration in public finance fundamentals is expected to be rapid with the fiscal deficit greater than -5% of GDP as soon as 2019 (from -2.3% in 2018) and public debt increasing by +6pp to 137% of GDP. The primary balance registers its first deficit since 2009 at -1.3% of GDP which keeps BTP spreads to the Bund above +400bp. The Italian economy enters a multi-year recession with GDP contracting by more than -2% in 2020 alone and there is marked contagion to the periphery.

Italy's sovereign debt could then be downgraded to non-investment grade as early as H1 2019 pushing the ECB to exclude Italy from its asset purchase program and to no longer accept Italian sovereign bonds as collateral in Eurosystem credit operations.

The sharp deterioration in market sentiment would trigger a banking crisis. Italy is left with no other choice than to seek an ESM program in an effort to avert a sovereign debt default and subsequent euro-exit.

In that case, the ECB could use the full toolbox: Outright Monetary Transactions (OMT); Emergency Liquidity Assistance (ELA); and resume non-standard measures such as Targeted Longer-Term Refinancing Operations (TLTROs).

As a result no ECB rate hike will be implemented until at least 2021; will be needed to alleviate banks' funding pressures. The Eurozone economy is likely to experience a contained recession with GDP contracting by less than -0.5%.

4. Italexit

The extreme case of an Italexit cannot be ruled out; it remains highly unlikely (<5% probability). In that case, not only the government coalition would pursue a marked fiscal expansion coupled with a confrontational EU stance, but a specific event triggers the perception that Italy becomes a systemic risk to Europe.

Possible triggers include: the refusal

of Europe's financial aid - through the ESM e.g. - because of too stringent conditionalities; a technical default from the Sovereign or a large bank; or a negative outcome to a referendum called by the government, following a constitutional change. The ECB would have to step in to safeguard financial stability. Spreads would rise by +500 bps from current highs and spillover effects to Eurozone countries would

be very concerning. In this tail risk scenario the recession in both Italy and the Eurozone will be deep with GDP contracting by -4.5% and -3.0% in 2020 respectively.

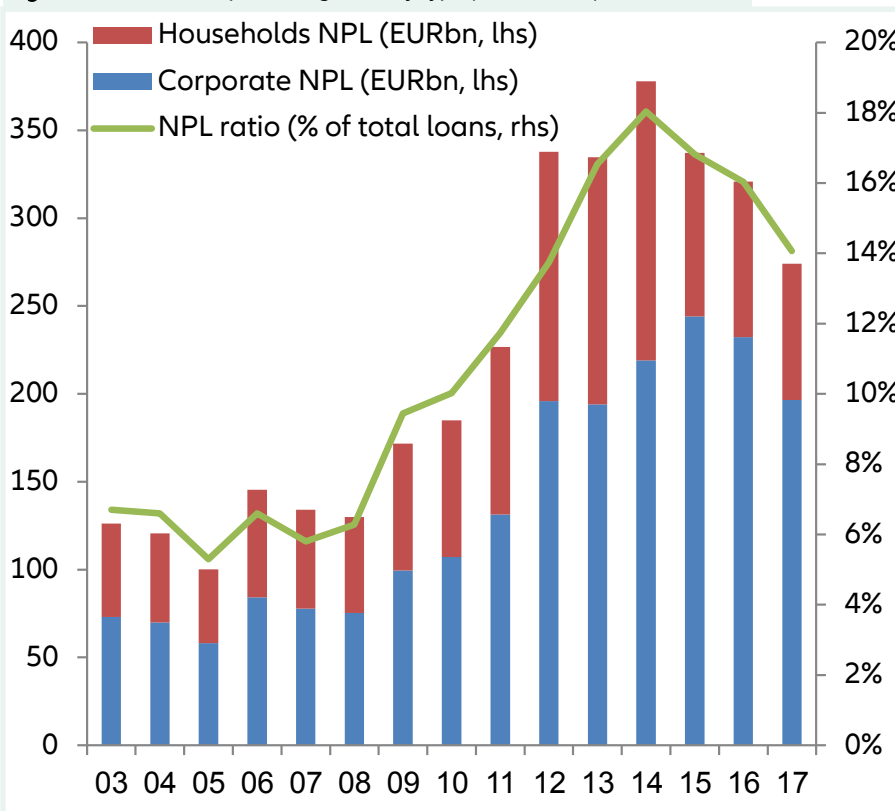
Meanwhile Italy's fiscal deficit would reach -6.5% in 2019 and rise above -7% in 2020 while public debt would reach 155% of GDP in 2020.

Figure 3 summarizes economic estimates under our four scenarios:

The downside scenario would dry up credit to SMEs

Banks' liquidity risk remains a concern should the shock on Italian financial conditions persist or worsen. If we simulate the spread shock as per our downside scenario, the rise in political uncertainty and the impact on banks' refinancing costs would drive bank rates on loans to SMEs up to 4% from below 2% currently. The +200bp increase in bank loans rates would call for Italian SMEs to use +9pp of their operating surplus to pay the additional interest expenditures on debt. This would mean that as much as 20% of their margin would be used for interest expenditures, which would weigh on their ability to expand investment. In this case, the ECB would likely renew its liquidity support through targeted longer-term refinancing operations (TLTRO).

Figure A Stock of non-performing loans by type (NPL, EUR bn) and NPL ratio



Sources: Bank of Italy, Allianz Research

Figure 3 Scenarios - Fiscal and Economic Impact

				30%				50%				15%				<5%
Expected implementation of proposed fiscal measures (% of total)		Upside scenario				Baseline scenario			Downside scenario			Tail Risk scenario				
		Mild Fiscal Expansion & Conciliatory EU Approach				U-turn After Significant Fiscal Expansion & Moderately Confrontational EU Approach			Considerable Fiscal Expansion & Confrontational EU Approach			Italexit				
		20%- repeal of past reforms with very limited leeway to include new spending plans				40%- repeal of past reforms with limited leeway to include new spending plans			60%- repeal of past reforms and significant new spending measures			above 60%- repeal of past reforms and significant new spending measures				
	2017	2018	2019	2020	2018	2019	2020	2018	2019	2020	2018	2019	2020			
Italy																
Real GDP growth(%)	1.5	1.3	1.0	1.0	1.2	0.8	0.6	1.0	-1.0	-1.2	0.5	-3.0	-4.5			
Primary balance (% of GDP)	1.5	1.5	0.6	0.6	1.5	0.3	-0.3	1.5	-1.3	-1.0	1.3	-2.2	-2.3			
Fiscal balance (% of GDP)	-2.3	-2.3	-3.2	-3.3	-2.3	-3.5	-4.4	-2.3	-5.3	-5.3	-2.3	-6.5	-7.4			
Public debt (% of GDP)	132	131	131	131	131	132	134	131	137	142	131	143	155			
Eurozone																
Real GDP growth(%)	2.5	2.2	2.0	1.7	2.2	1.9	1.5	2.0	0.7	-0.3	2.0	-2.5	-3.0			
ECB scenario		ECB policy: QE exit end-2018, first policy hike in H2 2019						ECB policy: QE exit end-2018, no rate hike in 2019/2020; new non-standard measures (e.g. TLTROs) ; OMT for Italy after ESM program signed			ECB steps in to safeguard financial stability with significant non-standard measures (incl. equity and bond purchases)					

Source: Allianz Research

Finding the right tone of voice: Europe's amenability will be pivotal

In its relations with Italy, the European Union will have to strike a delicate balance between upholding its own rules and working constructively with the new government, especially with a view to making tangible progress on EU reform. We do not foresee a showdown between the EU and Italy in the near future.

Anti-EU election rhetoric notwithstanding, it remains unclear what the European policies of the new government in Rome will look like. The men in charge of the finance and foreign ministries, and hence of the day-to-day management of EU relations, are rather pro-European. While party leaders di Maio and Salvini may continue attacking the EU publicly, constructive behind-the-

scenes diplomacy may proceed in parallel.

Upcoming meetings of Eurozone finance ministers and EU heads of state between June 26 and June 29 will give first clues. The first big test of EU fiscal rules should come in autumn, when Prime Minister Conte will present his 2019 budget plan to the Commission.

Given the extensive spending and tax cut pledges of the new government, we expect Italy's public deficit to increase under any of our scenarios.

We do not expect the EU to immediately take a tough stance on Italy.

On the contrary, the EU will likely seek to make some progress on migration management, since large inflows of migrants across the Adri-

atic are the top concern of Italian voters. With some Central and East European governments still staunchly opposed to any compulsory resettling of refugees, the other EU partners may decide to increase fiscal help to Italy in managing the inflows and resettlement.

Italy has traditionally punched below its weight in EU politics. Now, with the UK leaving, it will be the third largest EU member state and its engagement will be indispensable for progress on much needed reforms of the Eurozone, EU security policy and a European migration policy.

This is why it is so important that a disagreement about budget numbers does not result in a break between the EU and Italy that may then take years to repair.

Ana Boata, Katharina Utermöhl and Aldo Pellegrino

ASIA TAIWAN'S EXPORTS HEALTH CHECK-UP

In 2018, Taiwanese merchandise exports could increase by +USD 20bn driven by stronger demand from Asia. In the longer term, the economy will rely on a three-pronged strategy based on improved infrastructure, strong innovation efforts and strategic cooperations

A +USD20bn export opportunity

Taiwanese merchandise exports are projected to rise by +USD20bn in 2018 (after +USD37bn in 2017). This continuous improvement will be mainly driven by a rise in demand from Asia (+USD16bn). Europe (USD2.6bn) and North America (USD1.6bn) would follow. The sectors that are expected to enjoy most of the gains are electronics (USD9.3bn) and chemicals (+USD2.9bn).

The economy is set to benefit from a continued growth in global demand as World's economic (trade) growth is expected to rise above +3% (4%) for a second consecutive year in 2018. New exports orders would be supported in particular by growing consumer markets in Asia and a positive investment cycle in high income economies.

From a supply side point of view, business sentiment is broadly positive and credit conditions will likely remain supportive in the short run: the central bank is not in a hurry to raise policy rate considering the low level of inflation and the relative strength of the NTD.

Strong innovation efforts - Research and Development spending account for 3.1% GDP - and a strong specialization in the electronics sector help keep the economy competitive as

the integration of new technologies in the chain of productions represents the main engine of the ongoing global investment cycle.

Looking ahead, we see three pressing challenges.

First, rising protectionism and increasing trade tensions between its largest trade partners (US-Mainland China) pose a risk for the export-reliant economy.

Foreign trade value nearly represents 120% of Taiwan's nominal GDP, while net exports of goods and services amount to about 13% of GDP.

Second, non-payment risk becomes significant at the border with an increase of both corporate insolvencies and payment terms in Mainland China, its main trading partner.

Last, the market is faced with tough competition from neighboring economies such as South Korea, Singapore, Japan or Mainland China's cities that are investing heavily on innovation and specializing in the tech industries (especially in the context of the manufacturing 2025 strategy).

This stiff competition is exacerbated by the relative strength of the NTD. Against this background, stronger efforts to maintain market's export edge will be key.

A three pillar strategy: connect, innovate and cooperate

The strategy would hinge on a three-pronged approach that we could call: Connect, Innovate and Cooperate. The economy can leverage on strong policy buffers (central government debt is only at 31% GDP).

The first pillar Connect will consist of developing competitive infrastructures that improve connectivity in the market and reduce transaction costs.

This relates to authorities' "Forward-looking Infrastructure Program".

Funded by a special budget of nearly USD14bn over four years, this program is set to expand major infrastructures, especially, green railway, urban and rural facilities, green energy as well as digital infrastructures. This program could boost real GDP growth by an average 0.1pp per annum.

The second pillar Innovate will rely on the "Five plus Two Industrial Innovation Plan".

To transform and revitalize Taiwan's industries, the Tsai administration launched the 5+2 Industrial Innovation Plan targeting seven pillar industries, including biomedical, internet of things, green energy, smart machinery, defense, high-value agriculture, and circular economy.



This is expected to improve competitiveness through stronger innovation and industrial diversification. It would also act as a boost on growth through job creation, and the promotion of regional development. The plan is backed by an USD3bn+ Industrial Innovation and Transformation Fund and involves cooperation between central and local governments as well as the private sector. Experience from the past showed that the market has been

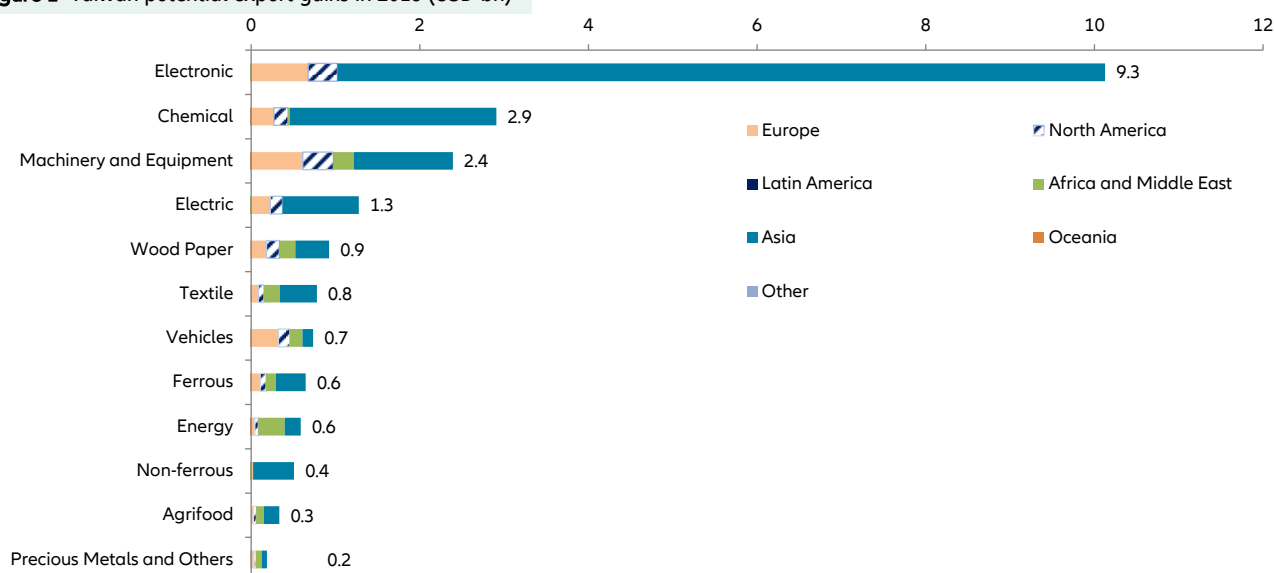
particularly efficient in delivering on its industrial promises.

The third pillar Cooperate refers to strategic partnerships. This includes international cooperation initiatives such as the New Southbound Policy which aims at fostering relations (trade, investment and industrial cooperation) between Taiwan and Southeast ASEAN nations. Such a collaboration should help diversify exports partners but also generate

revenues from foreign direct investments. Strategic private partnerships abroad could also be a clear driver of growth, as corporates look for new outlets. Partnership in the tech sector (Foxconn Technology Group - Apple, e.g.) have already proved being an important driver of new revenues. New partnerships surfing on the digital wave (Foxconn with Tencent, e.g.) could be the next growth avenue.

Mahamoud Islam, Patrick Liao

Figure 1 Taiwan potential export gains in 2018 (USD bn)



Sources: Chelem, Euler Hermes



LATIN AMERICA

BRAZIL'S WHISTLE

Brazil has tools to stay resilient to wider Emerging Markets volatility, and its recovery was hit yet not halted. But mind the persistent fiscal policy uncertainty.

Brazil is making the news, again. (i) Its cyclical recovery has slowed; (ii) market stress on Emerging Markets (EM) has taken a toll on its currency, especially after the government pressured Petrobras to keep a cap on gas prices and its CEO resigned; (iii) the risk of halted policy momentum has made a comeback ahead of the October presidential election. Yet we believe markets overlook idiosyncrasies of EM, preferring to sanction the entire asset class indiscriminately. Brazil should prove resilient, as long as it avoids policy mistakes.

Bumpy recovery, but potential for acceleration

Latest data releases show that consumer and business confidence receded in April, employment growth has slowed for three consecutive months and industrial production has stalled in Q1. The Brazilian economy expanded at a modest rate of +0.5% q/q in Q1. In addition, we estimate that the 10-day strike should cut real GDP growth by at most -0.4pp this year.

Yet, there are reasons to believe in Brazil's recovery, albeit a gradual and slow one. Company insolvencies should decline in 2018 (-3%) for the first time since 2011. Credit growth is back to positive territory for the first time since July 2016, while policy rate remains at a record low (6.50% after being cut by 775bps in eighteen months). The savings rate still has room to decrease, and employment growth continues, albeit at a slower pace (+1.7% in April). Overall, commodity prices are projected to stay high, while the temporary impact of higher oil prices should fade as they stabilize going forward. Privatizations could resume after the election (as no candidates radically opposes them), helping to bring back Foreign Direct Investment. We hence still expect private consumption and investment to drive growth, bringing our full-year 2018 forecast to +1.9% (down from +2.5% previously, lower than consensus), and +2.5% for 2019.

Not an external problem: trustworthy buffers and reduced vulnerabilities

Market stress on Brazil started as a moderate but steady currency depreciation, as carry-trade opportunities became less profitable (lower real rates, and stronger USD against the BRL, Brazilian Real). Yet the sell-off intensified and the exchange rate reached a 2-year low (BRL3.90 per USD) early June; stock

market valuations were also slashed, erasing 2018 ytd gains as Petrobras' share price dropped; this is due to what the markets viewed as a policy mistake as the government pledged to keep a lid on gas prices despite Petrobras' initial decision to increase it by +10%.

Brazil could prove resilient to the late cycle tensions and volatility. Indeed the central bank can rely on ample foreign exchange reserves (covering more than 20 months of imports), which our reserve adequacy indicator deems "high" and has conducted successful currency swaps. This means that Banco Central do Brasil (BCB) has the ability to smooth the impact of capital outflows, a potential drop in exports or an exchange rate depreciation. Foreign-currency denominated public debt only accounts for 3% of GDP and 15% for NFC (Non-Financial Corporations) debt, among the lowest shares in EM. The current account deficit has been drastically reduced to -0.5% of GDP in Dec. 2017 from -4.4% of GDP in June 2015. The government expects a surplus this year helped by depreciation. Besides, successful inflation targeting also reduces vulnerabilities.

Fiscal policy uncertainty risk remains

The policy risk which would reverse Brazil's fiscal reform momentum exists, as can be seen from recent polls; anti-establishment candidates (Jair Bolsonaro, currently polling second to Lula who is unlikely to run) and anti-austerity figures (Ciro Gomes, who could capture part of Lula's electorate) fare better than centrists. Yet four arguments temper this high risk scenario: (i) Large party structures and funding of establishment candidates, (ii) the rules of the media campaign which are biased against outsider candidates like Bolsonaro, (iii) the need for a coalition (in the absence of unifying party leaders and high rejection rates of most candidates) and (iv) the two-round voting system. Besides, the constitutional fiscal rule implemented would restrict the room for maneuver of future policymakers—more so than in the past. Yet, "no fiscal slippage" does not necessarily entail "improvement of fiscal accounts". The new administration would have to not only safeguard the progress made so far, but to step up efforts in curbing deficits. Social security is the most pressing issue. A failure to commit to such ambitious reforms would bring back volatility, but this time, a homegrown one., where debt sustainability would be at stake.

EMERGING EUROPE CURRENCY CRISIS



Photo by John M. Nelson/Unsplash

Turkey: Sharp slide of the lira in May darkens economic prospects

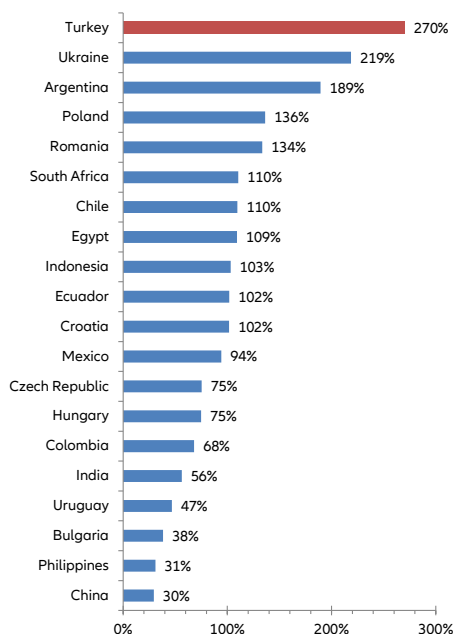
On the brink of collapse

The Turkish lira (TRY) experienced a sharp and accelerating sell-off in May, triggered by a range of weak data and bad news. A drop in the Manufacturing PMI, rising inflation, large portfolio investment outflows, a downgrade by S&P, and especially a remark by President Erdogan that he would take greater influence on monetary policy if he wins the presidential election this month shook investor confidence substantially. Belatedly, after the TRY had fallen -20% in the month, the Central Bank of Turkey took some decisive measures in the last week of May. It hiked the key policy interest rate by 300bp to 16.5% in an emergency meeting; and it simplified the operational framework of monetary policy. For now, these measures have helped the TRY recover some lost ground, although it has remained volatile and well below April's levels.

Vulnerabilities persist

Turkey's persistently large current account deficit further rose to -USD55bn in the 12 months ending March 2018 (approx. -6% of GDP). These shortfalls are mostly financed through short-term capital inflows, which can be easily reversed in the event that investors lose confidence. This appears to have happened in the past few months, as indicated by the substantial net portfolio investment outflows of -USD2.4bn in March and by the repatriation of foreign assets by Turkish banks in Q1 (USD4.2bn). In March 2018, the short-term external debt on a remaining maturity basis stood at USD182bn, while official FX reserves had fallen to USD85bn from a recent peak of USD96bn in October 2017. As a result, Turkey has the highest gross external financing requirement (defined as sum of current account deficit and external debt maturing within the next 12 months) in relation to FX reserves among major EM (see Chart 1).

Chart1 Gross external financing requirement* (% of FX reserves)



* Defined as sum of current account deficit and external debt maturing within the next 12 months.

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

What's next?

We believe that another rate hike in the region of 300bp is needed in order to calm down investors and facilitate a soft landing of the (previously overheating) economy. If it does not come, or too late, there is a risk of a hard landing. We have revised our soft landing scenario and now forecast full-year real GDP growth to slow down more markedly from +7.4% in 2017 to +3.7% in 2018 and +3% in 2019. The TRY is forecasted to lose -15% of its value against the USD on average in 2018 and -10% in 2019. This should result in an average CPI inflation of around 11% this year and 9.5% next year. Automatic stabilizers will widen the annual fiscal deficit to more than -3% of GDP and increase public debt to about 36% of GDP by end-2019. Still, public finances should remain manageable. The current account deficit will slightly narrow from today's level but remain large at more than -5% of GDP.

In a 'hard landing' scenario, where interest rates would need to be hiked by 1000bp or so at some point, GDP growth would be corrected more sharply to about +2.8% in 2018 and +1.2% in 2019. Inflation would rise and remain in double digits until end-2019, while the fiscal deficit would rise to more than -5% of GDP and public debt would approach 40% of GDP. Meanwhile, the current account deficit would narrow markedly as imports would collapse.

MIDDLE EAST SANCTIONS AGAIN

Iran: The economy will suffer following the US withdrawal from the JCPOA but less than in 2012-2015

What does the US withdrawal mean for trade with Iran?

On 8 May 2018, the US withdrew from the Joint Comprehensive Plan of Action (JCPOA), known commonly as the Iran nuclear deal, an agreement reached between Iran, the P5+1 (China, France, Russia, UK, US plus Germany) and the EU that has put curbs on Iran's nuclear program in exchange for sanctions relief, effective since January 2016. The US withdrawal implies the re-imposition of the pre-2016 US sanctions on Iran, including the secondary sanctions affecting non-US companies, within 90-180 days. In the US, big conglomerates such as Honeywell, Dover and GE are already shutting down their Iran business.

The other JCPOA signatories are opposed to the US decision and remain supportive of the deal. The EU is likely to resist imposing new sanctions, but EU-based companies will become more risk-averse to doing business with Iran in order to avoid US secondary sanctions. European companies that have already suspended or pulled out of operations in Iran include Total, PSA, Maersk and Danieli. China and Russia will not impose new sanctions on Iran, in particular as tensions between these two and the US are currently high over other conflicts (protectionism, Syria). China in particular already has some experience in doing business with Iran outside the reach of US sanctions, meaning that the two countries are likely to maintain economic ties. In Iran, authorities will attempt to protect the economy. We expect them to continue to initially comply with the JCPOA and see whether the non-US signatories uphold the deal.

Economic impact on Iran

Under the above assumptions, the impact of re-imposed sanctions on the Iranian economy will be significant, including currency depreciation, higher inflation, reduced oil output, and slower growth. However, the economic impact in 2018-2019 should be less dramatic than in 2011-2015, since the US this time does not have a broad-based support from other countries.

Pressure on the rial has already increased after the US withdrawal and the Central Bank may devalue the currency by up to -50% over the next 12 months, and perhaps re-introduce the dual exchange rate regime, which it had just abolished in April. The likely currency depreciation/devaluation will fuel CPI inflation, which could rise from currently around 10% up to an average of 25% in the next 12 months.

Iran's oil output rose from 3.4mn bbl/day in 2015 to 4.7mn

bbl/day in 2017, following the JCPOA. Going forward, countries with firms having strong business links with the US will have to reduce their oil imports from Iran. However, China, Turkey, India and many smaller countries are unlikely to follow this path. Overall, we forecast that Iran's oil output will fall back to around 4.5mn bbl/day in 2018 and 4mn bbl/day in 2019, i.e. less sharply than in 2012-2015.

The US move also threatens Iran's economic recovery. We forecast real GDP growth to slow down from an estimated +3.5% in fiscal year (FY) 2017/18 to +3% in FY 2018/19 and +2% in FY 2019/20 (instead of rising to +4% in both fiscal years in the absence of re-imposed or new US sanctions).

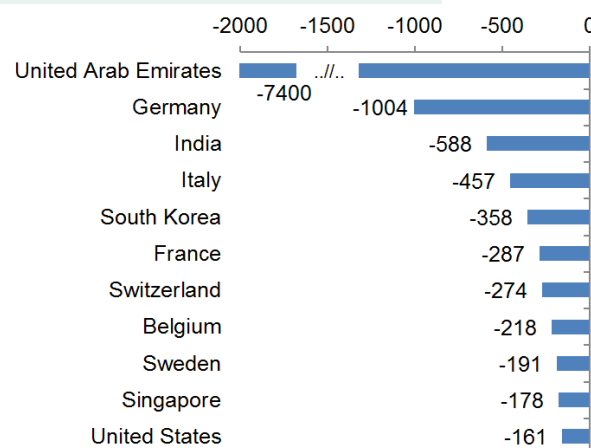
Impact on Iran's trade partners

To analyze the export losses for countries having some exposure to Iran we assume a size of the shock being equal to 50% of the fluctuations registered in nominal trade following the 2011-2012 first round of sanctions. The 50% discount factor could be justified by the fact that trade relations have been only partially restored since the signature of the JCPOA as well as the assumption that China and Russia will not comply on a broad scale with any re-imposed US sanctions.

The UAE is the most heavily exposed to export losses as Dubai is traditionally used as a re-export hub towards Iran. China, despite being the most important trade partner of Iran, would be slightly impacted as this country is unlikely to significantly alter its trade relation with Iran post renewal of sanctions. Germany could register USD1bn of export losses between 2018 and 2019, while France's losses could amount to almost USD300mn (see Chart 1).

Manfred Stamer

Chart 1 Export losses in 2018-2019 (USD mn)



AFRICA WALK LIKE AN EGYPTIAN



Egypt adopted long-awaited macroeconomic reforms. It was the A-List of this country's growth recovery, but that's not the full ABC

The A-List: Unwinding crisis-like environment

"The first day of the rest of your life" could represent what Egypt's economic policy experienced after tectonic moves, which were announced from November 2016. A floating exchange rate and the announcement of a progressive unwinding of subsidies (particularly to gasoline prices) have been presented as remedies to crisis-time symptoms: poor foreign reserve levels and structurally high fiscal deficits driven by an overconsumption of cheap and subsidized foreign currency imported goods.

The resulting depreciation of the Egyptian Pound (-50%) nurtured import substitution through import prices increase. The fundamental credibility of the plan easily qualified Egypt for an IMF funding, while private funding skyrocketed, ending crisis-times of poor reserve levels. Moreover, the country unwound some of its capital controls and regained its top destination position for capital investment (USD 36.6bn in 2016) in the Middle East and Africa.

Still on this A-List, Egypt declared its willingness to repay its debt to foreign oil companies in May 2017. The country repaid USD 3bn (2.2bn in June 2017, and 0.85bn in May 2018) and will have to repay USD 1.5bn next year.

Balance growth further

Higher foreign exchange reserves (9 months of imports now, compared to about 3 months in September 2016) is one key achievement, albeit not meaning a full job. The target of a complete rebalancing has been partially achieved, as the current account deficit declined from -6% of the GDP in 2016 to -3% in 2018.

The pillar measure consisting of progressively cutting existing oil price subsidies is underway. Doing it in a period of subdued oil prices was easier, but in a context of higher prices like today, it becomes more sensitive as households' purchasing power is impacted. It will nevertheless give the right incentive to lower demand for imported commodities.

More exchange rate flexibility should support competitiveness. Indeed it benefited to key Egyptian export sectors (tourism, Suez Canal) alongside favorable cyclical conditions visible at a global level. Regarding the manufacturing sector, the positive impact does not deal with higher exports, but with a higher domestic content in domestic sales, as imports of intermediate goods are deterred by low exchange rates.

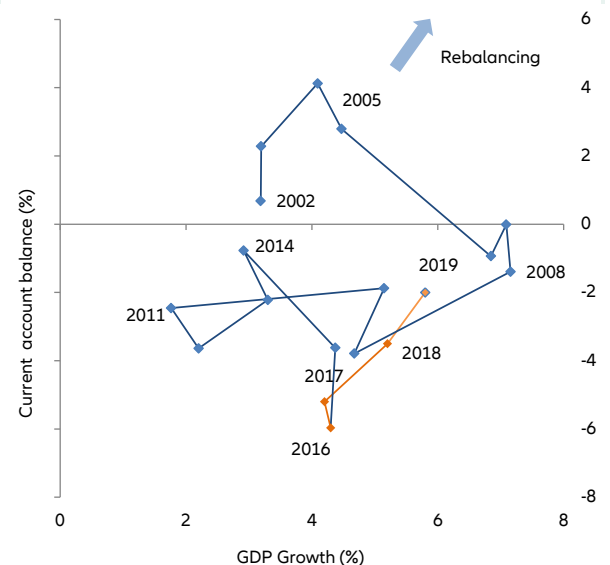
Comprehensive growth-enhancing reforms are needed

Product market regulation has not particularly improved. Egypt is still lagging in terms of business climate, including difficulty to pay taxes, enforce contracts, and barriers to trade across borders (including the impact of past capital controls on current transactions). These bottlenecks hide positive aspects, like the ease of dealing with construction permits and the relatively good access to electricity and credit. However, the cost in resolving bankruptcies is higher than the regional average.

Reforming poor business climate items is not a precondition for genuine growth acceleration, as the A-list already had a positive outcome (+5.2% of growth in 2018 after +4.2% in 2017). However, these reforms are needed in order to sustain longer-run high growth rates. As the country aims at developing its manufacturing sector, more trade openness would be particularly fruitful. We have calculated that exports gains stemming from the future African Continental Free Trade Area should imply +10bn of additional exports over the next decade.

Stéphane Colliac

Chart 1 Egypt, growth and current account balance (% of GDP)



Source: IHS Global Insight, Euler Hermes Forecasts

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

<http://www.eulerhermes.com/economic-research>
research@eulerhermes.com



[euler-hermes](#)



[eulerhermes](#)

FORWARD-LOOKING STATEMENTS

The statements contained herein may include prospects, statements of future expectations and other forward-looking statements that are based on management's current views and assumptions and involve known and unknown risks and uncertainties. Actual results, performance or events may differ materially from those expressed or implied in such forward-looking statements.

Such deviations may arise due to, without limitation, (i) changes of the general economic conditions and competitive situation, particularly in the Allianz Group's core business and core markets, (ii) performance of financial markets (particularly market volatility, liquidity and credit events), (iii) frequency and severity of insured loss events, including from natural catastrophes, and the development of loss expenses, (iv) mortality and morbidity levels and trends, (v) persistency levels, (vi) particularly in the banking business, the extent of credit defaults, (vii) interest rate levels, (viii) currency exchange rates including the EUR/USD exchange rate, (ix) changes in laws and regulations, including tax regulations, (x) the impact of acquisitions, including related integration issues, and reorganization measures, and (xi) general competitive factors, in each case on a local, regional, national and/or global basis. Many of these factors may be more likely to occur, or more pronounced, as a result of terrorist activities and their consequences.

NO DUTY TO UPDATE

The company assumes no obligation to update any information or forward-looking statement contained herein, save for any information required to be disclosed by law.