Atradius

Managing risk, enabling trade

November 2016

Economic Outlook

Trade pressures mount

Editorial

Global trade growth is grinding to a halt. Asia, the fastest growing region in GDP terms, has seen its trade volumes shrink at an accelerating pace in the first half of the year. Together with the United States which is experiencing flat trade growth, these regions are driving the slowdown. While it is still early to pinpoint a precise, comprehensive explanation for the size of the decline, there is a number of developments that has come to the fore recently that may be of help. They are documented in more detail in this Outlook.

The Asian trade decline has largely been caused by Chinese trade contraction. This has perhaps easily contributed to the slowdown and rebalancing of its economy. The impact of lower economic growth on trade seems straightforward. The one of Chinese rebalancing towards services, which are less trade-intensive than production, is already less so. Even more opaque is an underlying fundamental: the role of China as the "world's factory". China simply moves up the value chain, causing far fewer imports, exports, and re-imports as products move from intermediary to end-product. Moreover, with energy and commodity prices low, predominantly due to reduced Chinese demand and investments, Asian and global trade have been depressed as well. Capital goods production, which is trade intensive, is putting pressure on trade as well. These factors are compounded by ongoing finance constraints to the tune of USD 1.6 trillion and further accumulation of protectionist measures.

These developments as such already call the relationship between trade growth and economic growth into question. But matters for trade are made far worse by political developments. These are flatly trade unfriendly, as signalled not only by the Brexit vote in the UK, but also by the stalling of the regional trade liberalisation efforts like TPP (US/Asia), TTIP(EU/US) and even CETA (EU/Canada). Anti-trade rhetoric by US president-elect Donald Trump during the election campaign make matters even worse. The climate has changed; we will see that in future trade data. To what extent is unclear. What is however clear, is that – with all this uncertainty – trade has become far more difficult to forecast.

Hampering trade bodes ill for global economic developments, which are still depressed by lack of demand in the advanced economies and idiosyncratic issues in a number of emerging economies such as Brazil, Turkey and Russia. Indeed, with global GDP forecast to grow 2.8% in 2017, the qualification 'slow' that we that we provided in our May Economic outlook remains warranted. Nevertheless, the pressure on growth in the emerging economies is easing, driven by strong growth in India, bottoming out of energy and commodity prices and the ongoing search for yield as global monetary conditions remain soft. Meanwhile, the insolvency climate is not expected to change much with the figures in the majority of countries remaining significantly above pre-crisis levels. Special attention is warranted in the emerging economies where insolvencies are on the rise, with the exception of India. As opposed to the link between trade growth and GDP growth, the link between insolvencies and GDP growth remains stable – at least so far.

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Executive summary

Pressures on international trade are mounting around the globe. Particularly from China where the economy is rebalancing away from manufacturing exports to the US and Europe where the popular tides are turning against trade liberalisation. The global outlook is now subject to exceptional uncertainty and the link between global trade growth and GDP growth seems broken. GDP growth is expected to pick up in 2017, although this forecast is marked by significant downside risks, including further negative surprises regarding global trade.

Key points

- The global economic outlook in 2016 is largely unchanged: world GDP growth is likely to slow to 2.5% in 2016. In 2017, growth is forecast to accelerate slightly to 2.8% on the back of a pick up in growth in emerging economies.
- The recovery in the eurozone has been steady but it appears that headwinds are getting stronger with 1.6% growth forecast in 2016. Headline figures for the US have disappointed, now projected at 1.5%, due to low inventories. UK growth has fully rebounded to 1.9% from the post-Brexit downward revisions.
- The 0.3% contraction in total growth in Latin America is finally bottoming out as policymakers have taken a more orthodox direction. Growth is picking up in Eastern Europe to 1.5%. Asia-Pacific remains the fastest-growing region with growth of 5.7% forecast this year.
- Insolvencies in advanced markets are on track to be flat in 2016. Emerging market economies are facing rising insolvencies, though the magnitude is lower than previously expected as several key markets emerge from recession.

The global economic situation has stabilised since the turbulence seen in late 2015 and early 2016, led by emerging markets where slowing growth has begun easing and even rebounding. Advanced markets continue to face slow but steady growth, but their outlooks are increasingly clouded by uncertainty. The key global trends identified in Chapter 1 of this Economic Outlook are: the sharp slowdown in international trade; the tentatively positive outlook for oil and commodity prices; the stabilisation of international financial markets and the search for yield in EMEs; the limitations of monetary policy and the need for fiscal policy to pick up the slack.

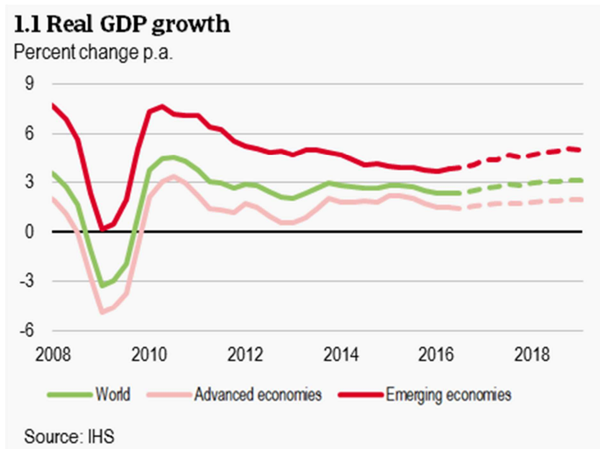
Risks to the outlook lean heavily to the downside. GDP forecasts for this year and next could be revised significantly downward in the case of (1) misguided, surprise monetary policy steps in the US, (2) a further slowdown in eurozone growth, or (3) a hard landing in China. While the likelihood of these events in our forecast period are low, the global impacts would be very high. More moderate impacts would come from (4) a failure of trade to pick up again or (5) a rapid rise in global oil prices but these are both more realistic risks.

Chapter 2 presents the advanced economies that continue to enjoy demand-driven recoveries, but there are significant headwinds coming up in each market. The strong USD and low investment has weighed on the business environment in the US while the outlook has turned much more uncertain following the November elections. The eurozone, growing below potential due to structural issues and crisis legacies, is facing significant political risks of its own. The UK, while enjoying a strong year so far, supported by the weak pound, is stepping into the unknown in 2017 as the negotiations to leave the EU should begin in March.

Emerging market economy growth appears to be bottoming out, as analysed in Chapter 3. New leadership and more orthodox macroeconomic policies are driving recoveries in Latin America, such as in Brazil and Argentina. Gradually recovering commodity prices are easing pressure on national finances and supporting growth in exporting countries like Russia and some markets in MENA and Africa. China's economy is slowing but still stable and will likely remain so in our forecast period. Accelerating growth is projected in 2017. Many EMEs remain vulnerable though to US monetary policy normalisation and capital outflows but shock absorption capacity has improved significantly compared to past bouts of market volatility.

In Chapter 4 the implication of these global developments for businesses around the world is explored. In advanced economies, no improvement in insolvency growth is forecast after a 7% decline in 2015, in line with their stagnating recoveries. Insolvencies are structurally higher in the eurozone (periphery), while postponed investment and higher production costs in the UK are likely to increase the rate of business failures. Low commodity prices have slashed business investment in the US and other resource rich countries like Canada and Norway, but the improving outlook is also likely to be reflected in their business environments. Insolvencies are expected to rise in most large EMEs except India. The commodity price is especially urgent for EME commodity-exporters, which aids stabilisation and the return to growth in markets like Brazil and Russia. Poor trade opportunities and vulnerability to external financial flows could continue to weigh on corporates across EMEs in 2017.

1. The global macroeconomic environment



Emerging economies growth slide ends

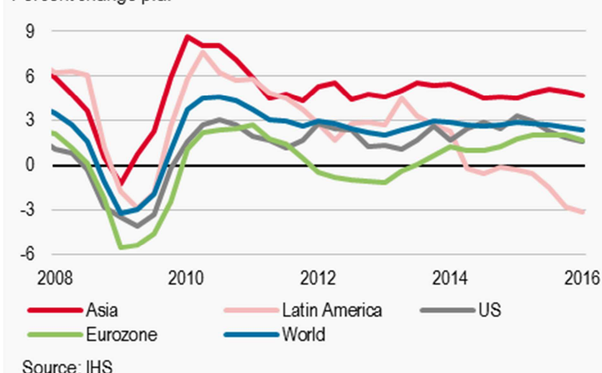
In May this year, the big story was the slide of GDP growth in the emerging economies (EMEs). The Chinese slowdown and the dire situation in Brazil and a few other Latin American countries in particular pushed the EME growth rate towards that of advanced economies. At the same time, growth in advanced economies, particularly the eurozone, seemed to be strengthening. Now six months later, it appears that EMEs have weathered the storm and will begin to see improving growth levels, showing some divergence again from the stagnant advanced economies.

As to the advanced economies, eurozone growth has more or less held up, whereas US growth has been under pressure due to incidental factors (inventory declines) and the high dollar which hindered exports. The Brexit vote by the UK electorate has created some uncertainty in the financial markets and more broadly. This has triggered firms to delay investment decisions, especially in the UK. But the impact on growth is rather limited, at least in the short term. Moreover, perhaps paradoxically, Brexit is likely to provide stimulus to emerging economies growth. As a result of the vote, financial markets have concluded that the loose monetary policy in advanced markets will not be departed from shortly. This has alleviated pressure coming from constraints of financial flows towards emerging economies as investors have resumed their search for yield.

Other developments have also helped bring capital back into the EMEs. The Chinese authorities have rather

convincingly continued to support growth by way of fiscal and monetary stimulus. At the same time the idiosyncratic issues in a number of large emerging economies, such as Brazil and Russia, are gradually fading. Strong support, moreover is coming from India, which is booming ahead, as is Asia.

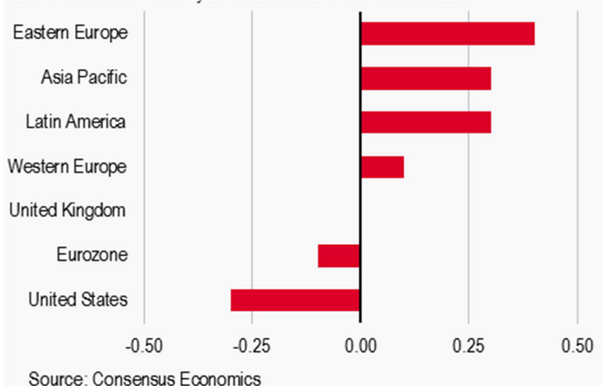
1.2 Regional real GDP growth
Percent change p.a.



Source: IHS

The disappointing developments in advanced markets and improving fortunes for EMEs can be seen in the pattern of 2016 GDP growth forecast revisions (figure 1.15). The overall picture for 2016 has not changed considerably with world economic growth forecast at 2.5% compared to 2.4% forecast earlier this year.

1.3 Change in 2016 GDP growth expectations
Difference between May 2016 and October 2016 forecasts



Source: Consensus Economics

For 2017, more importantly, we observe the already mentioned mild recovery in the emerging economies, notably in Latin America, where Brazil is forecast to improve significantly. Moreover, Russia will help push up Eastern European figures. Asian growth, supported by India and China, will remain flat at the highest global growth rate. Meanwhile, US growth is expected to accelerate to 2.2%, discarding the burden of pressure on inventories and the impact of the strong dollar. The recovery in the eurozone, however, is expected to come under pressure, slowing to 1.3%, as tailwinds from the low oil price and cheap euro phase out.

Table 1.1 Real GDP growth (%) – Major regions

	2015	2016f	2017f
Eurozone	1.9	1.6	1.3
United States	2.6	1.5	2.2
Asia-Pacific (ex. Japan)	5.9	5.7	5.6
Latin America	0.3	-0.3	2.1
Eastern Europe	0.6	1.5	2.3
Total	2.9	2.5	2.8

Source: Consensus Forecasts (Oct 2016)

Trade growth grinds to a halt

In our May Economic Outlook we observed that the pace of global trade growth was very low and that in Asia, the region with the highest economic growth, trade even shrank. Latin American trade growth was surprisingly holding up through a recession, whereas in Europe and the US trade growth was muted, in line with disappointingly low economic growth. These developments have been reinforced through 2016.

As the threat to trade from the policy angle is increasing, the actual picture of global trade continues to worsen. With a July y-o-y growth figure of 0.4% global trade has almost come to a halt in 2016, whereas 2015 showed 1.7% growth.[1] The picture has dramatically worsened for the US, where no trade growth in July was observed. Another major trade bloc, Asia, saw its volume of trade contract by 1.7%. Emerging Europe saw an even sharper contraction of 4%, but this is a marked improvement from the 12.7% contraction in 2015. There is positive y-o-y growth in the eurozone and Latin America of 2.1% and 2.6% respectively in July, but this is still a deceleration from 2015 figures.

Despite all this bad news, there is some evidence of a recovery in trade from the Baltic Dry Index, a leading indicator. The index has gone up from a trough of 400 in April to over 880 by the end of September. Under these circumstances, one could very well understand that economists find it early days for a comprehensive explanation. Still, a few paths can be explored, looking directly at Asia, Latin America and the US – the regions with the most noticeable trade pattern changes.

First, recent literature has confirmed what we suggested in our May Economic Outlook: the importance of China.[2] The 2015 China's contribution to the trade slowdown was unusually large, on the export as well as import side. The

[1] The figure is below the one reported in the May Economic Outlook of 2.5%. We have now – correctly – taken the 12 month rolling average at year-end and compared that with the same figure one year before. The previous calculated figure for 2015 used the annual average of the month-end figures over a year.
[2] See China and Asia in Global Trade Slowdown, IMF Working Paper, WP/16/105.

Box 1 The benefits (and costs) of trade

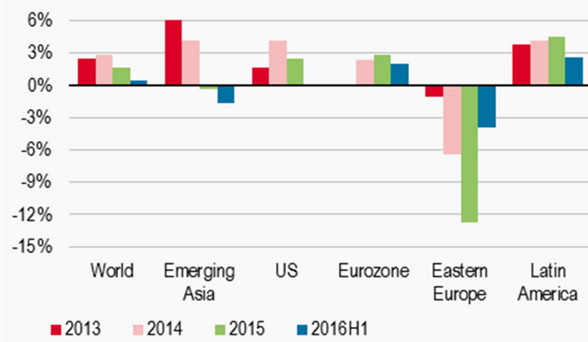
The benefits of trade centre on a number of mechanisms. First, trade liberalisation can improve productivity (and thus welfare) as it induces firms to specialise in what they are best at. This is most likely to be accompanied by reallocation of workers and investments to more efficient firms, providing a boost to productivity. Further benefits may be derived from economies of scale as larger (export) markets can be served. Second, individual (exporting) firms may also gain as they can learn from foreign markets. They may also be spurred to invest in technology as a critical business size is reached. Third, firms in the domestic market that now face more competition are forced to become more efficient, providing another spur to productivity. These benefits fall to consumers via lower prices, and thus raise real incomes. Moreover, the variety of goods and services increases. The problem, however, is that the benefits are not always evenly distributed. This is simply because the shake up in the economy that comes with trade liberalisation creates, apart from overall benefits, winners and losers. If the losers are not appropriately compensated, they will become loud. For example, there is evidence that Chinese import competition has led to higher unemployment in some US regions for some (unskilled) workers, despite beneficial overall effects.[i]

[i]See for reference IMF World Economic Outlook October 2016, Global Trade: what's behind the slowdown?

effects are especially acute in Emerging Asia, the second largest trade bloc in the world after the EU.

1.4 Total trade growth

Percent change p.a. in volume of goods and services



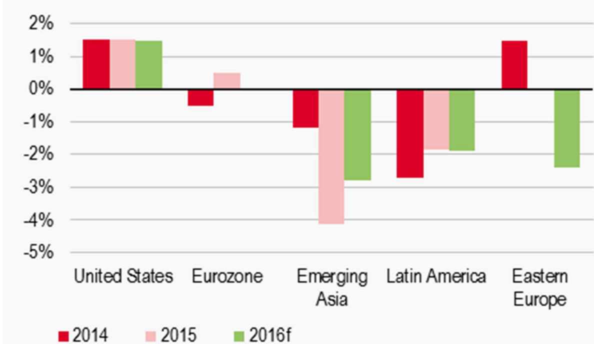
Source: CPB

It is worth looking more closely at the role that China is playing in the global trade slowdown. China has rapidly expanded to become the 'world's factory' since the early millennium. In recent years, China is facing lower external demand due to a combination of lower global growth and loss of competitiveness through an appreciation in the Renminbi. The lower demand for end products reverberates throughout the production chain: leading to lower capital and intermediate goods imports by China as well as lower exports from China. At the same time, China is rebalancing away from industrial production to services, which reinforces the lower demand for capital goods as services are less investment intensive. It is precisely capital investment that is the most trade intensive. On top of that, Chinese demand for capital goods imports is also depressed because the higher technological sophistication allows China to produce more capital goods at home.

This picture stresses the relevance of the pressure on trade in capital goods and is reflective of lower total investment in China as well as in other parts of the world. We see a very muted, possibly negative, development in investment globally, with only US investments showing any growth in 2016. The lower oil and commodity prices clearly have an impact here as well. Latin American investment growth is skewed by idiosyncratic developments in Brazil as well.

1.5 Total investments

Percent change p.a.



Source: IMF

Second, in the US the lack of trade growth is the result of import growth of around 2.5% which is offset by shrinking exports. This has become more pronounced in 2016, in 2015 higher imports more than compensated for lower exports, resulting in positive trade growth. As we reported in the May Outlook, the strength of the US dollar is an important determinant of that, a trend which has strengthened.

Third, apart from the structural developments, trade finance continues to be a worry. As reported by International Trade Finance (ITF), data from the Asian Development Bank suggests there was a trade finance gap of USD 1.6 trillion in 2015, up by USD 200 billion compared to 2014. A large chunk of this amount is attributable to Asia, whose finance gap is around USD 700 billion. SMEs in particular are bearing the brunt, with 57% of trade finance requests having been rejected.[3] The ITF

[3] International Trade Finance, September 2016.

points at regulation as one of the major factors of reluctance on the banks' side.

Fourth, as TPP is stalled for ratification by US congress, TTIP negotiations have effectively come to a halt, and Brexit has been announced, optimism for near future trade liberalisation has faded. Moreover, the election of Donald Trump as president of the United States is unlikely to be a trade growth booster either. His election campaign was built on a rather protectionist view, especially towards China. Whereas we were cautiously optimistic in May about developments in trade restrictions, a recent WTO report clearly points in another direction. During the six-month period up to May 2016, 22 new trade restrictive measures were introduced per month, a considerable uptick compared to the monthly average of 15 since 2011. During the same period 19 new measures were introduced per month aimed at facilitating trade. The stockpile of trade-restrictive measures has gone up by 11 percent. Since 2008, 2800 new trade-restrictive measures have been introduced. Only 25% has been removed.[4]

The outlook for international trade in 2016 and 2017, as a result, is increasingly gloomy but also puzzlingly difficult to predict. Atradius now predicts trade growth of only 0.5% in 2016, compared to 2.5% previously forecast. The WTO has also downgraded its forecast to 1.7% from 2.8%. Apart from the striking weakness of the figures, the link between trade growth and GDP growth seems completely blurred. In recent years, these two have moved more or less in tandem, that is to say 1% GDP growth has implied 1% trade growth.[5] One can argue that this still holds for the Eurozone, but for the US there seems to be no link at this stage. For Asia and Latin America it is now even negative: positive GDP growth with negative trade growth and vice versa. The breakdown of this relationship makes forecasting trade growth in 2017 and beyond very difficult, using Atradius' linear model or any other. Underlining this challenge, the WTO has recently provided a wide range of 1.8% to 3.1% as a 2017 global trade growth forecast

Some bright spots, however, may appear. Global growth may pick up, providing a positive impact on trade via the Chinese world factory function. In addition, it is likely that the USD will stay around current levels next year as well but the strengthening trend is finally easing, offering some potential for US trade to recover. Still, current trade growth forecast may prove to be overly optimistic, even at these low levels.

[4] WTO, Report to the TPRB from the Director-General on trade-related developments. July 4, 2016.
[5] See the slowdown in world trade: temporary or permanent? Atradius Economic Research Note October 2015.

Oil prices: never a dull moment

Oil prices have been moving sideways since May, fluctuating between USD 45 and slightly above 50 per barrel Brent. The question is whether this trend is expected to last. The answer is: probably not. For several reasons we expect to see a moderate increase in oil prices going forward.

OPEC is moving closer to reaching an agreement on cutting production. Since 2014, the cartel's strategy has been maintaining market share over profits. In September 2016 during an Algiers meeting OPEC seemed to finally concede by agreeing on a production reduction to 32.5-33 million barrels per day (mb/d). The Russian president, Vladimir Putin, has also indicated the willingness to reduce Russian production. Prices are rumoured to be targeted at USD 55-60 per barrel. This turn of events has increased prices to about USD 52 per barrel, but the OPEC negotiations and oil price outlook are still surrounded by uncertainty. Iran and Saudi Arabia are political opponents, with Saudi Arabia initially not agreeing to lower production without Iran taking a 'fair' share. The final shape of the OPEC production cut is still to be negotiated and uncertainty around this will likely cause price volatility.

While the OPEC announcement at least sets a price floor, developments in the US are likely to prevent an all too sharp price increase. The price increase to current levels has already triggered an increase in the number of oil rigs operating in the US from 316 to 371. This turnaround signals that the production decline of 1.1 mb/d since the mid-2015 peak is likely to taper off. The efficiency of US oil rigs is also rapidly improving: production per rig is 30% higher than last year. Moreover, the financial situation in the US shale industry is far less dire than previously expected as shown by the 37% increase in the energy index of the S&P small cap energy index.[6] Therefore, US shale producers, well positioned to benefit from a higher oil price, are likely to remain the swing producer of the oil market, a role previously held by Saudi Arabia.

Meanwhile, the lower oil price levels are pushing up consumption, especially in the OECD countries. In the US road transportation is up 2.5% (in miles) and vehicle sales are increasing; this includes sales of higher fuel consuming SUVs and trucks. Along with similar trends in the euro area, this more than compensates for the simultaneous drive for energy efficiency. In the longer term, the emerging market economies – especially China and India –fuel demand will grow, as road transportation is expected to expand rapidly.

[6] See IIF, Oil Market Adjustment Continues, August 2016.

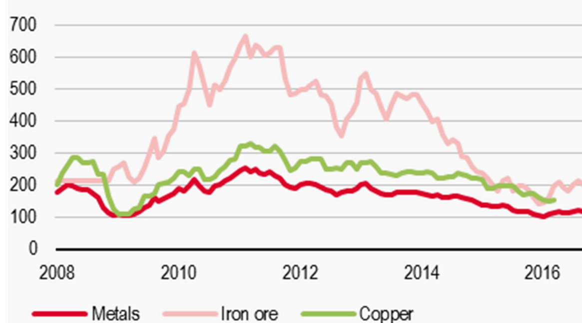
This provides a powerful force that will drive up prices over time as more expensive sources (such as tar sands and deep water) will have to be exploited. For the moment though, prices are expected to rise only modestly. The EIA forecasts oil to cost USD 45 per barrel by the end of 2016 and USD 55-60 by the end of 2017, roughly in line with the IMF's forecast.

Commodity prices: the worst may be over

In our previous Outlook we reported about the fading of the slide in other commodity prices, and therefore prices of industrial inputs. That picture has become more pronounced, even to the extent that prices are gradually improving. Indeed, metal and iron ore prices have firmed: as per September 2016, prices of iron ore are 31.3% higher than in January; prices of steel 46.3%; and aluminium, nickel and zinc respectively 8.6%, 20.9% and 42.3% higher. Only copper prices remained weak, gaining only 2.7% since January.

1.6 Global commodity prices

Price index, 2005 = 100



Source: IHS

But we are clearly not out of the woods yet. Prices are still at (very) low levels. Moreover, while inventories have fallen sharply, especially for aluminium and nickel, and to a lesser extent zinc, levels remain historically high.[7] As a result, prices are set to remain subdued, with the IMF even forecasting a decline in 2016 for metals, and only a mild recovery in 2017 (2%). This is echoed by the World Bank with a 15% decline in metals price projected.[8]

As the World Bank points out, metal prices have been held up by a number of factors this year, hinging on China in particular, which accounts for 51% of global demand. First, iron ore and steel benefited from the restocking of Chinese mills ahead of the construction season. Second, a stimulus programme focused on infrastructure development has provided a boost for the construction sector. These factors have somewhat veiled the underlying problems in these commodity markets where overcapacity reigns. Even worse, more capacity is being added: Large investments have been made for iron ore (Australia), copper (Peru) and aluminium (China). On the positive side, zinc prices will be supported by the closure of large zinc mines in Australia and Ireland.

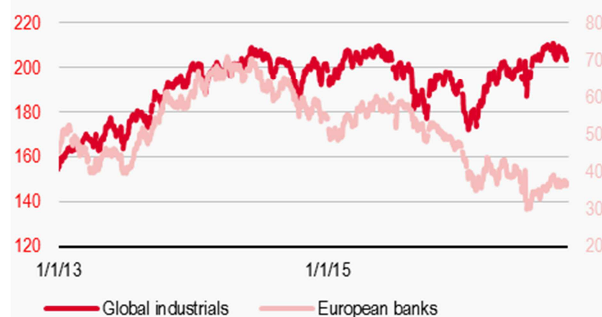
The implication of these developments in the commodity markets is that exporting countries will continue to face low prices while trading volumes remain subdued but further downward price pressure is unlikely. It appears that, in terms of price and volume declines, the worst (or as the IMF would put it: the 'acute phase' – is over.

Financial market anxiety from Brexit quickly fades as impact lasts

The EU membership referendum outcome in the UK this past June caught financial markets by surprise. It sent jitters through the market after a period of calm since the confirmation that the US Federal Reserve (Fed) would decelerate its monetary tightening cycle in March. In the immediate aftermath, stock exchange indices fell some 5%-8% in major economies and 15% in the UK as investors flew to safety in core advanced economies bonds. But the market recovered relatively quickly. The exceptions were European bank shares, of which the index dropped from 40 to 30 after the Brexit referendum (-25%). The impact, from a global perspective at least, seemed short-lived.

1.7 Eurozone banks and global industrials

Share prices; index 1998 = 100



Source: IHS

But a closer look reveals more lasting effects. The snag can be found in the statements of the Fed, ECB and Bank of England, followed by the People's Bank of China, emphasising the collaboration among central banks in providing liquidity to allow proper functioning of markets.[9] It was followed by the Bank of England taking measures to (further) ease monetary policy and the ECB

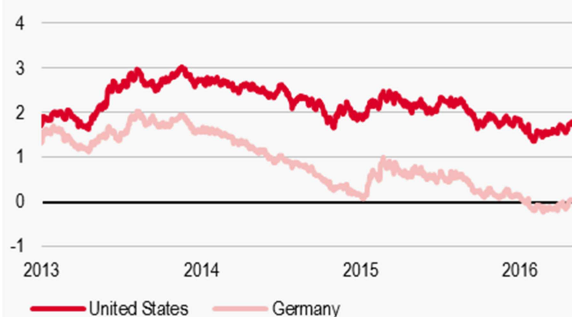
[7] The current volume of is nearly 2.5 times as high compared to before the crisis. And copper inventories have increased by no less than 45%, the highest ever increase.

[8] These prices are built on comparing full year 2016 to 2015 (and 2017 to 2016).

[9] See BIS Quarterly Review September 2016, note 1.

reaffirming ultra-expansionary monetary policy. Crucially, the Fed rate hikes were, again, pushed further into the future. The affirmation that rates would stay lower for longer allowed the equity markets to resume their pre-Brexit surges and bond yields to be further depressed. In fact, Germany was able to *issue* 10-year bunds with negative yields in July.

1.8 Long-term government bond yields
10-year maturity, percentage points



Source: IHS

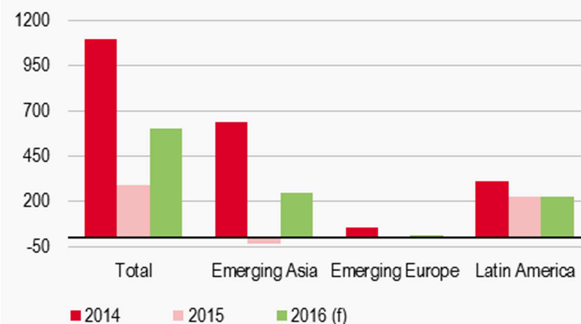
With negative yields in the advanced economies reaching highs of over USD 10 trillion there is a clear and reinforced search for yield. This is precisely what emerging economies, facing the threat of finance restrictions, need. The search for yield is evident in lower EME government bond spreads.

1.9 Emerging market sovereign spreads
JP Morgan EMBI Plus Sovereign Spread

Source: Bloomberg

Total capital flows to emerging economies are improving in 2016, which is helping to finance their economic growth, but this does not come without risks. Recovering growth based on capital flows increases the vulnerability of EMEs to international investor sentiment which can change rapidly, especially in the case of a surprise Fed move.

1.10 Capital flows to emerging economies
USD billion

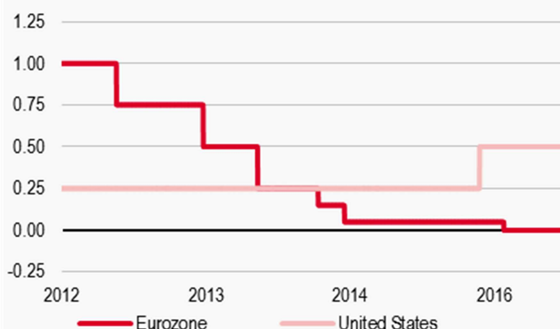


Source: IIF

Monetary policy trapped

The monetary policy stance of the Fed and the ECB has remained very accommodative through 2016. Official interest rates in both economies are historically low and money is still being pumped into the system by the ECB to the tune of EUR 80 billion per month. Moreover, the Fed's normalisation cycle is moving extremely gradually with December now slated as a likely second rate hike. Despite all these efforts, economic growth in the US and the eurozone has failed to pick up. Monetary policy seems no longer effective in the advanced economies.

1.11 Monetary policy rates, ECB and Fed
Policy interest rates, percent



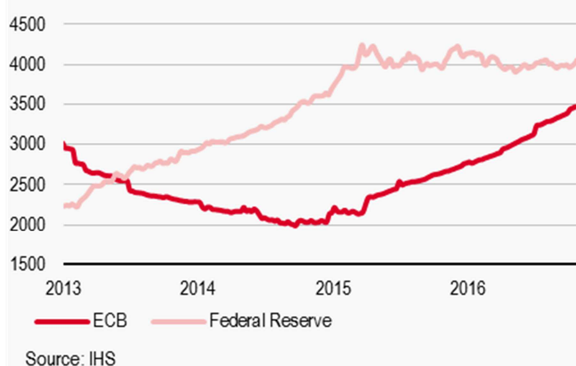
Source: IHS

In our previous economic outlook we have hinted at the 'secular stagnation' view as an explanation, attributed to Lawrence Summers, a former US Treasury Secretary. The point is that savings are too high relative to investments,[10] which drives down the interest rate. Interest rates are at the zero lower-bound though, requiring the economy to adjust through lower activity to decrease investments a very slow – and costly – process,

[10] Underlying causes for the high savings are aging, not only in the advanced economies, but also in China: in the latter country the savings rate is 43% (compare Eurozone: 24%). Apart from aging, debt hangovers as well as fear for rare events like the great financial crisis of 2008 play a role. See The Economist. September 24th, 2016.

as we will discuss below.[11] In normal times this would not be an issue, but in the current accommodative monetary environment rates cannot go any lower.[12] The interest rate is stuck in the so called liquidity trap and the economy needs to adjust via lower economic activity that triggers lower investments. In that manner saving and investment are equilibrated: via lowering the volume (viz. economic activity) rather than the price (viz. interest rate) component. And that volume adjustment is a very slow – and costly – process, as we will discuss below.

1.12 Eurozone banks and global industrials
Share prices; index 1998 = 100

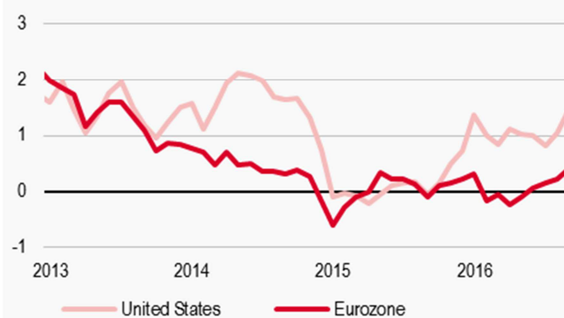


Source: IHS

Moreover, pumping money into the system via quantitative easing as the Fed and ECB does, does not make a lot of sense. Firms will not invest by the mere provision of cheap and abundant money. It is consumption that must go up (and thus savings down). Banks are supposed to play an important role through lending to promote consumption, but it is precisely the ultra-low interest rates that prevent them. In sum, the economy is trapped into a very slow adjustment process.

This painful adjustment process starts with the observation that low investment relative to savings indicates lower demand. That pushes down prices and thus lowers inflation. The snag is then that if nominal interest rates cannot be lowered anymore due to the zero bound, a lower inflation rate effectively means *higher* real interest rates,[13] the opposite of what is needed to stimulate demand. It will put pressure on investments and exports (via an appreciated real exchange rate), further lowering demand. Moreover, with the high debt levels that we have repeatedly discussed in previous outlooks,[14] firms', households' and governments' spending power will be eroded. This is simply because the real value of their debt goes up if inflation goes down. Lower demand then means again lower inflation, pulling the economy into a vicious circle of stagnation and lower inflation, even deflation.[15] That is where we seem to be trapped.

1.13 Consumer price inflation
CPI all items, percent change p.a.



Source: IHS

To avoid this trap something else than simply further lowering interest rates needs to happen. Central banks could aim for a higher inflation rate, possibly backed by unconventional policies such as 'helicopter money'. Or, more realistically, monetary policy should be complemented by demand improving fiscal stimulus.

Fiscal policy hopes

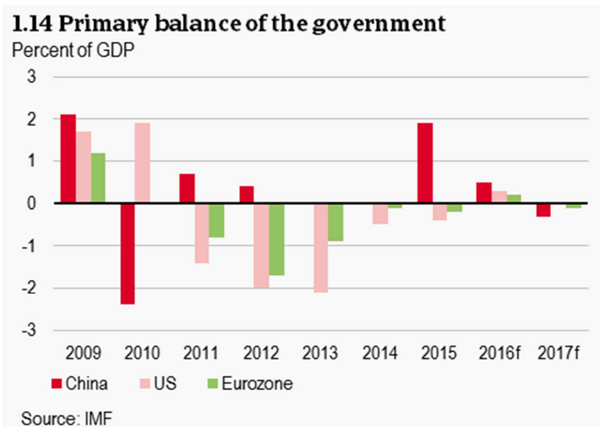
Fiscal policy is still failing to support growth. Looking at the change in the primary deficit as an indicator of fiscal policymaking, it appears that hardly anything is happening (figure 1.13). The change in the US and eurozone is especially miniscule in 2016 and 2017. Moreover while 2016 shows a marginal stimulus, this is already expected to revert in 2017.

Very high government debt-to-GDP levels in the advanced economies are still there as well, constraining fiscal loosening. At 109% of GDP in the US and 92% in the eurozone, the 2016 levels are still significantly above the 85% threshold that invariably suggests deleveraging. Chinese government debt is much lower at 46%, but growing relatively quickly having added 10 percentage points over the period 2007-2014.

But it is not all that bad. Looking only at debt-to-GDP levels may be somewhat delusive in the current low interest rate environment. Yields have come down considerably since 2011. This is confirmed when considering the interest payments by governments as a percentage of GDP. These, as the graph shows, have indeed actually fallen in the US and, especially, the Eurozone. Therefore, one can argue, more fiscal room is available than the high debt levels suggest. As a sign of

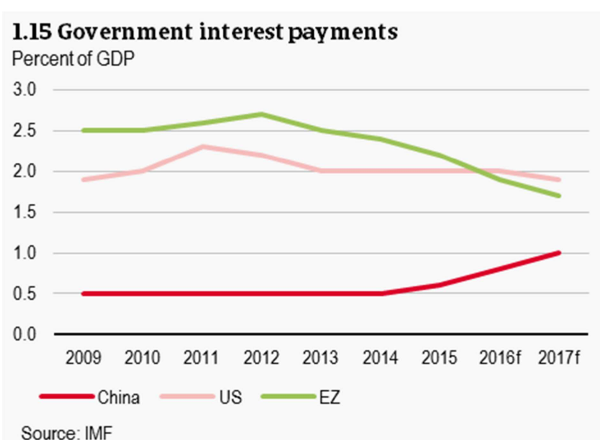
[11] The process may be hindered, or even obstructed, by the fact that households push up their savings in reaction to the lower interest rate to achieve e.g. a predefined pension level.
[12] Indeed, interest rates below zero would trigger cash hoarding as opposed to deposits and financial titles. To be precise, rates can go below zero just to the level where the cost of holding cash (insurance, security etc) matches. So if it takes 0.4% to cover these costs, the rate can be -0.4%.
[13] To understand this, we should consider the fact that when talking about interest rates above to balance savings and investments, it is real interest rates we are talking about. That is the nominal rate adjusted for inflation. Therefore, if the nominal rate is, say 0.25% and inflation 1%, the real rate is -0.75%.[13] Then if the real rate needed to achieve equilibrium between savings and investment is, say, -4.25%, we need a dose of inflation to achieve this: 4.5%.
[14] E.g. Atradius Economic Outlook, May 2016, p.7.
[15] See Jacobs (2016). Langdurige stagnatie. Je gaat het pas zien als je het door hebt. Economisch Statistische Berichten, September.

acknowledgement, the most recent G20 communiqué from the Finance Ministers and Central Bank Governors Meeting in Chengdu talks carefully about enhancing the use of the fiscal instrument.[16]



1.14 Primary balance of the government

There hardly seems to be a bright spot for fiscal policy though, despite the upbeat tone of, for example the IIF.[17] Japan clearly offers the most tangible policy, with the 2017 budget providing a fiscal impulse of around 0.5% of GDP. The UK authorities, triggered by post-Brexit referendum recession fear, have already indicated that the aim of a primary balance by 2020 may not be realistic. New spending on infrastructure and less social spending cuts is expected. In the US the new president may push for infrastructure spending, though apart from that fiscal restraints may continue to prevail. German government spending may be spurred by the inflow of refugees and the need for infrastructure projects, providing a stimulus of 0.8% of GDP in 2016. Still, the country is very unlikely to go beyond that, remaining firmly within the 3% deficit boundary set in the EU Growth and Stability Pact. Globally, a fiscal brake, rather than stimulus, of 0.3% of GDP is forecast in 2017.



1.15 Government interest payments

[16] It talks about '...fiscal strategies are being used to support our common growth objectives..." but at the same time aiming to keep policies '....enhancing resilience and ensuring debt is on a sustainable path'. See http://www.g20.org/English/Documents/Current/201607/t20160728_3091.html

[17] IIF, Global Economic Monitor, September 2016 mentions that fiscal policy has 'already turned stimulative in 2016'. It does not mention that in 2017 it will use the brakes.

Risks to the outlook

The outlook for the remainder of 2016 and for 2017 is, of course, not without its risks. While most risks cited in previous outlooks persist, we identify five key risks to the global economy that should be on the radar. These are: misguided Fed policy, a slide in eurozone GDP growth, a hard landing in China, no recovery in international trade, and a rapid rise in the price of oil.

1. **Misguided Fed policy**: Global central bank actions following the Brexit vote and the subsequent reaction of financial markets have stressed the power of monetary policy. It is not so much in terms of spurring real economic growth as we have argued, but rather of calming down financial markets. If the Fed surprises with a sooner or higher-than-expected rate hike, the yield-searching flows to EMEs can reverse, creating funding crunches for the emerging economies. That will seriously hamper growth. In chapter 3 we discuss the impact hereof for the emerging economies in more detail.
2. **Eurozone growth slide**: In light of the uncertainty that the Brexit vote has unearthed, and a few elections coming up in Europe in 2017, political uncertainty may start to dominate the scene with fears, or even reality, of a further EU break up progressing. This adds to the already weakening growth as tailwinds have started to fade and the banking sector, still already relatively weak (especially in for example Italy), is now coming under increasing pressure due to the ultralow interest rates.
3. **China hard landing**: Over the past 12-16 months, Chinese authorities have stressed the willingness to use monetary and fiscal means to uphold the targeted growth levels in the range of 6%-6.5%. Chinese policy communication has improved and the probabilityof a disorderly depreciation of the renminbi has become lower. Thus a hard landing is increasingly unrealistic, at least in 2017, but the risk has not completely disappeared. Furthermore, a high and increasing level of debt that helps support growth is a worry.
4. **No trade recovery**: Whereas there is clear agreement on trade as a driver of growth, less clarity exists as to the recent plummeting of global trade. We have offered a number of reasons, but are at the same time uncertain to what extent global trade can be expected to recover. For the time being the forecasts are that some sort of reversion to the link between GDP and trade growth will arise. That, as we have seen over the past period, is surrounded by unusually high uncertainty. It is compounded by the rapid rise of nationalistic, anti-trade sentiments in the political arena as witnessed, for example, by the Brexit vote.

Table 1.2 Risks to the global economic outlook

	Risk issue	Symptoms	Effects	Probability	Impact
1	Misguided Fed monetary policy	• Financial market turbulence • reversal of capital flows from EMEs	• Tighter credit access for EM firms	low	high
2	Eurozone growth slide	• High uncertainty/turbulence • Confidence plummets • Deflation and low bank lending	• Low growth, possibly recession • EU integration pressure • Lower trade growth	low	high
3	China hard landing	• Unstable banking sector, credit constraints • Capital outflow acceleration • Pressure on currency	• Financial market volatility • Spillover into dependent (EM) economies	low	high
4	No trade recovery	• Regional trade deals • Existing trade arrangements coming under pressure	• Pressure on GDP growth	moderate	moderate
5	Rapid rise in oil price	• Oil price increase quickly largely above USD 50 per barrel Brent	• Windfall for exporters • Higher costs for importers • Overall net negative impact	moderate	moderate

Source: Atradius Economic Research

5. **Rapid rise in oil price**: A rapid rise in oil prices could occur in the case of large supply disruptions, potentially due to conflict (spillover) with a major MENA producer or a higher-then-expected increase in demand in EMEs. While this would provide relief to exporters, the higher costs for oil importers, especially in developed economies and the largest EMEs (China, India) would hurt consumption, and thus global growth.

2. Advanced economies – prospects and risks

Table 2.1 Real GDP growth (%) – Major markets

	2015	2016f	2017f
Eurozone	1.9	1.6	1.3
United States	2.6	1.5	2.2
United Kingdom	2.2	1.9	0.9
Japan	0.6	0.6	0.9

Source: Consensus Forecasts (Oct 2016)

Foundations still shaky

Advanced economies have disappointed yet again in 2016. After appearing to be back in the driver's seat last November, the optimistic outlook for developed markets was revised downward in May due to financial market turbulence and emerging market weakness. Now, the problems are more internal.

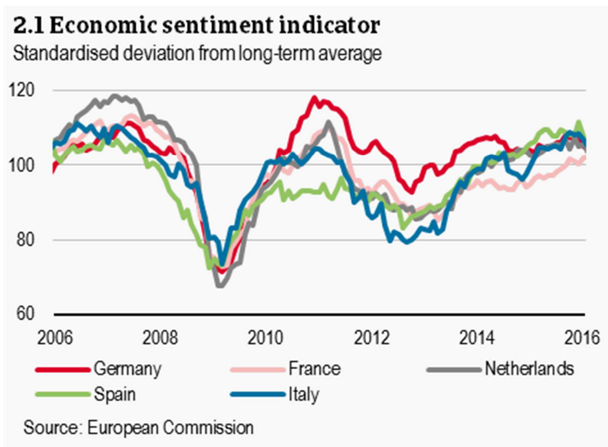
The eurozone economy is set to slow down in 2016 and further in 2017 largely due to fiscal policy failures, political uncertainty and underlying structural weakness. The UK, while experiencing strong H1 growth and resilience in the aftermath of the Brexit vote, is facing significant political uncertainty in 2017 which has brought its forecast for next year significantly down.

The economic performance of the US is weak this year but robust consumption will underpin 2.2% growth next year. Japan's outlook has improved but the country is still stuck in deflation and the potential effectiveness is questionable.

Eurozone: headwinds getting stronger

The eurozone recovery is finding some firm footing this year, with growth forecast at 1.6%, unchanged from May's Economic Outlook. This is underpinned by the Economic Sentiment Indicator (ESI) which suggests that growth is likely to continue over the short term.

In 2016, eurozone countries such as Germany (1.8%), Italy (0.8%) and Portugal (1%) see economic conditions improving, due to a stronger recovery in domestic demand on the back of an improving labour market, low oil prices and accommodative monetary policy. Ireland (3.7%) is faced with a loss of growth momentum, as both domestic demand and exports are hurt by uncertainty over Brexit. GDP growth in Spain (3.1%) was revised downwards as well compared to May's Economic Outlook.



The overall picture is that tailwinds are fading as some headwinds are getting stronger in the eurozone. This is making the 2017 outlook cloudier. The eurozone growth forecast has been lowered to 1.3%, compared to an estimated growth rate of 1.6% in May. The downward adjustment was strongest for Ireland – minus 0.7%-point – following the Brexit vote. In other countries with relatively strong trade ties to the UK, such as the Netherlands (1.5%) and Belgium (1.3%) the growth forecast has also worsened.

Table 2.2. Real GDP growth (%) – Major eurozone markets

	2015	2016f	2017f
Austria	1.0	1.3	1.2
Belgium	1.4	1.4	1.3
France	1.2	1.3	1.2
Germany	1.7	1.8	1.3
Greece	-0.2	-0.6	1.1
Ireland	26.3	3.7	3.0
Italy	0.7	0.8	0.7
Netherlands	2.0	1.6	1.5
Portugal	1.6	1.0	1.2
Spain	3.2	3.1	2.1
Eurozone	1.9	1.6	1.3

Source: Consensus Forecasts (Oct 2016)

External environment weakening

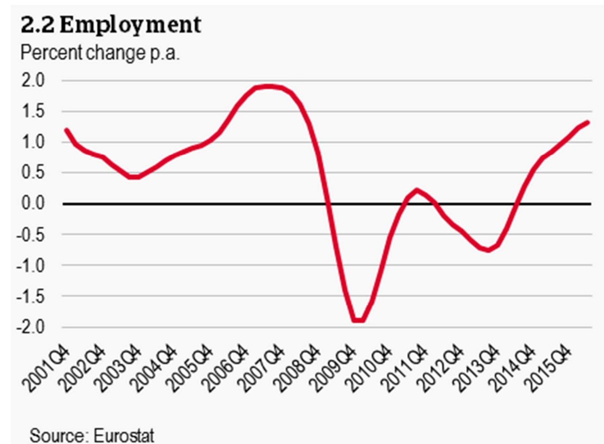
Export growth has been notably weaker over the first half of 2016 at 1.8% on an annualised basis, compared to an annual growth rate of 4.4% in 2014 and 6.1% in 2015. External demand has declined as emerging market growth is dragged down by low commodity prices and a slowing and rebalancing Chinese economy. Downward revisions in key developed export markets like the US and UK have also contributed. The slowdown is in line with the stagnant global trade growth described in Chapter 1.

Another tailwind is that the euro has appreciated. Since April 2015, the real effective exchange rate of the euro has appreciated by 5.4%, as expectations of monetary policy tightening (normalisation) were pushed back in the US and in the UK, and the Bank of Japan further eased its monetary policy. This removes the boost that eurozone exporters had from a weak euro.

External risks will persist over the outlook period, putting downward pressure on growth. Most worrying for the eurozone economy is the uncertainty created by Brexit negotiations, China's slowdown, unexpected US monetary policy movements and geopolitical risk spilling over from conflicts particularly in the Middle East.

Demand conditions improving

Domestic demand has picked up noticeably in the eurozone over the past two years, due to employment growth, real income growth and accommodative monetary policy. The main driver of GDP growth in 2015 was domestic demand, which rose on the back of private consumption. Fixed investment rose by 2.9%, which is a strong recovery compared to the two years before, but still subdued in historical perspective.



Consumption growth accelerated slightly to 1.8% in H1 2016 (annualised), compared to 1.7% in 2015. The inflation rate increased slightly throughout 2016, caused by a stabilisation of energy prices. This exerts some downward pressure on real wage growth. On the other hand, employment growth accelerated over the first half of this year (Graph 2.3). On balance, real disposable income growth is expected to accelerate this year which will support consumption. Furthermore, after several years of deleveraging and with house prices picking up in

Box 2 Brexit forms both threat and opportunity for eurozone

The Brexit vote came as a huge surprise. The impact on the British economy has been limited so far (see UK section). However, Brexit will eventually have a negative impact on UK and eurozone growth, as we have explained in a recent study.[i] Countries with strong trade and investment links are most exposed. Ireland stands out in terms of exports and the Netherlands in terms of FDI. Luxembourg, France, Germany, Spain, Switzerland and Belgium also stand out in both respects. However, Brexit also opens opportunities for European countries to lure in UK businesses that want to remain assured of access to Europe's single market. In particular, UK based banks and insurance companies benefit from 'passporting' rights, which allow them to sell services in the entire single market without having to establish a base in every country. The longer the uncertainty continues about the eventual form of a new trade agreement and the closer the UK gets to leaving the eurozone, the more realistic relocation of UK businesses to the eurozone becomes.

[i] The potential implications of Brexit on European insolvencies, Atradius Economic Research, June 2016

some eurozone countries, household balance sheets become less of a drag on spending.

Fixed investment growth slowed to 1.8% y-o-y. While investment is likely to pick up again in the near term, the pace is likely to be limited. High uncertainty – further inflamed by Brexit – is playing a role in discouraging investment. Another factor is muted export growth which lowers the need for expansionary investment.

Monetary policy remains very loose. In March this year the ECB announced new monetary policy measures. It lowered its key policy rate (to 0%), increased monthly purchases under the asset purchase program (to EUR 80 billion per month), extended the list of eligible assets and announced a new series of TLTRO operations. Credit conditions for households eased in Q3, whereas those for businesses remained unchanged (Graph 2.4).

2.3 Credit conditions eurozone

Weighted difference between share of banks reporting tightening of credit standards vs. easing

Source: ECB

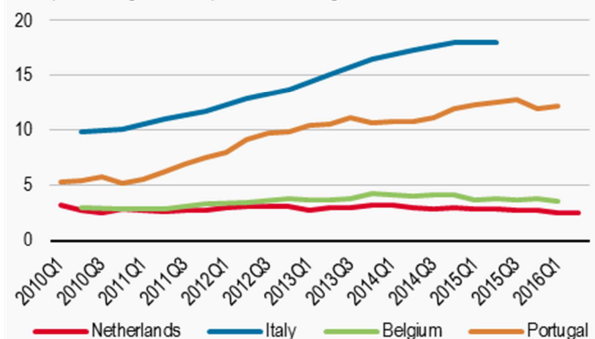
Structural weaknesses keep growth low

The eurozone continues to suffer from a number of structural weaknesses, especially in its banking sector. Eurozone banks continue to suffer from excess capacity, high NPLs, and poorly adapted business models. The Italian banking sector recently came under investor scrutiny, given its high rates of non-performing loans, which stem from a prolonged domestic property slump. But banking problems are not limited to Italy. NPL levels are high as well in, for instance, Greece and Portugal (Graph 2.5).

Weak bank balance sheets imply the monetary transmission channel is working sub-optimally, as banks' weak capital positions inhibit further lending even in a low-interest rate environment. While banks are healthier than before the financial crisis, low rates and flattened yield curves reduce the ability to earn income from maturity transformation. Loan loss provisions stemming from legacy problems are weighing on profitability as well. Increases in regulatory capital, for instance coming from Basel III, therefore have to be met increasingly by winding down risky asset positions and asset sell-offs.[18]

2.4 Eurozone banking sector weakness

Non-performing loans as percent of total gross loans



Source: IMF

There also remains considerable labour market slack in the euro area. Compared to pre-crisis levels, unemployment rates remain elevated in most eurozone countries, especially in Greece (23.2%), Spain (19.5%), Portugal (11%) and Italy (11.4%). Except for Ireland and a couple of small member states, eurozone countries are not operating at their full capacity, which follows from their negative output gap.[19] Failing to tackle economic slack, could leave member states in a negative cycle of

[18] Nimwegen and Bruinshoofd (2016), Converging to higher capital requirements: adjustment strategy and lending impact, Rabobank Special

[19] The output gap is the difference between actual GDP and potential GDP. Potential GDP is an assessment of GDP when the economy would run at its full productive capacity.

low investment, falling productivity, less dynamism and eroding human capital.

Fiscal policy needs to step in

The ECB has pursued a policy of extreme monetary loosening in the post-2008 period but is now constrained by the zero lower bound. The natural rate of interest is in negative territory, implying that the economy is adjusting through lower economic activity. Further monetary easing is ineffective and other measures need to complement it – specifically fiscal policy, as discussed in Chapter 1.

Government investment would be a natural candidate to stimulate economic growth. For OECD countries the medium-term fiscal multiplier is estimated at 1.4. This implies the rise in output is 1.4 times that of the initial investment. Infrastructure needs are sizeable in many eurozone countries, especially as fiscal consolidation in recent years has pushed down public capital spending to very low levels in many countries.[20] And at current flat yield curves countries can lock in very low long-term interest rates.

The fiscal space to boost public investment is limited by fiscal rules, in particular the EU Stability and Growth Pact (SGP). The SGP works with a corrective arm, which puts restrictions on the size of the government budget deficit (max 3%-GDP) and government debt (max 60%-GDP). But it also has a preventive arm, which consists of a government expenditure benchmark and a structural budget balance target.[21] Germany is the only major eurozone country that both in terms of its actual budget balance (0.2%-GDP in 2016) and its structural balance (0.4%) has the fiscal space for government stimulus. But a low appetite for any fiscal loosening in that country makes the stimulus there unlikely. Another group of countries, including the Netherlands, Belgium and Austria, comply with the SGP's deficit target, but have limited or no room for fiscal stimulus when looking at the structural budget balance. The European Commission has some flexibility in applying the rules and could grant countries with a strong track record of public finances more room to spend on investment, irrespective of whether they comply with the rules regarding the structural balance.

Political deadlocks threaten reforms

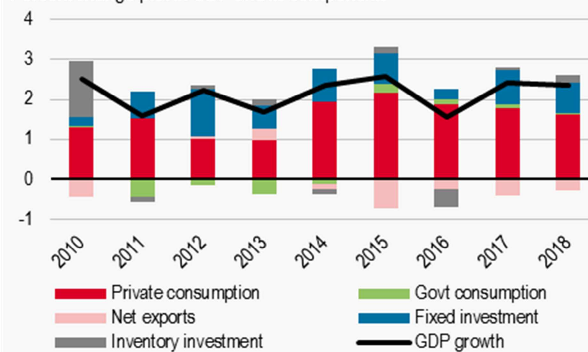
Besides fiscal stimulus, further reforms that can help to improve near-term productivity and lift potential output are also badly needed in many eurozone countries. Think of policies to stimulate labour force participation rates, improve flexibility in labour and product markets, and clean up bank and corporate balance sheets, but also to deal with European-wide challenges such as the influx of refugees. It is highly uncertain if the political will can be found to effectively deal with these issues. A number of countries are left with inconclusive election results. Spain is finally heading to a resolution of its political stalemate, but PM Rajoy will have to lead the country with a congressional minority, which leaves him in a weak position. Ireland installed a minority government earlier this year, after weeks of deadlock following an inconclusive election result. The elections that are scheduled to be held in 2017 in Germany, France and the Netherlands are also expected to lead to strongly divided parliaments. Divided politics against a more benign economic backdrop could very well undermine further European reform making.

United States: on the upswing

Economic growth in the US is among the most robust across developed markets, but the economy has still not managed to escape the difficulties experienced this year. The 2016 GDP growth forecast has been revised down from 1.8% in May to 1.6% in November, due to a weaker than expected H1. Economic developments in the US are characterised by robust consumer spending on the one hand, but muted investment and weak trade on the other.

2.5 US economic growth

Percent change p.a. in GDP and its components



Sources: IHS, Consensus Economics

US consumers keeping recovery on track

Consumption, which accounts for more than two-thirds of US GDP, has been growing on average 2.6% y-o-y in 2016. Following a steady reading of 2.5% (3-month moving average) in H1 of 2016, growth of personal consumption expenditures has accelerated to 2.8% in Q3. There are many tailwinds that are encouraging consumer spending and will persist through the outlook period.

First of all, the labour market is tightening: monthly jobs reports have been consistently strong in 2016. Unemployment is low at 4.9% and the labour force

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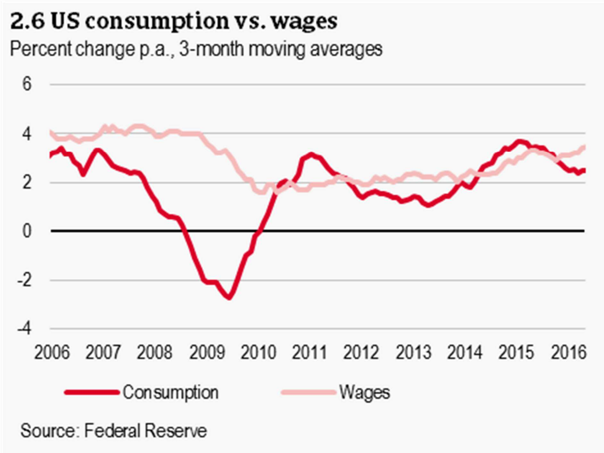
[20] Mourougane et al (2016), What is the scope for public investment to lift long-term growth?

[21] The structural budget balance is the actual budget balance adjusted for the economic cycle and one-off income or expenditure.

participation rate has held steady at 62.8% through the year. Wage growth is also accelerating, from 2% y-o-y in Q1 to 2.5% y-o-y in Q2.[22]

2.6 US consumption vs. wages
Percent change p.a., 3-month moving averages



Source: Federal Reserve

Second, money saved at the pump is being spent elsewhere. The national average price of a gallon of gas is USD 2.33 as of September 2016, compared to an average of USD 3.36 in 2014 before the collapse in oil prices. As it turned out, saving money at the pump did not cause a boon in consumption in 2015 or 2016 as originally predicted by the Fed among other institutions. But the sustained savings have indeed driven an increase in spending, especially on restaurants and retail.[23]

Third, the value of US property has nearly recovered to its pre-crash level. The US Federal Housing Finance Agency's House Price Index is 99.5% in Q2 2016 the level of the Q1 2007 peak. Since residential property accounts for roughly a quarter of total household wealth in the US, rising home prices increase homeowners' wealth and as such encourage consumption.[24]

Finally, the financial conditions set by the Fed are encouraging spending. Low interest rates (0.5%) make credit to households more accessible and BIS data shows lending to households rising 2.6% compared to 2015. Furthermore, the savings rate is also continuing its downward trend, from 6.2% at the beginning of 2016.

Private consumption will remain the key driver (68%) of GDP growth in the US in 2017. Consumption will remain underpinned by very low interest rates in line with the very gradual Fed tightening cycle, low oil prices, and a strengthening labour market. This anchors economic growth as well as inflation expectations which could encourage the Fed to take the next step in its monetary tightening cycle. Strong private consumption performance suggests that the negative effects of the crisis could be behind us, but the high dependence of US GDP growth on private consumption is also vulnerability if the underlying structural issues are not addressed.

Exports continue to put pressure on growth

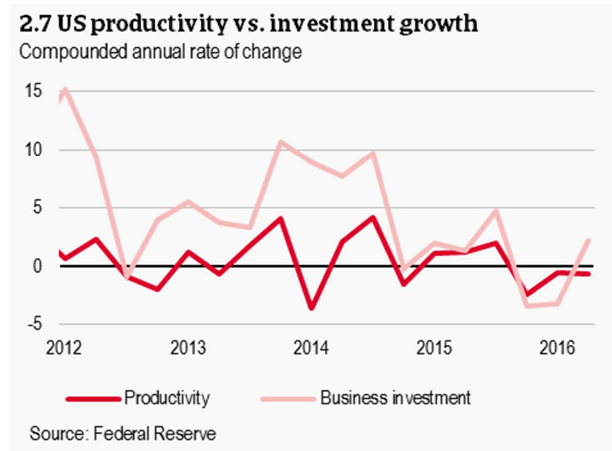
Since 2014, net exports have exerted downward pressure on growth. Import growth has been robust at 2.5% in 2016, a result of robust consumer demand. But this has not offset the weak exports. In the first half of 2016, total trade growth was flat, weighing on the global trade picture as discussed in Chapter 1.

The US dollar's 20% appreciation in trade-weighted terms from mid-2014 to end-2015 has strained US exporters already challenged by weak external demand. The US dollar will likely remain strong in 2016 and 2017 as its strong economic outlook and (very slightly) higher interest rates compared to other advanced economies increases its relative attractiveness. As a result, net exports will contribute negatively to growth again in 2017.

Investment low, weighing on future potential growth

Investment has also fared very poorly in 2016. In fact inventory investment is forecast to shave 0.47 percentage points off of GDP growth in 2016. Contributions from fixed investment have fallen from +0.75 points to only +0.26. The drag on growth from inventory investments is a cyclical effect that does not necessarily point to negative underlying factors for the US economy and will contribute positively (though minimally, 0.08 points) to GDP growth in 2017 again. Fixed investment though is contributing only one-third as much to 2016 growth as it did in 2015.

2.7 US productivity vs. investment growth
Compounded annual rate of change



Source: Federal Reserve

The rate of growth in business investment has been steadily decelerating from nearly 10% y-o-y in Q4 2015 to zero most recently. Growth has been flat this year even contracting slightly (-0.2%) in Q1. Why has business investment been falling while record low interest rates provide cheap money and consumer demand rises?

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[22] As measured by the Bureau of Labor Statistics' Employment Cost Index.
[23] JP Morgan Chase Institute, July 2016. "The Consumer Response to a Year of Low Gas Prices: Evidence from 1 Million People."
[24] The correlation between house prices and consumption is especially strong for older homeowners, important as the US population ages. Refer to "How do house prices affect consumption? Evidence from micro data," Journal of Monetary Economics, April 2007.

The primary reason for subdued business investment is uncertainty. Fed policy, tepid GDP outlook, strong dollar, and weak external demand all contribute to uncertainty about profitability in the future. This uncertainty is now exacerbated by the election of Donald Trump as president. There is a serious lack of clarity regarding the direction and feasibility of the president-elect's economic policies. Uncertainty motivates firms to forego long-term investments in favour of share buybacks and mergers and acquisitions to generate higher earnings.

The fall in investment is concentrated in the oil and gas sector, but this sector also makes up the majority of business investment in the US economy. In line with the slightly brighter outlook for the price of oil alongside strides in productivity and cost effectiveness, the rate of bankruptcies and the slowdown in investment appear to have peaked. This could be further aided by the deregulation of the energy sector pledged by Donald Trump. 2017 will remain difficult as firms must continue to operate in a low price environment below USD 60 per barrel, but those who have weathered the sub-USD 40 prices are finding stability. Manufacturers should also see a fading away of the negative effect of the US dollar in 2017 now that its strengthening has slowed.

Underlying mediocre investment growth in the United States though is the more fundamental problem of declining productivity – a trend likely reinforced by weak business investment. Productivity growth, as measured by the annual change in the real output per hour worked has been negative for the past three consecutive quarters – the worst performance since the 1970s. The slowdown in productivity since late 2015 is primarily due to capital deepening, the process of increasing output through new technology, which is growing at its weakest rates in over 60 years, largely due to the slowdown in business investment.[25 26]

Momentum to keep up in 2017

Despite some underlying structural weakness and subpar inflation, the strong tightening of the labour market through 2016, which is supporting robust economic growth, is making the case for a Fed rate hike of 0.25 basis points in December 2016 increasingly strong. At the same time, the uncertainty of the future Trump presidency could motivate the Fed to wait and see until early 2017. In any case, the tightening cycle will be very gradual, allowing the domestic economy to withstand the increase in borrowing costs.

The US economy is forecast to grow 2.2% in 2017. While net exports continue to weigh on growth, consumption will maintain its role as the primary growth driver. Moreover, business investment is set to recover gradually (+2.7% in 2017) as the energy sector adjusts to the new normal of lower-for-longer oil prices.

United Kingdom: Brexit means Brexit?

"Brexit means Brexit" proclaimed the newly-elected Conservative prime minister, Theresa May, in July 2016 following the British electorate's vote to leave the EU in the June referendum. While this offered but a small grain of certainty at a very uncertain time, even this has now been called into question as the High Court ruled that only Parliament has the power to trigger Article 50. The economy's reaction to Brexit thus far has been resilient but uncertainty increasingly clouds the 2017 outlook.

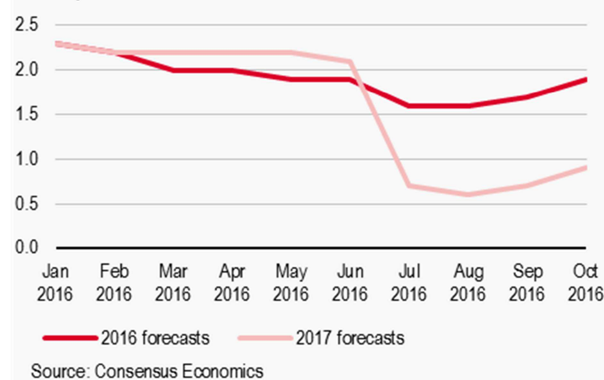
Economy shows resilience

The vote to leave the EU came as a surprise to markets which produced some initial volatility. The purchasing managers' index (PMI; an indicator of business conditions) saw its largest month-on-month drop ever and fell sharply into negative territory unseen since April 2009. The pound lost 9% of its value in one day. GDP forecasts for the UK for 2016 and (more strongly) for 2017 were cut as analysts began fearing the worst. But the severity of these initial jitters has largely been reversed and the economy has been surprisingly resilient through 2016.

Economic forecasters sharply reduced their GDP predictions for the UK in 2016 and 2017 from June to July. The consensus view for 2016 slid 0.3 points to 1.6%, while for 2017 it was brought down 1.4 points in one month to 0.7% (presented in Graph 2.8).

2.8 UK GDP growth forecasts

Monthly consensus forecasts for 2016 and 2017



Source: Consensus Economics

However, a great deal of uncertainty was eliminated when the new prime minister swiftly took office and the Bank of England took decisive monetary measures to limit the financial and economic fallout. Business and consumer sentiment indicators have both rebounded since July and currently stand in expansionary territory. The most apparent tailwind for the British economy has been the

[25] Refer to ECB Economic Bulletin, Issue 2 / 2016 – Box 1.
[26] In-depth analyses were undertaken by both the IMF and OECD in 2015. IMF World Economic Outlook April 2015 and OECD Economic Outlook June 2015.

increased export competitiveness wrought on by a weaker pound. As of October, the 2016 annual growth forecast has recovered all the ground lost after the vote. It is now relatively stable at 1.9%.

But it is not out of the woods yet

The risk of recession has been delayed thanks to the rapid appointment of the new prime minister and aggressive monetary stimulus but the outlook for 2017 and beyond remains exceptionally uncertain. While the weaker pound eases pressure on the sustainability of the UK's large current account deficit, the accompanying adverse effects will come into play in 2017.[27]

Inflation has risen from 0.3% y-o-y in January 2016 to 1% in September largely due to the exchange rate. The weak pound pushes up the costs of imports – a trend which is expected to cause prices to rise 2.3% in 2017. While rising inflation could limit the BoE's (already very limited) monetary toolkit, it should not produce major problems if it remains close to the 2% target.

PM May has committed to triggering Article 50 of the Lisbon Treaty by late Q1 2017, commencing the official negotiations of the UK's exit from the EU. But there is still no roadmap to indicate the UK's future relationship with the EU. As such, 2017 will be marked by uncertainty regarding the UK's future relationship with the EU which will weigh on economic growth, particularly through the investment channel. Fixed capital investment is expected to contract nearly 8% in 2017, compared to a 1% expansion this year. Uncertainty combined with rising inflation will also weigh on consumer sentiment and consumption which is set to contract 2% in 2017 compared to 2016.

At this point, the UK looks set to see 0.9% growth in 2017, a sharp slowdown but not as severe as previously expected. Looking forward beyond 2017, the outlook is increasingly uncertain – especially as a 'hard' Brexit, one that opts for national sovereignty over single market access, becomes increasingly likely.

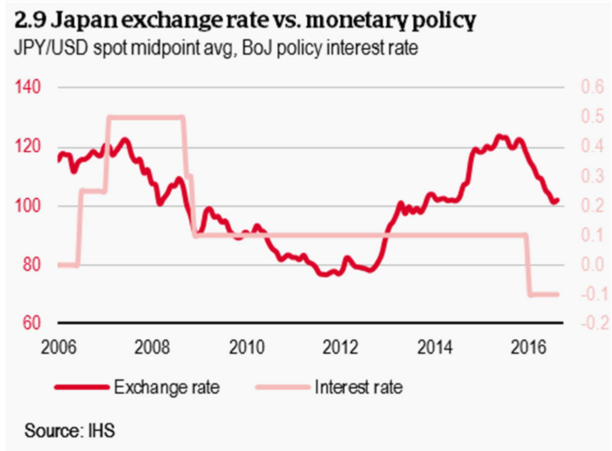
Japan: how low can you go

There is no end in sight for Japan's lacklustre economic situation. With 0.6% GDP growth forecast, 2016 is the third consecutive year of sub-1% growth. The economy is also still stuck in a deflationary rut, all despite the government and central bank's increasingly aggressive stimulus programme.

Prices in Japan have fallen for the past five months, marking the longest deflationary spell since 2013. There are many external factors weighing on prices – namely the strong yen and low oil prices – while inflation expectations have stayed very low, risking a self-fulfilling prophecy. Despite increasingly aggressive commitment to raising inflation to above 2% even, the outlook remains subdued. The oil price has found its floor yet this is not translating into upward pressure on inflation in Japan. Instead, deflation is spreading to other parts of the economy, like consumer goods, caused by the sharp appreciation of the yen. This is reflected in core inflation, which excludes volatile items like food and energy prices, which was *zero* as well in September compared to September 2015.

2.9 Japan exchange rate vs. monetary policy

JPY/USD spot midpoint avg, BoJ policy interest rate



Source: IHS

The yen has appreciated some 14% vis-à-vis the USD in 2016, despite the ultra-loose monetary stance of the Bank of Japan. Its safe haven role and market perceptions that it is undervalued are driving the rise. The yen will remain strong in 2017 which will continue to weigh on exporters and business sentiment. Inflation is expected to return to positive territory as commodity prices slowly recover, but only to an expected 0.4%. The consensus outlook for 2017 GDP growth is 0.9%, supported by large fiscal stimulus to the tune of 0.5% of GDP. But this could prove optimistic with key downside risks being failures of the stimulus to effectively boost demand.

[27] The sustainability of the UK's current account deficit was discussed in the May 2016 Economic Outlook. The appreciation of the pound is helping the sustainability of this deficit by boosting exports and decreasing the value of EUR-denominated external financing requirements in GBP terms.

3. Emerging economies – prospects and risks

Table 3.1 Real GDP growth (%) – Regional

	2015	2016f	2017f
Asia-Pacific (excl. Japan)	5.9	5.7	5.6
Eastern Europe	0.6	1.5	2.3
Latin America	0.3	-0.3	2.1
MENA	2.1	3.2	3.2
Sub-Saharan Africa	3.4	1.4	2.9

Sources: Consensus Forecasts (Oct 2016), IMF

Slowdown bottoming out but risks remain

The economic slowdown in EMEs as a whole is expected to bottom out this year at 3.9%, before accelerating to 4.5% in 2017. A recovery in commodity prices, especially of oil, will ease pressure on national finances and support economic growth in most commodity-exporting countries. For some of the largest EMEs, particularly in Latin America, domestic developments anchored by more market-friendly policymaking will support 2016 and 2017 growth. China is still levelling off, with a hard landing remaining a key, though improbable, risk to our outlook.

Despite the recent economic slowdown in most emerging markets there is an enormous appetite for emerging market debt as seen in the successful sovereign bond issues of Argentina and Saudi Arabia. Not entirely risk free, it underpins the search for yield explored in Chapter 1. Although it is helping these countries to finance their deficits it is also making them more vulnerable to international investor sentiment. For instance, a surprise rate hike by the US Fed could put an end to the search for yield and pull capital from the EMEs towards the US, the most significant risk to our outlook, as presented in Table 1.2. Countries with high external dependencies – high financing needs, dependency on volatile portfolio flows, a high degree of commodity dependency, low buffers and high external debt – are most exposed.[28] The uncertainty leading up to and after the US elections has demonstrated again the risk of fluctuations in international investor

[28] See "US interest rate rise: emerging markets at risk", Atradius Economic Research – December 2015.

sentiment on EMEs. The countries most exposed to external developments such as Brazil, Turkey and Mexico have seen their currencies depreciate again.

Emerging Asia: relatively high growth but mixed outlook

China, India and the main Southeast Asian economies are performing well economically; keeping the region the main engine of global growth. The outlook, however, is mixed. For India, risks concerning high levels of external corporate debt are manageable and probably will not endanger the rosy outlook. Indonesia and Malaysia can cope with their vulnerabilities to weaker financial markets sentiment in an adverse scenario. China can avoid a hard landing of the economy, but will find it hard to compensate lower credit growth with raising productivity growth. Much lower GDP growth is in the cards for the region's giant.

Table 3.2 Real GDP growth (%) – Asia-Pacific

	2015	2016f	2017f
China	6.9	6.6	6.3
Hong Kong	2.4	1.3	1.7
India	7.6	7.6	7.7
Indonesia	4.8	5.0	5.3
Singapore	2.0	1.7	1.8
Taiwan	0.6	1.0	1.7

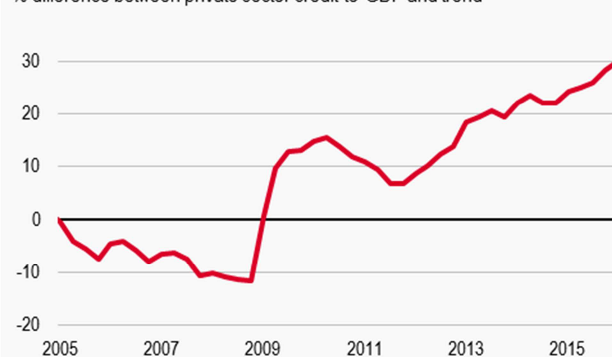
Source: Consensus Forecasts (Oct 2016)

China: no hard landing, but much lower growth still in the cards

The macroeconomic situation in China looks to be more stable than half a year ago, though the rising debt levels are still a risk. The Chinese economy expanded at an annual rate of 6.7% in the third quarter, exactly in line with the growth number in the first two quarters of the year and the government's target for the whole of 2016. The better than expected growth rate damped the worries of financial markets that China is heading for a hard landing of the economy. The government obviously is able to avoid a hard landing of the economy, a threat that led to turbulence on the financial markets in mid-2015 and early 2016. However, the fact that GDP growth is helped by strong expansion of credit, of which much is used for real estate sector developments and infrastructure projects, still worries economists, in China and elsewhere.

The Bank of International Settlements recently warned the combined amount of debt of governments, businesses and individuals in the second economy of the world sets the stage for a financial crisis. A crisis will not only affect China itself, but the entire world economy. It is not so much the size of China's total debt which creates this risk, but its high growth rate. Whereas debt was about 150% of GDP in 2008, it grew to more than 250% this year (and according to some sources to more than 300% of GDP). Because credit growth is much higher than the economy's growth rate, capital cannot be used in an efficient way for investment or consumption. The so-called credit gap (the difference between debt-to-GDP and the long-term trend) was 30.1% in March, which is now three times higher than the typical danger level and signalling unsustainable debt accumulation.

3.1 China credit gap
% difference between private sector credit-to-GDP and trend



Source: BIS

Enough tools to avoid hard landing

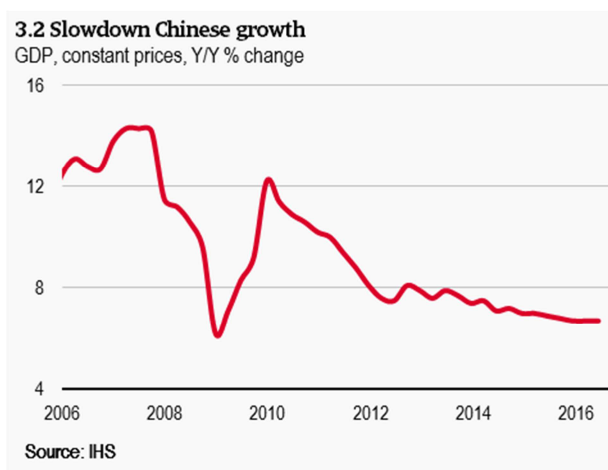
Hopeful is, however, that the Chinese authorities are aware of the risks. Urban governments have introduced measures to restrain house prices and advisers of China's president Xi Jinping criticised the overreliance on credit stimulus to fuel growth. Meanwhile, the Chinese authorities also want to avoid that deleveraging leads to a hard landing of the economy. Much of the debt is at lower governments and non-financial state-owned enterprises. The latter account for just 20% of industrial output, but absorb about half of all bank lending. The IMF urged the Chinese government to restructure highly indebted companies, especially in industries with overcapacity, like aluminum, cement, coal, construction, plate glass, and steel. The government is walking a tight rope here. It cannot cut credit too abruptly since that would create too much economic damage. But it has to moderate credit growth and restructure the sectors worst off to avoid a financial crisis.

China's low level of foreign debt is a mitigating factor in avoiding a hard landing. A debt crisis therefore will not be triggered by external developments and offers the government some time to deleverage SOEs and lower governments. And there are several more tools for the authorities to influence the growth rate: with moderate inflation and low public debt, there is room for both monetary and fiscal stimulus. Further, they can use the

exchange rate to stimulate exports and are in strong control in the banking sector. Because the bulk of the credits is public debt and lenders are often state-owned, banks can be instructed to refinance debt.

Weak long-term growth prospects

Since 1978, when China opened its economy for foreign trade and investments, GDP growth averaged a very high 10% annually. China was booming: whereas GDP was only one tenth of the US economy in 1980, it took over the number one position in 2014, if calculated on basis of purchasing power parity, and is the world's second economy in nominal terms. The global financial crisis led to a temporary dip in 2008 and a recovery in 2009/2010, but since then GDP growth is on a downward path (Figure 3.1).



Much has been written about the transition that China's economy makes from export-oriented investments to consumption-led growth. But this transition is only in an initial phase and has not been the reason for the growth slowdown up to now. Both private consumption and business investments contributed less to GDP during the growth slowdown in the last four years. And at the supply side the story is not different: the decline can be attributed to both the tertiary and the secondary sector (though the latter had the biggest impact).

Falling total factor productivity growth has been the main reason for the growth slowdown. Productivity growth already started to slow at the start of the century, but this was compensated for a large part by rising capital spending growth in the first decade. But whereas the latter remained stable in the last four years, productivity growth weakened from a healthy 5% in 2001-2005, to 3.8% in 2006-2010 and fell a bit faster to 1.5% in 2011-2013. Real GDP growth fell more or less in line with this.

Political climate does not help

There are good reasons to expect this trend will go further, before GDP growth stabilizes at a level of about 4%. According to economists at the Conference Board, China can only stop the trend if the government and Communist Party officials give market forces a large-enough role to stimulate innovation, which they don't think will happen. University of Groningen economists conclude on the basis of a survey of literature that it is uncertain whether the Chinese government is willing and able to play a supportive role, achieving reforms which lead to more urbanisation and restructuring and less imbalances.

Urbanisation helps because supply and demand of labor and goods match better in cities and knowledge-sharing is easier. China is, despite the large number of large cities, less urbanized than many other emerging economies at the same level of development. But there are several obstacles for further urbanisation. The 'hukou'-system has to be eased, because this hinders migration between regions. Infrastructure has to improve, because the connections between the coast provinces and the western part of the country are poor. And air pollution and traffic jams are also hindering further urbanisation.

Restructuring is mentioned as the way to modernize the Chinese economy and make the switch from low-grade industrial production to a modern center of innovation. The number of state-owned enterprises has declined in the last two decades, but in several sectors of the economy, they still play a dominant role. These SOEs in the oil, mining, telecom, utilities and transport sectors, are very large and capital intensive, and it is therefore difficult to privatize them. According to the World Bank more than 25% of these are not profitable.

Other impediments to support productivity growth are capital restrictions imposed by the government, which lead to misallocations of capital. Too much investment goes to the real estate sector and SOEs, and too little to the services sector. The earlier mentioned credit boom is just one result of this.

The key to raise productivity growth and create room for deleveraging would be to implement reforms. But this will be hard with a political climate characterised by authoritarian policies that tighten controls over civil society. It creates stability, but has a negative impact on the quality of policymaking. Controls over the education system, non-governmental organisations and the media are hindering long-term social and economic development. The government will be able to slow economic growth smoothly, thus avoid a hard landing and a financial crisis. The chance that it can support growth in a more structural way by reforms however is low.

India: it goes well as long as it goes well

In India, economic growth is on an upward path, with real GDP expected to reach 7.3% in 2016 and 7.5% in 2017. A stable political climate and reform-oriented policymaking

support India's status as one of the fastest-growing economies in the world.

Private consumption and government spending are the main drivers of India's sustained growth. Lower inflation induced by tight monetary policy is slowly restoring consumer confidence, whereas the government is investing in power infrastructure, one of the largest obstacles to India's economic growth potential. Growth of private-sector investments, however, is on the weak side.

Low commodity prices kept merchandise exports subdued but the trade balance deficit is partly mitigated by the satisfactory performance of IT-related services, which keeps the current account on a non-alarmingly negative position. India is only marginally vulnerable to muted demand in China, but as oil and commodity prices will climb in coming years, the current account deficit could deepen, given that the country is a net importer of crude oil, fuel and commodities.

Sound economic policies are contributing to faster economic growth. The Modi legislature has so far brought forward ambitious policies to promote urbanisation and improve connectivity and infrastructure, as well as finally unifying VAT across the country. FDI liberalisation, a modest reduction of the bureaucratic burden, merchandise output-enhancing initiatives and the activation of new power plants are likely to increase business confidence and stimulate investors' appetite further. However, since some bills need to be approved by both the Lower and the Upper House of Parliament, and the government has no majority in the latter, progress with reforms in sensitive areas is limited.

For the banking sector high corporate foreign debt is also a risk in the case of an adverse scenario. Banks improved their credit management, but their balance sheets continue to be weighed down by distressed assets, which for a large part is due to a lending spree in past years. Far more than other emerging economies, the potential expected loss from non-performing loans and current debt-at-risk is overwhelming bank loan loss reserves. The central bank tries to mitigate the risks for the banking sector by stimulating them to write-off non-performing loans, but this process is still in progress. The RBI's plans to ease some regulatory standards may reduce the pressure on balance sheets, but also mean that fully resolving the distressed assets on banks' and corporate balance sheets will be more difficult. Meanwhile, the government is too hesitant with recapitalizing state-owned banks. Low credit growth to the industrial sector is a reason for the declining trend in private investments in the last few years.

In general, India's economic outlook is promising. Downside risks related to high corporate external debt, NPL's and credit growth are manageable and will affect the country's growth outlook only in an adverse scenario.

Southeast Asia: private consumption supporting growth

Southeast Asian economies still report sustained economic growth rates for the short- and medium-term, but low prices of oil (Malaysia) and commodities (Indonesia, Thailand, Vietnam, Philippines), together with weakened demand from China keeps growth below potential. Currently, economic growth is mostly the result of sustained private consumption and recovering domestic sentiment. This, and robust fundamentals help to reduce Southeast Asian economies' exposure to trade shocks.

Indonesia, the largest economy in the region, is growing by 5% in 2016, and further acceleration is expected in 2017 because of economic policies' improvements and recovering investor confidence. The government has announced deregulations and fiscal incentives, to attract more FDI and encourage credit growth. Economic growth will continue to rely mainly on private consumption, as lower-than-forecast inflation rates increase consumers' purchasing power and a weaker rupiah augments import costs, maintaining the current account in a deficit position. Public finances are doing well, despite the negative impact of lower revenues from commodity exports and a structurally low tax base. The government has skipped and/or lowered subsidies on energy, keeping the budget deficit in control. While Indonesia is identified as one of the most vulnerable to shifts in investor sentiment, sound monetary policy and the fact that a large part of public external debt is long-term mitigate the risks.

Thailand's economy is growing faster than projections initially indicated (3.2% in 2016 and 3.3% in 2017), but will face headwinds from rising private debt levels, keeping it below potential. Tourism has held up well in recent years and the military junta has stimulated consumption and investments. Extensive fiscal populism is expected to be pursued until the next elections in late 2017. Lately both business and consumer confidence have picked up again. Household debt levels however are high as well as house prices, keeping a lid on growth and augmenting the risk of a housing bubble. Thailand is still suffering from low commodity prices and low export demand from China, which will reduce the current account surplus and widen the fiscal deficit gap further in the following years.

The economy of **Malaysia** is growing at a slower pace than expected (4.1% in 2016) because of low oil prices and China's muted export demand. Although private consumption is increasing, consumer and business confidence will only increase slowly over time. The ringgit will likely depreciate further in 2017 in light of tighter US monetary policy. Like Indonesia, Malaysia is vulnerable to weakening investors' appetite for emerging markets because of its relatively high level of debt denominated in foreign currencies. The financial mismanagement scandal

around Prime Minister Najib might negatively affect the general sentiment. Still, the consequences for political stability will be limited, even if the PM is forced to resign.

In **Vietnam**, economic growth was not largely affected by the recent drought (6.1% in 2016 and 6.5% in 2017). Agricultural output is picking up again, but persistent low commodity prices and sustained imports will bring the current account to a deficit in the upcoming years. Exports will grow again, though, since Chinese merchandise is being substituted by cheaper Vietnamese ones. Private consumption continues to contribute to economic growth because of low inflation, low local interest rates and rising wages. The difficult investment climate and low productivity of SOEs, which the government is only slowly addressing, continue to drag on the economy's performance.

The **Philippines'** economic performance is overshooting its projections (6.5% in 2016), on the back of increasing government spending and sustained private consumption. The populist measures passed by the Duterte government have been promoting infrastructure projects and are focused on empowering merchandise competitiveness and maintaining a current account surplus, but extensive spending might worsen the fiscal balance. Meanwhile, Duterte's statements about the public-private partnerships programme, which was set up to improve the infrastructure, is creating uncertainty among investors. If Duterte becomes increasingly authoritative and also jeopardises international relations (especially with the US), this will be a risk for the Philippines' economic outlook.

Latin America: toward recovery

Brazil and Argentina are set to exit recession next year following a return to orthodox policies. This will drive a recovery in domestic demand and will be positive for foreign investment. Growth in the region is also supported by easier monetary policies in most countries, excluding Mexico, on the back of lower inflation. Growth in the resource-rich region will also be supported by better external conditions. But overall, the recovery will be weak over the forecast period. Growth in some Caribbean countries might be negatively impacted by the UK's pending exit from the European Union (Brexit). And finally in Venezuela, there seems to be no light at the end of the tunnel, keeping default risks very high.

Argentina: short-term pain for long-term gain

The return to more market-friendly policies under the new administration of reform-minded President Macri has brightened the medium-term economic outlook, but the outlook remains challenging. The economy is currently in recession, which will deepen further before getting better. Fiscal consolidation is slower than anticipated because of political considerations, heightening the currency's vulnerability to shifts in market sentiment. Argentina's shock resistance is also limited due to still low official reserves.

Table 3.3 Real GDP (annual % change) - Latin America

	2015	2016f	2017f
Argentina	2.5	-1.6	3.2
Brazil	-3.8	-3.2	1.2
Chile	2.3	1.6	2.1
Colombia	3.1	2.2	2.8
Mexico	2.5	2.1	2.2
Peru	3.3	3.8	4.2
Venezuela	-5.7	-10.3	-3.5

Source: Consensus Forecasts (Oct 2016)

Political uncertainty has much improved under President Macri's administration. This helps with an ambitious transition toward a better, more orthodox, economic policy framework. Foreign-exchange controls have been removed and the heavily overvalued peso was devalued by 30%, costly energy and transport subsidies were reduced, terms with holdout creditors were agreed and access to international capital markets was restored. The central bank formally announced the adoption of an inflation-targeting regime at the end of September, a long-awaited move.

But the combined effect of a post-devaluation inflationary spike (> 40% y-o-y in August), cuts in energy and transport subsidies, and monetary policy tightening have fuelled social pressures. This is making fiscal consolidation much harder to achieve, given the minority status of the Macri government. Fiscal deficits will thus remain sizeable around 5% of GDP over the forecast period and the debt ratio will continue rising to over 50% of GDP (from 43% end-2014). The debt structure is relatively high risk (51% financed externally in foreign currency), making government finances vulnerable to exchange and refinancing risk. So far strong demand for Argentine debt mitigates the latter risk. The Argentine government is even able to borrow on international markets in peso as demonstrated by 10-year peso bond issuance in October.

Although liquidity has improved following the issuance of international bonds, it remains tight and is insufficient to cover gross external financing needs. This will keep the peso vulnerable to shifts in market sentiment as was illustrated since the Brexit vote. The peso has since depreciated by some 8% (and by 16% YTD), making it one of the weakest currencies this year.

Brazil: the worst is over

Brazil's economic outlook is improving following a much needed policy correction by the Temer administration. At

the end of August, the Senate voted to remove Dilma Rousseff from power, and confirmed Michel Temer as president through the end of 2018, removing a major source of political uncertainty. Since taking office in May, when the impeachment process began, Temer and his new economic team, started a much needed policy correction. The focus has been on dealing with Brazil's fiscal crisis, strengthening governance of state-owned enterprises and improving infrastructure.

The fiscal position has reached its worst level in over two decades, with a budget deficit at around 10% of GDP and debt at 70% of GDP. The debt structure is low risk, but the pace at which it is growing must be halted. A law to cap fiscal spending growth at the rate of inflation for the next 20 years is being reviewed with other fiscal measures addressing social security and labour bills in the pipeline. Progress on the fiscal front is essential in retaining business and investor confidence, which has much improved in the run-up to and during the new administration. The real has appreciated by 15% against the USD so far this year, making it the best performing currency this year. But it is clearly still susceptible to external developments: in the immediate aftermath of the election in the US, the real depreciated 6%.

Governability will continue to be hindered by the on-going *Lavo Jato* corruption investigations at the state-controlled oil company Petrobras, which have so far implicated numerous politicians (over half of Congress members). This will keep the currency vulnerable to shifts in market sentiment. But Brazil's shock resistance remains strong and underpinned by a flexible exchange rate, large official reserves and a sound banking system.

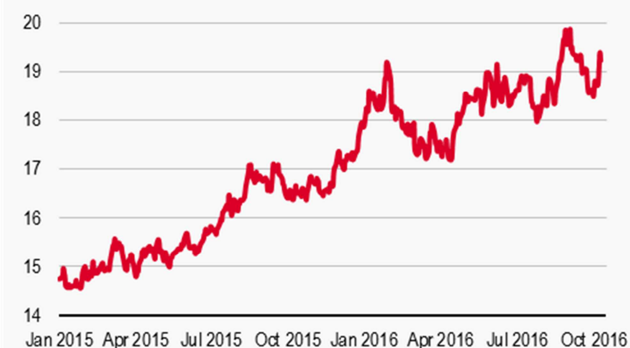
High frequency indicators show that Brazil's economy is turning a corner after two years of deep contraction (real GDP down 3.8% y-o-y in Q2 2016), on the back of improving business confidence. The recovery will remain weak overall though due to fiscal tightening, high and still rising unemployment (11.8% in August) and a less supportive contribution from exports. Exports have so far contributed positively to economic growth, but orders indicate weakening; possibly reflecting real appreciation.

The external sector remains strong, underpinning Brazil's shock resistance. The current account deficit has narrowed further this year and is expected to end the year at around 1% of GDP (from 3.3% in 2015). This was mainly due to import compression. The deficit is forecast to remain that low over the forecast period. Foreign direct investments (FDI) have held up and provide more than enough cover.

Mexico: dealing with a soft patch

Mexico is in a soft patch of 2% growth with risks to the outlook heavily to the downside on the back of policy tightening and uncertainty following Trump's election victory. The peso has been adversely affected by developments in the US presidential election, depreciating 15% so far in the aftermath of the election (23% YTD). The exchange rate is moving effectively as a shock absorber as international investors become more averse to Mexican assets due to its close trade and remittance ties to the US that are now at stake. In response, the central bank has raised interest rates several times to prop up the peso and limit the impact of depreciation on inflation and we expect the bank to continue doing so. While this confirms Mexico's solid policy framework, it will also weigh on GDP growth.

3.3 Mexico exchange rate
Peso per USD



Source: IHS

The government continues to make steady progress with the implementation of its impressive structural reform agenda. The telecommunications reform has resulted in lower tariffs and new entrants into the market. The ground-breaking energy reform is entering a critical stage: on December 5, tenders for the fourth round, which will include the more attractive deep-water blocs, will be held. Interest from major oil companies is growing: according to press reports, oil majors such as Shell, Chevron, ExxonMobil, BP, Total, Repsol and Statoil are among the 21 companies registered to bid for the blocks. This will bring in much needed investment and new technology into the ailing energy sector. It is already improving its governance as companies working in the sector are doing their utmost to get the needed certifications to tie up with the foreign companies. Mexican law forces these foreign companies to work with local companies; but these can only do so if they have the required certifications.

Concerns about government creditworthiness also increased despite additional policy measures. This has to do with a growing government debt ratio (to 56% of GDP in 2016 from 50% in 2014) and rising spending pressures, which are partly related to problems at state-owned and heavily leveraged oil company Pemex. Despite major cost-cutting plans and debt restructuring, the company might need additional support next to the – still relatively modest – already provided capital injections, reduced tax

tariffs and credit lines from state-owned banks. However, according to our base scenario of gradually recovering oil prices and continuing adjustments by both Pemex and the government, we continue to believe that a major shock will be prevented.

However, risks to the outlook continue to be mitigated by Mexico's strong shock absorbing capacity which is underpinned by sound policies, a stable macroeconomic environment, a flexible exchange rate, moderate external refinancing needs and sufficient buffers, which are supported by a precautionary credit line with the IMF.

Other Pacific Alliance: adjusting to low commodity prices

Chile, Colombia and Peru are showing robust economic fundamentals, but economic performance potential has not been met by all three countries alike. Whereas Peru has reported slightly higher economic growth rates than previously forecast because of renewed domestic confidence, Chile and Colombia are undershooting initial projections as a consequence of deteriorating domestic sentiment. All three countries still suffer from low oil and commodity prices, but continue to use their exchange rates as a shock absorber. In Peru's case it is increasingly so, as the country is transitioning from a managed to a floating exchange rate regime. To limit inflationary pressures, Chile, Colombia and Peru have raised their policy rates, showing robust macroeconomic policies. The outlook is moderately positive and is supported by a modest recovery in commodity prices. Pacific Alliance members have recently agreed that boosting international trade is essential to achieving sustained economic growth, and plans for merging Mercosur with the Pacific Alliance and integrating the members' financial systems are ongoing.

GDP Growth in **Chile** is more sluggish than expected, at 1.6% in 2016 and 2.2% in 2017, due to the low copper price and faltering domestic sentiment. Chile is vulnerable to weakening growth in China, and a decline in foreign trade contributes to less positive economic performance. Uncertainty over the government's reform agenda continues to depress confidence and investment. Finally, relatively high household debt and a potential housing bubble are negatively impacting economic growth.

House prices in Chile have risen 17% in real terms over the past five years and low interest rates are motivating small investors to obtain (more than one) mortgage loan per household. As a result, household debt is growing (42% of GDP in 2016, up from 32% in 2011), with households now allocating 30% of their income to servicing their debt. Loan delinquency rates for bank debtors remain stable at low levels. It is unlikely that these conditions will exacerbate systemic risk. But both the pace of growth of household debt and house prices raise the possibility of a housing bubble, which would negatively impact growth.

On the plus side, Chile is addressing this risk. To prevent prices from rising further a 19% VAT has been applied to new properties and mortgages should be provisioned only when they are within the loan-to-value threshold of 80% to reduce domestic demand.

Colombia's economic growth is expected to increase 2.2% by the end of 2016 and 2.8% in 2017. These estimates are more pessimistic than previously forecast because of growing domestic concerns, since the much-needed fiscal consolidation has been delayed to prioritise the peace agreement referendum with the FARC. The deal with the rebels has been surprisingly rejected by 50.2% of the voters. The voter turnout however was below 40%. Although the ceasefire will be maintained until December 31st, investments and consistent government spending destined to the regions under the rebels' control will be further delayed. On a more positive note, the government has recently sent a long-awaited tax reform bill to Congress, helping to maintain credibility in the country's fiscal framework. External factors, such as low oil and commodity prices, meteorological extremes (the multiyear drought has been followed by the floods of Hurricane Matthew) and the implosion of Venezuela's economy will keep current account deficits relatively large and economic growth below potential over the outlook period. Inflation is on a downward path as a result of a proactive increase in the policy rate. Relatively large albeit declining current account deficits keep Colombia vulnerable to shifts in market sentiment. But its shock absorbing capacity is strong and underpinned by a flexible exchange rate and sufficient official reserves. The latter are supported by a Flexible Credit Line with the IMF, a signal that the country relies on a robust macroeconomic policy framework.

Peru's economic outlook is improving, with growth reaching 3.7% in 2016 and 4.2% in 2017. The victory of the centre-right candidate Pedro Pablo Kuczynski in the July elections has reduced uncertainty and revived domestic confidence. An increasingly friendly business environment is likely to support investors' confidence and economic growth in the forecast period. Progress with productivity enhancing reforms is expected to be limited as policy making is restrained by the small majority of the President's party and strong opposition. Kuczynski has strengthened ties with the US and China aimed at increasing investments in the Peruvian mining sector and its infrastructure. The current account deficit still suffers from low commodity prices (especially copper), but shrinking imports will help narrow the still-small deficit in the short term. Inflation is returning to the 1%-3% target band following the effect of recent policy hikes. Public and external debt levels are relatively low as a result of prudent fiscal policy. The government is actively managing its debt, and has issued a USD 3 billion twice-oversubscribed sol-denominated bond in an attempt to reduce its share of dollar-denominated debt and increase

liquidity in the local securities market. These developments illustrate Peru's solid policy framework, which combined with large official reserves underpin the country's shock absorbing capacity.

Central and Eastern Europe: improving each year

Central and Eastern Europe (CEE) is forecast to see growth pick up to 1.5% this year after a weak 0.6% expansion last year. This is primarily due to better performances in Russia and the CIS which have stabilised and are now set to expand in 2017 as a result of rising oil prices. Turkey on the other hand has slowed down in 2016 and will likely remain at the lower growth rate of 3% next year due to heightened political risk.

Table 3.4 Real GDP growth (%) – Eastern Europe

	2015	2016f	2017f
Czech Republic	4.6	2.5	2.5
Hungary	2.9	2.0	2.6
Poland	3.6	3.1	3.3
Romania	3.8	4.8	3.3
Russia	-3.7	-0.6	1.2
Turkey	4.0	3.0	3.0
Ukraine	-9.9	1.1	2.5
CIS	-2.6	-0.1	1.6

Source: Consensus Forecasts (Oct 2016)

With the exception of Romania, the major economies of Central Europe are also seeing lower GDP growth in 2016 compared to last year. Political uncertainty has also risen in these markets due to increasing anti-establishment sentiment similar to that in the US and Western Europe. Lower EU development fund inflows are constraining growth in the Czech Republic, Hungary and Poland. The 2017 outlook for these economies is improving, anchored by tightening labour markets, robust private demand, accommodative monetary policy and fiscal loosening.

Russia: recovery is imminent as buffers run low

Supported by the gradually climbing oil price, the Russian economy is showing signs of stabilisation. While in 2015 the economy shrank by 3.7%, in the first half of 2016 the pace of contraction decelerated markedly – to 1% and 0.5% in the first and second quarter respectively. In Q3 Russia is even expected to return to growth and for 2017 full year growth of 0.7% is forecast. This is indeed subject to the higher oil price holding above USD 50 per barrel.

While marking a recovery, the 2016 GDP figures are weak and are solely driven by consumption. Confidence has been improving since early spring this year, helped by the decline in the unemployment rate to 5.3% in July from 6% earlier in the year. Real wages were on the up again as well now that public sector wages received a boost of 10%. The slowing of inflation to 6.9% in August, from almost 16% in 2015 has helped as well; while the oil price recovery has boosted the rouble. Even business confidence has gone up, marked by the level of the PMI which is now hovering around 50, the threshold level for growth. As a sign of fiscal prudence, the government contribution to GDP remained neutral as the overall deficit remained unchanged at 1.8% of GDP until August. Investment however remains very weak and the international sanctions are seriously hampering financing. Moreover, profits of firms have been flat so far this year. Trade even contributed negatively, primarily due to lower exports as imports started to recover with consumption.

Meanwhile, the Russian authorities have a reputation to tread carefully with the use of monetary policy and fiscal policy. We have discussed that already in our previous Outlook and observed that even the IMF struck an appreciative tone in this regard.[29] While Russia has broadly lived up to its reputation so far, the international sanctions imposed by the US and EU clearly have started to bite, posing a real threat.

With respect to monetary policy the key variable to watch is the rouble exchange rate to the US dollar. Given that the rouble has appreciated 20% on an annual basis, the upward pressure on inflation has been released. Even better, in August the first month of price stabilisation was observed since 2011. While this figure is relevant for assessing current economic conditions, for monetary policy purposes the inflation expectations are more important.[30] These are now lower, but still high at 12.6% in August, and, more importantly, much higher than the central bank target of 3%. This explains why there have been no further rate cuts since June when it was set at 10.5%. The fear is simply that as the economy is still close to full capacity, rate cuts might only spur inflation. Monetary policy stimulus is then to be predominantly underpinned by further rouble appreciation, which in turn depends primarily on the oil price. With the latter to be slowly increasing, there may not be much room for monetary stimulus in the short run.

On the fiscal side, Russia treads carefully as mentioned. Despite quite optimistic assumptions of an oil price of USD 50 per barrel and 1% economic growth, the budget deficit has been managed closely. Revenue stress was met by cuts in expenditures (-2% in real terms in H1), with social security falling 3% in real terms and even (official) defence spending lower at 3.5% from 4% last year. Pain was felt in subsidies to firms and education (-4%). The result for 2016 will be a 3.5% budget deficit, broadly

[29] Such tone was reiterated in the 2016 article IV consultation report. See IMF country report Russia, July 2016, 16/229, and even widened as they have, according to the IMF, helped soften the impact of the oil price shock.
[30] It is indeed inflation expectations, rather than current inflation, that are supposed to steer economic behaviour. Therefore, inflation expectations matter.

unchanged compared to last year and thus providing no stimulus to the economy.

While the fiscal stance is to be lauded as such, it is pro cyclical, and thus reinforcing, rather than softening, the recession. The snag is in the international sanctions that effectively bar Russia from access to the international financial markets.[31] To finance the deficit Russia now depends on its own reserve funds. The most liquid one, the Reserve Fund, is to be depleted to USD 15 billion by the end of the year, down from USD 50 billion early in 2016 and USD 85 billion in 2015. By mid-2017, it may run dry, triggering the tapping of the Welfare Fund of USD 72 billion. With this fund being far less liquid, aggressive withdrawals may be difficult. Russia may then have to turn to budget deficit reductions, straining already lacklustre economic growth forecasts.

3.4 Russia: international reserve fund

USD billion

With constrained monetary and fiscal policy, growth is set to remain very low in an economy that is producing very close to its potential. Potential growth can only be increased by improving the business climate. That will spur badly needed investment outside the energy sector. At the same time, such improvements are highly unlikely as it will affect the vested interest of the Russian elite around President Putin. Recent elections have confirmed the strong parliamentary support for the ruling United Russia party and the popular standing of President Putin remains invariably high at 77% in August. As long as this rating is strongly helped by an assertive foreign policy stance, international sanctions are not likely to be lifted and technology transfers as well as finance will remain tight. Russia, therefore, is set to face a period of very low economic growth.

Turkey: heightened political risk following failed coup

Subdued economic growth, high external financing needs and a vulnerable currency drive elevated credit risk in Turkey. The events since the failed coup and the ensuing state of emergency reinforce trends already put in motion that are negatively impacting country risk: concerns about the security situation, the political situation, institutions and independence of the central bank. The events will have lasting implications for Turkey's domestic political outlook, as well as destabilising effects on foreign relations and the economy.

Following the failed coup of July 15th, President Erdogan has tightened his grip on power. He has responded by intensifying his purges on military, judiciary, police and teachers and has imposed executive presidential rule. This has added to *de facto* concerns about institutional quality and rule of law and is straining relations with the EU and US. There is now a power struggle, in which Erdogan is strengthening his position at the expense of – alleged – opponents. This has deepened the conflict with the Kurds and worsened the security situation; the ongoing civil war in Syria and the fight against IS also playing a role.

Policy risk has further increased as policy has become more unbalanced after the (forced) leave of Prime Minister Davutoglu last May, who was in favour of more orthodox macroeconomic policies with an independent central bank. In the past months, the central bank has cut rates further. Even though inflation is falling, it is still above the target of 5%. Monetary policy is generally considered to be inappropriately loose given Turkey's macroeconomic fundamentals, including very low savings rates, persistent current account deficits, high external financing needs and still elevated inflation expectations.

The failed coup and the government's response is expected to have a negative impact on the economy. Weak business and consumer confidence and increased financial market volatility will dampen consumer demand and fixed investment. Additionally, heightened security risk will weigh negatively on the tourism sector and could counterbalance the positive impact of the lifting of Russia's economic sanctions against Turkey last July. Real GDP growth is expected to slow from 4% in 2015 to 3% over the forecast period. The moderation of the current account deficit has stalled and the deficit is now expected to stabilise this year at around 4.5% of GDP before widening to around 5% in 2017 on the back of gradually rising oil prices.

Although the initial sell-off of Turkish assets that hit equity prices and the Turkish lira was relatively short lived, the currency will remain vulnerable to shifts in market sentiment (the currency has depreciated by 12% YTD vis-à-vis the USD). Turkey’s shock absorbing capacity is limited due to relatively low official reserves, which are insufficient to cover the external financing need, and still high dollarization. The latter somewhat limits the shock absorbing role of the exchange rate and might necessitate regular interventions, putting downward pressure on official reserves. That said, shock absorbing capacity is underpinned by sound government finances, a healthy

[31] The bond sold in May was for a low amount (USD 1.75 billion) and very expensive at 7%.

banking system and still good access to international financial markets. This access is key to financing large infrastructure projects that are part of president Erdogan's "agenda 2023", when the Republic of Turkey celebrates its 100th anniversary. In our base scenario we therefore do not expect a complete loss of trust by financial markets.

MENA: consolidation efforts on their way

Political instability and the lower oil price are constraining economic activity in the Middle East and North Africa (MENA). Economic growth of 3.2% is expected in 2016 and 2017 as the positive impact from increasing oil prices will be offset by the fiscal consolidation measures taking place in several countries in this region. The main risks for the region are political instability and lower oil prices.

Table 3.5 Real GDP growth (%) – MENA

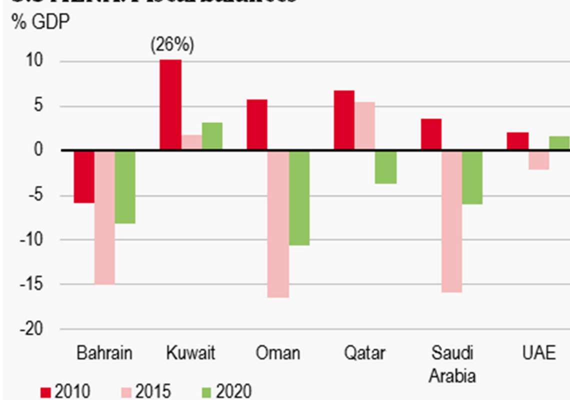
	2015	2016f	2017f
Egypt	4.2	3.0	4.6
Morocco	4.5	1.4	4.2
Qatar	3.6	3.5	3.8
Saudi Arabia	3.5	1.5	2.2
Tunisia	0.8	1.6	2.5
UAE	3.8	1.7	2.5

Source: IHS

Conflicts in Libya, Syria, Iraq and Yemen are having a negative impact on neighbouring countries, especially Lebanon and Jordan, through lower trade, investment and tourism. Accommodating the growing numbers of refugees is also putting pressure on public services in these countries.

Oil exporting countries are showing the lowest growth rates in years. For this year the average economic growth rate for the Gulf Cooperation Countries (GCC) is expected to decelerate to 1.7% from 3.4% last year. Declining export revenues, falling government revenues and the resulting cut in government spending are constraining economic growth. The sharp deterioration in the fiscal balances and an expected gradual increase in the oil price in the coming years call for substantial actions of the governments. Many have delayed investments, especially non-priority investments, subsidies have been reduced, and plans for privatisation have been announced. Even the introduction of taxes are on the agenda like the introduction of a VAT planned for 2018. With large deficits the sovereigns have increased their borrowing sharply in the past year.

Although there are some differences between the countries in their deficit financing strategies, depending on their buffers, most have drawn from their reserves (foreign reserves and sovereign wealth fund). But countries with low buffers, like Oman and Bahrain, are more dependent on domestic and external borrowing. Both have seen a sharp rise in public debt. Bahrain already has a high public debt as this country even had fiscal deficits in the period with high oil prices.



Oil-importing countries benefit from the lower oil price, but economic activity in these countries is being hampered by low confidence and lower tourism due to the weak security situation in some countries (Tunisia and Egypt) and spillover of regional conflicts (Jordan, Lebanon).

Saudi Arabia has taken drastic measures to reduce the fiscal deficit and to diversify its economy. Diversification of the economy is not only necessary to become less dependent on oil but also to create enough jobs in the private sector for the growing young labour force.

To consolidate the large fiscal deficit of 12% of GDP this year the authorities are implementing a cut in Minister's salaries of 20%, a reduction of the allowances of public employees, a reduction in subsidies on fuel, water and electricity, postponed investments and implemented a tax on land. In 2018 the introduction of VAT is expected across the GCC. Next to this the authorities announced plans to privatize public assets, even with the plan for a sale of a minor stake in Aramco. These measures are highly necessary as oil prices will not reach their previous highs and deficits of this size are not sustainable. Although Saudi Arabia has enormous buffers and large foreign exchange reserves, it does not want to deplete its entire savings. The financing of the deficit in 2015 resulted in a major decline (USD 116 billion) in reserves. This year the authorities will also draw from reserves, but they will increasingly turn to the international capital market. Recently, Saudi Arabia issued the largest emerging market bond of a sovereign ever (USD 17.5 billion). Due to the fiscal consolidation measures, lower government spending and private consumption, economic growth is slowing to 1.7% this year. Government arrears have increased in the past year, especially to the

construction sector. Next year a moderate recovery is expected to 2% in line with an expected higher oil price.

Sub-Saharan Africa: slowest growth in years

The economic slowdown in Sub-Saharan Africa is expected to bottom out at 1.4% this year. The largest economies in the region, Nigeria and South Africa, are particularly responsible for this slowdown. However, growth is unevenly divided in the region. Lower commodity prices, especially the lower oil price, are affecting the commodity-exporting countries, but the more diversified (eastern African) countries continue their high economic growth.

Table 3.6 Real GDP growth (%) – Sub-Saharan Africa

	2015	2016f	2017f
Ghana	3.9	3.5	5.2
Kenya	5.6	5.8	6.0
Nigeria	2.8	-2.0	0.3
South Africa	1.3	0.2	0.7

Source: IHS

Many commodity-exporting countries struggle with lower export revenues and lower government revenues resulting in high twin deficits and eroding foreign exchange reserves. Countries like Nigeria, Angola, Gabon and the Republic of Congo, all oil exporting countries, face challenging times. Angola and Nigeria have even introduced capital restrictions to preserve their declining foreign exchange reserves. In both countries foreign exchange shortages are hampering economic growth, although the situation is more severe in Nigeria. Countries where copper, gold or iron ore are the main export commodities are also seeing declining reserves. The depreciating currencies are resulting in higher debt servicing costs, which is particularly harmful for those countries where external debt has increased in the past years to finance their deficits. Not all is cloudy in the African region though, as the more diversified countries like Tanzania and Kenya are performing well. In line with a recovery of global commodity prices, economic growth will recover to 2.9% next year in the Sub-Saharan region.

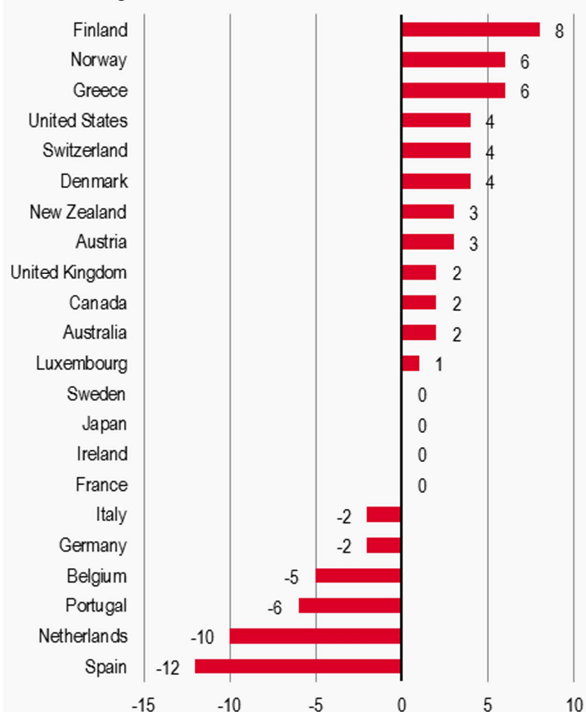
South Africa: Concrete downside risks

South Africa's economic growth has slowed down in 2016 to 0.1%. Faltering business confidence is deterring investments and China's declining demand for South African products has shrunk the current account balance. Brexit might trigger a reduction in capital inflows, which calls for urgent refinancing buffer measures. In Q2 2016 the energy and mining sectors revived, as reduced coal production in China increased foreign demand for South African coal and Eksom's enhanced capacity partially curbed electricity scarcity. The rand has recently appreciated against the USD, nonetheless inflation remains high due to the impact of El Nino drought's on food prices. Total government debt is rising but remains manageable, and only a small percentage of it is denominated in foreign currency. The banking sector is well capitalised and financial markets are deep and functioning well. Zuma's numerous scandals and its dispute with Minister of Finance Gordhan have affected recent municipal elections, weakening popular support for ANC. Policy uncertainty and protracted low economic growth could lead to a credit rating downgrade in the short term.

Nigeria: first recession since 2004

Nigeria has entered its first recession since 2004, with an expected decline of 1.7% this year. The lower oil price, reduced domestic oil production due to increased unrest in the Niger Delta, and the shortages of foreign exchanges have hit the economy hard. Due to a drop in imports (import restrictions and expensive imports) the deficit on the current account is declining to 0.7% of GDP this year. This relatively small deficit still has to be financed, but investor sentiment towards Nigeria has deteriorated due to the weak economic situation and introduction of capital restrictions, which resulted in capital outflows. Nigeria had to turn to some multilateral institutions to finance its deficits. It has recently received emergency loans from the World Bank and the African Development Bank. In June this year the central bank finally abandoned the fixed peg to the USD, leading to a sharp depreciation of the naira of around 50%. The expected improvement in dollar shortages did not happen (yet) and the Nigerian central bank did not abandon the capital restrictions. It also kept the ban on 41 import products to facilitate import substitution. These policies are highly ineffective and hamper economic activity. In addition, the financial sector is being affected by these dollar shortages. The situation in the banking sector already deteriorated due to their exposure to the oil and gas sector and foreign loans, leading to a sharp rise in non-performing loans. For next year a meagre 0.6% economic growth is anticipated, mainly due to an expected increase of the oil price.

4. Implications for the insolvency environment



Another difficult year but outlook improving

The 2.4% GDP growth forecast for 2016 is largely unchanged from our previous Outlook's forecasts, but the performance of advanced economies is not as strong as expected earlier in the year. Instead of strengthening, recoveries in the US and Europe have stagnated or worsened. As a result, full year insolvency growth is expected to lean toward further increases, especially in northern Europe and the US. Emerging markets on the other hand, faltering under financial volatility in early 2016, have largely weathered most turmoil and gradual recoveries are underway in major EME economies. While insolvencies are expected to continue rising in most EMEs (except for India), the increase is expected to be less severe than previously forecast. In 2017, the bankruptcy outlook in developed markets is more balanced with weak growth while insolvencies outlook in EMEs shows mostly increases with some stabilisation as countries emerge from recession.

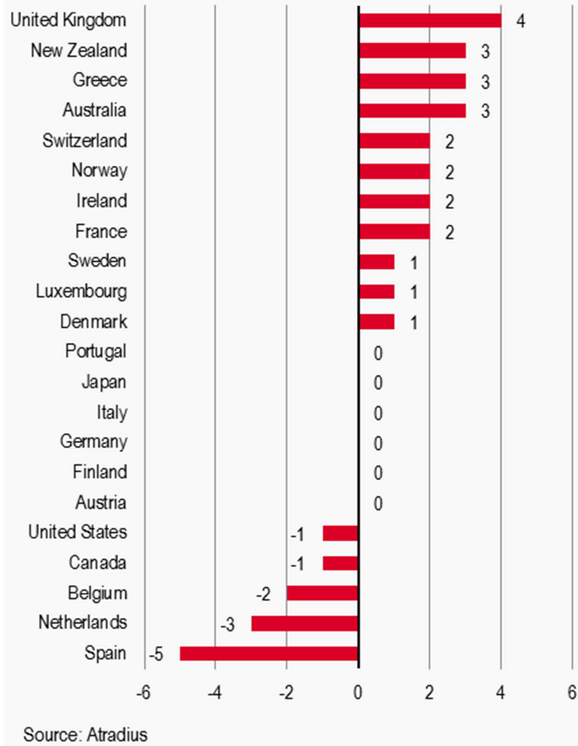
Insolvencies in advanced economies stabilising

At the aggregate level, the improving trend in the business environment across advanced economies is expected to come to a halt. Little to no change is expected in total insolvencies in 2016 and 2017. Changes in insolvencies are predominantly dependent on movements in the business cycle. As such, lower-than-expected 2016

GDP growth figures and largely stagnant recoveries imply a relatively stable insolvency outlook for most of the 22 advanced economies that we track.

4.2 Insolvency forecasts 2017

Percent change from 2016



Source: Atradius

In 2016 some countries are recovering from high insolvency rates, like Spain and Portugal, while other insolvency rates are moderate, such as in the Nordics except Sweden. For 2017 we expect no significant changes due to slow but steady growth in most developed countries.

In both 2016 and 2017, most improvement is expected in the Netherlands, Spain and Belgium. For the Netherlands, this follows a record high level of insolvencies in 2013 and is based on the expectation of robust economic growth over the coming period (1.8% this year and 2.1% in 2017). In Spain, while the magnitude of decline in insolvencies is strong, the level of insolvencies remains very high.

A schematic overview of the insolvency situation in advanced markets is illustrated in the Insolvency Matrix. All countries expected to see deterioration in their insolvency environment in 2017 are to be found in the top segment of the grid. Insolvencies are expected to increase by more than 2% in New Zealand, Australia, United Kingdom, and Greece. The majority of countries included in our forecasts are expected to display stable insolvency developments (i.e. a change in insolvency of no more than +/- 2%). The horizontal axis in the Insolvency Matrix depicts the absolute level of insolvencies – whether the frequency of insolvencies in a country is assessed as low, average or high – in a cross-country comparative context. As such, all countries perceived to be markets with comparatively high insolvency frequencies are to be found in the right-hand segment.

4.3 Insolvency matrix 2017

	Low	Average	High
Deteriorating	New Zealand	Australia, United Kingdom	Greece
Stable	Austria, Canada, Finland, Germany, Japan, Sweden	Norway, Switzerland, United States	Belgium, Denmark, France, Ireland, Italy, Luxembourg, Portugal
Improving	Netherlands		Spain

Source: Atradius Economic Research

All countries expected to see deterioration in their insolvency environment in 2017 are to be found in the top segment of the grid. In the upper right corner, in Greece it is expected that the insolvency rate deteriorates further from an already high level. For two countries insolvency rates are expected to improve considerably, the aforementioned recovering countries Spain and the Netherlands. The majority of countries included in our forecast however are expected to display a stable insolvency development this year (i.e. a change in insolvencies of no more than 2%). On the downside, for quite a few countries the number of insolvencies will stabilise or slightly increase in 2017 as bleak economic growth follows a period of economic stagnation. The expected increase of insolvencies in Norway this year (6%) follows weak economic activity stemming from the low oil price, causing unemployment to peak.

Brexit uncertainty weighing on insolvency outlook in UK and key trade partners

The United Kingdom is experiencing a relatively stable business environment this year with a small 2% rise in insolvencies expected. In Q3, UK insolvencies rose 2.2% compared to Q3 2015 – about two-thirds of that increase was in the construction sector. While some firms, particularly in manufacturing, are benefitting from the weak pound which increases the competitiveness of their exports, others are seeing the cost of their production input rise. Increasing uncertainty is also leading to postponement of business investment, which can be seen

in much slower new order growth in October compared to earlier in 2016.

The outlook for 2017 is worse – as uncertainty surrounding the negotiations with the EU rises and adverse effects from the weak pound set in. Higher inflation, largely driven from more expensive imports, along with uncertainty will put a dent in consumer spending next year which could have negative implications across a wide range of sectors, including the services sector which is the backbone of the British economy. Overall, sectors that operate primarily domestically are most vulnerable next year. At this point, we foresee a 4% rise in insolvencies in the UK next year, but this is subject to much higher-than-usual uncertainty.

The Brexit decision will also have moderate spillover effects on the EU in the short term through uncertainty in investment and trade. Countries with a large stock of FDI in the UK are seeing the euro value of their UK assets decline – the most vulnerable of which are France (+2% change in insolvencies in 2017), Luxembourg (+1%) and Netherlands (-3%). Countries that send a large share of their export goods to the UK will also suffer as their goods become more expensive to UK buyers. In this regard, the most vulnerable are the Netherlands, Norway (+2%), and Ireland (+2%). Across Europe, the most vulnerable sectors to the UK are transport equipment, food, textiles, electrical equipment and chemicals.[32]

Loose credit conditions fail to stimulate eurozone businesses in periphery

Credit conditions have continued loosening through 2016, as demonstrated by the ECB's October 2016 bank lending survey (BLS). Increased demand thanks to very low interest rates on short-term corporate loans supported loan growth in Q3. The overall outlook however is worsening as banks expect to tighten access to corporate credit in Q4 for the first time in two and a half years, due to increasing concerns about corporate profits in the current low rate environment.

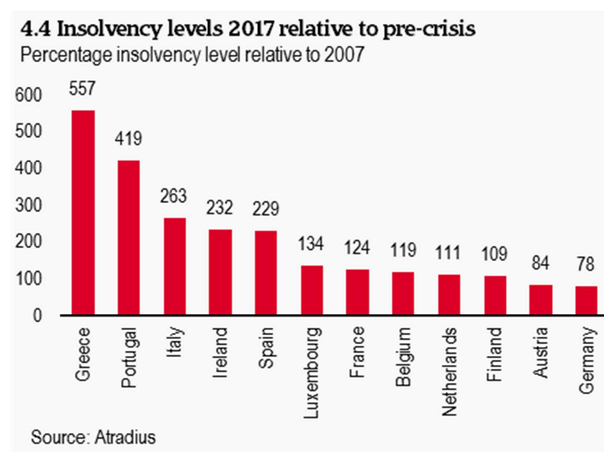
The recovery in business lending though has been concentrated in the stronger northern European countries, with Spain, Portugal and Greece seeing no improvement at all. This reflects weak balance sheets, corporate deleveraging and a lack of profitable investment opportunities. Weak solvency also makes it much more difficult for southern European banks to expand credit.

In the eurozone, changes in the supply of credit and the credit standards on loans to enterprises have a significant effect on real economic activity.[33] As such, lower access to credit has a real negative impact on GDP and thus also insolvencies. This bodes ill particularly for the peripheral eurozone countries that still have significantly higher insolvencies than before the financial crisis and are still not seeing meaningful improvements in bank lending.

Figure 4.4 illustrates a comparison of insolvencies with pre-crisis levels. Here, we set the 2017 forecast levels of insolvencies for developed countries as a percentage of their 2007 levels. The countries of the eurozone periphery, particularly Greece and Portugal still have extremely high levels of insolvencies relative to 2007. The Greek economy in particular still suffers from continued debt sustainability issues and economic distress, with Greek corporates held back by capital restrictions. The country is facing another year of economic contraction, with an increase in insolvencies forecast at 6%. Furthermore, Italy, Ireland and Spain also still face insolvency levels more than twice that of their pre-crisis levels.

4.4 Insolvency levels 2017 relative to pre-crisis

Percentage insolvency level relative to 2007



Source: Atradius

This tells us that, along with the current stabilising of insolvency rates, the low pre-crisis levels of insolvencies are not coming back for the peripheral euro area countries any time soon. Indeed, the current global stagnation of economic growth could indicate a new stable level of structurally higher incidence of insolvency in developed countries.

North American markets reaching turning point

Insolvencies in the United States are forecast to increase 4% in 2016 largely due to the strong USD and weak oil prices. The appreciation of the US dollar hurts the competitiveness of exporting businesses at a time when external demand has already fallen. While the oil and gas sector appears to be finding its footing in H2 2016, in line with the slight recovery in oil prices, many firms have filed for bankruptcy already in H1. Many firms in this sector are also highly leveraged, having taken on a lot of debt during the boom period, leaving them fragile despite rising prices and an improving economic outlook in the forecast period. Furthermore, banks have tightened their lending standards to corporates in H1 according to the

[32] See "Higher insolvencies anticipated in Europe following Brexit vote," Atradius Economic Research – June 2016.
[33] "Do bank loans and credit standards have an effect on output? A panel approach for the euro area," ECB Working Paper 1150, January 2010.

Federal Reserve Board's Senior Loan Officer Opinion Survey on Bank Lending Practices. In line with the imminent rate hike by the Fed, credit conditions will likely continue to tighten in the forecast period, but remain at record lows. In 2017, insolvencies are forecast to decrease 1% as firms adjust to more moderate oil prices as well as the stronger USD, though exporters will continue to face difficulties.

Canada is also facing an uptick in bankruptcies this year (+2%) also largely due to commodity prices, as Canada's oil is among the most expensive in the world. Businesses in the manufacturing, mining, quarrying, oil and gas extraction, and wholesale trade sectors are facing the greatest difficulties this year as these sectors are set to contract. Thanks to gradually rising global oil prices, it also appears that the worst is over for Canada as well, with corporate failures forecast to decrease 1% in 2017. Furthermore, as the US accounts for more than 75% of Canadian exports, so the stronger performance in that economy in 2017 should also support Canadian businesses.

Insolvencies expected to rise in BRIC markets, except for India

Emerging market economies are experiencing another difficult year in 2016 but the turbulence seen earlier this year has largely calmed down and the outlook for 2017 is slightly better. Credit conditions also continue to pose difficulties for corporates operating in emerging markets. Bank lending conditions deteriorated again in Q3 2016, according to the Institute of International Finance, the fourth consecutive quarter of tightening. The demand for loans weakened due to rising concerns about a risky business environment. While international investors may be more attracted to EMEs in their search for yield as risk perception relative to advanced economies has improved, credit risk remains elevated. Regionally, Latin America and Sub-Saharan Africa are the only regions that have seen an improvement in their credit risk metrics.

In general, economic conditions in many emerging markets have deteriorated, implying negative developments in their business environments. Commodity exporters suffer from lower natural resource prices, while the slowdown in China negatively impacts trade and finances in many markets. In addition, many emerging markets struggle with the expected rise in US interest rates and the stronger US dollar. EMEs are vulnerable to these external developments largely due to a build-up in external corporate debt, though shock absorbing capacity is strengthening.

Corporate debt in emerging markets has significantly increased in the aftermath of the global financial crisis, raising concerns about corporate creditworthiness in many of these markets and risks.[34] The firms most at risk for insolvency are those that are highly leveraged, with high shares of USD debt or low buffers. The stronger USD and relative depreciation of EME currencies makes the local currency value of their debt rise. Companies in Brazil, India, Indonesia, Russia, South Africa and Turkey are the most vulnerable. Taking a sectoral point of view, corporates operating in the energy, mining, construction and transport sectors are the most exposed while companies in the real estate sector are also vulnerable due to lack of hedging to foreign-exchange exposure.

Applying Atradius' insolvency forecast model to the largest emerging markets only provides a broad expectation of changes in insolvencies since the model has been built on data from advanced countries. With that caveat, the picture that appears is as follows.

Table 4.1 Insolvency growth

	2016f	2017f
China	Increase	Increase
Brazil	Increase	Stable
Russia	Increase	Increase
India	Decrease	Decrease

Source: Atradius

China, Brazil and Russia are experiencing increases in insolvencies in 2016. With China's economy slowing down and rebalancing, insolvencies are expected to increase substantially in 2016 and 2017. Companies face a change in funding conditions and in the structure of the economy as it rebalances towards more services and consumption, away from manufacturing. This is inevitably leading to shrinking business opportunities in the latter sectors, and insolvencies, with possibilities opening up in others.[35] The business environment in Russia has been struggling due to the low oil price and international sanctions, both contributing to a recession this year. This is driving the increase in insolvencies in 2016 but despite a return to economic growth in 2017, insolvencies are forecast to continue rising. This is partly due to the fact that the business climate remains inefficient and ruled by vested interests. Brazil is also forecast to emerge from recession in 2017, but its insolvency outlook is now stable, underpinned by improving business confidence under the new administration. India is forecast to see a lower number of corporate failures both this year and next as the economy grows robustly.

[34] See "A closer look at corporate debt in emerging market economies," Atradius Economic Research – May 2016.
[35] Note that the establishment of new firms as such drives down the insolvency rate due to the denominator effect (more firms drive down the ratio of insolvent and total firms).

Appendix: forecast tables

Table A1: Macroeconomic headline figures - Developed markets

	GDP growth (% change p.a.)			Inflation (% change p.a.)			Budget balance (% of GDP)			Current account (% of GDP)			Export growth (% change p.a.)		
	2015	2016	2017	2015	2016	2017	2015	2016	2017	2015	2016	2017	2015	2016	2017
Australia	2.4	3.0	2.8	1.5	1.2	2.2	-1.7	-1.6	-0.7	-4.8	-3.0	-3.0	6.0	7.0	3.6
Austria	1.0	1.3	1.2	0.9	0.8	1.5	-1.2	-1.6	-1.2	2.6	2.3	2.3	3.5	2.6	3.1
Belgium	1.4	1.4	1.3	0.6	1.9	1.9	-2.6	-2.7	-2.2	-0.8	2.4	2.8	4.8	3.0	2.2
Canada	1.1	1.2	2.0	1.1	1.6	2.3	-1.3	-1.9	-1.3	-3.2	-3.2	-2.3	3.4	0.7	1.9
Denmark	1.0	1.0	1.6	0.5	0.2	1.1	-1.4	-1.3	-1.1	7.1	8.2	9.6	0.3	1.9	5.3
Finland	0.2	0.9	1.1	0.1	0.3	1.4	-2.7	-2.5	-2.8	0.2	0.1	1.2	-0.2	1.0	2.0
France	1.2	1.3	1.2	0.0	0.3	1.6	-3.6	-3.2	-3.0	-0.2	-0.9	-1.2	6.0	0.5	0.7
Germany	1.7	1.8	1.3	-0.2	0.3	1.0	0.7	0.5	0.6	8.5	7.9	7.5	4.6	2.7	2.7
Greece	-0.2	-0.6	1.1	0.0	0.2	1.1	-7.2	-2.2	-1.5	0.0	0.2	0.4	-3.8	-7.5	3.1
Ireland	26.3	3.7	3.0	0.2	0.5	1.8	-1.8	-1.2	-1.0	10.2	8.2	9.3	34.5	4.4	3.5
Italy	0.7	0.8	0.7	-1.7	-0.7	0.5	-2.6	-2.5	-2.9	3.0	0.9	1.2	4.1	1.2	1.2
Japan	0.6	0.6	0.9	-0.3	0.3	0.8	-5.3	-6.6	-7.0	3.3	3.6	3.2	2.8	-1.5	1.5
Luxembourg	4.9	3.3	2.4	0.0	-0.1	1.1	1.5	0.9	0.5	5.1	4.5	4.5	7.1	3.3	4.0
Netherlands	2.0	1.6	1.5	0.8	-0.3	0.5	-1.9	-1.8	-1.5	8.6	8.4	11.5	5.0	4.7	4.7
New Zealand	2.5	3.2	3.0	0.5	0.3	2.1	0.3	0.1	0.7	-3.2	-2.7	-3.0	6.6	2.7	1.7
Norway	1.1	0.8	1.7	0.6	0.2	1.0	5.7	2.5	3.9	8.0	5.6	7.5	3.9	-1.3	1.6
Portugal	1.6	1.0	1.2	0.3	0.5	1.8	-7.7	-2.6	-2.0	0.5	0.6	-0.1	5.2	1.9	1.7
Spain	3.2	3.1	2.1	2.2	3.4	2.3	-5.1	-4.2	-3.3	1.4	1.2	0.7	5.4	4.3	2.7
Sweden	4.1	3.3	2.3	0.5	0.6	1.3	0.0	-0.4	-0.5	5.9	6.6	6.4	5.2	2.1	1.4
Switzerland	0.8	1.5	1.4	-0.5	-0.3	1.5	-0.2	-0.2	-0.1	11.1	8.5	8.3	0.8	5.0	2.8
United Kingdom	2.2	1.9	0.9	0.0	1.0	1.9	-4.2	-3.7	-4.0	-5.4	-5.9	-3.7	4.5	3.1	3.8
United States	2.6	1.5	2.2	-1.1	-0.4	0.1	-3.5	-4.0	-3.6	-2.6	-2.6	-2.1	0.1	-0.1	2.3
Eurozone	1.9	1.6	1.3	0.0	0.6	2.4	-2.1	-1.8	-1.6	4.0	3.3	3.5	6.2	2.6	2.6
European Union	2.3	1.8	1.4	0.1	1.3	2.5	-2.4	-2.1	-2.0	2.2	1.9	2.3	5.9	3.0	2.9

Sources: Consensus Economics, IHS

Table A2: Macroeconomic indicators - Developed markets

	Private cons. (% change p.a.)			Fixed investment (% change p.a.)			Government cons. (% change p.a.)			Retail sales (% change p.a.)			Industrial prod. (% change p.a.)		
	2015	2016	2017	2015	2016	2017	2015	2016	2017	2015	2016	2017	2015	2016	2017
Australia	2.8	2.8	3.0	-3.9	-3.0	0.6	2.9	3.2	1.2	2.7	1.8	2.5	1.6	3.4	2.0
Austria	-0.1	1.1	1.5	0.5	3.0	2.4	1.8	1.3	1.2	0.8	1.3	1.2	0.6	1.7	2.3
Belgium	1.3	0.9	1.2	2.3	3.5	2.1	0.2	0.3	0.8	-0.3	-2.6	0.2	-0.1	4.7	2.7
Canada	1.9	2.1	2.1	-4.4	-2.9	1.4	1.7	2.4	2.6	0.5	1.9	0.1	-1.1	-0.8	1.6
Denmark	2.3	1.8	1.4	1.1	1.7	3.8	-0.7	1.2	1.3	0.9	-0.9	0.4	1.1	3.6	1.8
Finland	1.5	1.2	0.2	0.7	3.8	2.0	0.4	0.3	0.1	-0.7	1.2	1.8	-1.1	1.9	0.9
France	1.5	1.6	1.3	0.9	2.6	1.1	1.4	1.5	1.4	1.2	1.1	1.8	1.5	0.4	0.9
Germany	1.9	1.6	1.8	1.1	2.4	2.0	2.8	3.8	2.2	2.3	1.0	0.5	0.5	1.4	2.2
Greece	0.3	-1.1	0.5	0.9	0.8	-0.1	-0.1	-1.1	0.5	-1.2	-0.8	0.4	1.0	1.7	1.7
Ireland	4.5	3.5	1.3	32.5	4.0	3.5	1.1	2.5	2.0	5.4	3.7	0.1	37.1	-4.2	-10.9
Italy	0.9	1.1	0.5	0.6	1.7	0.4	-0.7	0.7	0.6	0.7	0.4	0.2	0.9	0.8	0.8
Japan	-1.2	0.4	0.9	0.2	0.5	1.5	1.2	2.1	1.3	-1.2	-1.0	1.9	-1.2	-0.7	1.6
Luxembourg	0.1	0.8	2.6	5.8	4.5	1.5	2.7	1.7	2.0	7.4	12.6	2.9	1.2	1.4	3.7
Netherlands	1.8	1.3	1.7	9.9	5.1	0.5	0.2	1.1	1.4	0.8	2.2	2.1	-3.3	-0.9	0.7
New Zealand	2.4	3.3	3.0	2.8	4.7	-0.4	1.9	1.5	1.5	4.3	4.0	3.2	0.9	0.4	1.7
Norway	2.1	1.8	1.3	-3.8	-2.0	-1.0	2.0	2.3	3.1	0.8	-1.1	0.2	0.7	0.3	1.0
Portugal	2.6	1.9	1.1	4.1	-1.5	-0.7	0.6	1.0	0.9	0.6	1.2	1.0	1.8	0.7	0.6
Spain	3.1	3.2	2.0	6.4	3.7	1.8	2.7	0.5	0.2	2.2	1.9	-0.1	3.2	1.8	1.4
Sweden	2.6	2.2	1.5	6.8	6.9	2.3	2.2	3.3	2.3	5.8	2.0	0.2	2.7	0.7	1.1
Switzerland	1.0	1.0	1.4	1.5	2.3	2.0	2.2	2.5	2.1	-1.8	-2.1	0.5	-2.7	1.2	2.5
United Kingdom	2.5	2.8	1.5	3.4	0.1	-2.8	1.5	1.2	1.0	0.9	1.8	0.6	1.3	1.1	-0.6
United States	3.2	2.7	2.5	3.7	0.8	3.2	1.6	0.8	0.0	2.2	1.5	1.4	0.3	-1.0	1.1
Eurozone	1.7	1.6	1.4	2.9	2.7	1.5	1.4	1.8	1.3	-	-	-	1.6	1.1	1.2
European Union	2.0	2.0	1.6	3.3	2.1	1.1	1.4	1.8	1.4	-	-	-	1.8	1.2	1.0

Source: IHS

Table A3: Macroeconomic headline figures - Emerging markets

	GDP growth (% change p.a.)			Inflation (% change p.a.)			Current account (% of GDP)			Private cons. (% change p.a.)			Export growth (% change p.a.)		
	2015	2016	2017	2015	2016	2017	2015	2016	2017	2015	2016	2017	2015	2016	2017
Asia Pacific	4.8	4.7	4.6	2.0	2.2	2.5	2.8	2.9	3.5	6.3	6.0	5.6	1.2	2.6	4.8
ASEAN	4.5	4.2	4.4	2.8	2.1	3.6	3.8	3.3	2.6	5.2	5.1	4.9	2.7	2.3	3.2
China	6.9	6.6	6.3	1.4	1.7	1.7	3.1	3.4	4.9	8.3	7.3	6.7	2.4	3.2	5.4
Hong Kong	2.4	1.3	1.7	3.0	2.7	2.4	3.0	4.1	3.4	4.7	1.6	2.0	-1.5	-0.1	3.2
Taiwan	0.6	1.0	1.7	-0.3	1.0	1.0	14.5	14.3	13.7	2.4	1.9	2.2	0.0	0.3	1.6
India	7.6	7.6	7.7	4.9	5.4	5.8	-1.1	-1.0	-1.9	7.4	8.6	7.3	-5.3	2.9	6.1
Singapore	2.0	1.7	1.8	-0.5	-0.5	1.6	19.8	18.5	16.9	4.5	2.3	4.0	2.5	1.7	1.9
Latin America	0.3	-0.3	2.1	14.9	50.0	14.8	-3.6	-2.3	-2.2	-1.4	-2.3	1.0	2.0	3.0	1.9
Argentina	2.5	-1.6	3.2	16.4	37.3	25.1	-2.5	-2.0	-2.3	3.5	-0.1	1.0	-0.6	4.9	0.5
Brazil	-3.8	-3.2	1.2	9.0	8.8	5.6	-3.3	-1.1	-1.6	-4.0	-4.6	0.4	6.1	6.7	3.5
Mexico	2.5	2.1	2.2	2.7	2.8	3.2	-2.8	-2.5	-1.3	3.1	2.3	2.2	9.1	1.5	7.0
CIS	-2.6	-0.1	1.6	15.4	8.2	5.9	2.8	0.6	0.7	-7.1	-3.1	2.3	-0.4	-1.7	3.4
Czech Republic	4.6	2.5	2.5	0.3	0.6	1.9	0.9	1.1	0.3	3.1	2.5	2.8	7.9	5.6	3.6
Hungary	2.9	2.0	2.6	-0.1	0.3	1.8	4.4	4.1	3.4	2.6	3.9	2.4	8.4	7.0	4.1
Poland	3.6	3.1	3.3	-0.9	-0.7	1.8	-0.6	-1.2	-1.6	3.0	3.6	3.5	6.8	8.6	3.8
Russia	-3.7	-0.6	1.2	15.5	6.9	5.0	5.2	2.1	1.8	-9.5	-4.5	1.5	3.5	-1.9	2.4
Turkey	4.0	3.0	3.0	7.7	7.9	8.3	-4.5	-4.4	-4.0	4.8	4.4	2.7	-0.9	0.1	1.5
Africa	2.9	2.7	3.6	7.4	12.5	10.6	-6.3	-5.9	-5.1	3.2	1.6	3.3	-0.3	0.5	5.2
Nigeria	2.8	0.1	3.0	9.0	15.9	18.5	-3.1	-3.8	-3.8	0.4	-2.4	1.5	-14.2	-9.4	6.7
South Africa	1.2	0.5	1.3	4.6	6.6	5.8	-4.3	-3.4	-3.9	1.7	0.4	0.8	4.1	1.5	3.1
MENA	2.4	2.1	3.2	4.6	4.9	6.4	-2.5	-3.9	-1.0	1.6	3.1	3.6	2.8	3.8	3.7
World	2.9	2.5	2.8	2.4	4.7	3.2	-	-	-	2.6	2.6	2.8	3.0	2.1	3.4

Sources: Consensus Economics, IHS

Table A4: Insolvency growth (% per annum)

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016f	2017f
Australia	-4	18	3	-1	5	1	4	-22	10	2	3
Austria	-6	0	9	-8	-8	3	-10	-1	-5	3	0
Belgium	1	10	11	2	7	4	11	-9	-9	-5	-2
Canada	-7	-2	-12	-20	-11	-12	-2	-2	-1	2	-1
Denmark	21	54	54	13	-15	0	-10	-20	1	4	-1
Finland	-1	16	25	-13	3	0	11	-11	-22	8	0
France	7	8	14	-5	-1	3	2	0	0	0	2
Germany	-15	0	12	-2	-6	-6	-8	-7	-4	-2	0
Greece	0	30	40	30	33	30	10	3	10	6	3
Ireland	19	100	50	10	7	3	-19	-15	-10	0	2
Italy	-35	18	29	21	8	14	16	10	-6	-2	0
Japan	6	11	-1	-14	-4	-5	-11	-10	-9	0	0
Luxembourg	5	-13	17	33	5	8	2	-20	6	1	1
Netherlands	-23	1	73	-10	-1	21	10	-19	-24	-10	-3
New Zealand	-5	-35	45	-6	-12	-8	-13	-7	4	3	3
Norway	-6	28	38	-12	-2	-12	20	-5	-7	6	2
Portugal	-12	54	36	16	18	42	8	-9	12	-6	0
Spain	10	100	50	-2	14	38	13	-30	-25	-12	-5
Sweden	-5	7	20	-4	-4	7	5	-7	-9	0	1
Switzerland	-5	-2	24	20	7	3	-5	-7	7	4	2
United Kingdom	-5	24	23	-16	5	-4	-7	-6	-9	2	4
United States	2	52	41	-7	-15	-16	-17	-19	-8	4	-1

Source: National bureaus, Atradius Economic Research
f=forecast

Table A5: Insolvency level, index

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016f	2017f
Australia	100	118	121	120	126	127	133	104	115	117	121
Austria	100	100	110	101	93	96	87	86	82	84	84
Belgium	100	110	123	125	133	138	153	140	127	121	118
Canada	100	98	86	69	62	54	54	52	52	53	52
Denmark	100	154	238	269	228	227	204	163	165	172	170
Finland	100	116	145	127	131	131	145	129	101	109	109
France	100	108	123	118	116	119	122	122	122	122	124
Germany	100	100	112	110	103	97	89	83	79	78	78
Greece	100	130	182	237	315	409	450	463	510	540	557
Ireland	100	200	300	330	354	365	296	252	228	228	233
Italy	100	118	151	183	197	223	259	285	268	262	262
Japan	100	111	110	95	90	86	77	69	63	63	63
Luxembourg	100	87	102	135	141	152	155	124	130	132	133
Netherlands	100	101	175	158	156	189	207	167	127	114	111
New Zealand	100	65	94	89	78	72	63	58	61	62	64
Norway	100	128	176	156	153	134	161	152	142	150	153
Portugal	100	154	210	242	286	405	438	398	446	419	419
Spain	100	200	300	293	335	463	523	366	274	241	229
Sweden	100	107	128	123	117	126	133	123	112	112	113
Switzerland	100	98	121	145	154	159	150	140	149	155	158
United Kingdom	100	124	153	128	135	129	120	112	102	104	108
United States	100	152	215	199	169	142	117	95	88	91	90

Source: National bureaus, Atradius Economic Research
f=forecast, index 2007 = 100