

Major Country Developments June 2017



By Byron Shoulton

Global Overview

Despite increased global political risks appearing in the Middle East, Europe, Asia, Latin America and the U.S., the global economy today looks more robust than it has been for some time. Two interest rate rises in the past six months by the U.S. Federal Reserve, growing inflation in major economies, higher manufacturing purchasing managers' indices, improving employment indicators and a strong start to 2017 in China - all suggest that there is an acceleration in global economic activity underway; albeit a modest one.

The big concerns about the global economy of recent years: deflation, negative bond yields and overly restrictive fiscal policies – have all become less apparent. The consensus is for average global expansion of 2.7% in 2017-18 compared with a lackluster 2.3% growth in 2016. There are nonetheless, a number of caveats to this more upbeat outlook. Global growth is not synchronized, reflecting that the world's leading economies are at different points of their business cycles. **China** appears to be furthest through its expansion phase: there is evidence of capacity constraints in some sectors, while the government tightens monetary policy through gradual curbing of credit growth (particularly to the real estate sector). In the U.S. the Fed is increasing the pace of its interest rate hikes as wages and inflation edge upwards and the labor market approaches full employment.

The expansion in **Europe** is less well advanced even though the regional economy is firmly in recovery mode. While unemployment is still elevated there are signs of a release to pent-up demand as consumers step up spending and businesses invest in advanced technology amidst a renewal in export growth. The European Central Bank remains some months away

from beginning to taper its quantitative easing program – preferring to keep showing that it will support the expansion as needed. The uneven recovery stages among the regions will mostly prevent a surge in economic growth or major upward pressure on commodity prices. Europe was the region that appeared to benefit most from low oil prices, but the recovery now appears to be sufficiently well established to withstand the current rising trends in energy prices, inflation and market interest rates. However, the fact that global growth is accelerating at a time when interest rates are gradually increasing and post-crisis stimulus is being slowly withdrawn represents an important step in the global recovery from the financial crisis of a decade ago.

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Among the consequences of the strengthening economic outlook are rising bond yields and inflation. Government bond yields in the U.S. and other developed markets have been on a generally upward trend this year, possibly signaling the end of a three-decade long bull market for these bonds. Global inflation of 4.5% is projected for 2017, the highest rate since 2011.

A rise in market interest rates will cause some casualties among overleveraged borrowers, but on the whole this is a welcome development, marking another milestone in the recovery from the 2008-09 global financial crisis. It will provide relief to financial institutions whose profitability has been undermined by

very low, and in some cases, negative interest rates. Overall, the expectation is that both bond yields and policy interest rates will remain low by historic standards. The Fed is likely to lift its funds rate modestly over the next two years (which would take it no higher than 2%), but policy rates will remain at zero in both the **euro zone and in Japan**. These forecasts suggest a reasonably benign interest-rate environment for emerging-market borrowers (notably corporates) with hard currency debt to refinance.

Against the backdrop of a steady global economy lies the highest level of political risk seen in years. At the center of this is uncertainty surrounding the Trump Administration in the U.S. With a flair for unpredictability and impulsiveness, an 'America first' trade and foreign policy, threatening to abandon support for NATO, renegotiating NAFTA, distancing from the European Union and from existing trade agreements, there's growing unease regarding the reliability of the U.S. as an ally and its standing vis-à-vis western political and economic alliances. In addition, ISIS has stepped up its attacks on western targets as well as within the Middle East. Among some unknowns are whether the political strains now visible in the Middle East and concerns over growing nationalist tendencies in the U.S. and the UK could set the stage for renewed loss of confidence which would dampen the current momentum to spend and consume.

China

The health of the Chinese economy remains one of the big risks to the global economy. After growing by 6.7% in 2016 the outlook is for GDP growth of 6.5% in 2017 before slowing to 4.5% in 2018. Growth has continued despite persistent inefficiencies in the state sector and recessionary conditions in the industrial north-east. Growth was attained last year at the cost of further increase in debt. The build-up in debt, particularly in the corporate sector and in real estate, is unsustainable. The speculation is that once President Xi Jinping has consolidated power at the

upcoming Chinese Communist Party conference in late 2017, he will sanction policies to rein in credit growth across the board. So far, the government has mostly targeted the real estate sector for reduced access to credit. Bottom line: slower Chinese growth seems inevitable over the next few years.

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Given China's importance as an engine of global growth and demand, the ripple effects will be felt around the world. Worst hit will be those countries that depend on exporting hard commodities to China, such as Australia, Chile and Mongolia. Next will be countries that have deep and broad trading relationships with China, such as South Korea and Taiwan. The rest of the world will feel the chill through turbulence in financial markets and declines in consumer and business confidence. The consensus is for a relatively benign outcome, given China's extreme level of indebtedness. Other economies whose paths China is tracking, such as Japan in the 1980's and Spain in the 2000's, were brought to their knees by systemic crises. This is not foreseen for China, partly because state involvement in the banking sector will ensure that no major lenders go bankrupt. Moreover, the slowdown will be policy induced, so the credit bubble will deflate rather than burst. However the balance of risks are still tilted to the downside and it is possible that the government may not be able to exert the level of control over the economy that it would like.

With the Chinese economy entering uncharted waters, a range of responses is plausible. For example, the slowdown could trigger a setback [if not a recession] in the U.S. in 2019, by weakening consumer and business sentiment. These confidence factors, together with higher interest rates, would likely bear down

on private consumption and investment. This could cause the U.S. economy to contract in 2019. The Fed would cut rates back toward zero, but overall growth would likely be limited to 1% and demand for imports would hit the U.S.'s main suppliers. Consequently, global growth would likely remain stuck at 2.1% in 2019. The forecast is for stronger growth in 2020-21 in both emerging markets and the developed world. The U.S. would in all likelihood experience a rebound and growth in China would strengthen, although at an average of 5% it will be below current growth rates, reflecting the economy's transition to one in which consumption rather than investment would be the main driver of growth.

Australia

Australia is undergoing structural changes as the mining investment boom, which peaked in 2012, continues to wind down. Since October-December 2016 the economy bounced back from a short-lived quarter-on-quarter contraction, and real GDP growth averaged 2.5% for the year as a whole. Growth is forecast to pick-up to 2.7% in 2017, reflecting disruption to economic activity (notably to coal exports and agriculture) caused by a cyclone which hit the State of Queensland in March. A subdued outlook for global growth and commodity prices will act as a constraint on both fiscal and monetary policy over the next 3-4 years, weighing on government revenue and keeping interest rates at low levels. In this environment, the sustainability and social impact of high and rising real estate prices will remain a cause for concern.

The economy's ongoing transition from the investment phase of the mining boom to the production phase will continue to weigh on growth. Mining investment is not expected to bottom out until 2018. Weak global demand will also limit GDP growth over the next two years. Although prices for Australia's raw material exports, notably coal and iron ore, have increased since 2016, they may lose momentum during 2017 and decline next year, when it is expected that China's economic growth will slow sharply.

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The impact on the Australian economy would be widespread, as lower commodity export prices have a negative effect on government, business and household incomes. Overall, the consensus is for economic growth to average 2.5% per year over the next 3-4 years. This would be among the fastest rate of growth in the OECD, but below Australia's historic average of 3.8% a year during 1996-2005.

Inflation is forecast to accelerate to 2.2% in 2017 up from 1.3% in 2016. This mainly reflects recovering energy prices, although damage to crops in some of Queensland's key agricultural areas from the cyclone will also exert temporary upward pressure on fresh produce prices.

Australia's external sector is tied closely to commodity prices, with iron ore, coal and liquefied natural gas constituting 54% of exports. The combination of recovering commodity prices and mining export volumes has propelled the trade balance back into surplus since late 2016. Meanwhile, the services balance has benefited from the depreciation of the Australian dollar since 2014, which has supported tourism and educational services exports. It is expected that these trends will be maintained through 2017-18. However, deteriorating global economic conditions in 2018 could put renewed downward pressure on commodity export prices and cause the trade balance to fall back into deficit by year-end 2018.

Australia's long-standing security alliance with the U.S. will continue to be of primary importance, but it is likely to become harder to manage under President Trump. The strong reaffirmation of security ties during official meetings between the U.S. President and Vice President with the Australian Prime Minister

have gone some ways in soothing diplomatic relations between both countries. Australia will face a potentially delicate balancing act between its security ties with the U.S. and strengthening economic ties with China, its largest trading partner.

Australia is likely to pursue deeper bilateral relations with other regional allies such as Japan, Singapore and Indonesia as a mitigation strategy. Within the Pacific region, Australia remains a major player. However, its dominant status in the region is becoming more contested. China's economic footprint in the Pacific is growing, and Australia's share of foreign aid to the region has shrunk, owing to budget-saving measures.

Saudi Arabia

While the Saudi authorities are sincere about their goal of increasing the share of the kingdom's non-oil exports, the ratio of non-oil exports to imports have not changed much from the previous decade. A worrying conundrum of the persistent slump in oil prices is that, given its lack of a track record in building a viable non-oil economy, the kingdom needs relatively high, stable revenue from oil exports in order to fund the non-oil export industries needed to move the economy away from its dependence on oil.

In operational terms, this means that the development of the non-oil sector depends on the health of the government's foreign currency reserves. A lessening of Saudi's demand for imports could help sustain reserves; indeed in April 2017 the central bank announced that FX reserves were solid, equivalent to 80% of GDP. This might be helped further by a decline in Saudi imports over the next year.

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Given that Saudi Arabia's exports of crude have remained fairly constant, even during the recent period of low prices, it is evident that the kingdom uses its chief export commodity as part of a geopolitical strategy. When keeping export volumes of crude high, the country's rulers aim to put downward pressure on market prices, lowering the profitability of rival producers and maintaining the kingdom's dominance over the oil export market. When agreeing to lower production and export, it strives to reduce global supply and increase demand and market prices.

During the recent visit of President Trump, Saudi Arabia negotiated deals with U.S. corporates in defense, aviation, industry, energy and financial services sectors worth hundreds of billions of dollars. Although some of these deals await final agreements and execution, they attest to a substantial intensification of Saudi-U.S. commercial ties, with significant strategic implications for both countries. The amounts involved are estimated to total between \$300 billion- \$400 billion.

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Defense purchases are center stage, reflecting the importance placed on defense in the context of the U.S.-Saudi Defense Ministry \$110 billion package unveiled in Riyadh. Important to note is that some of the deals involve a domestic Saudi manufacturing component, meeting a key aim of the Vision 2030 program – led by the Saudi deputy crown prince.

In the energy sector – the mainstay of the Saudi economy- the state-owned Saudi Aramco oil company signed \$50 billion worth of deals with 12 U.S. companies, which affirms the strategic linkages between the kingdom's oil and gas sector and U.S. engineering and service companies. The small share of investment in

the oil sector – relative to defense – is likely to be a reflection of the impact of low crude prices on oil and gas investments. Financial sector investments are also prominent, with the kingdom’s sovereign wealth fund – the Public Investment Fund- announcing plans to place \$20 billion with a U.S. asset management firm. However, this also increases the kingdom’s financial exposure to risks in the U.S. market and the broader global economy.

The Saudi government is committed to maintaining the free convertibility of the currency, the riyal; hence there are no significant restrictions on inward or outward movement of funds by companies or individuals. Although there are no restrictions, the Saudi Monetary Authority (SAMA) closely monitors foreign-exchange transactions to deter speculation, fraud and money-laundering. Banks must report to SAMA the export of riyal bank notes and receive approval prior to the participation of foreign banks in riyal-denominated syndicated loans or foreign-currency syndicated transactions arranged by nonresidents. SAMA has shown considerable flexibility towards such arrangements, however, and has cooperated fully with the vast majority of transactions.

As the Saudi population continues to grow and national budget deficits persist in the face of low oil prices, many of the kingdom’s leaders have turned toward a form of “austerity” on subsidies. If the country’s leader receives more leeway to conduct reforms, he will need to proceed cautiously so as to avoid encouraging public discontent. Traditionally, Saudi rulers have used subsidies, cash grants and related largess to buy a measure of political tranquility. The necessary belt-tightening will almost unavoidably lead to some negative political and social outcomes over time.

Taiwan

Over the past three decades Taiwan’s growth has

been underpinned by its deepening economic links with mainland China, despite past political antagonism. Increased investment by Taiwan in China and other Asian countries initially encouraged the relocation offshore of labor-intensive industries; more recently, more capital intensive industrial capacity has also begun to depart. Accordingly, Taiwan has developed some higher value-added industries, including high-end electronics. Progress has also been made on developing the international reputation of domestic companies and enhancing its services sector, but Taiwan lags a number of its rivals in Asia, such as South Korea, on this front.

This is further compounded by a lack of free-trade agreements compared with its competitors. Taiwan has one of the highest levels of GDP per head in Asia (\$48,400), but income growth has stagnated in recent years amid weak economic expansion.

Taiwan’s long-term prospects will rise and fall in line with those of mainland China. The mainland is already Taiwan’s main export market, and, despite the Taiwan government’s best efforts, dependence on the Chinese economy will fall only slightly over the medium term. A more drastic economic slowdown in China than currently expected would have significant negative repercussions for Taiwan.

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Emerging South-east Asian economies will increasingly alleviate this reliance but not for some time. Taiwan will be in a strong position to tap into these maturing consumer markets, given its long-standing and adaptable high-technology industrial base. Beginning in 2030 China is expected to review its approach towards Taiwan including investment and commercial

relations. However, most Taiwanese residents may be unreceptive to closer political relations. Links with other key allies will therefore remain important as Taiwan looks to shape its interaction with the mainland on favorable terms. Going forward Taiwan's economic policy will increasingly focus on developing trade relations with regional and international economies other than China. This will be vital to sustaining export growth as well as investment in the domestic economy. A focus on commercial ties with Asian countries other than China has helped tourism. Despite a loss of travelers from the mainland recently, Taiwan has seen an increase in visitors from Japan, South Korea and South-east Asia.

Local political pressures will force the government to implement further increases in social spending in 2017-21; however, thereafter fiscal allowances will become untenable under the weight of the growing dependent population. Immigration policies may have to be loosened despite some public opposition, in order to maintain the competitiveness of the workforce. The central bank of Taiwan will have to adapt as the economy becomes increasingly integrated with that of China and the rest of Asia.

Sustained economic growth will depend on the continued successful shift of the economy from industry to services. However, within the next decade the emphasis will have moved towards raising the quality of the degree of value added within the services sector itself. Taiwan's location in one of the most dynamic regions will continue to support economic expansion. However, it will be its changing relationship with China that will be most influential in its long-term performance. As China becomes an all-out competitor, in addition to a key market, Taiwan will have to cope with a new norm of low growth with real GDP expected to expand by an annual average of closer to 1% beginning in the next decade. Taiwan's president, in office for one year, is crafting an industrial policy to promote innovation that seeks to create an Asian Silicon Valley in Taiwan and launching a

\$29.3 billion infrastructure stimulus, covering projects from railways to renewable energy. Investors may like the story they have been told about revitalizing the Taiwanese economy. The test will be their willingness to invest in the new plans outlined by the government.

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FCIA's Deals Of the Month

Bank's A/R Purchase Policy: \$31,500,000 limit of liability on a Key Buyer Policy in Mexico's auto sector.

Single Buyer Policy: \$18,000,000 limit of liability on a single buyer nonpayment coverage in domestic auto sector.

What is Trade Credit Insurance?

If you are a company selling products or services on credit terms, or a financial institution financing those sales, you are providing trade credit. When you provide trade credit, non-payment by your buyer or borrower is always a possibility. FCIA's Trade Credit Insurance products protect you against loss resulting from that non-payment.