

Macroeconomic  
and Country Risk Outlook

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## The Price of Growth

Global growth will slow down to +2.4% in 2016, its lowest level since the great recession

Economic Research



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## EDITORIAL



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# Price Tag

LUDOVIC SUBRAN

Remember how English singer-songwriter Jessie J howled and crooned that "*It's all about the money*" at the 2012 Olympics closing ceremony? Her song, *Price Tag*, magically became the number one song, the Song of the Summer. The Song of the Summer is a fuzzy title, an award bestowed on a song simply for the fact that it dominates an entire season. It is as sticky as a Popsicle under the sun. It will assault commuters' ears every time an Uber driver connects a phone to her car's sound system. Turn on the radio, and there it is. Walk into a mall, and it will play. It is inescapable. Not that you want to escape it, not really. Well, maybe not until September.

As we enter the Olympics season once more, this time in Rio de Janeiro, Brazil, we thought we would search for the Song of Summer 2016, with a touch of economics. *Oops, [we] did it again* (Britney P. style), we sang our way through the economic forecasting exercise. We did deserve some gratuitous joy since the first half of the year was daunting. Mini crises – some of them still in the making – rattled almost every part of the world and global growth disappointed massively.

Why should *Price Tag* be the theme music of this outlook? Because a price (tag) is exactly what the global economy is missing. Priceless growth affects decisions, incentives and expectations around the world. So, to honor another summer of cheap growth, here is our playlist of another kind:

#1 David Bowie & Queen *Under pressure* because prices and turnovers are under pressure in today's economy.  
 #2 Nancy Sinatra *These boo(s)ts are made for walkin'* because low prices continue to fuel consumption in Europe and the US.

#3 Beach Boys *Good Vibrations* because low interest rates (and cheaper building materials) are eventually driving a recovery of the construction sector in Europe and the US.

#4 Dire Straits *Money for Nothing* because negative interest rates became the norm in a growing number of countries thanks to accommodative Central Banks.

#5 Guns'n'Roses *Knocking on heaven's door* because USD12trn of bonds are placed with negative yields.

#6 Sniff in the Tears *Driver's seat* because China and the Fed are driving world commodity prices and world interest rates.

#71 Monster *The backseat of my car* because most Emerging Markets are price takers.

#8 50 Cent *Get rich or die trying* because commodity exporters got richer over the past few years and are now suffering important output and wealth losses (and risking policy mistakes).

#9 Rod Stewart *Da ya think I'm sexy* because Emerging Markets which rebalanced their economy earlier than others are experiencing capital inflows.

#10 Antares *Ride on a meteorite* because corporate debt is strong and worrying in some countries, particularly China. Playahitty's *The Summer is Magic* was in everybody's Walkman back in 1994. This song never gets old. Let's hope the summer washes away some of the concerns weighing on global growth. In the meantime, enjoy your holidays!

## OVERVIEW

# The Price of Growth

Global growth will slow down to +2.4% in 2016, its lowest level since the great recession

## THE MACROECONOMIC RESEARCH TEAM

- Global growth could slow this year to +2.4% and might accelerate marginally in 2017 (+2.7%).
- The slowdown in prices has pushed down nominal growth, turnovers, and trade both domestically and abroad.
- This priceless growth is set to cause a rise in insolvencies by +1% this year and in 2017: the first rise since the great recession. Two reasons: (i) first, the difficulty to deleverage while debt overhang is important in countries like Brazil and China and sectors such as utilities; and (ii) second, commodities-related sectors and countries are still at risk.
- Subdued prices (and yields) generate both winners and losers. Net consumers, importers, and debtors benefit from low prices, while net producers and exporters, savers and creditors are having a hard time.

## Bumpy growth: Here to stay

The global economy was hit by several shocks over the past quarters. These shocks erased positive effects that lower prices should have had on growth. Bumpy growth is here to stay and the global economy would expand by a humble +2.4% in 2016, the weakest growth rate since the great recession. 2017 (+2.7%) will be the sixth consecutive year under 3%. Whilst a prolonged period of lower oil prices is good for growth, the continued deflation at the producer prices level is both symptom and balm. The low pricing environment is a symptom of ailing overcapacity and a clear indication that turnovers will take longer to recover. Yet it is a balm for profits and investment costs, as long as incentives (and confidence) are well-oriented. Indeed, priceless growth could be a problem for sectors with high debt levels. Moreover, price variability translated into exchange rate volatility and blurred the price signal for corporates: at the end of the day, was it good or bad for growth? The high cash balances of households and corporates and the low yield environment in financial markets are two sides of the same coin: precautionary savings. Low confidence and low prices help explain why people and companies continue to hoard cash. Central bank balance sheets

**+2.4%**

Real global  
GDP growth  
in 2016

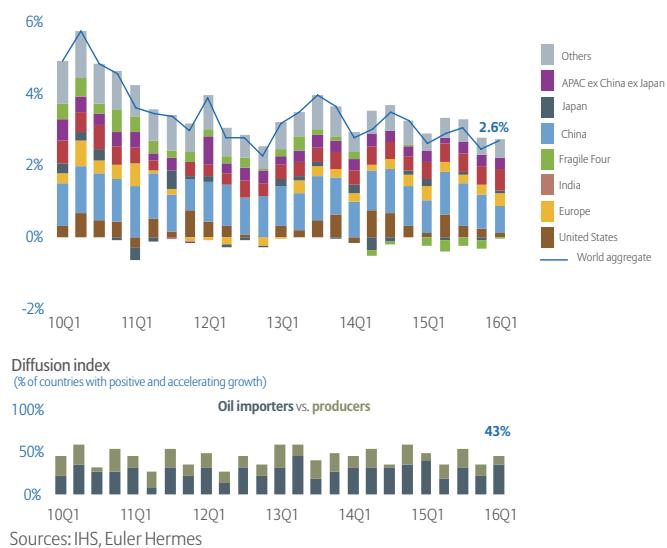
have continued to increase thanks to the European Central Bank (ECB) and the Bank of Japan's (BoJ) bond-buying programs.

Yet this money does not trickle down, as a rising share of savers decides to keep it for a little longer instead of buying or selling it on a regular basis. The velocity of money is weakening and as a result nominal growth fails to speed up.

Two far-reaching consequences emerged:

- ✓ Growth engines are upside down. Commodity importers and consumers accelerated while exporters and producers slowed down. Unfortunately, the former tend to be high income/low growth economies while the latter is middle income/high growth economies. This explains why global growth weakened (see Chart 1).
- ✓ A dollar recession cut world wealth in 2015. Exchange rate depreciations acted as a wealth shock for many emerging economies. Despite a price recovery, the shock is still generating pain as these economies are experiencing second-round effects: inflation pickup, rising insolvencies, and still tightening domestic

Chart 1: World growth q/q  
(Seasonally adjusted, annualized rate)  
Fragile Four=Brazil, Russia, Turkey and South Africa





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credit conditions. The reason: turnovers growth did not match debt growth in some sectors (commodities) or countries. Brazil and China are clear examples.

## In the near future, China, oil and nudges on the watch list

Three shocks have been shaping the economic landscape:

1. Fears of Chinese hard landing;
2. OPEC's decision to stick with its market share. Last December's decision sent oil prices tumbling, hitting record lows. The combination of this deliberate oversupply and the growing concerns over demand from China anchored the expectations of low for longer oil prices; and
3. Finally, the first round of Brexit effects nudged financial markets all over Europe and created a flight to quality as well as a collective dovish move among Central Banks.

Elevated risk levels – or apprehension thereof – depressed equity markets and created a flight to quality. The main market makers turned dovish. Monetary tightening was delayed in the US, the European Central Bank expanded its bond-buying program to corporate debt and China credit policy was eased during earlier this year causing growing discontent (and a divide) among Chinese policy-makers, some questioning more stimuli when previous rounds have not proven effective.

Doves came to the rescue. Emerging Markets benefited from capital inflows (USD25bn by month on average) in Q2 2016 for the first time in a year. Commodity prices and exchange rates recovered to some extent. The combination of a price recovery and easy money does not generate the appropriate signal to cut existing overcapacities. Future shocks seem likely because corporate debt is still too high in some Emerging Economies, namely China and the currency mismatch adds to the existing debt burden. In Advanced Economies, companies still have to find a balance between better business conditions (lower input costs, low debt cost) and the relatively high likelihood of another shock in the next quarters: from a new confidence crisis in China to the escalation of new risks in or close enough to home (vulnerability of the Italian banking sector, Turkey's normalization after the failed coup, safety risks) to a series of policy faux-pas in the US. ■

### Real GDP growth, annual change, %

	Weight*	2014	2015	2016f	2017f
<b>GLOBAL GDP</b>	<b>100</b>	<b>2.7</b>	<b>2.6</b>	<b>2.4</b>	<b>2.7</b>
<b>Advanced economies</b>	<b>62</b>	<b>1.8</b>	<b>1.9</b>	<b>1.7</b>	<b>1.8</b>
<b>Emerging economies</b>	<b>38</b>	<b>4.6</b>	<b>3.8</b>	<b>3.5</b>	<b>4.2</b>
<b>North America</b>	<b>24</b>	<b>2.4</b>	<b>2.3</b>	<b>1.8</b>	<b>2.1</b>
United States	22	2.4	2.4	1.9	2.0
Canada	2	2.5	1.1	1.3	2.2
<b>Latin America</b>	<b>8</b>	<b>0.3</b>	<b>-0.3</b>	<b>-0.7</b>	<b>0.3</b>
Brazil	3	0.1	-3.9	-3.5	0.2
<b>Western Europe</b>	<b>24</b>	<b>1.4</b>	<b>1.7</b>	<b>1.5</b>	<b>1.5</b>
United Kingdom	4	2.9	2.3	1.3	1.0
<b>Eurozone</b>	<b>17</b>	<b>1.0</b>	<b>1.6</b>	<b>1.6</b>	<b>1.6</b>
Germany	5	1.6	1.4	1.7	1.7
France	4	0.7	1.2	1.5	1.5
Italy	3	-0.3	0.6	1.0	1.0
Spain	2	1.4	3.2	2.6	2.0
The Netherlands	1	1.0	2.0	1.4	1.4
Portugal	0	0.9	1.5	1.3	1.6
<b>Central and Eastern Europe</b>	<b>6</b>	<b>1.5</b>	<b>-0.1</b>	<b>1.2</b>	<b>2.1</b>
Russia	3	0.7	-3.7	-0.9	1.0
Turkey	1	3.0	4.0	3.6	3.5
Poland	1	3.3	3.6	3.3	3.2
<b>Asia</b>	<b>29</b>	<b>4.8</b>	<b>4.9</b>	<b>4.6</b>	<b>4.7</b>
China	13	7.3	6.9	6.5	6.4
Japan	6	-0.1	0.6	0.7	1.0
India	2	7.2	7.6	7.6	7.7
<b>Oceania</b>	<b>2</b>	<b>2.7</b>	<b>2.6</b>	<b>2.8</b>	<b>2.6</b>
Australia	2	2.7	2.5	2.8	2.6
<b>Middle East</b>	<b>4</b>	<b>2.6</b>	<b>2.6</b>	<b>2.1</b>	<b>3.4</b>
Saudi Arabia	1	3.6	3.4	1.5	3.0
United Arab Emirates	1	4.6	3.4	2.0	3.0
<b>Africa</b>	<b>3</b>	<b>3.5</b>	<b>2.9</b>	<b>2.5</b>	<b>3.6</b>
Morocco	0	2.4	4.5	2.0	4.5
South Africa	0	1.5	1.3	0.5	1.5

\* Weights in global GDP at market prices, 2014

Sources: National sources, IMF, IHS, Euler Hermes forecasts

## GROWING CHEAP

Businesses across the world are still faced with low nominal growth: volumes pick up but without price effects. As a result, turnovers growth continues to be weak: +0.8% in 2015 in the Eurozone and still only +1.2% expected in 2016. There are two almost competing rationales behind priceless growth: first, unsynchronized price cycles around the world; and second, a structural softening of prices.

### Where are we in the price cycle? Certainly not in sync

Business cycles impact prices, and vice versa. Unfortunately, each part of the world is in a different phase of the price cycle (see Chart 2):

✓ **Phase 1** – Eurozone and India. Low prices fuel purchasing power and demand growth. Supply growth is sustainable, as it is driven by demand. There is no overheating risk and the growth cycle is in its early stage.

✓ **Phase 2** – The U.S. Then, as growth accelerates, prices are increasing. There are no more spare capacities in the economy and GDP is reaching its potential. Monetary tightening be-

came an issue and growth is losing momentum. In the US, core inflation is above 2% already and CPI inflation is kept very low mainly by food and energy prices. As a result, we expect lower growth this year +1.9%, and next +2%, from +2.4% in 2015.

✓ **Phase 3** – Turkey. The growth cycle may generate excesses. If prices keep increasing for too long, they become a drag on the purchasing power of households and companies. The growth cycle looks like a blind run, still growing, but in a less sustainable way.

✓ **Phase 4** – China. Bubble-like growth has created spare capacities. Deflation becomes a risk, but policy support is still avoiding a hard landing. In China, growth is eroding at a slow pace to +6.5% in 2016, from +6.9% in 2015.

✓ **Phase 5** – Brazil, Russia, South Africa. In some countries, policymakers are unable or unwilling to support the economy. Debt becomes less sustainable and borrowers must rush to deleverage precipitating supply cuts and recessions.

The problem is that to achieve full recovery, the world needs to ignite all its engines, at the same

time. As the bigger Emerging Markets are still in adjustment mode, growth can only pickup in some regions (Eurozone, India) but not globally. Prices and nominal growth will recover at some point. A short-term price upswing is possible, but a sustained recovery will have to wait for the final countdown on price adjustment, as some shocks are still likely, especially in the emerging world.

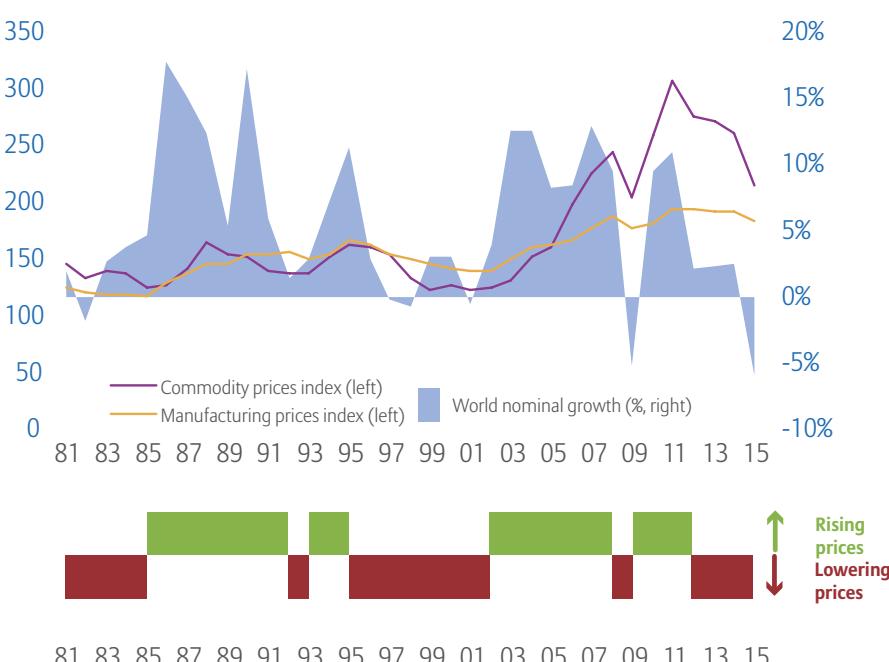
### What if prices were low(er) for (almost) ever?

In 2015, inflation in advanced economies was hardly positive at +0.3%, the second lowest rate since World War II. Only the 2009 figure was lower, at +0.2%. Why? There might be a structural change in overall pricing power. Short-term shocks are part of the short-term story, so low oil prices explain current disinflation. Yet, one should note that inflation has been on a downward trend over the past 35 years as the fundamental drivers behind inflation are weakening:

1. Wage growth is lower during this growth cycle than the past one. In the US for instance, despite a tight labor market, the employment cost index is up by +2% y/y. The index used to grow at a strong +3.5% in 2007, with similar labor market conditions.

Chart 2: World growth and world prices

1977 = 100



Sources: IIF, Euler Hermes



Image courtesy of viktor hanacek, picjumbo.com

**2.** Productivity growth almost disappeared in advanced economies and was cut by one-third in Emerging Economies. In China, for instance, productivity is expected to grow by +6.5% y/y in 2016, from +10% in 2010.

**3.** Crowding-out effects and servitization are increasing. On the one hand, there are stronger incentives to move down the value chain to meet the growing demand from emerging markets which basically consist of raw materials (China e.g.). On the other hand, sectors with lower productivity, such as services, represent a larger share of the economy. A good example is the share of financial services in overall profit by car manufacturers. Servitization, defined as the delivery of a service component as an added value when providing products, is a permanent change with little pricing power on the manufactured goods (so far).

**4.** Investment lags weakened growth potential. Indeed, the legacy of recent crises led to record low investments and affected labor productivity. Secular disinflation is not irreversible. Some emerging economies, particularly China, will enter a new phase of development. Indeed, China income level (GDP per capita) only reached one third of the one in Advanced Economies. China spends on an annual basis, 2% of its GDP in R&D and is expected to close the gap with the US by 2020. In the meantime, low prices and low-in-

terest rates do create an upside down situation, with new winners and losers, and a different call to action for companies and households alike. Understanding how this cheap growth phenomenon translates into six key macroeconomic variables is an important first step.

## Price #1: Money for nothing

2016 marked the first year in an uncharted territory of negative interest rates. The zero lower bound no longer holds. Some Central Banks already took the plunge in the past, but it was in 2016 that negative yields became a mass market. Decisive steps came from the ECB and the Bank of Japan. Each shock serves as an argument to become more risk averse and to expect more dovishness from Central Banks.

One of the results of Brexit, the last tremor in a series, was a new rush to safe havens. Central Banks' issued proactive statements in an effort to avoid contagion and financial volatility. Consequently, monetary policy expectations are even more dovish, including in the UK.

A rising share of the sovereign bond market now has negative yields and stands at USD11.7trn end-June, or 32% of the bond market (see Chart 3). 10-year interest rates are negative in Germany and in Japan, and yields hit fresh lows in the US (1.36%) and in the UK (0.77%). ►

# USD11.7trn

Worth of sovereign bonds  
at negative yields  
(+USD8.5trn  
since end-2015)

Chart 3: Government bonds with negative yields on the secondary market  
(USD trillions)



Sources: BIS, Bloomberg, Euler Hermes

## Price #2: Wholesale consume

Low prices are good news for consumers, especially those whose income has nothing to do with commodity-related sectors. This explains why consumers in Advanced Economies are still the main winners, while their peers in emerging commodity-exporting economies are suffering. As the major shocks might be over, so could be the first-round effects in Advanced Economies. Second-round positive effects are likely, as investment is already picking up in some economies. These should arise from the positive impact of private investment on unemployment and are still in the making. In France, unemployment fears reached their lower level since 2008 and drove consumer confidence to its 2007-peak: a long-awaited, yet fragile U-turn.

## Price #3: Priceless growth to cause a rise in insolvencies

Producer prices are still declining worldwide (fourth year in a row in Asia and Germany). As a result, input costs have decreased and industrial production strengthened (almost +6% y/y in Q1 in China). Everything would be under control if we did not see a negative price effect on

the balance sheet especially for companies with strong liabilities. Since turnovers did not grow as much as needed to repay debts and that pricing power is limited, vulnerabilities have increased in many industrial sectors. Limited sales and little deleveraging can explain why insolvencies should rise again in 2016 by +1% (see Chart 4). The main culprit will be the deterioration in some oil-related, industrial metals & coal sectors and countries. In these cases, the pair commodities-debt can create havoc: +22% increase in insolvencies in Brazil in 2016; +20% in China.

## Price #4: Trading at any price?

Global trade volumes kept growing by +3% in 2015, but trade value decreased by -10.4%. In 2016, we expect trade value to slide by -2% more and trade volumes will probably grow by +2.2%. This is a record low for volumes since the great trade collapse of the Great recession.

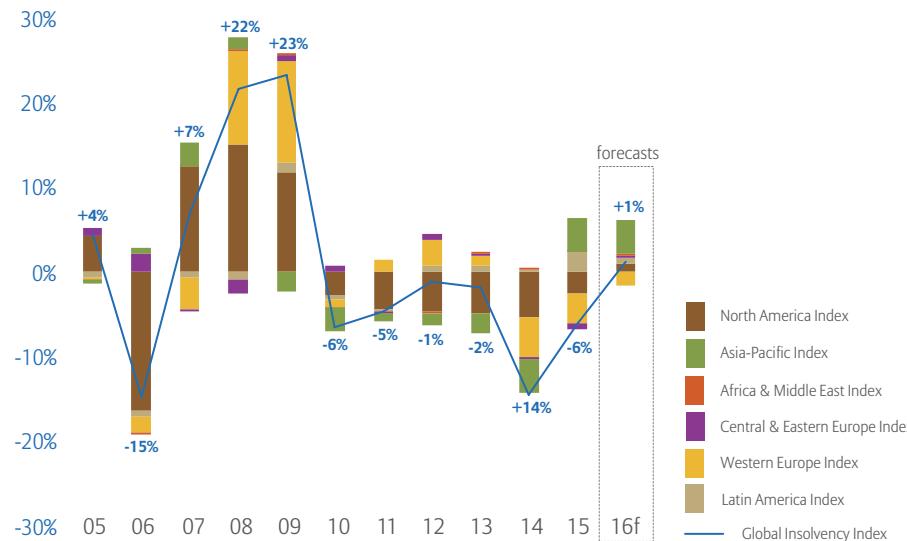
Trade value losses were the main trigger behind exchange rate depreciation in Emerging Markets, with limited effect. Very few countries benefited and the so-called currency war ended up in a no-win situation for global trade, including new protectionist measures. As commodity prices have recovered by 50% from their January 2016-low and returned to their mid-2015 level, trade value growth is supposed to gain momentum. It will be meaningful next year (+5.7%).



**+1%**

Business insolvencies worldwide, 2016 forecast

Chart 4 Euler Hermes Global Insolvency Index and regional indices  
Yearly level basis 100 = 2000



Sources: National figures, Euler Hermes forecasts

## Price #5: Corporates are still hoarding cash

Corporates have had to cope with multiple shocks over the last years. As a result, they preferred to pile rather than spend vast amounts of cash. Total cash piling amounts for USD7trn (see Chart 5). This precautionary savings situation comes from limited opportunities in the real economy in a subdued growth situation, as well as worries on classic shocks on companies from higher taxes to exchange rate variations to capital controls. It is important to note that faced with fading organic growth, cash-rich companies have spurred a real M&A wave which started in 2015 and has continued in 2016. Yet, corporate investments have not picked up as much as returns on these investments are questioned by too-constrained turnover growth.



**+2.2%**

Growth in  
global trade volume,  
but **-2%** in value  
in 2016

prices have skyrocketed, especially in London while household indebtedness in the UK stands among the highest among the G7 countries, close to 140% of disposable income. Brexit caused collateral damage including panic among large commercial real estate funds. As capital flight and negative wealth effects for households take center stage, prices should decline and bankruptcies in the construction sector rise.

Second, China, where the construction sector is important both locally and globally: Chinese cement production was 62% of total world output in 2015. When housing prices recovered, investments and global metal prices did too (+20% between January and June 2016). Chinese households were waiting for the end of the housing prices slowdown (mid-2014 to mid-2015) to buy cheaper houses. A price recovery last year, driven by lower inventories, was the starting point of a new cycle. The Chinese cycle should unfortunately not last for long, as Chinese asset prices typically overheat, a bubble-like behavior. ■

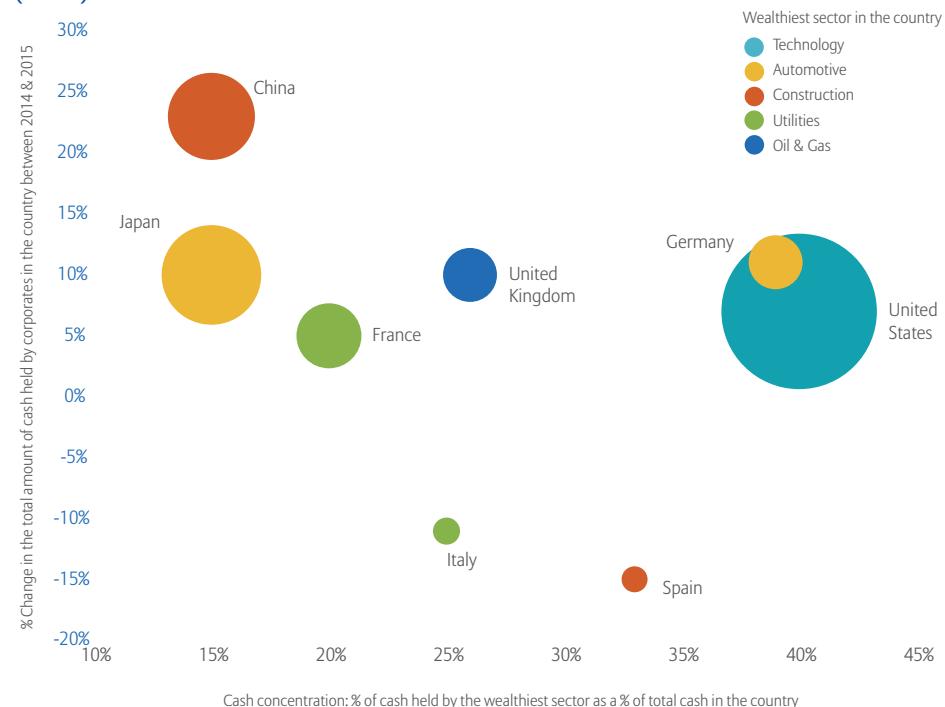
This unspent cash also explains, in part, why interest rates are so low since savings remain stronger than investment. The global savings glut is alive and kicking. If disinflation pressures are transient, companies might be waiting for cheap and profitable opportunities. But the hidden structural softening of prices may be a stronger determinant of further cash hoarding. In Japan, where the liquidity trap is obvious, the cash pile is among the highest. In China, companies' debt levels are record high (115% on average for listed companies) but net gearing (debt – cash to equity) is below 100%. The cash on balance sheets has grown by +23% in 2015. Corporates have to grow their liquid assets in order to repay the debt – and face turmoil on the renminbi.

## Price #6: What is in the house?

Household investment fundamentals recently improved in key economies and housing prices grew by +3% in the Eurozone in Q1 2016, the best performance since 2007. This good news comes after years of painful recovery for the construction sector. Low-interest rates, higher purchasing power and subdued costs of construction material have been supportive in the US and the Eurozone. Yet, there are two cautionary tales worth mentioning.

First, the UK where the Brexit vote caused tremendous pressures on the real estate sector, proving that it takes only a small nudge to prick a bubble. Confidence in the sector was fragile even before the vote and fell below 50 in June, for the first time since mid-2013. Residential

Chart 5: Concentration and variation of cash held by non-financial corporates in selected countries (USD tn)



Sources: Bloomberg, Euler Hermes

## PRICE MAKERS, PRICE TAKERS, PRICE BREAKERS

Fading policy support in price-making economies, particularly China and the US, was a key driver behind the vanishing growth momentum in Emerging Markets. Many economies are price takers nowadays, sitting in the back seat and adjusting their policies to avoid any counterproductive spillover. Fortunately, price makers have turned more and more dovish, making life easier for the back-seaters.

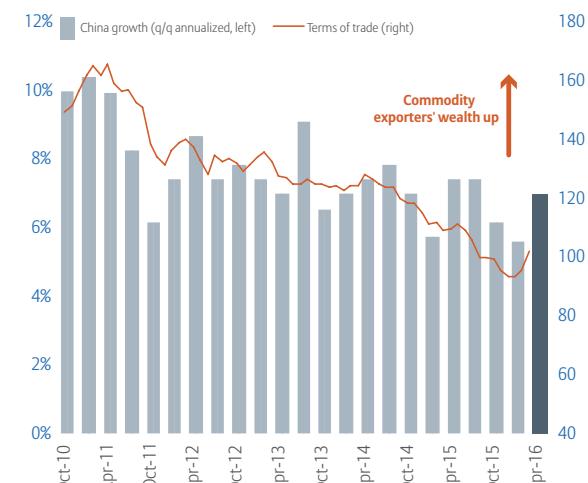
### Price maker #1: China's financial bandwagon is back. No need to try to jump on it

China's rising market share in global trade and demand for commodity made both its financial and real economic cycles pivotal for world wealth creation and redistribution. Chinese growth is strongly correlated with world terms of trade, namely the ratio between commodity prices and manufacturing prices (see Chart 6). A negative growth surprise in China hit both the wealth and growth rate of commodity exporters, including those who have no direct trade relationships with China. Fortunately, Chinese growth probably accelerated during 2016 Q2, backed by a credit stimulus: new credit flows increased by +33% in Q1 2016.

The country's unprecedented stimulus back in 2009 supported world trade (Chinese imports grew by +40% in 2010), commodity prices and the currencies of commodity producers. As a result, commodity producers decided to increase output but the resulting too-high exchange rate hampered competitiveness of the manufacturing sector: a Chinese-born Dutch disease. De-industrialization became obvious in other BRICS economies such as Brazil, Russia & South Africa. In Brazil, for instance, the share of the manufacturing sector in total value-added went from 27% of GDP in 2011 to less than 23% in 2015. China went under additional scrutiny (with known consequences on market fears lately) for a good reason: it became even more meaningful for these countries.

Since then, China became more parsimonious, even in the face of the Eurozone crisis, as cor-

Chart 6: China growth and terms of trade  
Terms of trade = commodity prices/manufacturing prices  
Dark grey=forecast



Sources: IHS, Euler Hermes

porate debt skyrocketed as a corollary to the large stimulus; since then world GDP, trade and commodity prices have remained subdued. China's growth decline is a long-landing process. Short-term accelerations are possible, which was the case in the Q2 2016, creating a mini-momentum for commodity prices. Yet this recent good news is also debt-prone pointing to a time-bound Chinese boost. The question will again be whether China can manage an even harder soft landing – oxymoron intended.

### Price maker #2: Central banks in Advanced Economies, easier than easy?

Each shock that rattled the world economy exposed the ongoing structural nature of price adjustment. Market long-term expectations are increasingly conservative and nominal long-term yields have been declining ever since, with no real reason for them to pick up in the near to medium term. Central Banks have thus adapted their monetary policy stance, being somehow stuck in the dovish corner, and should continue to do whatever it takes to fight not only the risk full-fledged deflation but the reputational risk of being the next crisis-maker.

As a result, the Fed hiked a humble 25 basis points in December 2015. More integration of capital markets caused the Fed to care more for China's growth momentum. It explained the postponed hike from September 2015 to December and will explain other delays in the future. In addition, the Fed could not ignore that

other key players are still in easing mode. The Bank of Japan - whose balance sheet is above 80% of GDP - and the European Central Bank are clear examples. A too-hawkish-too-soon Fed would have caused stronger capital inflows to the US and harder USD appreciation. Next hike

**+33% y/y**

New credit flows in China Q1 2016. Nominal GDP growth was (only) +7%



# -53%

Nigerian Naira depreciation against the dollar since the beginning of the year

will come, eventually, in H2 2016 but it will nonetheless be the slowest tightening in recent history.

Interestingly enough and in spite of the many Cassandras, financial excesses are absent in advanced economies. There is no overvaluation of the equity market and no housing price bubble (including in the US). Risks associated with easy money remain acceptable, and Central Banks have no reason to stop the lifeline too early.

A counter example to this risk-free landscape will come from the UK, where house prices rose sharply (+10% y/y in Q1 2016). Brexit did affect confidence and nudged real estate funds while hitting capital flows to the UK. Portfolio inflows (GBP60bn each quarter in 2015) turned to outflows during Q1 2016 (-GBP12bn). The Bank of England stepped up to avoid any liquidity

drought and eased interest rates. Next step could include swap lines, with an unlimited amount, between Central Banks if needed. This is yet another move into experimental monetary policy-making to offset Governments' mistakes.

## There are happy price takers... and unhappy ones

Thanks to cheap growth, households and companies alike gained purchasing power. Life has also become easier for Sovereigns, especially across Emerging Markets. Interest rates have decreased, including in countries like Brazil where the 10-year rates dropped from 16% in January 2016 to 12% in June 2016, in spite of growing political defiance. However, some price backseaters still suffer from negative second-round effects emanating from past policy shocks. Credit conditions are still worsening for the private sector in important economies such as Brazil, Turkey, and South Africa. Banks in these countries cope with diminishing returns and rising non-performing loans.

Past depreciations also coincided with a painful labor market adjustment and brought about stagflation (simultaneously rising inflation and unemployment) in many commodity exporters in Latin America and Sub-Saharan Africa. Social discontent is on the rise and the road to reforms is now bumpier. There is a risk that profligacy in

sensitive countries, particularly where fixed exchange rates are in place, like Venezuela for example, generates even more second-round effects. The introduction of a flexible exchange rate regime in Nigeria, was good news although depreciation has already boosted inflation (+16% y/y in Q1 2016) and hit consumers. As a consequence, Nigeria, Africa's largest economy is heading towards recession this year.

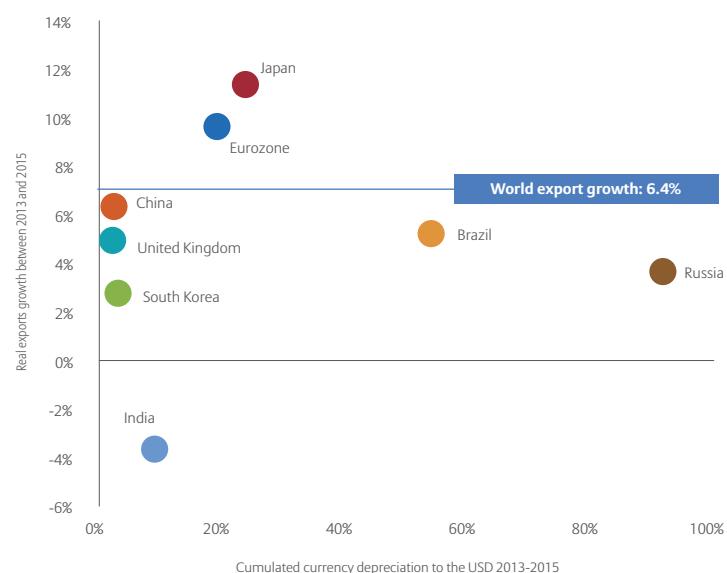
Going forward, we expect more exchange rate volatility as the Federal Reserve hikes once more this year and imbalances remain. There will be critical pressures on countries running large current account deficits to show resilience and transparent monetary and fiscal policies to understand how these pressures translate on the banking sector, companies, and households.

## Price breaker: Competitive devaluations, everywhere, at the same time

As mentioned above, key economies have seen their exchange rate depreciate. Only a few countries like Sweden depreciated on purpose. However, so far, it has been almost impossible to see any positive effect of lower exchange rates on exports (see Chart 7). There is no J curve effect. Worse than that, global (and somehow structural) price adjustments often mean that depreciations are causing more wealth loss (see terms of trade in Chart 6) than enhanced price competitiveness for exporters. It is difficult to gain market share when global trade is lazy. ■



Chart 7: Currency depreciations and real exports growth



Sources: IHS, Euler Hermes

## NAVIGATING THROUGH EMERGING MARKETS

# Policy reaction in Emerging Markets: The importance of being earnest

Emerging Markets have been in the eye of the storm for the past year. This has happened to a large extent because as price-takers, they have had a hard time managing domestic and international pressures at the same time.

Still, there is a myriad of opportunities to seize. Many Emerging Markets, particularly in Asia, self-insured against shocks with structural external surpluses (in South Korea it accounts for 9% of GDP) and high foreign exchange reserves. Remember, when the driver hits the brakes, backseaters are safer with a fastened seat belt. Some emerging markets are even ready to change gear if needed to be meaningful growth engines in this priceless road to global recovery.

In the face of many shocks from China's weaker demand and the end of a super accommodative Fed to the fear of (sovereign) debt and growing political risks, some emerging economies did their homework to return to sustainable growth, while others are still adjusting (without much growth as a consequence). As a result, there are five broad clusters of emerging countries for investors and companies to base their decisions (see Chart 8):

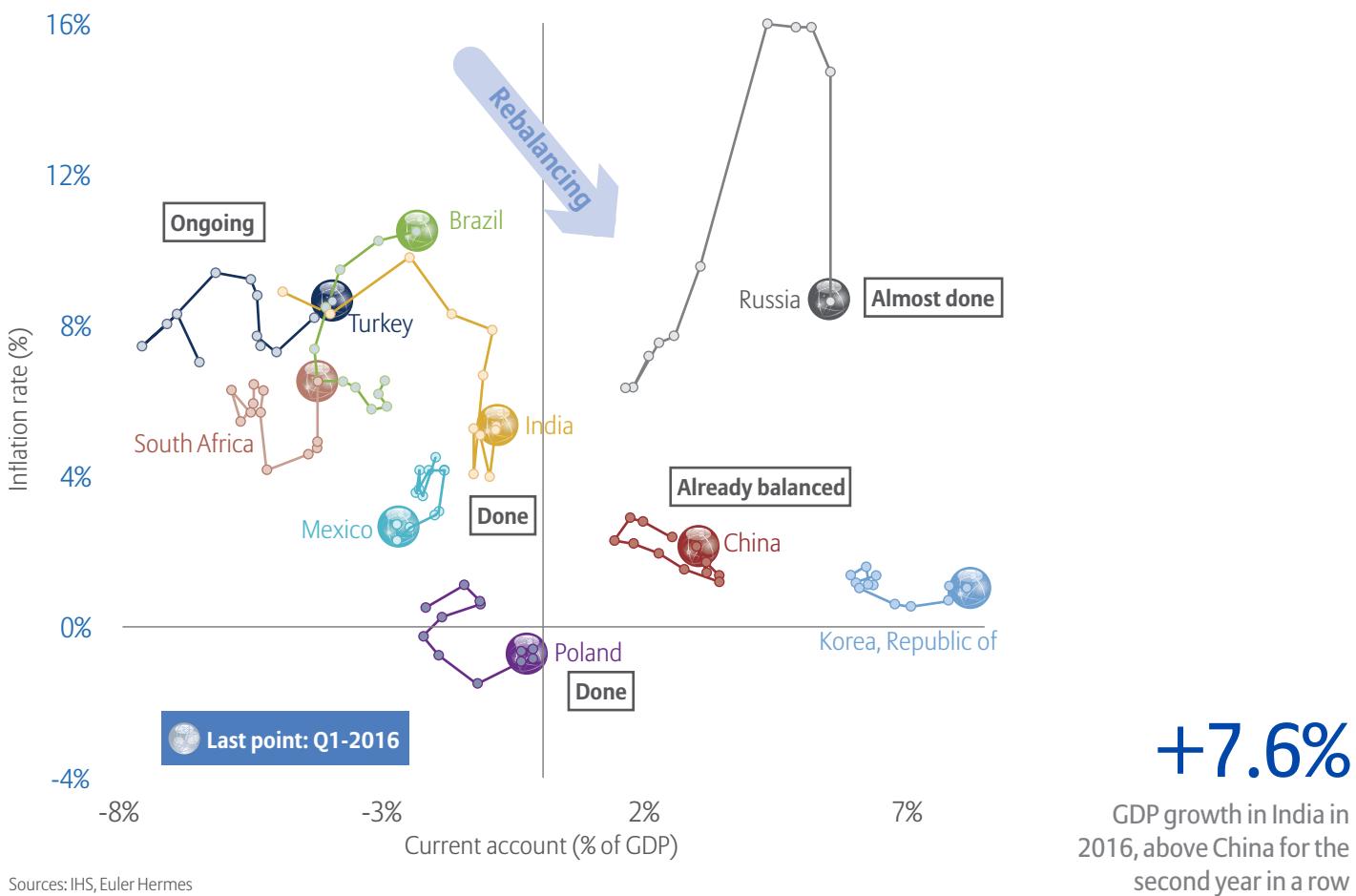
1. Already balanced. Many Asian economies, such as South Korea. Growth weakened as the exports boost faded away. Yet these economies kept on growing, as there was no external financing issue. South Korea will grow by +2.7% in 2017, a good performance for a high-income economy.
2. Newly balanced. India and Eastern European economies such as Poland. These countries were hit by a growth shock very early and reacted on time. Marginal external deficit and low

inflation are key assets and growth surprised on the upside. India will grow by +7.6% in 2016.

3. Rebalancing almost done. Russia is the epitome of this group. The country was the hardest hit by the combination of the oil shock and international sanctions. A strong rebalancing effort was made by the private sector and the public sector managed to keep public debt low (18% of GDP end of 2015) and the sovereign wealth fund unscathed (11% of GDP). The rebalancing was strong. Despite adverse price changes, the current account surplus rose from 1.5% of GDP in 2013 to more 5% currently. Should sanctions be lifted and the world agrees to partake in financing Russia's growth, it may surprise on the upside.

4. Rebalancing still ongoing. This is the case for Brazil and South Africa to name a few. These economies were badly hit by the unwinding commodity super-cycle. The needed adjustment in the private sector was worsened by crowding-out effects, as the public sector let fiscal deficit rise. Net private savings increased by more than 10% of GDP in Brazil between 2013 and 2016. Public debt worsened and could reach

Chart 8: Inflation and Current account balance dynamics over the past three years (quarterly data)

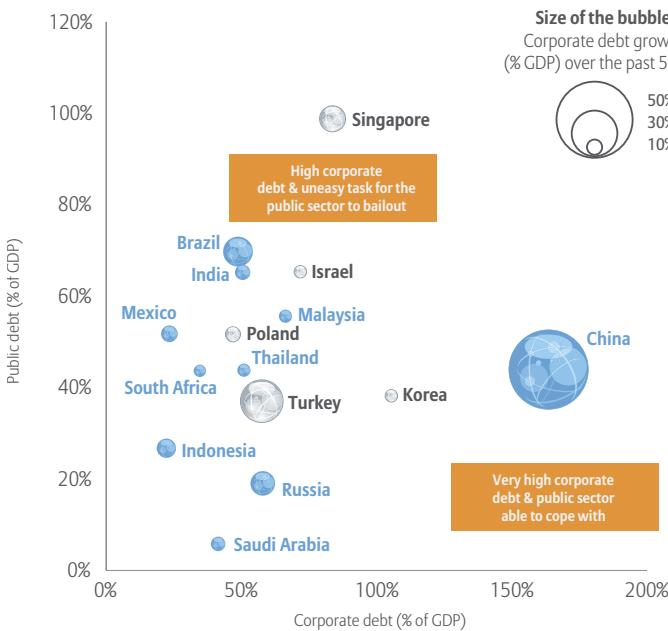


90% mid-2017 or earlier if contingent liabilities arise from the corporate sector. State-Owned Enterprises (SOEs) in the commodity and financial sectors are a particular source of concern. In these countries, the fast depreciation of the currencies worsened the inflation outlook and stagflation hit the consumer as labor market deteriorated and created social and political tensions such as the recurrent strikes in South Africa.

5. Partial rebalancing. The Turkish economy rebalanced along with a price effect. As a commodity importer, Turkey benefited from the low oil price. The external deficit decreased and the same might happen with inflation. However, there was no evidence of a more structural rebalancing as the trade balance in volume is almost unchanged. Growth was hit by external shocks and will certainly be from the recent failed coup attempt, but the country was never in recession.

We continue to expect sizeable growth in 2016 at +3.6%. In addition, low oil prices and supportive policies (public debt only at 33% of GDP end 2015) will continue to support growth if needed. However, the private sector already experiences high corporate debt levels (75% of GDP, accounting for domestic and external debt) and reacts strongly to volatility of the Turkish lira. Restoring confidence will be pivotal to reaching growth targets as tourism revenue disappoint; political risk needs extra monitoring.

Chart 9: Corporate and Public debt in selected Emerging Markets  
Blue = Mostly SOE debt for this country



Sources: IHS, Euler Hermes



## Alive (and kicking) overcapacity in the Emerging World

Among Emerging Economies middle-income ones (BRIC and MIST e.g.) face many challenges. They will have to revamp their economic model to keep growing and cope with growing public debt.

A long-term fix will come from value-added growth and jobs coming from consumer- and services-related sectors. A shorter-term one could still come from policy-makers in using

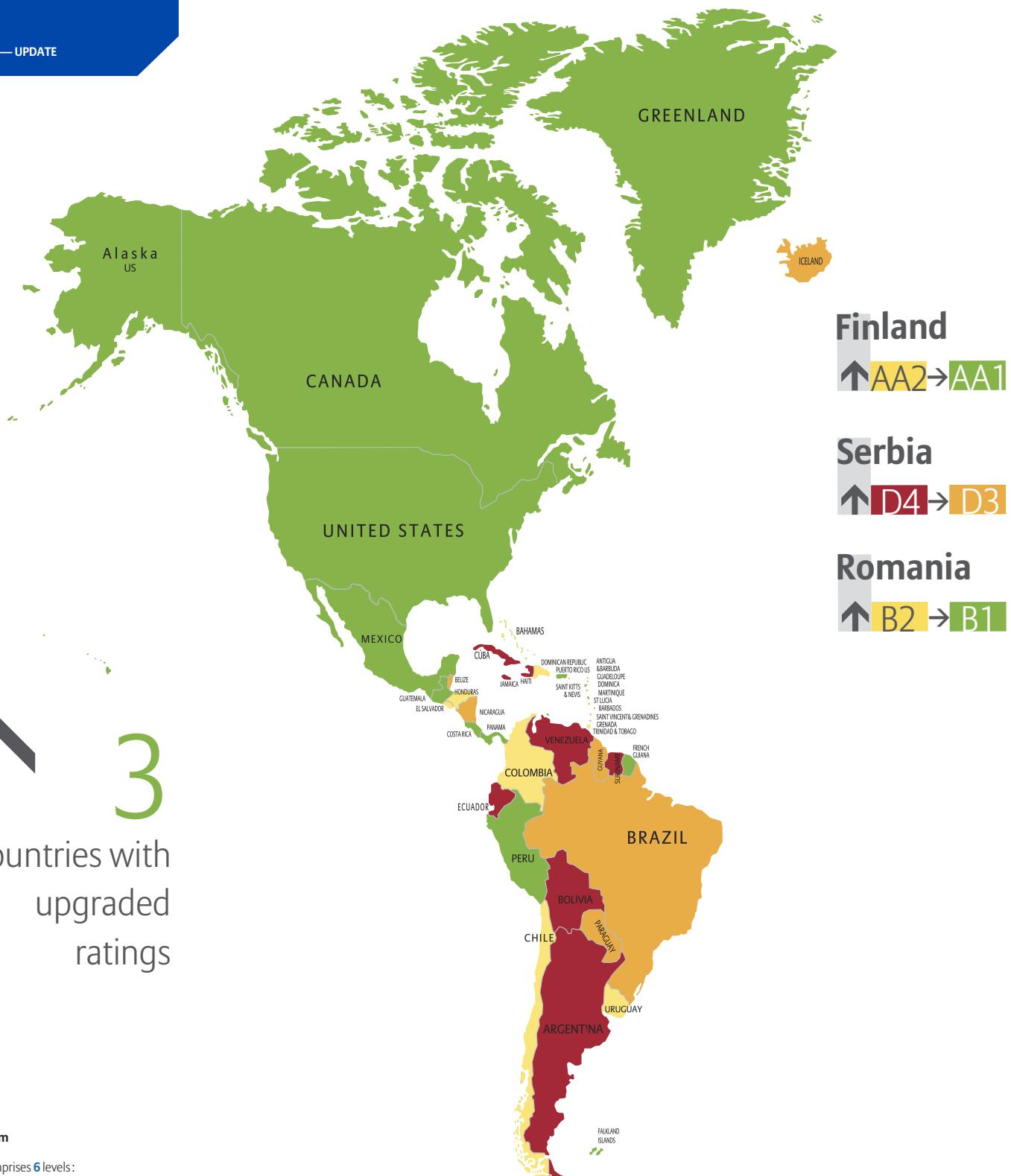
their toolbox to avoid a hard landing. China did not choose between the short- and the long-run remedies yet and will continue to wander between these two solutions for years to come. The political will to support corporate sector balance sheets can be strong, even more so when companies are partially state-owned and labor intensive. Once more, China comes to mind (see Chart 9). China has over 250,000 State-Owned Enterprises (SOEs) and most of them are the legacy of a planned economy. A handful of the largest ones known as the State-owned Assets Supervision and Administration Commission (SASAC; 106 largest SOEs) have fueled oversupply. The long-due adjustment in the metals, construction and commodity segments could come quite abruptly and raise insolvencies. Tolerance of SOEs debt will eventually decrease as its fiscal costs increase.

The implicit guarantee behind public corporates' debt could spark a confidence crisis if market expectations are not met. Such mechanism contributed to the sovereign debt crisis in the Eurozone: unmet expectations regarding an automatic guarantee for Greek, Irish or Portuguese public debt led to strong capital outflows. Policymakers in Emerging markets will have to recognize more nonperforming loans without creating a confidence shock.

The tricky and crucial part is to avoid policy mistakes. As some key economies are still walking on a tightrope, there is not much room for big errors. In the meantime, growth acceleration will have to wait. ■

# Country Risk Outlook 2016

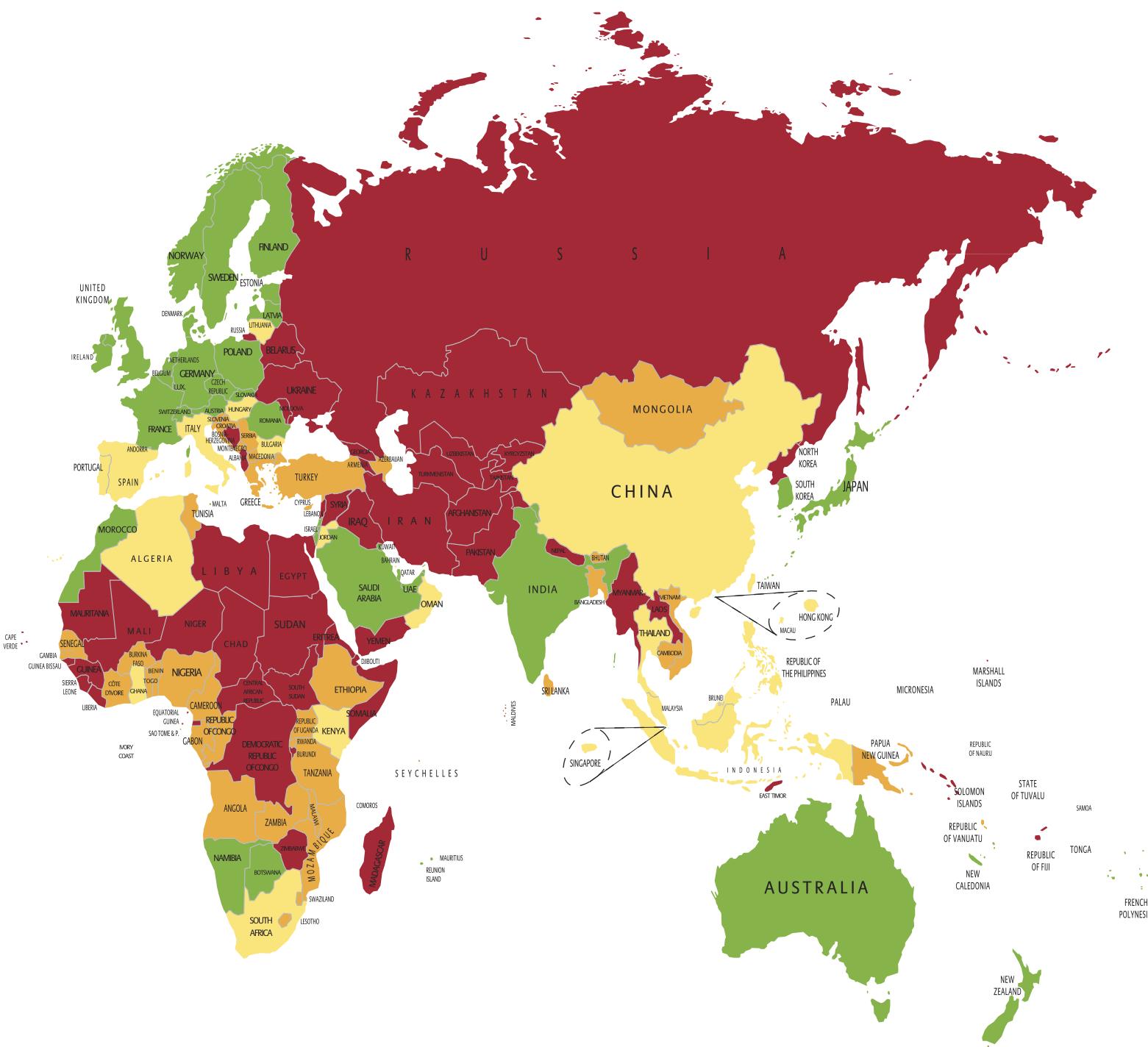
Q2 2016 — UPDATE



# 3 changes in country risk ratings

## 2<sup>nd</sup> Quarter 2016

MACROECONOMIC RESEARCH AND COUNTRY RISK TEAM



Low risk   Medium risk   Sensitive risk   High risk

↑ Improved rating

↓ Deteriorated rating

Source: Euler Hermes, as of June 22, 2016



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