



Macroeconomic
and Country Risk Outlook

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December 2013-January 2014

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Top Ten Game Changers in 2014

Getting back in the game

Economic Research

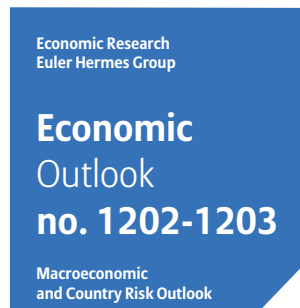


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EDITORIAL



Is the world finally checking into rehab?

LUDOVIC SUBRAN

I will spare you the entire song that inspired this editorial, as well as any analogy between the year 2013 in numbers and an attempt to define Winehouse economics. Yet, for your listening pleasure, here is just the intro of her signature song: "They tried to make me go to rehab, but I said 'No, no, no.'" You certainly get the point, the world eventually decided to address its dependency problem, after years on easy money and erratic public spending. Close to overdosing in 2009, it has been a bumpy road to recovery since, in spite of massive counselling - though treatments do not seem to have evolved much in the past century - and plenty of autosuggestion - French apothecary Emile Coué should be canonized for his contribution to avoiding another crisis in the past years. However, it seems that everything is about to change in 2014, following a very special Central Bankers Anonymous (CBA) meeting: "Hi, I am Janet and I am a money junky" she said. "Hi Janet" they all replied timidly. Mario sounded particularly ashamed. "I have been sober for a month" she continued. Shinzo started to sob, Mark was beaming and Zhou looked a bit puzzled by what he had just heard. Voilà: this imaginary meeting is the inspiration behind our first economic outlook of the year! Like the twelve-step program by Alcoholics Anonymous, we searched for the right steps to a global recovery. We only found ten of them and, actually, called them game changers – yes, it sounds like denial. For each game changer, we found a sponsor (a country or a region) that will be supporting world recovery and tried to emphasize what rehabilitation meant for close friends and relatives, that is to say companies. As a matter of fact, the news is not bad: on the one

hand, public spending backsliders (also known as advanced economies) have been non-indulgent for three years now and, on the other hand, currency tampering addicts (aka emerging markets) will eventually learn how to control their cravings. The battle is not won but it certainly looks like normalization is on its way. Companies will still fear a possible withdrawal syndrome (the so called "cold turkey"), especially in the beginning. But, with time, they will mend their margins and their anticipations, less scared of country risk setbacks. Remember, preventing relapse will not be easy, as abstinence is far from on the table at this stage, but where there is a will, there is a way, right?

OVERVIEW

Getting back in the game

REMY CARASSE

+3.2 % GDP growth

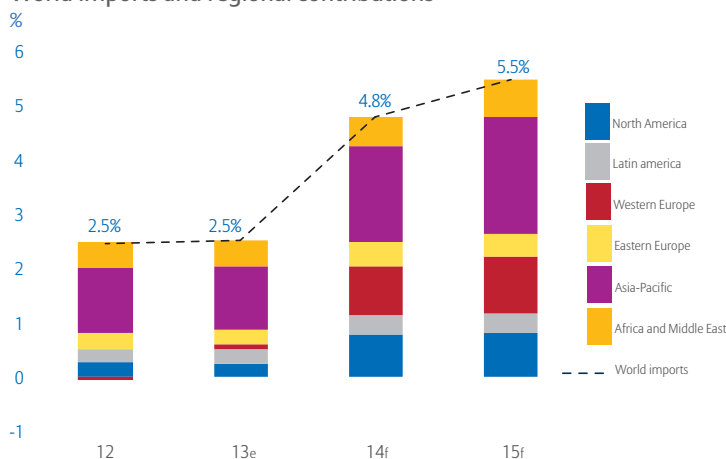
in the United States in 2015

After falling to +2.3% in 2013 – the slowest pace since 2009 – world GDP growth is finally gaining traction: we forecast global activity will grow modestly, by +3.1% in 2014 and +3.3% in 2015. Although emerging economies will remain the biggest contributors to global growth, economic activity is set to be more evenly distributed as a result of improved prospects for advanced economies (+2.2% in 2014 and +2.3% in 2015), while growth momentum in emerging markets is expected to remain relatively moderate (+4.6% in 2014 and +4.8% in 2015).

However, mind the gap; 2014 will indeed be a challenging year. Substantial difficulties persist and may hold back activity, which is already very fragile. In particular, financing the recovery will be a crucial issue. We expect central banks in advanced economies will maintain a very accommodative monetary policy stance for as long as necessary, in order to sustain the growth momentum. Nevertheless, as economies gain traction, managing a (soft) exit from easy money policies will be a key point to watch (notably in the United States), in particular regarding emerging economies that face both cyclical and liquidity risks and could be directly impacted by market expectations, as sparked during the summer of 2013. Major elections will also have to be monitored in key emerging countries, as well as reform progress in advanced economies especially in the eurozone and Japan.



World imports and regional contributions



Sources: IHS Global Insight, Euler Hermes

Global trade is forecast to benefit from improving global prospects: +4.8% in 2014 and +5.5% in 2015 (compared with +2.5% in 2012 and 2013).

Advanced and emerging economies are expected to grow together: the former group is set to contribute 41% and the latter 59% of world import growth in 2014. Asia will remain the main trade hub but the upswing in North America and in the eurozone is ongoing.

Advanced economies are back in the game!

After years of crisis, economic prospects are improving in the advanced economies, which are set to provide a larger contribution to global growth: about 45% in 2014 and 2015 compared with only one-third in 2013. However, downside risks to the recovery remain as the eurozone will continue to face headwinds from deleveraging while a prolonged period of low inflation could make the process painful. In the United States, the pace of the Fed tapering will be key. In Japan, domestic demand recovery is still to emerge while the implementation of structural reforms will be mandatory for investor confidence, given the excessive stock of debt.

North America

GDP growth is set to rise from +1.8% in 2013 to +2.9% in 2014 and +3.1% in 2015, especially reflecting an expected rebound in activity in the United States after a soft end-2013.

TO WATCH

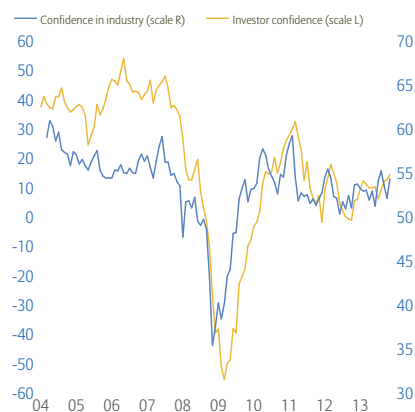
- **Game Changer #1:**
China's transformation will be under control
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Building blocks: a new form of protectionism?
- **Game Changer #10:**
Global rebalancing: don't put the cart before the horse

Recent strong improvements in business confidence, coupled with an easing in fiscal consolidation, and an expected pick up in investment and consumer spending should indeed boost real GDP growth in the country (to +3.0% in 2014 and +3.2% in 2015). We do not expect any major change in the Fed's policy line: we forecast a progressive tapering so that policy decisions will not interrupt the growth momentum. However, some issues, such as the 2014 debt ceiling expected in February, require monitoring even if downside risks seem moderate.

Eurozone

The eurozone will finally return to (modest) growth! After two years of recession, improved sentiment is expected in 2014 on the back of a first round of rebalancing with better prospects for exports and domestic demand. However, economic activity is far from buoyant. We forecast GDP growth at +0.9% in 2014 and +1.3% in 2015, mainly driven by

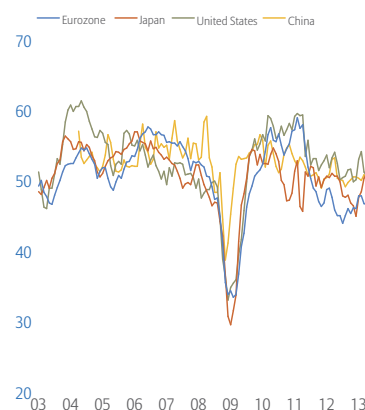
Global economic cycle indicators



Sources: Markit, Sentix, Euler Hermes

Industrial confidence index

Manufacturing PMI



Sources: Markit, Bloomberg, Euler Hermes

+1.3 %
GDP growth

in the eurozone
in 2015

► stronger activity in Germany (+1.6% in 2014 and +1.7% in 2015). Italy and Spain are expected to pull out of recession in 2014 and to recover progressively in 2015 while activity in France will grow at a very moderate pace (+0.6% in 2014 and +1.2% in 2015). Difficulties will remain significant and include continued high unemployment, subdued credit growth and large private and public debt. Inflation will continue to be below the European Central Bank's 2% target: disinflationary pressures must be watched carefully in 2014, since they have the potential, if they last too long, to hold back the recovery, to endanger debt sustainability and to impact adversely on corporate profitability. In addition, ability to address financial stress will be a key issue and the reform progress is still a big challenge for the sustainability of the area.

GDP growth, annual change, in %

	Weights*	2012	2013	2014	2015
WORLD GDP GROWTH	100	2.5	2.3	3.1	3.3
Advanced economies	62	1.5	1.2	2.2	2.3
Emerging economies	38	4.3	4.1	4.6	4.8
North America	25	2.7	1.8	2.9	3.1
United States	23	2.8	1.8	3.0	3.2
Canada	3	1.7	1.8	2.6	2.6
Latin America	8	2.6	2.6	3.1	3.5
Brazil	3	0.9	2.4	2.5	2.9
Western Europe	23	-0.3	0.0	1.2	1.6
United Kingdom	3	0.3	1.8	2.3	2.5
Sweden	1	1.3	0.9	2.3	3.2
Eurozone members	17	-0.6	-0.5	0.9	1.3
Germany	5	0.9	0.5	1.6	1.7
France	4	0.0	0.2	0.6	1.2
Italy	3	-2.6	-1.9	0.3	0.8
Spain	2	-1.6	-1.3	0.5	1.0
Netherlands	1	-1.3	-1.1	0.8	1.3
Greece	0	-6.4	-3.8	-0.2	0.5
Ireland	0	0.1	0.1	1.4	1.5
Portugal	0	-3.2	-1.6	0.5	1.0
Central and Eastern Europe	6	2.1	1.7	2.7	2.9
Russia	3	3.4	1.5	3.0	3.1
Turkey	1	2.2	4.0	4.0	4.2
Poland	1	1.9	1.2	2.2	2.4
Asia	29	4.7	4.7	4.8	4.7
China	11	7.7	7.6	7.5	7.3
Japan	8	1.9	1.9	1.6	1.0
India	3	3.2	4.4	5.3	5.8
Oceania	2	3.5	2.3	2.9	3.3
Australia	2	3.6	2.3	2.9	3.3
Middle East	4	3.2	2.4	3.7	4.3
Saudi Arabia	1	5.0	4.0	4.5	5.0
United Arab Emirates	1	4.4	3.5	4.0	4.0
Africa	2	5.8	4.0	4.9	5.1
South Africa	1	2.5	2.1	3.5	4.0
Morocco	0	2.7	4.5	4.5	5.0

Sources: IHS Global Insight, Euler Hermes forecasts
*Weights in global GDP at market price, 2012

Japan

Economic growth in Japan will remain relatively sound although it is set to slow slightly in the coming years (+1.6% in 2014 and +1.0% in 2015) mainly held back by weak wage growth and slow progress in relation to the structural reform agenda (excessive debt issues are still to be addressed). Some uncertainties about the sustainability of *Abenomics* may emerge in 2014. As public finances have deteriorated markedly, steps towards fiscal consolidation are already scheduled for this year (including a 3pps increase in the sales tax effective in April 2014). However, the accommodative monetary policy is expected to continue in order to boost prices and activity. The implementation of structural reforms (mainly regarding labour market flexibility, competitiveness and international trade) will be key for maintaining growth on a positive trend.

Substantial challenges for emerging countries in the coming years

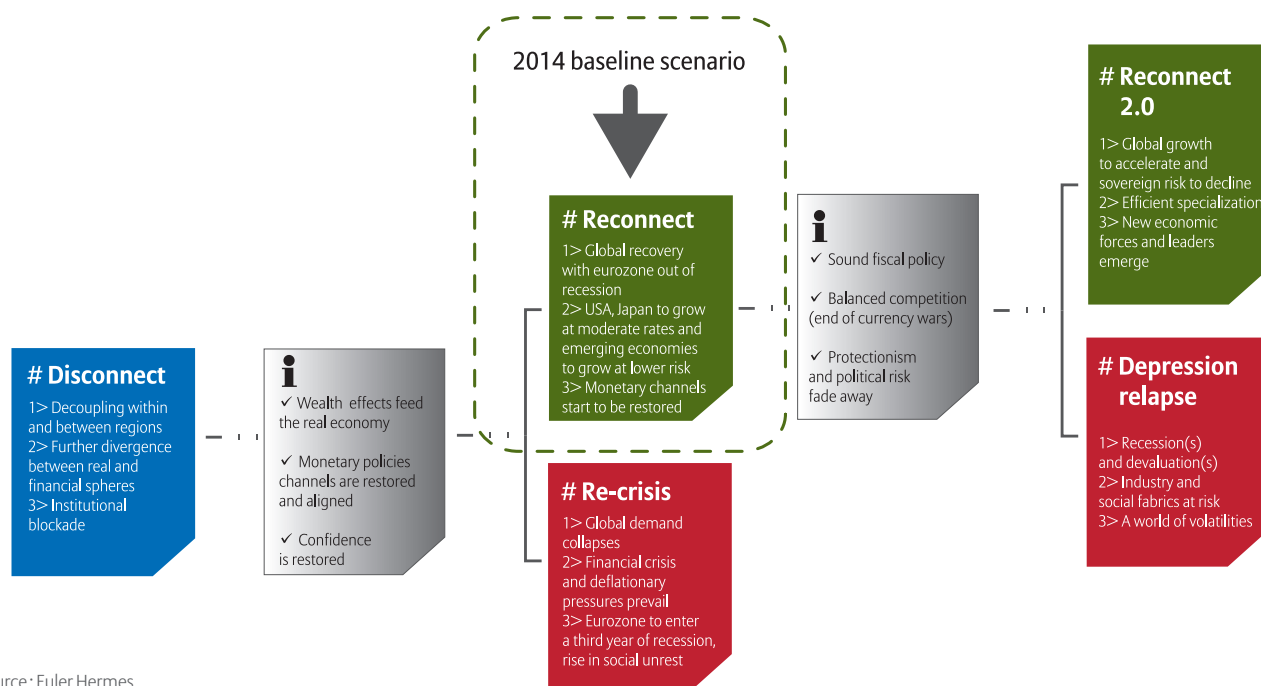
Economic activity in emerging markets is expected to grow at a moderate pace. 2013 highlighted their vulnerabilities, which need to be monitored further in 2014, especially concerning their high external imbalances that, for some economies, are significantly challenging to finance. As illustrated by the concerns sparked during the summer of 2013 (including acceleration in capital outflows as a result of expectations of a slowdown in Fed quantitative easing programme), managing a (progressive) exit from easy money will be a major issue. Even so, we think that most of the emerging economies have the ability to handle external shocks: the key solution lies to a large extent in the policy toolbox now available. The second main concern in the coming years is related to a slower growth momentum compared with the pre-crisis period. China's economic model transformation is central to concerns as the country's levels of economic activity contribute significantly to both regional and global GDP growth. Nevertheless, we think that a sustainable and better-balanced growth model is in sight, with robust intra-regional trade acting as a cushion. 2014 will therefore be full of challenges for emerging economies: fragile fundamentals and external vulnerabilities to manage, coupled with imminent elections.

Emerging Asia

Real GDP growth will stabilise at a decent pace, +6.1% in 2014 and +6.2% in 2015, reflecting robust domestic demand and better export prospects for the region. Real GDP growth in China is expected to slow only slightly, to +7.5% and +7.3% in

Looking for Reconnection?

The world at a crossroad for the next few years...



Source: Euler Hermes

2014 and 2015, respectively, as the economic drivers are projected to change smoothly and become more consumption-based. The regional growth engine is set to rebalance in favour of the other regional heavyweights (such as India and Malaysia) and also of small economies thanks to a shift in production to neighbor countries (Vietnam, Laos). Political turmoil in Thailand and elections in Indonesia and India will have to be watched in 2014 for potential new policy directions.

Emerging Europe

Activity is set to accelerate in Emerging Europe, with GDP expected to expand by +2.7% in 2014 and +2.9% in 2015, taking advantage of the improved external economic environment (especially in the eurozone) and at the same time underpinned by stronger domestic demand. However, the region will remain marked by a growing divergence among countries. Russia is not expected to recover to its pre-crisis trend as real wage growth has moderated and benefits from the commodity-based growth model are stagnating. In Turkey, future activity will also have to be monitored, given the country's weak external financial conditions and potential for political turmoil. Ukraine is still a high risk, due to weak macroeconomic fundamentals and, additionally, political and social fragilities. Moreover, external liquidity and public debt to GDP ratios remain a concern in Croatia, Serbia and Slovenia.

Latin America

We forecast real GDP growth will gain some momentum but at a very moderate pace, +3.1% in 2014 and +3.5% in 2015, mostly driven by the strengthening in North America's economy and a robust domestic demand. However, the positive trend also masks deep vulnerabilities. While activity in

Mexico is expected to accelerate on the back of better confidence and the recovery in the United States - its main trading partner - the risks to the general scenario remain skewed on the downside for several countries (less favourable financing conditions, Fed tapering, decrease in global commodity prices and slowdown in Chinese demand). Brazil, Argentina and Venezuela remain the most exposed economies in the region. Brazil will continue to face challenges related to relatively high inflation and tightened monetary policy, even if the economy is set to benefit from the World Cup in 2014. Argentina and Venezuela will have to deal with deep macroeconomic weaknesses.

Africa and the Middle East

After several years of political turmoil and economic crisis, Africa and the Middle East are expected to gain momentum, but slowly and, above all, with significant uncertainties (+4.9% in 2014 and +5.1% in 2015 for Africa and +3.7% and +4.3%, respectively, for the Middle East). Non-hydrocarbon growth and large financial surpluses will remain robust in most oil-exporting countries, especially in the GCC. In contrast, the political situation remains highly volatile and economic risks are still largely weighted to the downside for oil-importing countries: high vulnerability to oil prices, demand and output changes, challenging political transitions and potential for contagion from conflicts. In 2014, we expect the political transition in Egypt to move forward but it will remain fragile, with significant potential for social unrest and disruption to commercial activity. We do not expect that sanctions against Iran will be lifted significantly in H1 2014 and the economy is likely to continue to struggle. However, signs of rapprochement between Iran and the international community have the potential to improve regional dynamics.

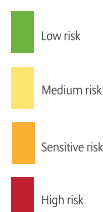
+3.5 %
GDP growth
in Latin America
in 2015

Country Risk Outlook

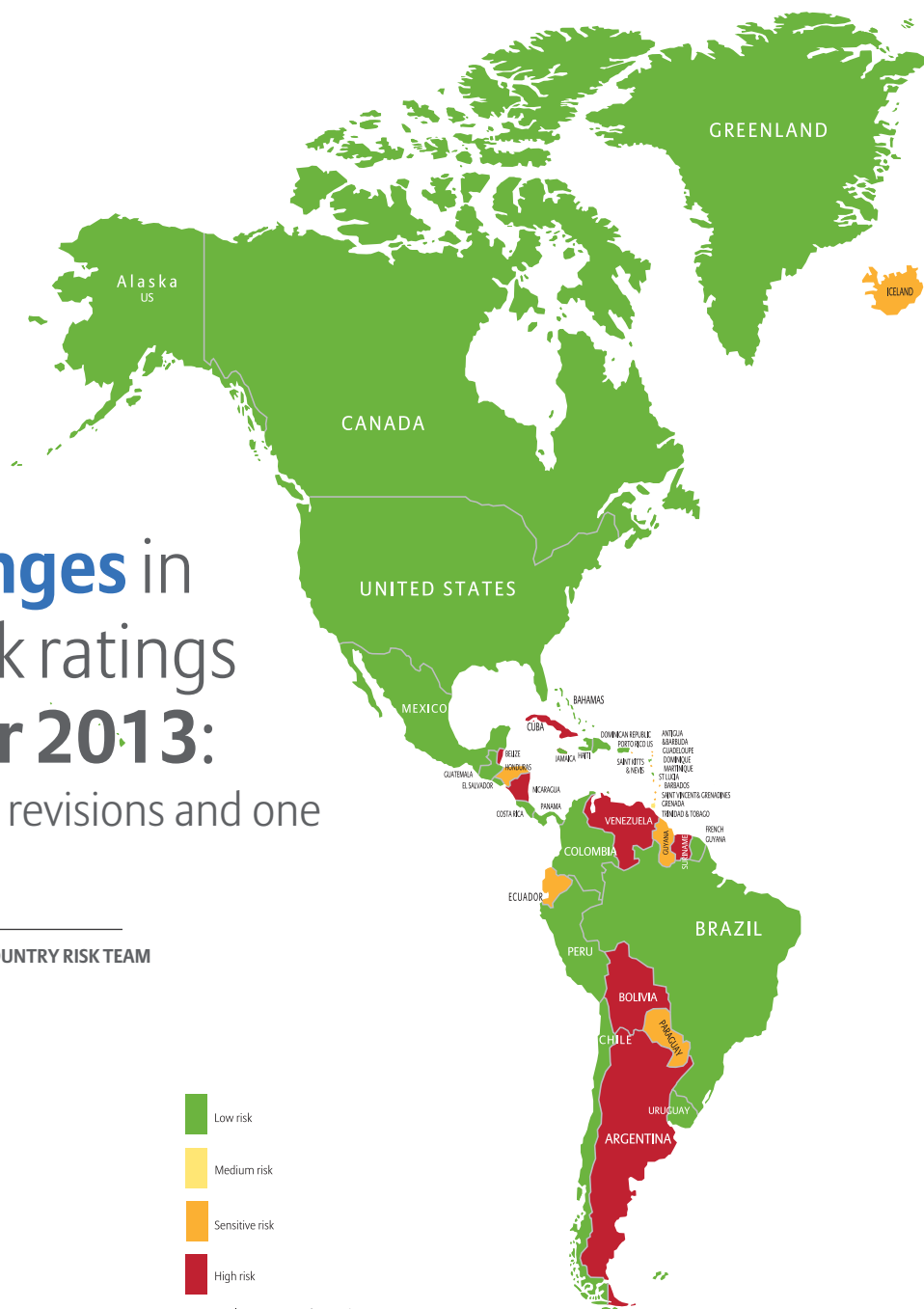
2013 Q4

Eight changes in country risk ratings 4th quarter 2013: seven downward revisions and one upward revision

MACROECONOMIC RESEARCH AND COUNTRY RISK TEAM



Source: Euler Hermes, as of December 16, 2013



7
downward
revisions

Medium term risk:
the scale comprises 6 levels:
AA represents the lowest risk,
D the highest.

Short term risk:
the scale comprises 4 levels:
1 represents the lowest risk,
4 the highest.

Ecuador

D4 C3

Public finances and external debt have improved and stabilized.

Morocco

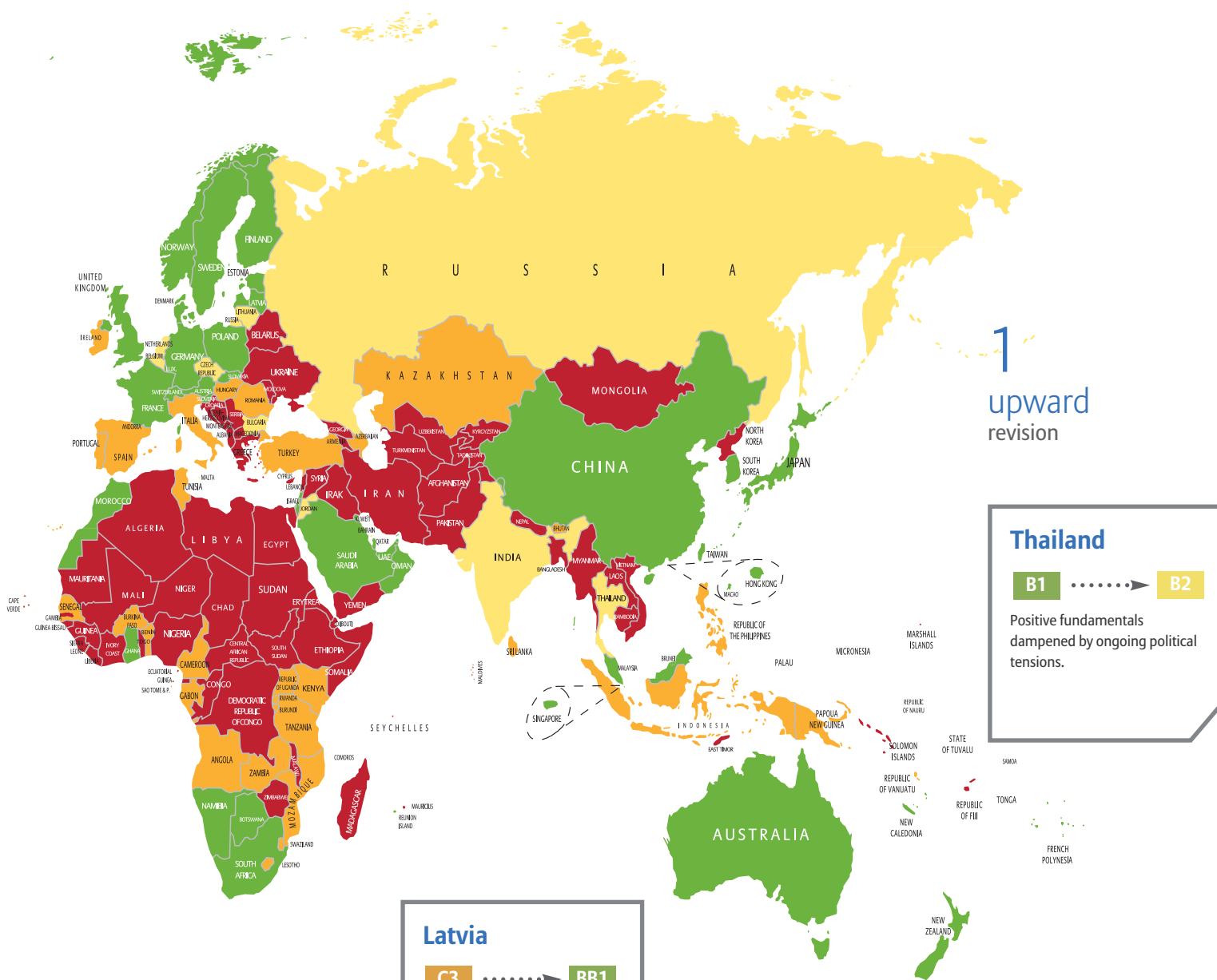
B2 B1

Rebound from 2012 drought now firmly embedded in data.

Bahrain

B3 B2

Economic outlook for GDP growth improved in the short-term but social and sectarian tensions remain evident and pose downside risks to the outlook.



Game Changer #1: China's transformation will be under control

MAHAMOUD ISLAM

The Asia Pacific region is on the verge of a new cycle or, as EH is calling it, the 3S-Cycle: "Solid, Sustainable but Slower"

✓ **The region will continue to contribute robustly to world GDP growth** (at a marked 50% to 60%) with five distinct clusters. These consist of "The OECDs" (Japan and South Korea); *Greater China* (China and its hubs); the "ASEAN-5"; *South Asia* (India and its neighbours); and *Oceania* (Australia and New Zealand).

✓ While the Asia Pacific region will remain the world's economic driver and China its main growth engine, **Asia will be in relatively low growth mode** (at +4.7% per year) compared with the previous decade (+5%). However, this growth will be more sustainable, with resilient intra-regional trade acting as a cushion.

Stable growth may be good enough

The end of 2013 was a turning point for the Chinese economy as the leadership started to set the milestones for future growth. Indeed, two key events took place in Q4: (i) the third Plenum meeting of the 18th Party Congress (mid-November), which set a comprehensive reform agenda to enhance medium-term growth, and (ii) the Central Economic Work Conference (CEWC), which set the key economic policy targets for 2014. The Chinese authorities confirmed their willingness to shift towards more inclusive and sustainable growth, less reliant on exports. According to the CEWC statement, they will support "appropriate growth" and maintain "proactive fiscal" and prudent monetary "policies". Economic transformation is expected to continue in a stepped and measured way. GDP growth will probably slow from +7.6% in 2013 to +7.5% in 2014 and to +7.3% in 2015. Economic growth is likely to be more consumption-based, supported by rising incomes

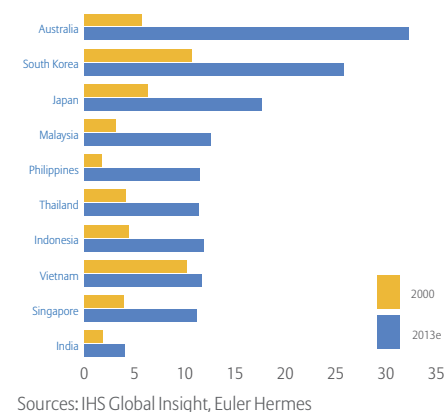
and employment. Investment growth is likely to decelerate (an annual average +5.5% in 2014 and 2015, compared with +12% between 2000 and 2012) in line with the slowdown in exports, but remain at high level driven by a rise in infrastructure projects as part of the urbanisation process.

Credit and Financing: finally aiming at quality

On the financing side, major changes are in the pipeline. According to the "Third Plenum blueprint", the role of the private sector in the financial system will be enhanced as markets are expected to get "a decisive" role in resource allocation. This contrasts with the previous model for financing that considered markets as "basic" method of distributing resources. Moreover, the financial sector will be opened further to include acceleration in interest rate liberalisation and the convertibility of the RMB capital account. The latter is consistent with the objective of making the RMB a global currency for trade and international reserves. From a domestic point of view, consumer credit may be more targeted to limit imbalances and reduce overcapacities but also to contain non-standard financing growth ("shadow banking"). Indeed, while total social financing (a broad measure of credit) grew by 15% y/y in November 2013 (from 23% in the corresponding period of 2012), the major part of the non-standard financing (trust and entrusted loans), increased by 90% (from 71% in 2012). Although there is no clear

Export dependency to China

Exports to China, % of total exports



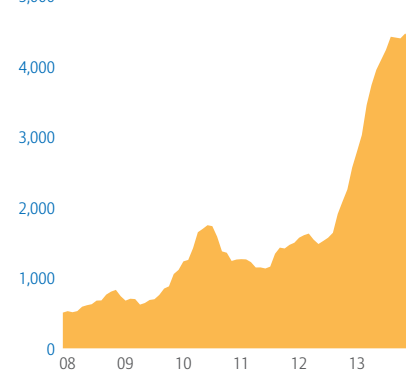
strategy to fight shadow banking at this stage, some milestones were set, especially through (i) financial regulation (China Banking Regulatory Commission supervision) and monetary policy (a more cautious stance) and (ii) also by the commitment made by the authorities to keep local government debt (a key driver) under control.

Regional trade: while China transforms its business model, South East Asia finds new growth engines

The Asia-Pacific region is projected to record solid growth, but at a slower rate than the past decade, at +4.6% in 2014 and +4.6% in 2015, in line with China's rebalancing. Imports from China will continue to fuel growth in the region in 2014 (+3.8%) and 2015 (+4%), but at lower pace than before (+14% between 2000-12) as re-exporting activities are projected to ease. As a result, main trade partners, notably south Asian countries are planning to encourage the development of new growth engines, notably through infrastructure investment (all ASEAN countries, for example), development of more value-added industries (including Indonesia with nickel ore) and wage increases (Malaysia, Thailand and Indonesia raised their minimum wages in 2013) to boost domestic demand and cope with the Chinese transition.

Trust and entrusted loans

Billions RMB



Game Changer #2: The United States will re-industrialize with or without easy money

DAN NORTH

Both the United States and Canadian economies are expected to see modest improvement in 2014

✓ **In the United States**, fiscal uncertainty has eased, the labor market has shown substantial signs of improvement in the past few months, and expectations of continued strength in manufacturing, autos, and housing are likely to boost the economy to a 3% growth rate in 2014 compared to 1.8% in 2013.

✓ **Canada** is likely to experience increased demand for its exports as global growth accelerates, particularly in the United States. In addition, low inflation is pushing loose monetary policy which is likely to weaken the Canadian dollar, further boosting the critical export sector and driving GDP growth to 2.6% in 2014 compared to 1.8% in 2013.

Limited impact of the Fed tapering except perhaps for the housing market

Most economic data has turned somewhat more positive in the past few months. As a result the Fed announced tapering of its QE program, with expectations that it will terminate by the end of 2014. But the Fed will still be buying securities and adding to already massive excess reserves, so tapering is not tightening. In addition the Fed will keep short term rates at 0% through 2015 or later. Therefore monetary policy remains very loose and is expected to contribute to growth in most sectors. As QE tapers, long term rates will likely rise, making lending more profitable which will expand credit more rapidly, boosting the entire economy. Housing however has been derailed somewhat because of rising mortgage rates, but rising prices and low inventory suggest the rebound will most likely continue.

Managing short-term political turmoil

Fiscal policy uncertainty has been reduced somewhat. Congress approved the first budget in four years, averting a government shutdown, raising revenue, reducing automatic budget cuts, and providing a boost to GDP forecasts. However the debt ceiling issue will arise again in February, and Republicans may use the opportunity to demand further spending cuts and debt reduction. More political battles may result from immigration

reform later this year. The roll-out of Obamacare has created significant uncertainty as private health insurance has suddenly been cancelled for millions of Americans, and it's unclear if the new program will be able to provide the coverage promised.

Policy-mix = energy x energy

The United States energy revolution will continue as new reserves of shale gas and crude oil continue to flood the United States market with cheap energy. Currently WTI crude in the United States sells at a 13% discount to the global Brent price. While natural gas has recently been bid up due to cold weather to \$4/mmbtu, it's still very cheap compared to \$10-\$15 for much of the industrialized world. As United States energy production expands, the United States is importing less crude and exporting more refined products, closing the petroleum trade gap 22% or \$4.3bn in Novem-

+3.0%

GDP growth in the United States in 2014

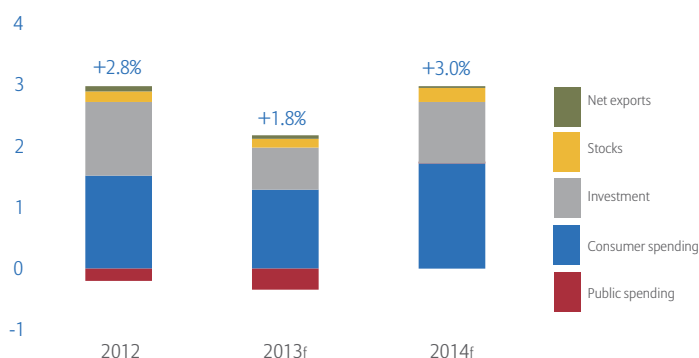
United States long-term bond interest rates



Sources: Bloomberg, Euler Hermes

ber, contributing to the lowest trade gap in four years. Cheap energy is boosting manufacturing now, including advances in natural gas powered autos and trains, and if energy export restrictions were lifted, it could provide a significant boost to the entire economy.

US GDP growth and components



Sources: IHS Global Insight, Euler Hermes

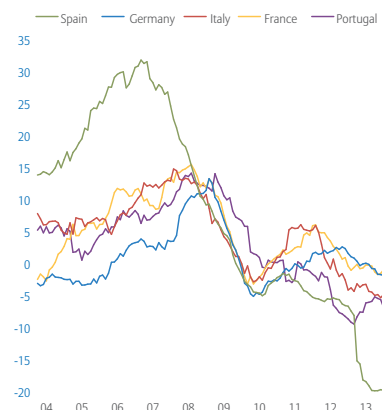
Game Changer #3: The Eurozone must keep its eye on the ball, but the ball is rolling

ANA BOATA

+0.9%

GDP growth
in the eurozone
in 2014

Credit to non financial corporations
Year-on-year change, in %



Sources: Bloomberg, Euler Hermes

be supported by Germany where households will start to be an important driver of GDP growth as a result of supportive public policies (including installment of a minimum wage and additional public spending, including pensions). This will support a pick-up in import growth in Germany and therefore result in a reduction in the still-elevated current account surplus.

Germany's export competitiveness and boost industrial performance. In contrast, policy action remains limited in France where labour market rigidity and the tax burden remain very high and act as a drag on competitiveness. In addition, the fiscal environment in France is one of the least business-friendly within the region given its complexity, its volatility and its high tax rates.

Ability to reform will differentiate the good from the bad

Greece, Spain, Portugal and, to a lesser extent, Italy have been the eurozone countries that have responded positively to a majority of the OECD recommendations in terms of structural reforms (including action on labour market rigidity, regulatory barriers to competition and tax evasion). While Spain began to reform its labour market in 2010, Italy implemented its first measures only in mid-2012. This delay is reflected in relative unit labour cost adjustments (-10% in Spain since 2010, compared with +1% in Italy) and therefore in a more subdued export performance as the structure of Italian exports, although among the most diverse in the world, remains highly oriented towards medium range products, which are very labour intensive. In contrast, Germany, the European leader in terms of high-tech exports, started to implement a strategy towards a 'smart industry' by 2020 aiming to allow last-minute changes to production, responding flexibly to disruptions, solving energy and resource efficiency issues and enabling technological transfers to SMEs. This is expected to strengthen further

Financing the recovery will be key

One of the main issues for the eurozone during the crisis has been the credit crunch in southern European countries. Credit to firms is also contracting in countries such as Germany and France (although at a moderate pace) due to weak demand and a reluctance of firms to invest. Taking into account the fact that two thirds of corporate funding in the eurozone comes from banks it is crucial to have a common strategy to restore credit channels and therefore investment. In this regard, several options lie ahead: 1/ new ECB VLTRO similar to the BoE's Funding for Lending Scheme stimulating bank lending to the real economy; 2/ creation of structures able to help corporates finance more on the bond markets; 3/ enhancement of credit insurance direct financing of corporates and 4/ strengthening of the securitisation of existing and new corporate loans and support for venture capital through mutual efforts from European institutions. In addition to all this, an increase in R&D spending, a common energy policy and a lower EUR would be supportive of an increase in investment and sustained economic growth.

First round of rebalancing brought a mechanical recovery

Since the crisis, internal imbalances between the eurozone countries have reduced significantly through consistent reductions in current account deficits (more than 10% of GDP in Greece, Portugal and Spain). This was mainly due to improvements in trade balances on the back of weaker imports, but also to a pick-up in exports as a result of restored competitiveness. In this regard, wage adjustments (notably in Spain, Greece and Portugal) and large-scale layoffs have allowed marked improvements in cost-competitiveness. Further, fiscal consolidation reduced significantly public refinancing needs. Going forward, salvation is expected from exports of countries that adjusted the most and benefit from a robust industrial base, namely Spain, Portugal and, to a lesser extent, Italy. The rebalancing process will also

2014 will be the ECB's year

✓ **Selective and conditional liquidity**
(VLTRO similar to the BoE's Funding for Lending Scheme) in H1 2014.

✓ **ECB Asset Quality Review** (AQR) results in H2 2014.

✓ **The Single Supervisory Mechanism** (SSM) to be fully in place in November 2014.

Game Changer #4: The monetary musketeers and Japan's d'Artagnan

CLÉMENTINE CAZALET

Central banks' support of the recovery will be determining

✓ **United States:** progressive tapering and improved forward guidance not likely to endanger the recovery.

✓ **United Kingdom and eurozone:** targeted liquidity to help the recovery.

✓ **Japan:** accommodative monetary policy to boost both prices and activity.

Fall 2014

expected end of the Fed quantitative easing programme

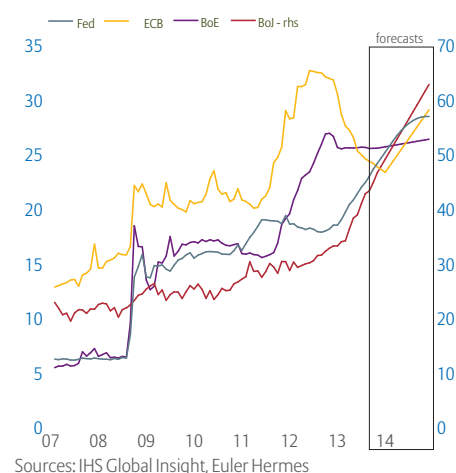
Yellen: a musketeer having a global impact

Despite Fed tapering to start in January, United States monetary policy will remain very accommodative through 2014: Chairman Ben Bernanke will be succeeded by Janet Yellen but this is unlikely to lead to any major change in the policy stance. Tapering is expected to be very progressive in order not to threaten the recovery and to avoid a strongly negative market reaction; the asset purchase programme is expected to end in Fall 2014. The Fed has successfully adapted its forward guidance regarding the policy rate (maintaining the status quo even when unemployment reaches 6.5%, especially if inflation remains under the 2% target). Equity markets reacted positively to this announcement, suggesting the decision was well anticipated. If the recovery of the United States economy remains on track, stronger uncertainties will weigh on emerging markets, which could suffer from renewed capital outflows.

Carney and Draghi: two musketeers focusing on forward guidance and (targeted) liquidity

In the United Kingdom, Governor Mark Carney established a very explicit forward guidance, explaining that the Bank of England's monetary policy will remain accommodative as long as the rate of unemployment exceeds 7%. In this regard, monetary policy should remain accommodative through 2014 (continuation of the asset purchase programme and key interest rate at 0.5%). The major change will come from the Funding for Lending Scheme (extended until January 2015) which will be re-focused to support only business lending as credit conditions for households have improved substantially. At the ECB, President Mario Draghi also strengthened forward guidance (though to a lesser extent) by specifying that monetary policy will remain accommodative as long as necessary. Given the fall in inflation, the ECB decided to cut its key interest rate by 0.25bps (to 0.25%) last November. The fragile recovery of the eurozone, as well as the outlook for prices, suggests that further actions may be taken in H1 2014. The ECB is likely to use conventional measures in the first instance: another key rate cut and/or a negative deposit rate are possible if inflation rates weaken further while a new VLTRO is likely if the ECB Asset Quality Review and EBA stress tests result in increased market stress. A potential new LTRO would be inspired by the BoE's Funding for Lending Scheme: targeted liquidity to support SMEs. Other options within the ECB toolkit include sovereign debt purchases on the secondary bond market (SMP, OMT)

Total Central Bank balance sheets % of GDP

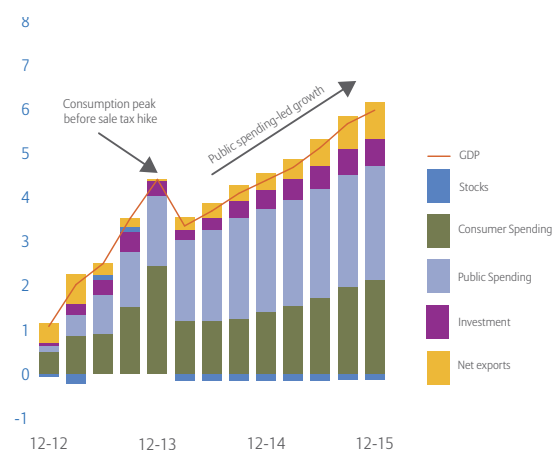


and/or purchases of private sector securities (ABS and private loans).

Abenomics: arrows or swords for d'Artagnan

Prime Minister Shinzo Abe based Japan's economic programme on three main actions: a very accommodative monetary policy, an expansionary fiscal policy and structural reforms. In this regard, the Bank of Japan will continue its quantitative easing (doubling the monetary base by 2015) though there are uncertainties on whether the increased liquidity will remain in the country, given the still fragile recovery. The government has already announced an additional fiscal stimulus (JPY5 billion) to boost economic activity but the deteriorating public finances make such an expansionary policy unsustainable. Abe has already taken a first step towards fiscal consolidation, through a 3% increase in the sales tax rate, effective in April 2014, but further measures will be necessary. With regard to the structural reform agenda, Abe's government announced its intention to improve labour market flexibility, to boost high value-added industries and to support international trade; but for now, there is nothing concrete. However, these reforms will determine mid-term growth, as the current economic model, although effective in the short-term, is not sustainable.

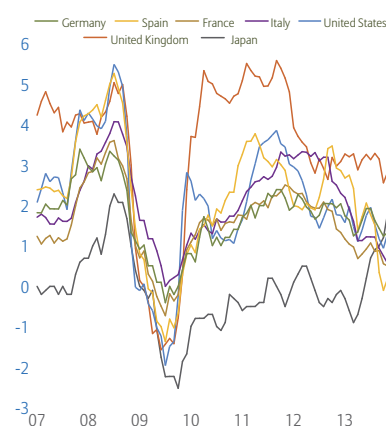
GDP growth and contributions to growth in Japan since Abenomics introduction, in %



Game Changer #5: "It's the price, stupid!" - when disinflation matters in the advanced economies

ANA BOATA

Headline inflation Year-on-year, in %



Sources: IHS Global Insight, Euler Hermes

Supply and demand, main drivers for disinflation in the advanced economies

Inflation in developed economies has gradually moderated since early 2012. In the space of two years, the inflation rate in the United States weakened from 3.0% in January 2012 to 1.2% in November 2013, while it fell from 2.7% to 0.8% in December 2013 in the eurozone. Japan is the exception given the change in monetary policy of the central bank in early 2013. This disinflationary trend is mainly due to weak demand and supply on the back of record high unemployment rates, contracting (or decelerating) wages, negative (or weak) credit growth, a gloomy business environment and overcapacity in industry. Further, moderation in prices for raw materials and energy has also been a drag on inflation.

+0.8%

Headline inflation in the eurozone in Dec. 2013

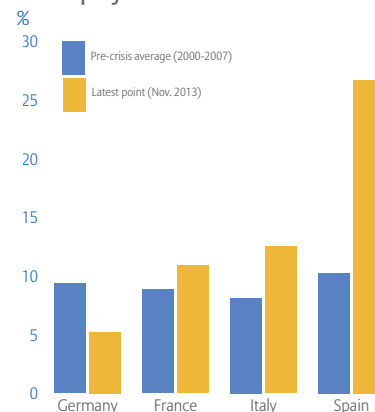
2014 will not be the year of commodities

China's more moderate pace of expansion and the less accommodative monetary policy stance of the Fed, triggering an appreciation of the dollar, increase the downside risks to commodity prices. Nevertheless, upside risks remain on the back of structural factors: demographic trends (for food-related commodities), rising incomes, growing middle classes and industrialization/urbanization rates in the emerging markets (for energy and metals). Supply side risks mainly from instability in the Middle East and North Africa will also remain a key issue to monitor in the coming years. We, however, expect commodity prices to remain broadly stable in 2014.

Disinflationary pressures in the EMU may affect the recovery

Disinflation in the eurozone is not a big surprise. Rising unemployment rates at record levels in southern European economies, leading to sharp declines in real wages, and

Unemployment rate

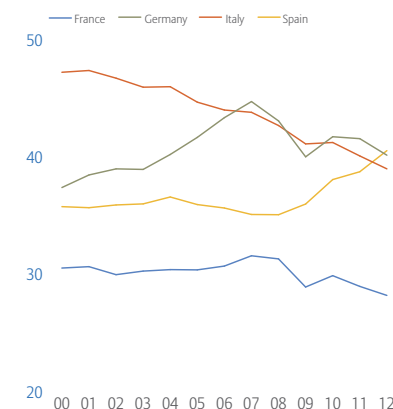


Sources: IHS Global Insight, Euler Hermes

the credit crunch, increased downward pressures on prices in these countries. Greece and Cyprus have experienced deflation since March/April 2013 when inflation rates turned negative, while prices are moderating rapidly in Spain, Italy, Portugal and Ireland. The situation is not as severe as in 2009 and the ECB could act if deflationary pressures endanger the recovery or debt sustainability, notably in countries with still large primary deficits such as Spain (as higher real interest rates will make deleveraging more painful). Finally, downside pressures on prices could endanger corporate profitability, which is already weak in France and Italy.

Profit share of non-financial corporations in the EMU

Gross operating surplus/gross value added, in %



Sources: IHS Global Insight, Euler Hermes

Game Changer #6: Periphery countries - dodging the liquidity crunch, piggy backing the recovery

MANFRED STAMER

Resilience to external shocks has improved overall in Latin America and Emerging Europe, but there is a growing divergence on risks

✓ **The impact of United States Fed tapering** will be limited, except for Turkey.

✓ Most countries have rebalanced their economies post-crisis, but **external liquidity risk remains a key concern** for Ukraine, Turkey, Argentina and Venezuela.

✓ **In 2014, the Latin America and Emerging Europe regions** will benefit from the recovery in the United States and the eurozone.

Latin America and Emerging Europe: Handling the collateral damage

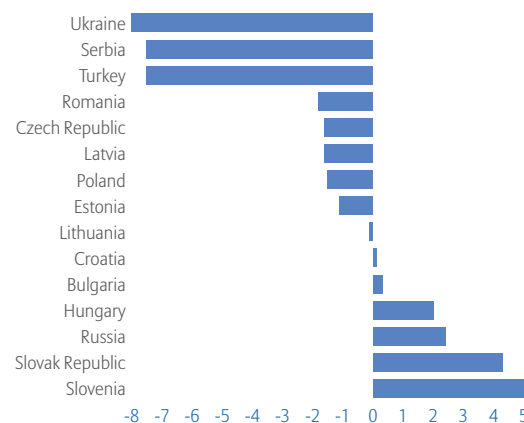
In Latin America, the announcement on 18 December 2013 of the start of the United States Fed's tapering in January 2014 has had limited impact on financial markets so far. Should downward pressure on national currencies increase in H1 2014, EH expects reactive central bank intervention to reduce any potential damage as happened during the emerging market sell-off in mid-2013. In Emerging Europe, most countries avoided that sell-off – as they had not attracted substantial capital inflows in the previous years – and should also remain unscathed by the tapering in 2014. The notable exception is Turkey where large short-term capital inflows have financed high current account deficits in recent years. The indication of forthcoming Fed tapering caused a 13% depreciation of the TRY against a USD-EUR basket in mid-2013 and another 6.5% decline at the turn of the year

2013/2014, when political turmoil added to the already high vulnerability of financing flows. The Central Bank of Turkey has so far tried to stem depreciation pressures mainly through FX interventions, however, should downward pressure on the TRY continue, it may no longer be able to refrain from interest rate hikes.

Mind the heterogeneity

Most major countries in Emerging Europe were able to rebalance their economies after the Great Recession in 2009, reflected in narrowing current account deficits. Notable exceptions are Turkey, Serbia and Ukraine which have posted external shortfalls of more than 7% of GDP in 2013. However, the legacy of earlier large current account deficits has left many countries in the region with high annual external debt payments falling due which, in 2014, will exceed foreign exchange reserves in Ukraine, Turkey, Poland, Bulgaria, Hungary and Romania. As a result, external liquidity risk remains a concern in Emerging Europe. The overall situation is better in Latin America where most major economies have accumulated ample foreign exchange reserves that are more than sufficient to cover their annual external financing needs. Even the current account deficits of Peru and Uruguay which have risen to around 5% of GDP in 2013 appear unproblematic. The exceptions are Argentina and Venezuela which have relatively low foreign exchange reserves despite years of current account surpluses, but this is a result of a decade of economic mismanage-

Current account balance % of GDP



Sources: IHS Global Insight, Euler Hermes

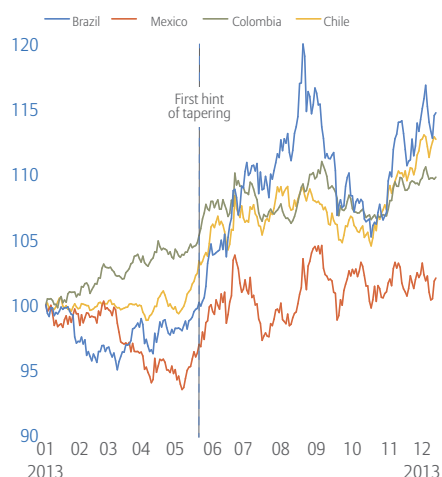
ment and investor-unfriendly policies that have left these countries as high risk.

Restoring export markets

The improving global economic environment will benefit the export and thus growth performance in the Latin America and Emerging Europe regions, especially the recovery in the United States and the eurozone, their respective key export markets. Assuming relatively stable commodity prices and stabilising demand from China, the brighter outlook for the United States will support most Latin American countries, especially Mexico which ships around 80% of its exports to its neighbour in the north. The outlook for Emerging Europe is somewhat more diverse. The eurozone recovery will improve the external demand picture for the EU members in the region and the Balkans, which send around 60% of its exports to the eurozone. Turkey should also benefit even though the share of its exports going to the eurozone has fallen to 27% (39% for the EU28). Russia and Ukraine will benefit less from the eurozone recovery as capacity bottlenecks in the commodity sectors combined with stable commodity prices will constrain export growth. Substantial structural reforms are needed to return to pre-crisis growth trends in these two countries, but appear unlikely soon.

Exchange rates

LCU/USD, base 100 = 01/01/2013



Sources: IHS Global Insight, Euler Hermes

Game Changer #8: Old and new political risk in 2014

ANDREW ATKINSON

2014 will bring more of the same political risks, but expect some surprises

✓ **The Middle East and North Africa** will remain a region beset by political and social changes and shifting dynamics.

✓ **A busy electoral schedule** in 2014 and H1 2015 is likely to provide reminders of the fickle nature of electorates, with some regime changes.

✓ **Political and civil institutions** require strengthening in 2014. In some areas, including Africa, improved governance can provide an environment to increase investment inflows and GDP growth. In others, including the eurozone, improvements in institutional frameworks are required to foster economic, financial and integral development.

MENA will remain a region beset by political and social changes

While political risks will manifest themselves around the world in 2014, including tensions in Central Asia and the Caucasus, North Korea and, perhaps, Bangladesh and Venezuela, the region likely to experience the most widespread political and social upheaval and conflict is likely to be the Middle East and North Africa. To an extent, some of this represents ongoing risks, including fragile political transitions in North Africa (Egypt, Libya and Tunisia) and Yemen, civil war in Syria with contagion effects in neighbouring countries (including Lebanon), unresolved sectarian issues in Bahrain, high security alerts in Iraq and a continuing stand-off between Israel and the authorities in the Palestinian territories. Moreover, overlaying all this are concerns relating to Iran's nuclear program and to that country's influences, direct and indirect, on shifting regional power dynamics. In 2014, EH expects Iran will remain part of the

centre stage of international diplomacy. Tensions between Shia and Sunni Moslem communities may intensify in 2014 and the impact and extent of the Arab Spring are far from over. Further south, the Sahel region and central Africa, with ill-defined and porous borders are areas of continuing high risk, including Mali and the Central African Republic but also involving sectarian divides in northern Nigeria and ongoing conflict in the Sudans.

A busy political calendar in the next 18 months

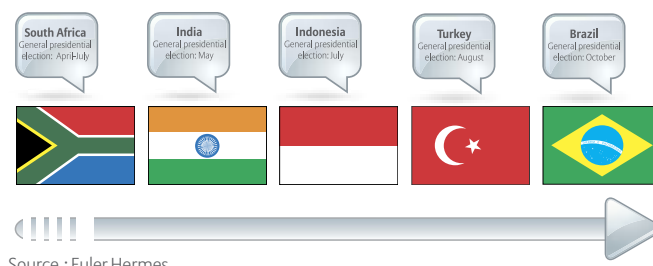
In 2014 and H1 2015, some potentially significant elections are scheduled to take place. These encompass some of the BRICS (Brazil, India and South Africa) and other large emerging economies (including Indonesia, Turkey and Ukraine) but also the United States (Congressional) and the United Kingdom (a referendum in Scotland that may be the vanguard to a partial break-up of the United Kingdom). The ANC government is likely to win a new mandate in South Africa but its support base is eroding and the political landscape is now changing, with associated risks increasing. In India, which has an electoral track record of unseating incumbent governments, a change in regime appears possible, with a more pro-business administration taking over, but one that may herald greater ethnic unrest.

Institutions and societal risk to be closely monitored

The strength of political, civil, monetary and economic institutions will be critical in limiting risks in 2014.

A strong and stable political base forms a good bedrock for cultivating external investor and trading interests (another reason to watch closely 2014's unfolding election timetable). The Arab Spring provided firm evidence of the need for politicians and other leaders to take account of changing dynamics in society and how people now communicate. It had been evident for some time that social pressures were building in MENA because of the lack of political enfranchisement and freedom of expression, combined with high unemployment rates. Modern communication systems, including widespread availability of mobile telephony, were used to harness this pressure, which was finally released in Tunisia in 2011 and quickly spread. However, the ability to mobilise opposition forces and demonstrators using modern communication techniques has been seen elsewhere, including the eurozone and may emerge as political challenges elsewhere in 2014. Political risk is ever-present and, in addition to ongoing conflicts and tensions, will emerge in new forms and areas in 2014. EH expects further evidence this year of attempts by some governments to seize increased control of natural resources. Sectarian, tribal and religious conflicts will take place around the world. Attempts will be made to further strengthen political governance and institutional supervision, but will be challenging. Overall, decision-making in relation to commercial opportunities should take account of political risk factors and, in this respect, information is key.

Elections in key emerging countries in 2014



Despite an improved outlook, economic risks remain weighted towards the downside in MENA



Source: Euler Hermes

Game Changer #9: Building blocks - a new form of protectionism

CLÉMENTINE CAZALET

What if regional blocs were one country?

✓ **Pacific Alliance** (Chile, Colombia, Mexico and Peru) would be the 6th largest economy.

✓ **ASEAN** (Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand and Vietnam) would be the 8th largest economy.

✓ **GCC** (Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and UAE) would be the 14th largest economy.

Transatlantic Agreement:
40%
of global trade

Pacific Agreement:
26%
of global trade

Deepening regional blocs: ASEAN Economic Community (AEC), Pacific Alliance and GCC

Strength through unity; it seems that a large number of countries find the old adage more and more appealing. The AEC aims at creating a single market and production base for an equitable economic development in a competitive and world-integrated region. The ten countries have already succeeded in tariff elimination but they are facing difficulties in removing non-tariff barriers. A single regional common market may be created in 2015, with the target of zero import duties, which should help the members to increase their competitiveness with China and India. The initial goal of the Pacific Alliance is to advance free trade with a "clear orientation towards Asia". In late 2013, the four members agreed to liberalise 92% of their exchanges of goods and services, and they are hoping to reach 99% within seven years. In addition to reducing trade barriers, they have started to implement other projects aiming at regional integration, including a common stock exchange and joint embassies. The GCC countries are facing more difficulties in forming a regional bloc. A common market was launched in 2008, removing all barriers to intra-country investment and trade in services. However, for now the story ends here as the customs union was breached when Bahrain signed a free trade agreement with the United States and the UAE and Oman have rejected membership of a monetary union.

Bridging continents: Transatlantic Agreement, Pacific Agreement

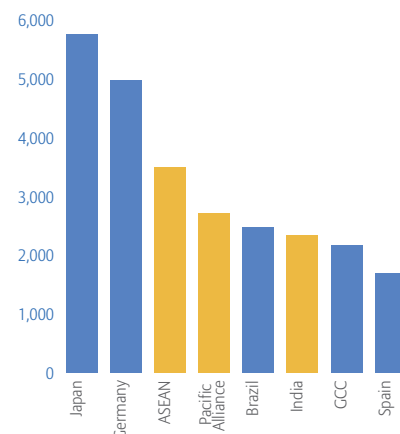
The *Transatlantic agreement* aims at reinvigorating bilateral trade between the United States and the EU. As there is limited potential for tariff cuts, the main emphasis should be reductions in non-tariff barriers (including harmonisation of technical and environmental regulations). If the European Commission President hopes to reach an agreement by late 2014, it is likely that negotiations will last a little longer. Together, the countries account for 40% of global trade and GDP and this agreement could enable them to make up some global market share lost to emerging countries. The *Pacific Agreement* is a trade agreement under negotiation between 12 countries, including the US, Chile, Japan and Malaysia. This area represents 40% of global GDP and 26% of global trade. The agreement could eliminate tariffs on goods and services, reduce non-tariff barriers and harmonise regulations. However, even if negotiations are well advanced, United States regulations could prevent swift implementation as a majority vote of support in the House of Representatives and the Senate is required.

Removing supply chain barriers could be six times more effective than eliminating tariffs

In 2013, a World Bank report pointed out that reducing supply chain barriers to trade could increase global GDP by +4.7% and global trade by +15%. The report identifies four main obstacles: market access, border administration, telecommunications and transportation infrastructure and the business environment. The main reason why lowering supply chain barriers

GDP

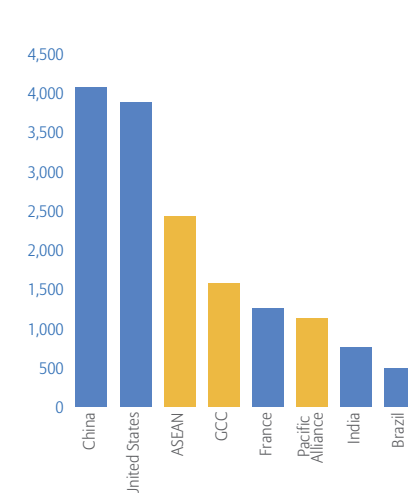
USD bn - Trade unions and Benchmark countries



Sources: IHS Global Insight, Euler Hermes

Trade (exports + imports)

USD bn - Trade unions and Benchmark countries



Sources: IHS Global Insight, Euler Hermes

could be so effective is because the gains would be more fairly distributed among countries than the gains from reducing tariffs. The effect would be more important for smaller businesses, as barriers for them are harder to overcome. In its Enabling Trade Index, the World Bank identifies the "best" countries as Singapore, Hong Kong and the Nordics. This ranking could change over time as the latest Doing Business report (one component of the Enabling Trade Index) underlined the fact that low-income economies improved the most in 2013 in terms of their business environments, particularly some Sub-Saharan African countries.

Game Changer #10: Global rebalancing - don't put the cart before the horse

MAHAMOUD ISLAM

55%

of world GDP growth to come from the emerging markets in 2014-15

Growing in sync

Recent economic development has shown how strongly emerging economies have caught up with advanced economies and how growth paths between regions have become more synchronised. Between 2001 and 2008, the contribution of emerging economies to world GDP growth increased from 36% of GDP growth in 2001 to 98% in 2008, largely reflecting the Chinese boom and strong catch-up of other emerging economies (BRI and ECA). During the financial crisis and up to 2012, emerging economies supported global GDP growth (contributing 60%). In 2014 and 2015, AE and EM are expected to grow in synch, (i) together on rise, (ii) contributing to growth at quasi-similar levels (55% to 2014 GDP growth for the emerging economies). In particular, growth in emerging economies should ease to a more sustainable level on the back of rebalancing in China, while growth in advanced economies is projected to accelerate. Meanwhile, living standards will continue to improve in all main regions. In the early 2000s only the

GCC countries and Asian dragons (Singapore, South Korea, Hong Kong and Taiwan) among the emerging economies were able to match the living standards of advanced economies. Since then, some other countries have caught up, particularly some in Emerging Europe, such as Slovenia and Slovakia). This process is likely to continue in Asia and in Latin America, with countries such as Malaysia, Uruguay and Chile projected to reach living standard levels of the AE in the mid-term.

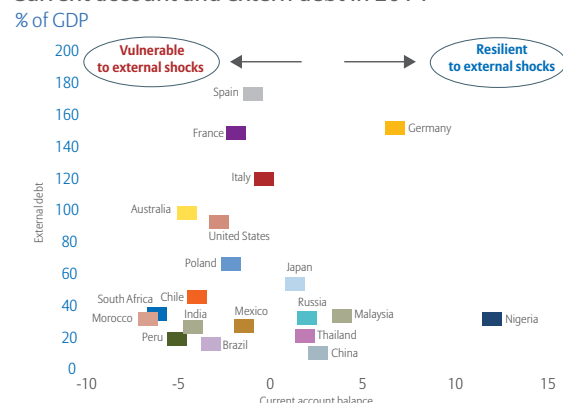
Current account swings

Enhancing financial strength will be crucial. One lesson that can be drawn from past years is that advanced economies are not immune to external financial shocks, particularly in relation to their debt sustainability. Indeed, vulnerabilities have increased through widening current account deficits and external debt levels, making them more fragile than emerging economies such as Malaysia. Weak public finances were perhaps the main trigger of this deteriorating financial strength. Restoring confidence through the improvement of financial fundamentals will be the key in the next few years to avoid new financial pressures. Fiscal consolidation in the eurozone was a start for the countries most at risk in that region, with current accounts set to continue to improve (from -0.4% of GDP in 2013 to +0.3% in 2014 for Greece and from -0.2% in 2013 to +0.6% in 2014 for Portugal), but economic growth is needed to consolidate these efforts.

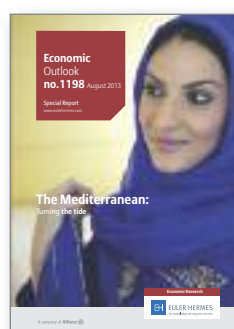
Politics vs. economics

Consolidating growth requires strong foundations. Structural adjustments through reforms will be key drivers for long-term growth. In the advanced economies, efforts will be concentrated on competitiveness to boost exports, innovation to reinforce growth potential and also fiscal policy to avoid financing gaps and maintenance of public debt at manageable levels. For the emerging economies, the process is under way. The business environment is improving in some but there is still a long way to go as many of the large emerging economies (including Brazil, Russia and India) continue to be difficult markets for investors because of legal barriers, administrative delays and perceptions of corruption. Building strong infrastructures should be part of this process as they are important engines for trade. However, perhaps even more important in this process are politics and the regulatory environment, with improvements in political stability and the rule of law key factors in reassuring investors and promoting corporate activity. This is all the more necessary since politics and economics often work to differing timetables. Indeed, economic agents need reassurance about the outcome of their investments and stable politics and appropriate legal frameworks are therefore needed. Moreover, structural adjustment processes take time before benefits materialise, typically from 5 to 10 years depending on the reforms implemented. For example, trade reforms as well as labour market reforms could take at least five years to have a durable effect on growth.

Current account and extern debt in 2014



Sources: IHS Global Insight, Euler Hermes



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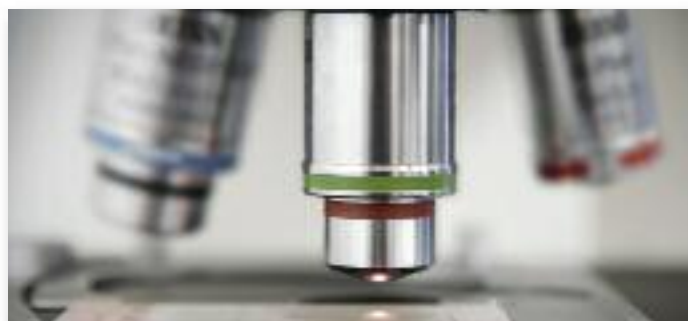
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