Economic Insight

A breeze of growth

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Executive Summary

- Global growth is accelerating (at last), yet not all engines are in sync. A disappointing U.S., reassuring Europe and stabilizing Emerging markets create good – not great – momentum. We forecast GDP to grow +2.9% in 2017 and 2018, unchanged from our last scenario. It will be the seventh consecutive year below 3%.
- There are five boosters behind the pickup in growth: (i) inflation is (partially) back creating a nominal boost to confidence and investment; (ii) consumption and turnovers are up as a result; (iii) trade is adding half a point to headline growth, after two years of contraction in value terms; (iv) the policy mix is a major plus; and (v) political nudges are underestimated.
- However, growth quality is at stake: confidence, investments, trade, and jobs are up while the political risk, private debt and inflation should remain under scrutiny. For each booster, there is a reason to worry: (i) reflation could create a jaw effect; (ii) the investment cycle is financed largely through debt; (iii) protectionism is not receding; (iv) the risk of a flat tire for policy-makers is high if faced with a new crisis; and (v) political risk and markets could reconnect soon.

Disappointing U.S., reassuring Europe and stabilizing Emerging markets

The genuine pick up in the global economy which started in H2 2016 continued in H1 2017. Global GDP growth accelerated to +2.9% y/y in Q1 from +2.7% in Q4, its highest pace in two years. While GDP growth disappointed in the US, it has been strong in China, thanks to past stimuli, and firm in the Eurozone, mainly thanks to export growth. Business confidence has significantly improved as companies are finally feeling the boost from stronger demand and improved pricing power, after several years of sluggish growth. Strong business confidence suggests continued growth in investment and progressively improving labor markets. The combination of both should spur private spending looking forward.

Overall, both 2017 and 2018 global GDP growth forecasts remain unchanged at +2.9%, for the 7th consecutive year below 3%. Upward revisions in the Eurozone (+0.2pp to +1.9%), China (+0.4pp to 6.7%) and Japan (+0.1pp to 1.3%) were counterbalanced by downside revisions in the US (-0.1pp to 2.2%), Latin America (-0.2pp to +1.2%), the Middle East (-0.2pp to +2.1%) and South Africa (-0.4pp to +0.6%).

In the advanced economies, GDP growth is expected to accelerate to +2.0% from +1.7% in 2016, but to slow down in 2018. In the US, GDP growth is expected to remain in line with the post-crisis average (see Figure 1) thanks to a well-anticipated monetary tightening and positive wealth effects from rising stocks markets. The stronger-than-expected Eurozone GDP growth is driven by higher trade and investment growth in the aftermath of high political uncertainty (France, Austria, the Netherlands). Risks to the outlook remain tilted to the upside given possible stronger secondary effects from the rise in investment on employment.

The (moderate) return of risk appetite, better global economic momentum and strong growth in China should help growth in the emerging markets rebound from an 8-year low in 2016 (+4.0%) to +4.4% in 2017 (see Figure 1). Business confidence indicators continue to suggest that growth momentum holds. Latin America is finally edging up after two years of recession, Emerging Europe is benefiting from the pick up in the eurozone while Emerging Asia is surfing the positive trade momentum. In Africa and the Middle East, the impact of low for longer commodity prices (particularly oil) and (geo)political pressures is still weighing on growth.

Figure 1 – Annual real GDP growth, %

	*Weight**	2015	2016	2017	2018
Global GDP	*100*	**2.8**	**2.5**	**2.9**	**2.9**
Advanced economies	*60*	**2.2**	**1.7**	**2.0**	**1.9**
Emerging economies	*40*	**3.7**	**3.9**	**4.4**	**4.5**
North America	*24*	**2.4**	**1.6**	**2.2**	**2.3**
United States	*21*	2.6	1.6	2.2	2.3
Canada	*2*	0.9	1.5	2.5	2.0
Latin America	*8*	**-0.3**	**-1.3**	**1.2**	**2.2**
Brazil	*4*	-3.8	-3.6	0.6	1.9
United Kingdom	*4*	2.2	1.8	1.4	1.0
Eurozone	*19*	***1.9***	***1.7***	***1.9***	***1.7***
Germany	*5*	1.5	1.8	1.9	1.7
France	*4*	1.0	1.1	1.5	1.5
Italy	*3*	0.7	1.0	1.2	1.0
Spain	*2*	3.2	3.2	2.8	2.3
Central and Eastern Europe	*6*	**0.6**	**1.5**	**2.5**	**2.4**
Russia	*3*	-2.8	-0.2	1.3	1.6
Turkey	*1*	6.1	2.9	3.7	3.0
Poland	*1*	**3.8**	**2.7**	3.4	3.2
Asia	*28*	**5.0**	**5.0**	**5.0**	**4.8**
China	*10*	6.9	6.7	6.7	6.3
Japan	*8*	1.2	1.0	1.3	0.9
India	*3*	8.0	7.1	7.2	7.3
Oceania	*2*	**2.5**	**2.6**	**2.3**	**2.6**
Australia	*2*	2.4	2.5	2.3	2.6
Middle East	*4*	**2.5**	**3.4**	**2.1**	**2.6**
Saudi Arabia	*1*	4.1	1.4	1.5	2.0
United Arab Emirates	*0*	3.8	2.3	2.0	3.0
Africa	*3*	**3.0**	**1.4**	**2.4**	**3.1**
Morocco	*0*	4.5	1.1	4.5	4.5
South Africa	*1*	1.3	0.3	0.6	1.2

** Weights in global GDP at market price, 2016*

Sources: National sources, Euler Hermes, Allianz Research

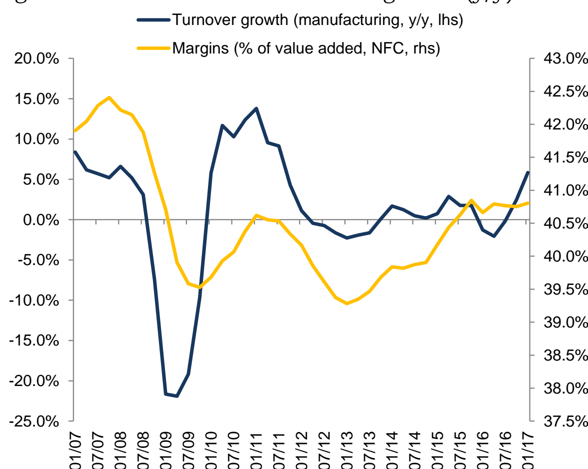
Inflation is back: Just enough?

The price recovery since the start of the year has been essentially driven by commodity prices as core inflation remained broadly stable. We expect the reflationary trend to have a rather moderate tempo going ahead as: (i) oil prices are expected to remain relatively stable (USD57/bbl in 2017 and USD59/bbl in 2018); (ii) currencies in the emerging markets are recovering thus limiting imported inflation; and (iii) the acceleration in wages should remain limited, in line with the gradual pace of employment recovery. Overall, inflation rates in 2017 and 2018 should reach +2.2% and +2.5% in the US; +1.6% and +1.6% in the Eurozone; +4.9% and +4.1% in the emerging economies. This should boost global

inflation to +2.9% in 2017, up from +2.0% in 2016, before a slight slowdown to +2.7% in 2018. Albeit moderate, this reflationary trend coupled with higher demand boosts nominal GDP growth, wage expectations and contributed to the trade momentum.

Reflation, in its current phase, is positive for companies' turnover and households' consumption. Yet there is always a risk that margins and purchasing power react negatively. The window of opportunity should be short-lived and the potential jaw effect should be monitored (see Figure 2). As a side note, companies will continue to cope with rising business insolvencies in the emerging markets in 2017 (+13% in Brazil, +10% in China, +8% in Russia and +4% in Turkey), but also a reversing trend in the US (+0%) and the UK (+6%).

Figure 2 - Eurozone: Firms' turnover growth (y/y) vs margins (% of value added)



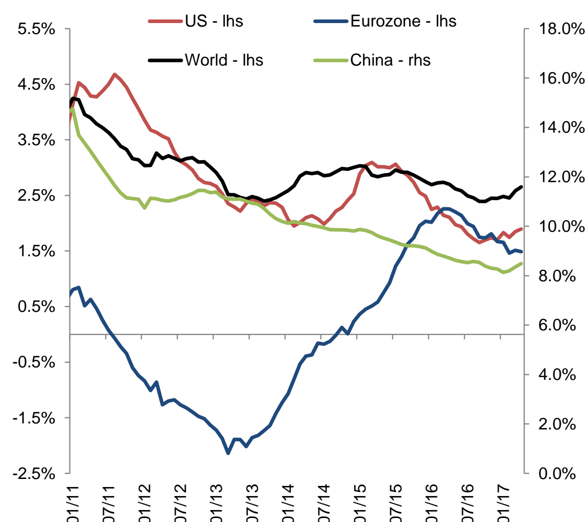
Sources: Datastream, IHS, Euler Hermes, Allianz Research

Consumption and investments are up; so is debt

Retail sales have accelerated globally, notably in the US and China while keeping a good pace in the eurozone – see Figure 3. Confidence levels are at unprecedented levels in the Eurozone (6-year high in France e.g.). The investment cycle is picking up. In the US, higher energy prices and the prospect of an improved business climate have driven up total private investment, while in Europe, foreign direct investment is back and expected to peak at USD600bn by end-2018. Jobs growth is also strong across countries. In the Emerging world, consumption and investment are up thanks to appreciating currencies. The cyclical recovery is obvious.

Going forward, the return to normal business cycles à la Samuelson points to risks to reach peak growth sooner rather than later. The L-shaped and priceless recovery of the past years has distorted the previous cycle but in the US, for instance, record new orders and jobs numbers, combined with higher private debt levels, could end in a possible deceleration by end of this year, without a sizeable fiscal stimulus. Higher debt levels are also a concern in Europe (public debt) and in major emerging markets (private debt). As monetary policy normalizes across the board, higher interest rates could jeopardize the investment cycle particularly when debt levels are high already. Latin American and Asian countries are particularly at stake.

Figure 3 – Retail sales in volume (12M/12M growth)



Sources: IHS, Euler Hermes, Allianz Research

The trade accelerator

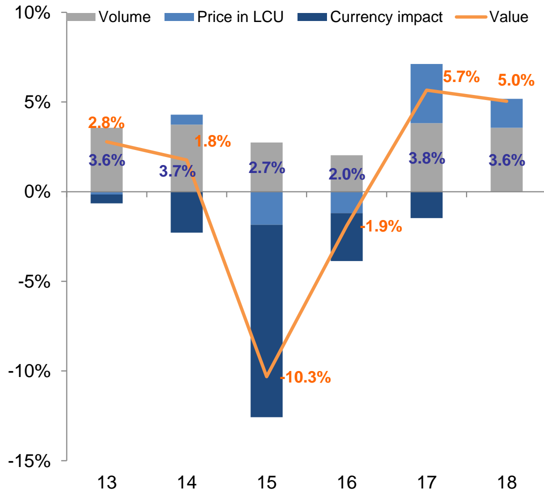
Global exports continued to recover in the H1 2017 in both volume and value terms, after two years of contraction (in value terms). Global goods exports increased by +2.3% 12m/12m in April 2017. The broad-based acceleration in the Eurozone, the US, China and Japan combined with a small J-curve effect in the emerging markets explain this performance. New export orders point to continued improvement in trade growth, notably in Europe. Overall, global trade of goods and services is set to increase by +3.8% in volume in 2017 (+5.7% in value) and +3.6% in 2018 (+5.0% in value) – see Figure 4. Stronger trade momentum should add +0.5pp to global GDP growth. In nominal terms, nearly USD1200bn will be added to trade in 2017 (almost USD3000bn were cut in 2015 and 2016).

Going forward, protectionism is a risk, yet the evidence shows that the number of new protectionist measures is stabilizing, including from the US, Russia, India and Argentina. The trend towards shorter supply-chains is however reinforced by financial balkanization as at the global scale total cross-border/local bank credit continues to fall despite the increase in import content in total production (see Figure 5).

Policies are (very) supportive for now

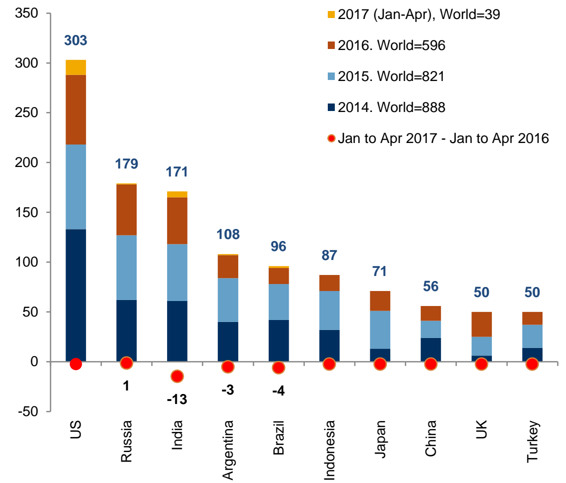
Monetary policy should remain broadly accommodative as global liquidity reached record high levels (above USD19 trillion) and should remain abundant despite balance sheet adjustments. Our key rates expectations are: (i) In the US, one more rate hike in H2 2017 by the Federal Reserve and Federal funds rate to reach 2% to 2.25% at end of 2018 (see Figure 6); (ii) the ECB to announce its exit plan in the Fall with a reduced pace of its monthly asset purchases (QE) in January 2018 in order to end it by fall 2018; and (iii) In China, normalization should come from tighter lending rules (e.g. limit on house purchases, enhanced macro-prudential rules) to address financial risks namely a property market bubble and large amounts of corporate debt. These exit strategies also point for moderate growth going forward.

Figure 4 - Global exports of goods and services, annual growth



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

Figure 5 - New protectionist measures



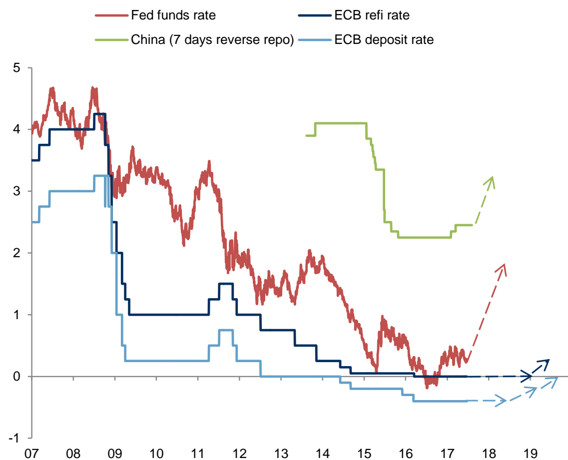
NB: No number annotated below the red dot means there were no protectionism measures from January to April in both 2016 and 2017.

Sources: GTA, Euler Hermes

Fiscal policy will get increasingly supportive in China (fiscal deficit expected at -4.2% of GDP, 1.2pp of GDP above the target). Fiscal consolidation is on hold in the eurozone, and in the US, the boost from the tax reform and the infrastructure plan will be more gradual than previously thought with the biggest part of the stimulus expected in 2018. We expect the Federal budget deficit to increase from -3.2% of GDP in 2017 to -4.3% in 2018 (see Figure 7).

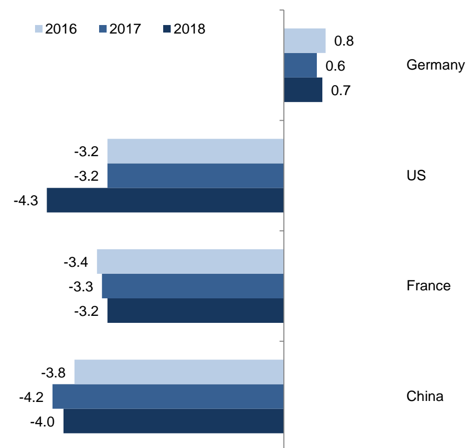
Policy-makers' eyes are on the risk of a flat tire, that is not to have recuperated enough room to maneuver before the next crisis. In addition, a policy faux-pas could create substantial financial stress in Europe, especially for Italy, and in the US.

Figure 6 - Monetary policy rates, %



Sources: IHS, Datastream, Euler Hermes, Allianz Research

Figure 7 - Fiscal balances, % of GDP



Sources: IHS, Datastream, Euler Hermes, Allianz Research

Perceived political risk has softened, except for the US

After record levels of political risk in Europe, it is now the US's turn to concentrate global political stress. There are three major risks currently not priced: (i) a technical default and government shutdown, from a lack of agreement with Congress on raising the debt ceiling in September; (ii) a formal impeachment proceeding as mid-term elections in 2018 could lead to a Democratic Congress; and (iii) an escalation of the tensions between the US and North Korea.

In Europe, no full-fledged political and financial crisis is expected as Italy enters its legislative elections moment in Q1 2018. Mitigants include: the ECB QE program (and ready-to-use OMT); Europe's renewed camaraderie; and Italy's fiscal primary surplus (+1.5% of GDP in 2016) and limited external imbalances including a current account surplus and limited private debt. Political uncertainty in the UK will continue and amplify financial volatility (exchange rate e.g.). We expect GDP growth in the UK to continue to soften (+1.4% in 2017; +1.0% in 2018) as consumers are increasingly feeling the pain from the loss of real purchasing power.

Figure 8 summarizes expected nudges between H2 2017 all the way into 2018.

Figure 8 –Political nudges in 2018

Sources: Euler Hermes, Allianz Research

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