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SCENARIOECO

Economic and Sector Studies

SUSTAINED GROWTH, BUT PAST THE SWEET SPOT

- The world economy is on track to reach 3.8% growth in 2018, marginally up from the 3.7% recorded in 2017, on the back of a fiscal impulse in the United States, and faster demand growth in commodity-exporting countries. While shifting toward a domestic consumption-driven economy, China's economic growth is slowing down but remains a key driver of the global expansion.
- There are signs, however, that the growth momentum is no longer broad-based as it was in 2017. After last year's acceleration, activity in the euro area and in Japan is moderating.
- Tariffs on imports announced by the Unites States and the first retaliatory measures still only concern a small fraction of global trade. The risk is, however, that this escalates to a full-blown trade war.
- A busy political agenda awaits with several important elections and the challenge in Europe to quickly advance on the reform agenda to tackle migration, deepen EMU and finalise the Brexit Withdrawal agreement.
- Market volatility has already seen several spikes this year, and not just due to political risks. Emerging markets remain under pressure from Fed policy tightening and the risk of further significant dollar appreciation, albeit that the situation varies greatly from country to country.

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Outlook Summary

GLOBAL ECONOMY

- The ongoing fiscal expansion in the United States is likely to extend the cyclical upswing underway since mid-2016. China still enjoys strong growth momentum with manufacturing accelerating. With the two largest economies on a firm footing, the world economy is on track to reach 3.8% growth in 2018, marginally up from 3.7% last year.
- Yet, there are signs that the momentum is no longer broad-based as it was in 2017. After last year's acceleration, activity in the euro area and Japan is showing a moderation.
- Tariffs on imports announced by the Unites States and the first retaliatory measures still only concern a small fraction of global trade. The risk is, however, that this escalates to a full-blown trade war.
- Headline inflation is moving up both in the US and the euro area, driven by higher energy prices, but core inflation is broadly stable.

ADVANCED ECONOMIES

- Tax cuts and higher spending caps in the United States will sustain strong GDP growth over the next two years, lifting both consumer spending and investment and extending the current expansion cycle into 2020.
- The euro area has lost dynamism since the beginning of 2018, with a soft manufacturing performance in the 1Q18 and a decline in business optimism. Trade tensions are a downside risk, especially for the important export-oriented industries of Germany. We still expect above trend growth in the euro area in 2018 (over 2%) with demand supported by job creation (the unemployment rate stood at 8.5% in March, the lowest value since end-2008) and still robust global trade. In France, growth disappointed in 1Q18, but the full year is expected to clock in at close to 2% in 2018.
- Since early 2018, Brexit negotiations have stalled. Despite strong export demand, growing uncertainties on the actual consequences of the UK-EU divorce after the "transition period" are having an adverse impact on investment, thus lowering UK growth relative its European partners.

EMERGING MARKETS

- Emerging markets are expected to benefit from firm global growth and recovering commodity prices. Asia will remain the fastest-growing region worldwide with continued strong growth in China and India.
- We expect a modest recovery in activity in Latin America reflecting improving prospects for commodity exporters. Brazil emerged from a two-year-long recession in 2017, but economic growth will remain sluggish reflecting stagnant private consumption.
- In Africa, economic growth is benefiting from the improved international economic environment, with exports growing at more than 20% yoy in 1Q18, amid volume and price increases. Internal drivers are slow-moving and overall GDP growth will remain modest. The rise in public debt and recurring current account deficits constitutes vulnerability factors.

CENTRAL BANKS

- The ECB set out a timetable to end QE, cutting asset purchases by half after September and ending QE altogether at year-end. We expect to see the first ECB rate hike in September 2019.
- Rapid US growth should lift core inflation and trigger further Fed tightening. We expect four more 25bp hikes up to December 2019. We expect a gradual reduction of Fed's balance sheet size until 2020.
- Central banks in emerging-markets are set to tighten monetary policy in a context of less favourable international monetary conditions.

FINANCIAL MARKETS

- The US 10Y Treasury bond yield broke 3% in April, for the first time in over four years. Interest rates are expected to increase further up to 2020 with Fed tightening, larger bond issuances to finance the fiscal stimulus and higher inflation expected to put pressure on yields.
- Euro area interest rates are also likely to increase in the aftermath of the end of the quantitative easing (end 2018). We expect the 10Y Italian sovereign spread (over Germany) to remain at around 200bp with the prospect of looser fiscal policy and on-going political uncertainty.
- In contrast to 2017, one of the historically least volatile years on record for financial markets, we expect to see further volatility spikes in 2018 and 2019, amid higher risks in the global economy and tighter monetary policy.
- Emerging FX markets have seen some volatility, with Argentina and Turkey hardest hit. The emerging market complex is exposed to tighter global monetary conditions, but the economic fundamentals differ making a systemic emerging market financial crisis unlikely at this stage.

DEBT: A CURB ON GROWTH?

- **The recovery in global growth conceals a rise in debt.**
- **Emerging countries are exposed to tighter global monetary conditions.**
- **The nature of their debt provides some differentiating factors.**

The IMF has sounded the alarm

In its annual report on global public finances published in April, the IMF laments the fact that total global debt, public and private, has reached a new record of $164tn, or 225% of global GDP. This ratio is up 12pp compared with the previous peak of 213% in 2009.

This increase in global debt is largely attributable to China which alone accounts for 43% of the increase since 2007. However, the phenomenon also affects other countries. Public debt now averages 106% of GDP in developed countries, a record level since World War II. In major emerging countries, private sector debt has risen significantly over the last ten years, from initially low levels. The public debt of these countries is at levels seen only during the 1980s' debt crisis, amounting to an average of 50% of GDP. Finally, in low-income developing countries, the public debt ratio has risen rapidly to an average of 40% of GDP in 2017.

This warning from the IMF contrasts with the message of previous years which encouraged countries that could, to use debt expansion to support activity. Today, global growth is robust and the normalisation of US monetary policy is already well under way. The IMF's message resounds as a criticism of US fiscal stimulus and a warning signal on the indebtedness of emerging countries.

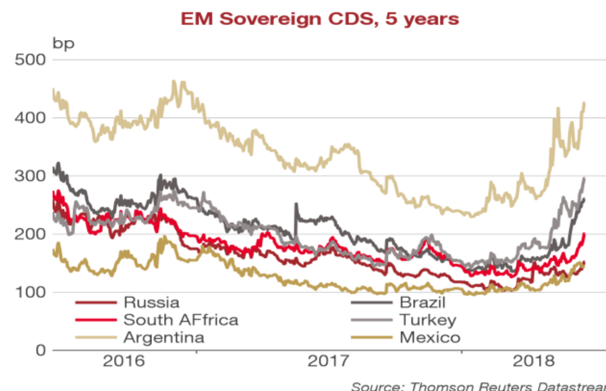
A curb on growth

In developed countries, the great financial crisis in 2009 ultimately failed to reverse the trend of growing debt. The way in which central banks had to deal with the crisis even had the effect of stimulating this trend. While it is necessary to be concerned, it is difficult to maintain that this constitutes an immediate curb on growth or an imminent danger for financial stability. A low interest rate regime makes it easier to carry this debt, as illustrated over the last three decades by the case of Japan.

It is much more of an open question for the major emerging countries. Given the lack of adequate domestic savings, part of their debt continues to be denominated in convertible currencies, often in dollars. Servicing this debt becomes increasingly expensive with the rise in US rates or the appreciation of the dollar, with no connection with their own economic cycle. When their currency depreciates, they are driven to tighten their monetary policy in response to increased aversion to emerging market risks. If, in this context, US rates were to be raised more significantly than expected and the dollar appreciated substantially, the conditions would be in place for a shock to the growth of emerging countries.

With the normalisation of US monetary policy, global monetary conditions are gradually tightening. Since end-April, in the wake of the divergence of the Argentinian peso, the markets have started to reassess the underlying risk to emerging market assets. This has resulted in a decline in stock market valuations, the depreciation of currencies against the dollar and an increase in bond yields.

EM Sovereign CDS, 5 years



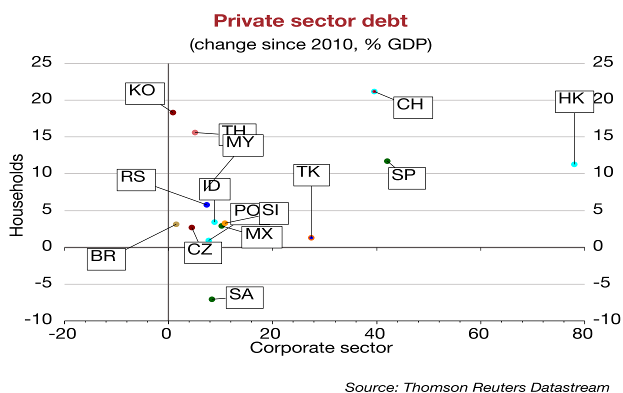
Source: Thomson Reuters Datastream

This is taking place against the backdrop of a rise in US bond yields and the appreciation of the dollar since the beginning of the year, two features which recall those of the systemic emerging market crises (dollar-denominated sovereign debt crisis in 1982, Mexican crisis in 1994, Asian crisis in 1997). The question is whether these market movements are the prelude to a more significant adjustment that could be amplified by a reassessment of the political risks, notably in Turkey and Latin America.

Important differentiating factors

Are we on the eve of a systemic crisis such as emerging countries have experienced on a recurring basis in history? An examination of the indebtedness of the major countries provides some differentiating factors and helps temper this fear. While the public debt of some

countries is significantly higher (South Africa, Brazil, Egypt, China), the debt is now primarily issued and denominated in local currency. The levels of foreign currency-denominated public debt are generally lower, a notable difference compared with the past.



Source: Thomson Reuters Datastream

The debt of the non-financial private sector, companies and households, has increased substantially since the beginning of the decade, but from often low initial levels. This is due in part to a virtuous phenomenon of developing national banking sectors and financial deepening. However, the speed at which this debt has been accumulated raises the issue of its quality. It will be tested during the next reversal of the cycle, particularly in China. In Turkey, credit has been partially financed by banks' external debt, which exposes the country to a growth and external financing shock. Moreover, corporate debt denominated in hard currencies has increased significantly in various countries (Brazil, South Africa, Turkey, Mexico, Indonesia, China, etc.). It is sometimes the counterpart of foreign asset acquisition, which can help temper the fears. In the event of pressures on the dollar, the risk would be sectoral rather than macro-economic as the overall level of this external corporate debt generally remains manageable.

However, low-income countries less integrated in the international capital markets, in Sub-Saharan Africa and Central Asia, are more directly sensitive and exposed to tougher dollar-denominated financing conditions.

A risk related to the rise in rates in dollars

The repricing under way of emerging market assets has until now been moderate when compared to the repricing that accompanied the "taper tantrum" in May 2013 or during the fears over China in August 2015. Argentina is a singular case among the major countries as there has been a significant deterioration in its fundamentals recently. Apart from Argentina, Turkey has diverged due to the scale of its current account deficit. In other major countries, we have not seen any substantial capital outflow. Moreover, the current account deficits of these countries are lower than in the past. Inflation is generally moderate, there has been little or no increase in local rates and debt is mainly in local currency. The translation to a higher US yield curve which is currently under way was bound to lead to repricing. It is not unusual for this to take place through successive shocks. Consequently, we remain constructive for the growth scenario of major emerging countries which continues to be bolstered in 2018 by global trade and the rise in commodity prices, with China decelerating slowly.

We do not anticipate any sharp appreciation in the dollar, or US long-term interest rates, but if this were the case, they would be factors aggravating the risks and stress for emerging countries. Long-term interest rates could increase due to US Treasury issue requirements and the end of quantitative easing which will reduce the relative scarcity of risk-free assets. These trends and the uncertainties over inflation could lead to a rebound in the term premium. This premium remains unusually low, as shown in the models which break down long-term rates between an estimate of the real neutral rate, expected inflation and a term premium. If this rise were to occur suddenly and coincided with a stronger than expected slowdown in China, the entire context for growth in emerging countries would be modified. We do not anticipate this in 2018. However, these factors could have an impact subsequently.

Economic Forecasts

Real GDP growth (annual, %)	2015	2016	2017	2018 (f)	2019 (f)	Share of world GDP 2016 (%) Purchasing power parities[1]	Share of world GDP 2016 (%) Current exchange rates	GDP - 2016 USDbn Current exchange rates
Developed markets	**2.3**	**1.6**	**2.3**	**2.2**	**1.9**	**37.8**	**57.1**	**43 042**
United States	2.9	1.5	2.3	2.8	2.4	15.5	24.7	18 624
Japan	1.4	1.0	1.7	1.2	0.9	4.4	6.6	4 961
Euro area	2.0	1.8	2.5	2.1	1.8	11.6	15.7	11 930
Germany	1.5	1.9	2.5	2.0	1.9	3.3	4.6	3 473
France	1.0	1.1	2.3	1.8	1.7	2.3	3.3	2 464
Italy	0.8	1.0	1.6	1.4	1.5	1.9	2.5	1 861
Spain	3.4	3.3	3.1	2.6	2.1	1.4	1.6	1 238
United Kingdom	2.3	1.9	1.8	1.5	1.3	2.3	3.5	2 658
Emerging markets	**4.1**	**4.2**	**4.6**	**4.7**	**4.6**	**62.2**	**42.9**	**31 261**
Asia	6.3	6.0	6.2	6.1	5.9	35.0	24.8	18 728
China	6.9	6.7	6.9	6.6	6.2	17.7	14.9	11 181
India	8.2	7.1	6.7	7.2	7.1	7.3	3.0	2 210
Sub-Saharan Africa	3.2	0.9	2.3	3.1	3.8	3.9	2.3	1 148
Latin America	0.1	-0.6	1.5	2.1	2.5	7.9	6.6	4 801
Brazil	-3.8	-3.6	1.0	2.0	2.5	2.6	2.4	1 809
Eastern Europe (incl. Turkey, ex. Russia)	3.0	2.6	5.2	3.8	3.0	4.8	3.1	2 341
Russia	-2.8	-0.1	1.5	1.2	1.2	3.2	1.7	1 296
North Africa and Middle East	2.7	5.3	1.8	2.9	3.3	7.4	4.3	2 947
World - Weighted by PPP rates	**3.4**	**3.2**	**3.7**	**3.8**	**3.6**	**100**		
World - At current exchange rates	**3.0**	**2.7**	**3.3**	**3.3**	**3.1**		**100**	**74 303**
Oil price (Brent USD/Barrel)	**52.5**	**43.5**	**54.0**	**70.0**	**65.0**			
Consumer prices index (annual growth rate, %)								
United States	0.1	1.3	2.1	2.4	2.2			
Japan	0.8	-0.1	0.5	1.4	1.7			
Euro area	0.0	0.2	1.5	1.4	1.6			
Germany (HICP)	0.2	0.5	1.7	2.0	1.9			
France (CPI)	0.0	0.2	1.0	1.8	1.5			
Italy (HICP)	0.1	-0.1	1.3	1.0	0.9			
Spain (HICP)	-0.6	1.4	1.4	1.4	1.3			
United Kingdom	0.0	0.7	2.6	2.4	2.3			

[1] Purchasing Power Parity (PPP) rates are used to equalise the cost of a standardised basket of goods between different countries. The GDP weighting of different countries as a share of world GDP expressed in PPP is based on the latest estimates by the World Bank.

	19/06/2018	déc 2018	juin 2019	déc 2019	2016	2017	2018 (f)	2019 (f)
Interest rates								
United States								
Fed Funds target rate	1.75-2	2-2.25	2.5-2.75	2.75-3	0.39	0.95	1.80	2.50
10 year Gvt Bonds	2.9	3.4	3.5	3.7	1.8	2.4	3.1	3.5
Japan								
Complementary Deposit Facility rate	-0.10	-0.10	-0.10	-0.10	-0.08	-0.10	-0.10	-0.10
10 year Gvt Bonds	0.0	0.2	0.3	0.4	0.0	0.1	0.1	0.3
United Kingdom								
Bank rate	0.50	0.75	0.75	0.75	0.40	0.30	0.60	0.75
10 year Gvt Bonds	1.3	1.5	1.5	1.5	1.3	1.2	1.5	1.5
Euro area								
Refinancing rate	0.00	0.00	0.00	0.25	0.01	0.00	0.00	0.05
10 year Gvt Bonds								
Germany	0.4	0.9	1.2	1.4	0.1	0.4	0.7	1.2
France	0.7	1.2	1.5	1.7	0.5	0.8	0.9	1.5
Italy	2.6	3.3	3.5	3.6	1.5	2.1	2.7	3.5
Spain	1.2	1.9	2.2	2.4	1.4	1.6	1.6	2.2
Exchange rates								
EUR / USD	1.15	1.20	1.22	1.25	1.11	1.13	1.21	1.23
EUR / GBP	0.88	0.91	0.93	0.94	0.82	0.88	0.89	0.93
EUR / JPY	127	132	135	138	120	127	132	135
GBP / USD	1.32	1.32	1.32	1.32	1.35	1.29	1.36	1.32
USD / JPY	110	110	110	110	109	112	109	110

EURO AREA

- **GDP growth will remain strong in 2018 but will start to gradually soften in 2019.**
- **The ECB will end its quantitative easing after December 2018 and start its rate hikes in late 2019.**
- **Political uncertainties and the threat of mounting trade protectionism are the main risks.**

The euro area is set to post above-trend growth in 2018. Following several years of underinvestment, capital expenditures will continue to recover. Consumer confidence indices, still at historical highs, also suggest strong domestic demand ahead.

The soft patch at the beginning of 2018 seems related to the negative impact of higher oil prices, the lagged effect of euro appreciation, and uncertainties regarding US trade policy. Growth should, nonetheless, remain on track, backed by an improvement in employment levels, strong private consumption and a still accommodative policy mix. Buoyant international trade will also remain supportive for both intra- and extra-euro area exports in 2018 and 2019.

Economic activity is however likely to weaken in 2019. After three years of strong growth, the investment cycle should soften. Long term interest rates and risk premia are expected to adjust upwards, along with the very gradual "normalization" of monetary policy. At the June meeting, the ECB said that it expects to keep rates at their present level at least through the summer of 2019 and set out a timetable for ending QE, cutting asset purchases by half after September and ending it altogether after December 2018.

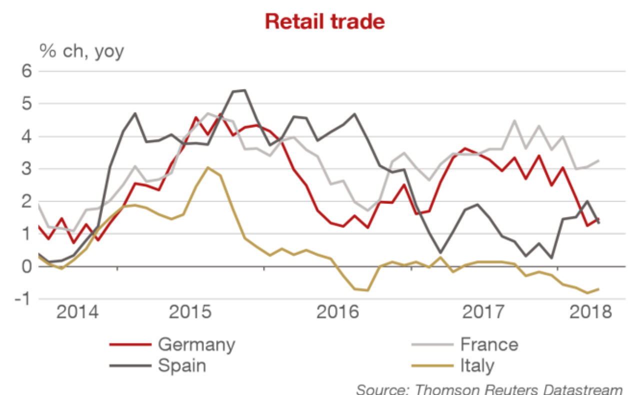
Looking ahead, inflation is likely to accelerate under the effect of the euro depreciation and with growing supply-side constraints. We nonetheless expect inflation to remain below the 2% mark in 2018-19. There is however a risk that inflation could pick-up faster, with bottlenecks in the labour market leading to a faster-than-expected monetary tightening, precisely when growth starts to run out of steam.

The threat of mounting trade protectionism and political uncertainties undermining support for European cooperation are the main risks. As observed in April-June, when markets repriced political risk in Italy, the perceived fragilities regarding economic policy coordination at the European level can ultimately damage confidence and hurt economic growth.

Long term interest rates, public bond 10-y yields

Source: Thomson Reuters Datastream

Retail trade



Source: Thomson Reuters Datastream

	2015	2016	2017	2018 (f)	2019 (f)
Real GDP, % ch	**2.0**	**1.8**	**2.5**	**2.1**	**1.8**
Household consumption	1.8	1.9	1.7	1.5	1.7
Public consumption	1.3	1.8	1.2	1.3	1.5
Investment	3.0	4.5	3.1	2.7	2.4
Exports	6.1	3.4	5.3	3.7	4.0
Imports	6.5	4.8	4.3	3.1	4.2
Purchasing power of disposable income, % ch	**1.5**	**1.8**	**1.6**	**1.7**	**1.4**
Unemployment rate, %	**10.9**	**10.0**	**9.1**	**8.4**	**7.9**
Households saving rate, % of disposable income	**12.4**	**12.2**	**12.1**	**12.2**	**11.9**
Inflation rate, %	**0.0**	**0.2**	**1.5**	**1.4**	**1.6**
Fiscal balance, % of GDP	**-2.1**	**-1.5**	**-1.2**	**-0.9**	**-1.2**
Current account balance, % of GDP	**3.2**	**3.4**	**3.5**	**2.9**	**2.9**

GERMANY

- **Albeit is still firm, growth will slow down in relation to the level seen in 2017.**
- **Inflation is being push up by the rise in oil prices and should increase slightly in 2018.**
- **Fiscal policy will maintain a slight expansionist bias in the years ahead.**

GDP rose by 2.5% in 2017, the strongest annual growth level since 2011. High-frequency indicators already suggest a slackening of pace in early 2018, which confirms our scenario of some slowdown. We look for GDP growth of 2% in 2018 and 1.9% in 2019.

Exports are set to remain firm, driven by still strong international trade, but investment should moderate in 2018-2019. Uncertainties around increased trade protectionism, which is a problem for the many export-driven German industries, are already reflected in the opinion surveys of business managers, which show a deterioration in confidence in 1H18.

Despite stronger wage trends, consumption should slow with higher energy prices penalising purchasing power and a on the back of a slight increase in the household savings rate.

The strength of the labour market, characterised by growth in employment and wages (in the public sector and metals sector), has only produced moderate signs of inflationary pressure. However, surveys in the industrial sector indicate significant difficulties in recruitment, and supply constraints could end giving rise to price pressures going forward and a steeper increase in core inflation. The increase in the oil price is already weighing on consumer prices, which are expected to increase by 2% in 2018 and 1.7% in 2019 (versus an average of 0.8% in 2015-2017).

Fiscal policy will remain slightly expansionary with increased public investment in social housing and infrastructures. The coalition agreement also agreed to cut taxes (a gradual cut in the solidarity tax paid by citizens of the former West Germany after reunification) and support family-related expenditure. The government will nonetheless still maintain a budget surplus.

Bond yields will continue to rise moderately (the average 10Y Bund yield was 0.5% in 1H18 versus 0.4% in 2017), such that monetary conditions will remain very favourable.

The main risks weighing on our scenario are a more protectionist US trade policy and a disorderly Brexit. In the longer term, Germany's low level of demographic growth, with a decline in the working population, should increasingly weigh on growth potential.

	2015	2016	2017	2018 (f)	2019 (f)
Real GDP, % ch	**1.5**	**1.9**	**2.5**	**2.0**	**1.9**
Household consumption	1.6	1.9	2.0	1.4	1.7
Public consumption	2.9	3.7	1.5	1.3	2.1
Investment	1.0	2.9	4.0	3.2	2.1
Exports	4.7	2.4	5.3	3.6	4.1
Imports	5.2	3.8	5.6	3.1	4.3
Purchasing power of disposable income, % ch	**1.9**	**2.2**	**2.0**	**2.0**	**1.9**
Unemployment rate, %	**6.4**	**6.1**	**5.7**	**5.2**	**4.9**
Households saving rate, % of disposable income	**9.6**	**9.7**	**9.9**	**10.5**	**10.7**
Inflation rate, %	**0.2**	**0.5**	**1.7**	**2.0**	**1.9**
Fiscal balance, % of GDP	**0.7**	**0.8**	**0.9**	**1.0**	**1.0**
Current account balance, % of GDP	**9.0**	**8.5**	**8.1**	**8.0**	**7.9**

FRANCE

- **Growth is set to moderate slightly in 2018-2019, but will remain above potential.**
- **The employment recovery will continue and drive down the unemployment rate.**
- **Rising oil prices and renewed political uncertainty in the euro area are key risk factors to watch.**

Activity is going through a soft spot in early 2018. The French economy is feeling the pinch of several negative temporary factors (timing of tax changes, strikes in the transportation sector, rising oil prices…) which we expect to ease in the second half.

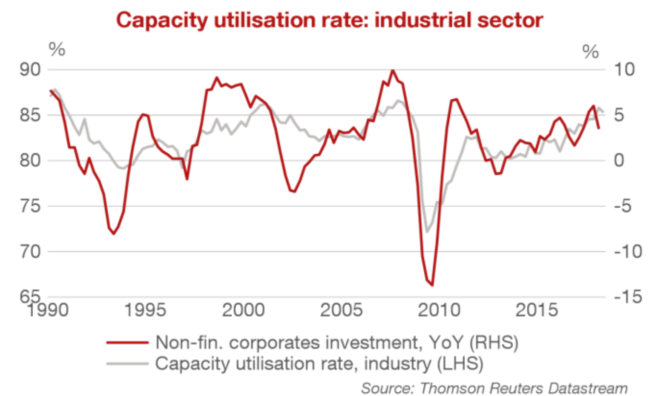
Notwithstanding short-term fluctuations, GDP growth is expected to remain above potential, although slightly below 2%, on average in 2018 and 2019. Key to this forecast is our expectation that private consumption will accelerate starting in mid-2018 after nearly two years of weakness. Indeed, we expect oil prices to moderate from their recent highs and to weigh less on households' purchasing power. Furthermore, tax changes are now set to turn more favourable to consumers (cut on social contributions set for October) and the labour market will keep on recovering.

Employment and hiring intentions

Source: Thomson Reuters Datastream

More robust consumption is set to further support business investment, especially as capacity utilisation in the industrial sector is already high. On the other hand, prospects for household investment look more modest after a strong bounce-back in 2016-2017: public support schemes are being scaled back and households' housing purchasing power will be hit by rising prices and increasing interest rates.

Capacity utilisation rate: industrial sector



Source: Thomson Reuters Datastream

On the external front, we expect exports to benefit from firm global demand over coming years. The effects of recent and ongoing reforms (labour market, professional training, unemployment insurance…) on competitiveness are likely to stem the trend decrease in France's export market share in the medium term.

Key risks to this scenario relate to the external environment, notably to oil prices and political risks in the euro area. On the domestic front, high levels of debt (both in the public and the corporate sectors) have structurally increased France's sensitivity to a rise in interest rates. Furthermore, the appearance of labour shortages, despite still-high unemployment, needs monitoring as it could weigh on growth.

	2015	2016	2017	2018 (f)	2019 (f)
Real GDP, % ch	**1.0**	**1.1**	**2.3**	**1.8**	**1.7**
Household consumption	1.4	2.0	1.1	1.1	1.7
Public consumption	1.0	1.4	1.4	1.3	1.2
Investment	0.9	2.7	4.7	2.7	2.2
Exports	4.4	1.5	4.7	4.7	4.2
Imports	5.7	3.1	4.1	2.6	4.1
Inflation rate, %	**0.0**	**0.2**	**1.0**	**1.8**	**1.5**
Purchasing power of disposable income, % ch	**0.9**	**1.8**	**1.4**	**1.0**	**1.9**
Unemployment rate, %	**10.0**	**9.8**	**9.1**	**8.7**	**8.1**
Households saving rate, % of disposable income	**14.1**	**14.0**	**14.2**	**14.1**	**14.2**
Fiscal balance, % of GDP	**-3.6**	**-3.4**	**-2.6**	**-2.4**	**-2.9**
Current account balance, % of GDP	**-0.4**	**-0.8**	**-0.6**	**-1.2**	**-1.0**

ITALY

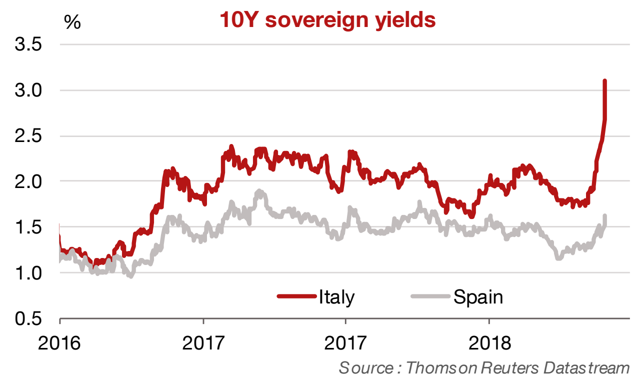
- **GDP growth is expected to moderate in 2018 and 2019 amid higher political uncertainty.**
- **The announced tax cuts are expected to support growth, but will delay fiscal consolidation.**
- **Financial market tensions are set to persist, but market access should not be compromised.**

Italy's economy expanded 1.5% in 2017, the most since 2010, but well below the average of the euro area. GDP growth is set to moderate in 2018 and 2019 and to continue benefiting from export demand and a recovery in business investment.

Risks to the growth outlook have become more tilted to the downside due to political uncertainty and higher market volatility. At the same time, fiscal expansion may offer some near-term support to growth, while any reform roll-back would erode the already low growth trend potential. A preliminary agreement between the League and the Five-Star Movement forming a government coalition collapsed in late May, due to the President's objection to the appointment of a finance minister hostile to the euro. The President's veto triggered a political crisis and market turbulence. A last-minute agreement led by the same coalition helped restore confidence.

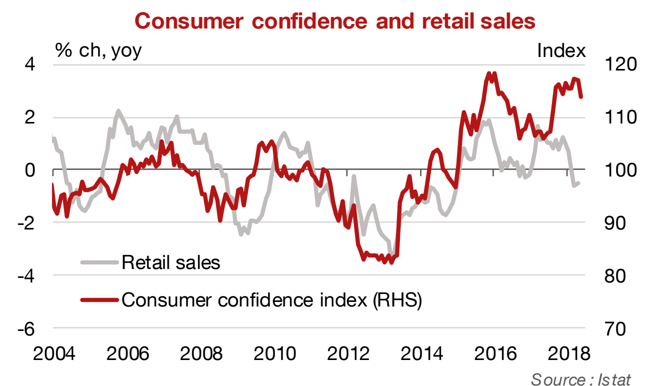
The climate of uncertainty has already led to a marked rise in sovereign spreads. Higher financing costs are likely to weigh on business investment, which was very robust until 1Q18. Household consumption is also likely to weaken, despite the improving purchasing power of disposable income.

The new government plans to increase public spending and lower taxes. The tax cut announced for next year (simplification of the taxation scale to two tax brackets, 15% and 20%) would cost the government between €35bn and €40bn, i.e. 2% of GDP. This fiscal easing, which aims to boost growth, nonetheless raises doubts as to the path of government finances. The country is likely to fail complying with European rules regarding structural adjustment of public finances.



As long as Italy is able to maintain access to market funding, which is our baseline scenario, declining uncertainty as 2019 approaches is projected to be positive for an upturn in domestic demand.

However, a scenario of greater financial market stress inducing a slowdown in GDP growth cannot be ruled out.



	2015	2016	2017	2018 (f)	2019 (f)
Real GDP, % ch	**0.8**	**1.0**	**1.6**	**1.4**	**1.5**
Household consumption	1.9	1.4	1.4	1.1	1.7
Public consumption	-0.6	0.6	0.1	0.3	0.6
Investment	1.9	3.3	3.9	2.7	2.4
Exports	4.2	2.6	6.0	1.7	3.7
Imports	6.6	3.8	5.7	2.3	4.5
Inflation rate, %	**0.1**	**-0.1**	**1.3**	**1.0**	**0.9**
Purchasing power of disposable income, % ch	**1.4**	**0.9**	**0.5**	**0.9**	**2.6**
Unemployment rate, %	**11.9**	**11.7**	**11.3**	**10.9**	**10.5**
Households saving rate, % of disposable income	**10.6**	**10.4**	**9.7**	**9.6**	**10.3**
Fiscal balance, % of GDP	**-2.6**	**-2.5**	**-2.3**	**-2.0**	**-3.7**
Current account balance, % of GDP	**1.5**	**2.6**	**2.8**	**2.5**	**2.3**

SPAIN

- **Growth continues at a solid pace, above the euro area average, but is set to slow in 2018-2019.**
- **Spain is exiting the excessive deficit procedure this year, despite fiscal stimulus measures.**
- **Political uncertainty is expected to have only a modest impact on growth.**

Economic activity is expected to gradually slacken in the second half of 2018 and in 2019 but to remain above the euro area average. Notwithstanding the improvement in the labour market, consumption is expected to slow as the catch-up effects of expenditure by households, which up to now had deferred purchases of durable goods, come to an end.

Investment should remain robust, especially in export-oriented industries. The construction sector would also benefit from resilient demand and higher housing prices. Exports are likely to benefit from the momentum in the euro area, but they too are expected to slow. The past appreciation of the euro against the dollar is expected to put a strain on the competitiveness of Spanish exports outside the euro area.

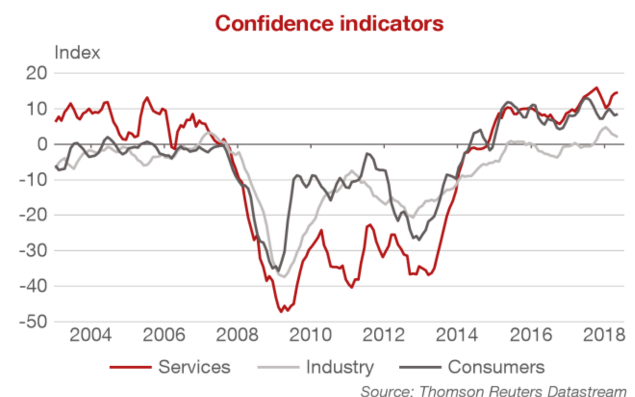
International trade in goods (volume)

Source: Thomson Reuters Datastream

Fiscal policy is expected to be expansionary in 2018 with a planned increase in pensions and €2bn in income tax cuts for the lowest income households. Nevertheless, the budget deficit is expected to decrease to 2.4% of GDP on the back of sustained growth, allowing Spain to exit the excessive deficit procedure.

Despite accommodative financing conditions, lending growth is likely to be sluggish against a backdrop of household and business deleveraging. The weakness of lending will continue to hurt the profitability of the banking sector even though its solvency and the quality of its loan book have improved.

Confidence indicators



Source: Thomson Reuters Datastream

So far, the political upheaval has not had any significant negative impact on market confidence. The financial market tensions in the wake of the conviction of several Partido Popular members in the Gürtel case eased rapidly after the appointment of Pedro Sánchez (PSOE) as President of the Government and his decision to carry forward the budget approved by Mariano Rajoy, who was removed from office.

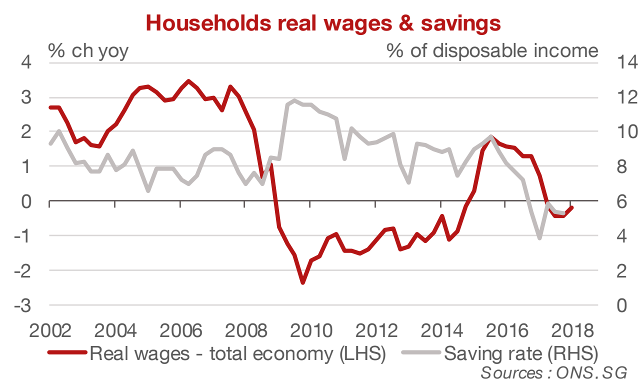
	2015	2016	2017	2018 (f)	2019 (f)
Real GDP, % ch	**3.4**	**3.3**	**3.1**	**2.6**	**2.1**
Household consumption	3.0	3.0	2.4	2.4	1.6
Public consumption	2.1	0.8	1.6	1.9	2.0
Investment	6.5	3.3	5.0	3.5	3.3
Exports	3.9	3.1	5.0	2.9	3.7
Imports	6.1	1.3	5.0	3.2	3.7
Purchasing power of disposable income, % ch	**2.3**	**2.0**	**1.2**	**1.7**	**1.8**
Unemployment rate, %	**22.1**	**19.7**	**17.2**	**15.6**	**14.4**
Households saving rate, % of disposable income	**8.6**	**7.7**	**6.9**	**6.2**	**6.3**
Inflation rate, %	**-0.6**	**1.4**	**1.4**	**1.4**	**1.3**
Fiscal balance, % of GDP	**-5.3**	**-4.5**	**-3.1**	**-2.4**	**-1.9**
Current account balance, % of GDP	**1.1**	**1.9**	**1.9**	**1.8**	**1.9**

UNITED KINGDOM

- **GDP growth is set to slow to 1.5% in 2018 and 1.3% in 2019.**
- **Political uncertainty related to Brexit negotiations will continue to weigh on business investment.**
- **The Bank of England should deliver one further rate hike of 25bp through 2020.**

The UK economy has been resilient in the aftermath of the Brexit referendum, growing 1.9% on average in the last two years. As Brexit becomes reality, we expect a slowdown, with GDP growing at 1.5% and 1.3% in 2018 and 2019 respectively. Robust global growth should support exports, but investment and private consumption are expected to slow with mounting uncertainty regarding future relations with the EU after the official departure date on 29 March 2019.

Households real wages & savings



Sources : ONS, SG

Brexit negotiations remain in deadlocks with no resolution in sight regarding complex issues, including the Irish border, a key component of the orderly withdrawal process. The legal implementation of the transition period, which maintains the status-quo in UK-EU relations until year-end 2020, relies on a final binding agreement on the withdrawal bill. We expect it to be ratified by late-2018, with the EU's backstop proposal for the Irish border as a temporary solution to be reviewed during the trade negotiations However, there are considerable uncertainties regarding the post-transition period, with potential disruptions in supply chains should trade relations deteriorate sharply.

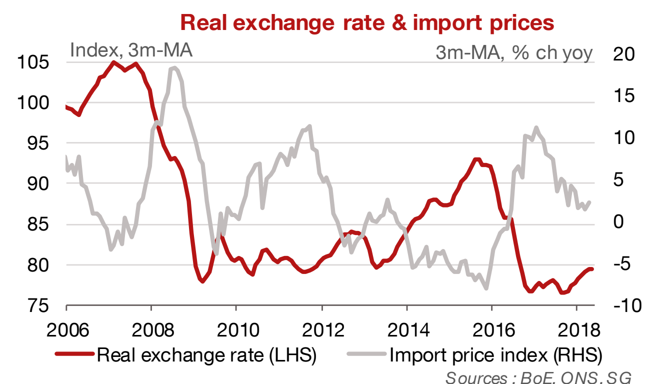
Inflation has accelerated since the Brexit vote, reflecting a rebound in oil prices and the effects of the sterling depreciation. Yet, we believe these underlying effects have now vanished. As such, inflation is likely to ease, but should remain above the BoE's inflation target of 2% in 2018 and 2019.

In our view, the Bank of England will maintain an accommodative monetary policy throughout the Brexit negotiations, and deliver one further rate hike of 25bp in 2018 before a pause in 2019.

The government remains on track to meet its fiscal mandate of reducing the deficit below 2% of GDP by 2021. Yet, with the prospective cost of Brexit financial settlement estimated at £37.1bn, the deficit is likely to remain just above 2% over the medium run.

The main risk to our scenario concerns the modality of the divorce with the EU. Should Brexit negotiations fall apart, the likelihood of a cliff-edge scenario would then increase. Sterling volatility is likely to surge, spurring additional price pressures and forcing the BoE to defend the currency precisely whilst activity take a hit.

Real exchange rate & import prices



Sources : BoE, ONS, SG

	2015	2016	2017	2018 (f)	2019 (f)
Real GDP, % ch	**2.3**	**1.9**	**1.8**	**1.5**	**1.3**
Household consumption	2.6	2.9	1.7	1.4	1.1
Public consumption	0.6	0.8	0.1	1.5	1.6
Investment	2.8	1.8	4.0	2.3	0.5
Exports	5.0	2.3	5.7	2.3	3.1
Imports	5.1	4.8	3.2	3.7	2.6
Purchasing power of disposable income, % ch	**5.3**	**0.2**	**0.2**	**2.0**	**2.1**
Unemployment rate, %	**5.3**	**4.9**	**4.4**	**4.1**	**4.1**
Households saving rate, % of disposable income	**9.2**	**7.1**	**6.1**	**6.1**	**6.9**
Inflation rate, %	**0.0**	**0.7**	**2.6**	**2.4**	**2.3**
Fiscal balance, % of GDP	**-4.3**	**-2.9**	**-1.8**	**-1.9**	**-2.1**
Current account balance, % of GDP	**-5.2**	**-5.7**	**-4.1**	**-4.1**	**-3.8**

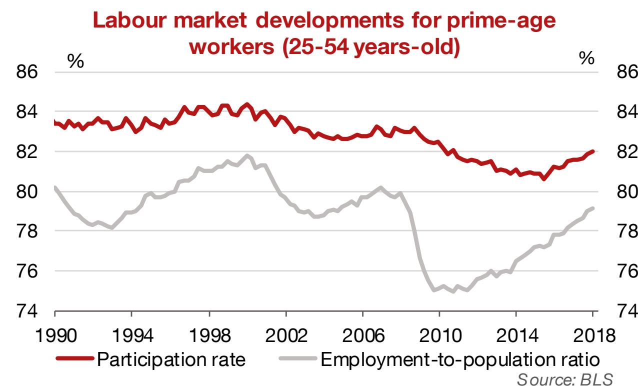
UNITED STATES

- **The ongoing fiscal expansion is set to support GDP growth over the next two years.**
- **The Fed will deliver four more rate hikes of 25bp each throughout the ongoing tightening cycle.**
- **Higher oil prices and interest rates are set to offset some of the boost from fiscal expansion.**

The ongoing fiscal expansion is set to lift GDP growth over the next two years, extending the current expansion cycle into 2020. We expect GDP to expand 2.8% and 2.4% in 2018 and 2019, respectively, before slowing in 2020. We see a cyclical trough of 1% in 2021-2022, on the back of a progressive scale-back in budget caps under the next administration.

After a temporary drag in Q1 due to higher gasoline prices, consumer spending is set to rebound markedly in coming quarters. With confidence still high and tax cuts yet to show up in households' disposable income, the outlook for consumption growth remains strong. Yet, rising consumer credit and a saving ratio near record lows may act as a headwind in the medium-run in a context of higher energy prices.

Labour market developments for prime-age workers (25-54 years-old)



Source: BLS

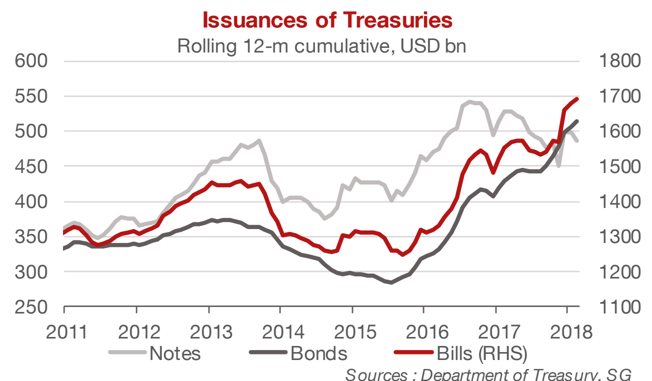
The US labour market is nearing full capacity, but some shadow slack remains. Stronger business investment and employment should draw more people into the labour force. A tick-up in the prime-age participation rate is likely to fasten wage growth and drive both headline and core inflation above 2% in 2018 and 2019.

Such environment is consistent with a progressive tightening in monetary policy. As the Fed steps-up the unwinding process of its balance sheet, it should proceed with four more interest rate hikes of 25bp each until the end of the ongoing tightening cycle in 2020, when Fed funds rates would reach 2.75-3%.

With larger issuances of Treasuries required to finance a widening budget deficit, which we forecast at 5.9% and 6.6% in 2018 and 2019 respectively, bond yields are expected to increase.

Issuances of Treasuries

Rolling 12-m cumulative, USD bn



Sources : Department of Treasury, SG

Should inflation surprise to the upside, the Fed may tighten monetary policy faster than expected. Higher borrowing costs would eventually weigh or profit margins, slowing investment and hiring.

A full-blown trade war remains a serious risk to our central scenario with the approach of mid-term elections in November 2018.

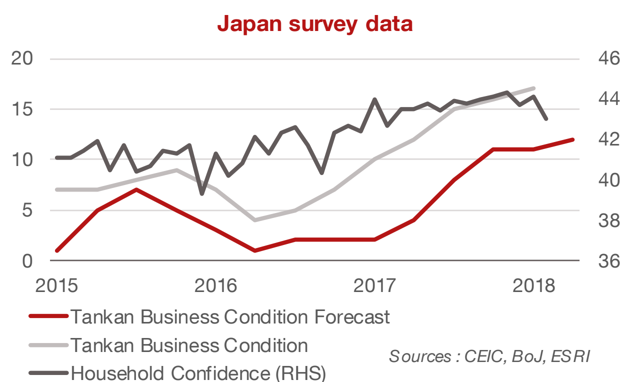
	2015	2016	2017	2018 (f)	2019 (f)
Real GDP, % ch	**2.9**	**1.5**	**2.3**	**2.8**	**2.4**
Household consumption	3.6	2.7	2.8	2.6	2.4
Public consumption	1.4	0.8	0.1	2.1	3.4
Investment	3.4	2.2	3.1	3.3	2.8
Exports	0.4	-0.3	3.4	4.6	3.9
Imports	5.0	1.3	4.0	5.9	6.2
Purchasing power of disposable income, % ch	**3.1**	**0.8**	**1.4**	**3.1**	**3.1**
Unemployment rate, %	**5.3**	**4.9**	**4.4**	**3.8**	**3.6**
Households saving rate, % of disposable income	**6.1**	**4.9**	**3.4**	**3.6**	**4.2**
Inflation rate, %	**0.1**	**1.3**	**2.1**	**2.4**	**2.2**
Fiscal balance, % of GDP	**-4.3**	**-5.0**	**-4.3**	**-5.9**	**-6.6**
Current account balance, % of GDP	**-2.4**	**-2.4**	**-2.4**	**-3.0**	**-3.5**

JAPAN

- **Still running well above potential, GDP growth is beginning to show signs of slowing.**
- **Inflation continues to accelerate but the BoJ's reflation target will be hard to reach.**
- **Faster-than-expected yen appreciation and the future of Abenomics policy are main risks.**

After eight consecutive quarters of continuous growth, quarterly GDP fell 0.2% in 1Q18. Since confidence of households and businesses remain strong and exports progress at a rapid pace, Japan GDP is expected to grow by 1.2% in 2018, above the potential of 0.5%-1% estimated by the Bank of Japan (BoJ). As investment cycle is maturing, GDP will decelerate further in 2019. Survey data shows a slight decline in the confidence of households and businesses which are still at high levels.

Japan survey data



Sources : CEIC, BoJ, ESRI

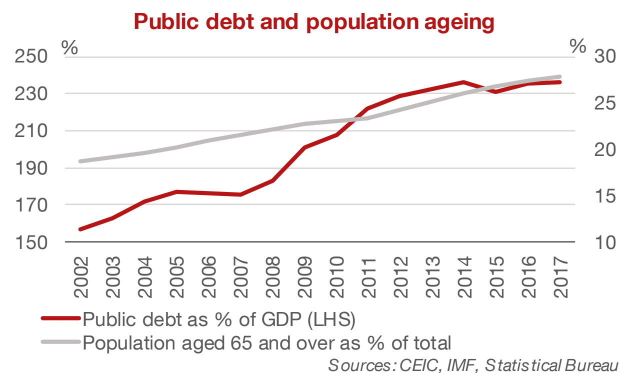
The renewal of Haruhiko Kuroda's mandate as Governor (for the record, it is very rare to see a BoJ governor reappointed to a second term) suggests the continuation of monetary policy favourable to price reflation. Fiscal policy also remains accommodative, which in the short run is good for growth.

Inflation is expected to continue to climb, driven by the upward trend in wages and rising oil prices. The scheduled hike in VAT from 8% to 10% in October 2019 (assuming it actually takes place and is not phased in gradually), should push inflation towards 2% by 2020. Inflation is then expected to fall due to the structural weaknesses (including a shrinking workforce) that weigh on domestic demand.

In the short term, the Japanese economy faces two major risks: 1/ An overly fast appreciation of the yen as a safe-haven currency in the event of heightened risk at the international level, which would hurt the island nation's exports; 2/ the uncertain future of Abenomics, the policy that has been adopted since 2013. Prime Minister Shinzo Abe's popularity has waned following accusations of favouritism and irregularities linked to a real estate deal. These scandals have raised doubts about his political future and, more immediately, his chances of re-election as leader of the LDP in September 2018.

In the longer term, the persistence of structural problems (public finances imbalances, shrinking of the labour force) could plunge Japan into a new deflationary spiral.

Public debt and population ageing



Sources: CEIC, IMF, Statistical Bureau

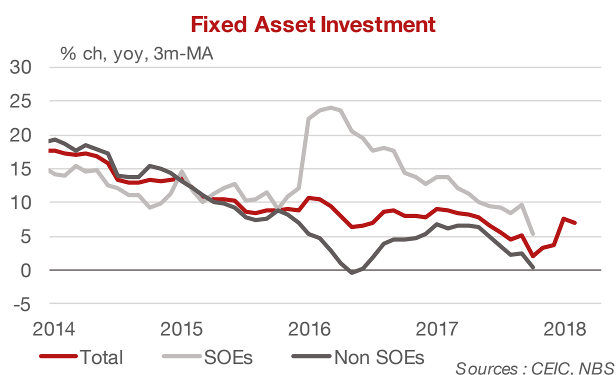
	2015	2016	2017	2018 (f)	2019 (f)
Real GDP, % ch	**1.4**	**1.0**	**1.7**	**1.2**	**0.9**
Household consumption	0.0	0.1	0.9	0.7	1.0
Investment	1.8	1.1	3.8	2.1	1.0
Exports	2.9	1.7	6.7	5.2	4.6
Imports	0.7	-1.6	3.4	4.5	4.6
Purch. power of net disposable income, % ch	**0.8**	**2.3**	**1.6**	**1.0**	**1.5**
Unemployment rate, %	**3.4**	**3.1**	**2.8**	**2.8**	**2.8**
Saving rate, % of net disposable income	**2.8**	**5.1**	**5.7**	**6.0**	**6.5**
Inflation rate, %	**0.8**	**-0.1**	**0.5**	**1.4**	**1.7**
Fiscal balance, % of GDP	**-3.5**	**-4.2**	**-4.1**	**-3.8**	**-3.0**
Current account balance, % of GDP	**3.1**	**3.8**	**4.0**	**3.1**	**3.0**

CHINA

- **Growth is expected to start slowing down in 2Q18.**
- **The policy mix attempts to balance deleveraging and "appropriate" growth.**
- **The financial position of private companies could deteriorate.**

As GDP growth was better than expected in the first two quarters, we are raising our 2018 growth forecast from 6.4% to 6.6%. Nonetheless, we are maintaining our deceleration scenario for 2018 and 2018 as business indicators started to show signs deteriorating.

Growth is expected to start slowing down in 2Q18. Committed to adjusting financial imbalances, financial regulation is expected to become increasingly effective, which should make credit terms more stringent, especially for private sector businesses. This is coupled with tighter environmental and fiscal standards, which could squeeze corporate margins and slow investment in the private sector.



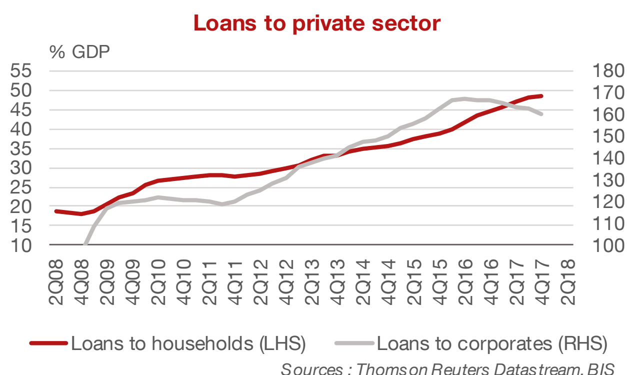
Lastly, relative to 2017 when the international backdrop and, as a result, world trade was very favourable, we foresee external trade contributing less to Chinese growth in 2018 and 2019.

With the prospect of GDP deceleration, payment difficulties may arise for corporate private borrowers, which is already priced in by the corporate bond market. Although its objective is to encourage debt reduction, economic policy is still focused on avoiding a sharp deceleration in growth, in which case the financial risk would become less manageable.

Policy should counter the expected slowdown in investment, especially with accommodative fiscal policy and monetary policy progressively tilted toward easing.

A systemic crisis is not in our central scenario. However, one risk to watch out for would be a policy mix that places too much emphasis on debt reduction policies (banking and shadow banking) to the detriment of support for growth, which could lead to a more severe economic downturn accompanied by upheaval and posing a threat to financial stability.

The risk of a trade war with the US remains live and while still manageable, this remains an important risk.



	2015	2016	2017	2018 (f)	2019 (f)
Real GDP, % ch	**6.9**	**6.7**	**6.9**	**6.6**	**6.2**
Consumption	8.2	8.7	7.8	8.0	7.7
Investment	6.1	6.2	4.8	4.6	4.0
Net exports (contrib. to growth, pp)	-0.1	-0.7	0.6	0.3	0.3
Inflation rate, %	**1.4**	**2.0**	**1.5**	**2.1**	**2.1**
General government balance, % of GDP	**-2.4**	**-3.0**	**-3.0**	**-2.6**	**-3.1**
General government debt, % of GDP	**41.1**	**44.3**	**47.6**	**50.8**	**53.9**
External debt , % of GDP	**11.8**	**12.0**	**13.0**	**14.0**	**15.0**
Current account balance, % of GDP	**2.8**	**1.8**	**1.3**	**1.0**	**0.9**

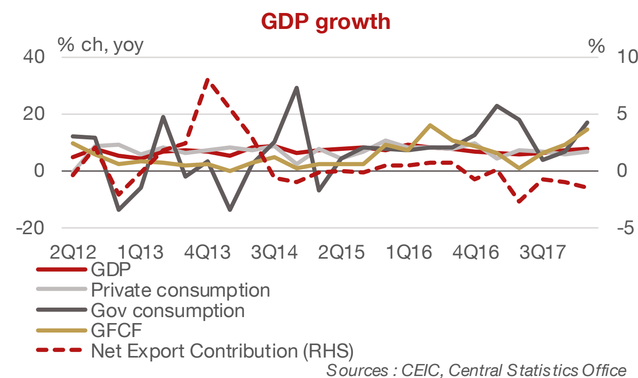
INDIA

- **Economic growth is expected to keep the momentum.**
- **With general elections approaching, budget consolidation is likely to pause.**
- **The rise in oil prices is causing an increase in inflationary risk and in the current account deficit.**

The outlook for India's economic growth is positive. Activity is expected to speed up gradually in 2018 and will remain solid in 2019 thanks to strong domestic demand.

Activity growth should continue at a vigorous pace driven by an improvement in the macroeconomic fundamentals. Long considered a factor of instability, inflation seems to be under control. The current account deficit has narrowed over the last five years, thus reducing the level of external vulnerability. The government has also sought to improve the business climate (adoption of a bankruptcy code, increase in the FDI ceiling) and favour access to banking services to reduce the number of "unbanked". Following the implementation of economic reforms, consumption and investment should remain strong.

GDP growth



Sources : CEIC, Central Statistics Office

The budget deficit remains high, despite efforts to reduce it. An expansionary budget in 2018/19 will slow down the process of budget consolidation. In fact, pending the general elections in April/May 2019, the government would be tempted to support constituencies by various fiscal measures. The NDA (National Democratic Alliance) is expected to maintain a strong position of power in a parliament dominated by the BJP (Bharatiya Janata Party).

If the 2018 monsoon comes out "normal" as expected, food price inflation should remain moderate in 2018 but the rise in fuel prices will cause an increase in inflation, which has been rising since the 2H17. Although prices are expected to remain within the RBI's inflation target range (2%-6%), the central bank may raise interest rates slightly in 2018 to stabilise inflationary anticipations.

Inflation and interest rate

Sources : CEIC, RBI

Apart from inflationary risks, India faces risks linked to a widening of its current account deficit notably due to the rise in the oil price. An increase in volatility on the global financial markets could also have a disruptive effect on the FX market.

	2015	2016	2017	2018 (f)	2019 (f)
Real GDP, % ch (fiscal year)	**8.2**	**7.1**	**6.7**	**7.2**	**7.1**
Household consumption	7.4	7.3	6.6	4.8	7.4
Investment	5.2	10.1	7.6	12.3	8.1
Exports	-5.6	5.0	5.6	3.0	3.8
Imports	-5.9	4.0	12.4	8.0	8.0
Inflation rate, %	**6.0**	**4.5**	**4.6**	**4.9**	**4.8**
General government balance, % of GDP	**-7.1**	**-6.6**	**-6.4**	**-6.2**	**-5.9**
General government debt, % of GDP	**69.5**	**69.6**	**68.7**	**67.1**	**65.2**
External debt , % of GDP	**22.7**	**21.4**	**19.3**	**19.8**	**19.5**
Current account balance, % of GDP	**-1.1**	**-0.7**	**-1.4**	**-1.5**	**-1.6**

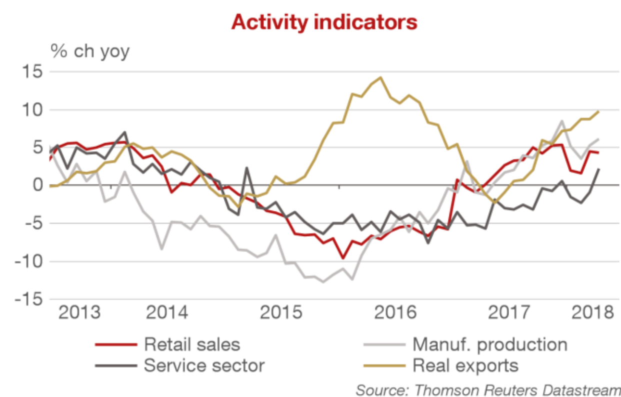
BRAZIL

- **Economic growth remains sluggish, reflecting stagnant private consumption.**
- **Inflation is still low but is set to increase with higher oil prices and a weaker BRL.**
- **Risks are related to the upcoming general elections and the fiscal reform adoption.**

Economic activity started the year on a soft note. Real GDP grew by 0.4% on 1Q18 (1.5% yoy) reflecting still weak private consumption. On the bright side, investment pursued its recovery, with higher expenditures on machinery & equipment, and exports remain dynamic.

Activity is still set to expand in 2018 and to accelerate in 2019. In a still low inflationary environment, private consumption will benefit from, the progressive recovery of wages in the formal sector and easier credit conditions. Investment is also projected to gradually pick-up on the back of higher commodity prices and the ongoing privatization and public concessions program. Higher external demand and improving terms of trade should boost exports, although a slowdown in Argentina may have an adverse impact on manufacturing shipments.

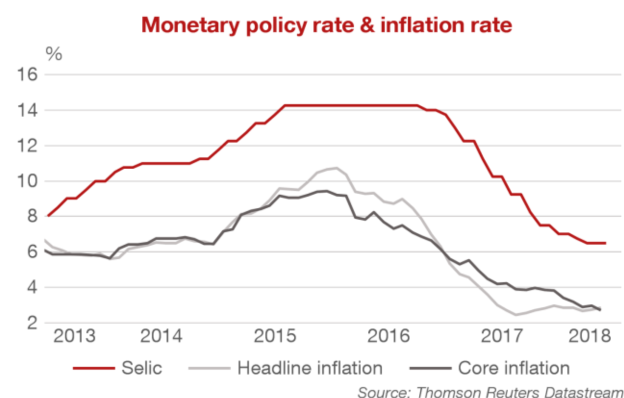
Activity indicators



Source: Thomson Reuters Datastream

Headline inflation remains stable at historically low levels. Food prices are declining as the harvest was very good. In addition, non-tradeable good prices are also on a downward trend (2,6% yoy in April), pointing to high degree of slack in the economy. Despite inflation tracking below the target of 4%+/1, the BCB decided at the May COPOM meeting to keep its policy rate at 6.5% as financial volatility has increased, putting pressure on the BRL. All in all, inflation is likely to pick-up in the coming months with higher oil prices and some FX pass through to prices, and converge progressively towards the BCB target.

Monetary policy rate & inflation rate



Source: Thomson Reuters Datastream

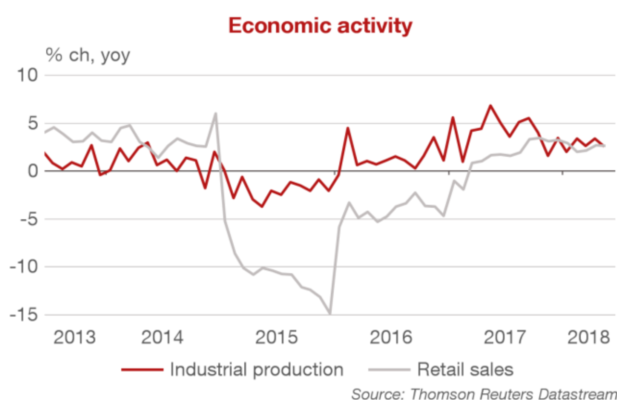
The main risks to the outlook are related to the fiscal trends and the upcoming October general elections. The result of the elections would determine whether the elected government has the ability or the willingness to pursue the reform of fiscal expenditures. The primary fiscal deficit is currently adjusting slowly but mainly on the back of one-off revenues. A sustainable consolidation would need a reform of mandatory expenditures, which require a two-third majority in Congress.

	2015	2016	2017	2018 (f)	2019 (f)
Real GDP, % ch	**-3.5**	**-3.5**	**1.0**	**2.0**	**2.5**
Household consumption	-3.2	-4.3	1.0	2.0	2.4
Public consumption	-1.4	-0.1	-0.6	-0.6	0.0
Investment	-13.9	-10.3	-1.8	4.7	6.0
Exports	6.8	1.9	5.2	4.0	3.8
Imports	-14.2	-10.2	5.0	3.5	4.0
Inflation rate, %	**9.5**	**8.0**	**3.7**	**4.0**	**4.5**
General government balance, % of GDP	**-10.3**	**-9.2**	**-7.9**	**-7.0**	**-6.0**
General government debt, % of GDP	**65.5**	**70.0**	**74.0**	**75.0**	**77.0**
External debt , % of GDP	**25.6**	**29.0**	**27.0**	**26.5**	**26.0**
Current account balance, % of GDP	**-3.3**	**-1.3**	**-0.5**	**-1.0**	**-1.5**

RUSSIA

- **Economic growth is expected to remain subdued due to weak investment performance.**
- **Inflation should remain contained despite the RUB depreciation following US sanctions in April.**
- **A reversal in oil prices or further sanctions could generate financial volatility.**

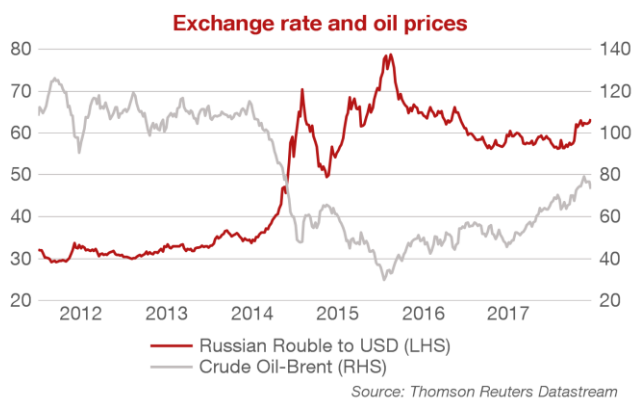
While out of recession, the Russian economy has been growing slowly. Following a weak 1.5% reading in 2017, GDP expanded 1.3% in 1Q18 yoy amid low investment, structural bottlenecks and lagging productivity. Despite the rise in oil prices, growth in Russia is expected to remain below 2% in 2018-2019.



The imposition of a new set of sanctions by the US Treasury Department in April 2018 (targeting seven oligarchs, 17 senior government officials and 14 companies) led to a temporary sell-off in financial markets, higher uncertainties and is expected to have an adverse impact on investment. The US sanctions coupled with the Russian counter-sanctions lowers external funding availability and increase funding costs. According to the Bank for International Settlements, foreign financing has become more difficult: the total lending stock of foreign banks to Russia has declined by 50% since 2014. Lower corporate margins would also cast a cloud over the investment outlook.

Household consumption should remain resilient amid strong real wage gains in an environment of historically low unemployment (5% in 1Q18).

Exports, which grew sharply in 2017, are likely to benefit from the strength of the EU economy (which accounts for 40% of Russian exports) and Asia (30% of Russian exports, of which 11% to China). The country should also benefit from hosting the World Cup in 2018. The current account surplus topped $40bn over twelve months as of 1Q18, and should increase further in 2018-2019.



In 2017 and 1Q18, inflation fell to level not seen since the Soviet era (2.2% yoy in Feb. 2018), prompting the Central Bank of Russia (CBR) to reduce its key interest rate to 7.25% in March 2018. The RUB depreciation in April 2018 following the announcement of US sanctions led to a small pick-up in inflation (2.4% yoy in April-May 2018). In this context, the CBR has reconsidered its plan for a gradual reduction of the key interest rate leaving rates unchanged in April and May 2018.

	2015	2016	2017	2018 (f)	2019 (f)
Real GDP, % ch	**-2.8**	**-0.1**	**1.5**	**1.2**	**1.2**
Household consumption	-8.1	-1.5	3.9	3.0	2.5
Investment	-13.4	-0.8	4.0	2.5	2.0
Exports	3.7	3.2	5.0	3.0	2.5
Imports	-25.8	-3.8	16.7	9.0	7.0
Inflation rate, %	**15.5**	**7.0**	**3.7**	**2.5**	**3.5**
General government balance, % of GDP	**-3.4**	**-3.7**	**-2.1**	**-1.5**	**-1.0**
General government debt, % of GDP	**15.9**	**15.6**	**17.4**	**17.7**	**18.2**
External debt , % of GDP	**38.0**	**40.0**	**35.9**	**35.0**	**34.6**
Current account balance, % of GDP	**5.0**	**2.0**	**2.8**	**3.2**	**3.6**

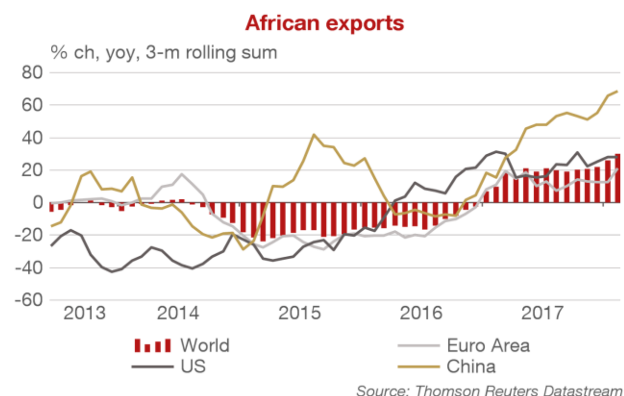
AFRICA

- **Regional growth is accelerating, driven by an improved international economic environment.**
- **However, this growth remains insufficient and diverse.**
- **The rise in public debt levels constitutes a new vulnerability factor.**

Regional growth is likely to continue to accelerate in 2018, to around 4% (vs. ca. 3.5% last year): 32 of the 53 countries in the region are expected to post higher real GDP growth this year than in 2017. This can be attributed primarily to an acceleration in external growth drivers, underpinned by an improved international economic environment. African exports have grown rapidly (+30% year-on-year in February 2018), benefiting both from a volume effect (confirmation of the economic dynamism of the main trading partners) and a price effect (rise in the prices of the main commodities exported: hydrocarbons, agricultural products, cotton, etc.). Conversely, internal drivers are still slow-moving: for example, credit distribution to the private sector generally remains sluggish, while numerous regional banking sectors are weakened by high levels of non-performing loans.

Overall, the expected pace of growth between now and 2020 remains i) diverse and differentiated between the different sub-regions, between the different economic structures (oil producing or non-oil producing countries), between “small” and “large” countries; ii) insufficient to ensure tangible growth in GDP per inhabitant (the total African population being expected to grow by 2.5% per year between now and 2020), and iii) lower than the growth rates recorded between 2004 and 2007 (more than 5% per year).

African exports



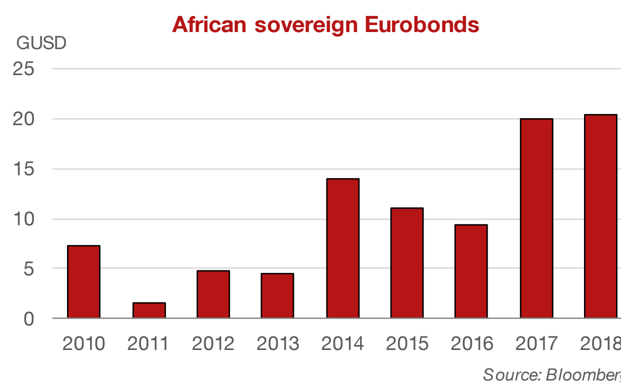
Source: Thomson Reuters Datastream

In this more favourable context, external financial imbalances are gradually being reduced: slight reduction in current account deficits, high confidence of international investors encouraging financing flows (FDIs, portfolio investments – having led to a rise in the main regional stock markets, debt flows – see below), tendency for greater flexibility (at least partially) in exchange rate regimes (Angola, Nigeria, Morocco). The majority of countries have seen a slight rise in their foreign exchange reserves, even if overall the level in terms of coverage of imports remains low.

Regional public finances seem more fragile. While the regional fiscal deficit is also expected to gradually reduce in the coming years, public debt levels have increased significantly throughout the region (from 35% of GDP at end-2012 to 55% of GDP at end-2017) whereas the mobilisation of fiscal resources could still be improved (taxes accounting for less than 20% of GDP on average on the continent). In addition, the composition of this public debt has changed in favour of more costly resources, i.e. non-Paris Club bilateral creditors (in particular China) and international capital markets.

To benefit from still relatively affordable debt costs (and thus pre-empt the increase under way in global interest rates), African countries have increased sovereign issuance: more than $20bn of Eurobonds have been issued since the beginning of the year, already exceeding the previous historic record level of 2017. This increase in public debt represents a new vulnerability factor, especially in the case of disappointing growth, further budgetary slippage, sharp exchange rate fluctuations, or the more-rapid-than-expected toughening of financial conditions. According to the IMF, the viability of low-income countries’ debt has deteriorated: 15 African countries (out of 35) are now overindebted or risk becoming so, vs. 6 out of 34 at end-2014.

African sovereign Eurobonds



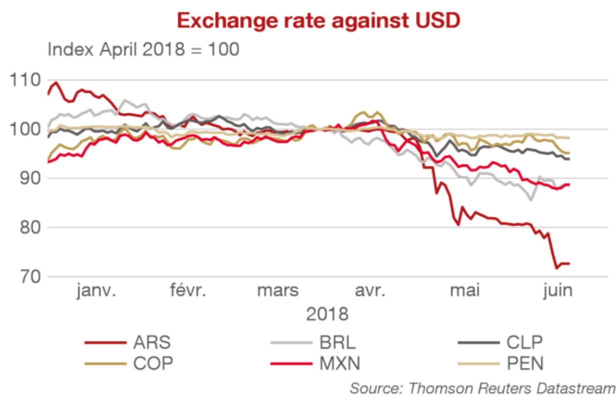
Source: Bloomberg

LATIN AMERICA

- **In a global environment of rising interest rates, the FX market adjusted downwards.**
- **The sharp drop of the ARS and interest rate hikes are likely to weigh on growth and inflation.**
- **The BRL and MXN depreciation has been moderate, but markets will keep an eye on elections.**

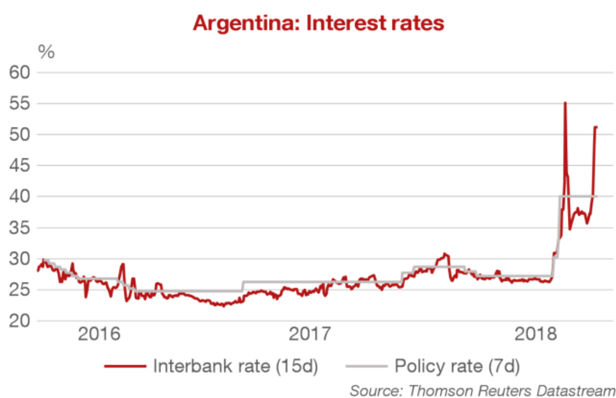
Latin American markets have experienced increasing volatility since end April in a global environment of rising interest rates and of emerging markets risk repricing. All major currencies have been under pressure against the dollar but the drop has been deeper in Argentina, Brazil and Mexico.

Exchange rate against USD



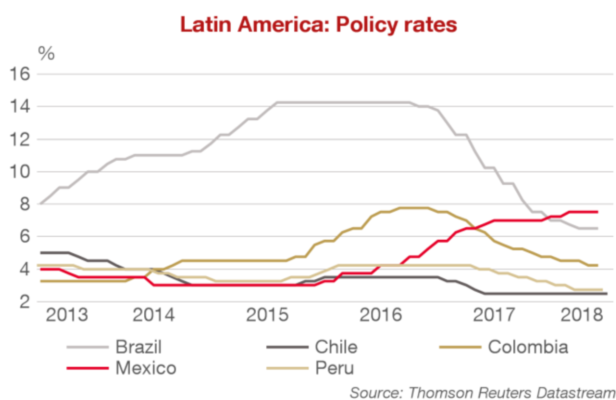
Source: Thomson Reuters Datastream

Argentina: Interest rates



Source: Thomson Reuters Datastream

Latin America: Policy rates



Source: Thomson Reuters Datastream

In Argentina, the sharp FX movement is related to the deterioration of macroeconomic fundamentals. Despite a reduction in government subsidies, the fiscal deficit has widened (6% of GDP in 2017) and inflation remains high (26% yoy in April). A widening current account deficit (4.8% of GDP) has been mainly financed through a rapid increase of external debt, including significant amounts of short-term securities issued by the Central Bank.

To relax pressures on the FX market, the Central Bank increased its policy rate from 27% to 40% while the government announced higher expenditures cuts. Meanwhile, the Argentine authorities and the IMF have reached an agreement on a 36-month Stand-By Arrangement amounting to USD 50bn. Because of higher interest rates and public expenditure cuts, economic growth is likely to decelerate while inflation would remain high amid FX pass through effects on domestic prices.

The currency adjustment in Brazil (10% against the dollar since January) seems less problematic at this stage. The country has record low inflation and below the central bank target. The monetary authorities did not intervene and kept the Selic at historical low. The current account is almost balanced and FX reserves are largely comfortable. FX pressure could however accentuate whether markets perceive that the general elections (next October) will end with a weak government unable to implement fiscal reform.

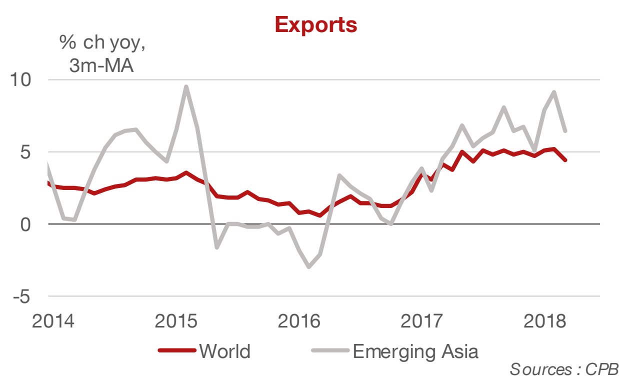
As in Brazil, the depreciation of the MXN also does not threaten the prospects of a moderate acceleration in GDP growth in 2018. With inflation trending down, the BanXico has keep its policy rate stable and has not intervene in the FX market. The risks steams from General elections on July 1 in an environment of high rejection of traditional parties. Furthermore, delays on NAFTA renegotiations may also create volatility.

In contrast with larger economies, the currencies of Chile, Colombia and Peru depreciated only modestly. In these countries, macro fundamentals look stronger. Growth accelerated in 1Q18 and would remain sustained in 2018, supported by strong external demand and resilient private consumption.

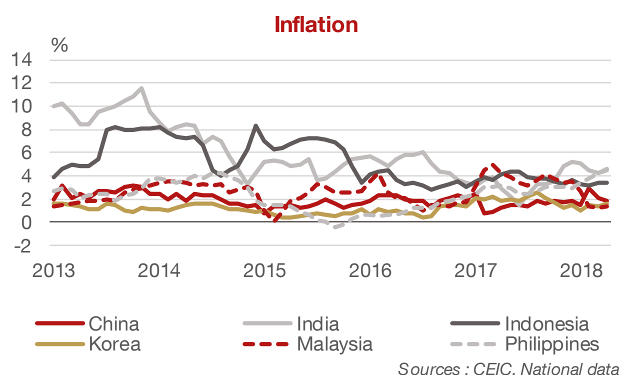
EMERGING ASIA

- **Growth should remain strong with ongoing positive export trends.**
- **Inflation is leaning higher, which could trigger the start of a monetary tightening cycle.**
- **An increase in international rates and greater protectionism are the risks to be monitored.**

Emerging Asia is likely to see a stabilisation of growth in 2018 (6.1% versus 6.2% in 2017) and a slight deceleration in 2019 (5.8%). This region continues to be the world's most dynamic region by far. Emerging Asia is participating fully in the technology cycle (smartphones, connected objects, semiconductors) and enjoys vigorous external demand, which stimulates investment.



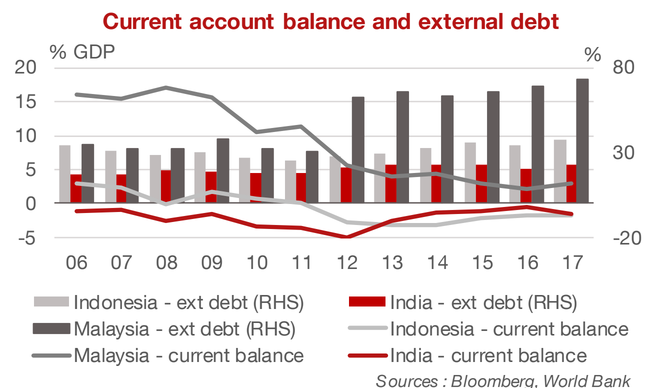
Despite the growth acceleration in 2017, inflation remained broadly moderate due to a combination of factors, which among other things include the fall in commodity prices since 2013 and the effects of technological progress, including the automation of production processes.



However, inflation has been on an upward trend since late 2017, largely attributable to the partial rebound in commodity prices. In response to this trend, many central banks could start to tighten monetary policy in 2018, but for the time being it remains very accommodative.

The main uncertainties concern a possible tightening of global financial conditions and the risk of increased protectionism.

In terms of external liquidity, most emerging Asian countries have built up external buffers - a considerable volume of foreign exchange reserves - which should help to offset any external shocks, even durable ones. As regards external vulnerabilities, India and Indonesia run current account deficits and are therefore more vulnerable. Malaysia's external debt shows a strong upward trend, which would also represent a weakness in the event of an increase in risk aversion on international markets.



An increase in protectionism could significantly disrupt global value chains and given Asia's international integration, could weigh heavily on growth.

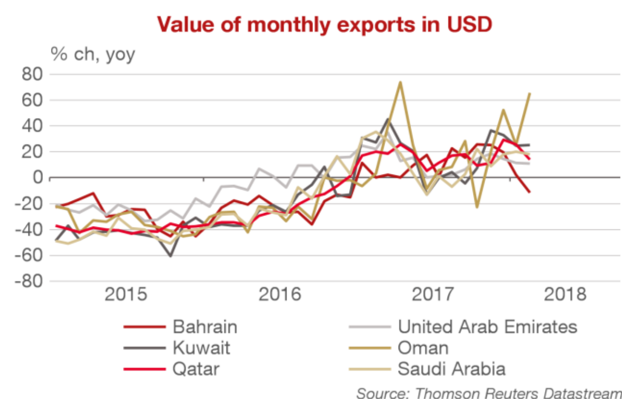
GULF STATES

- **The increase in oil revenues has reduced the immediate need for budget adjustment.**
- **However, the rapid accumulation of public debt remains a source of concern.**
- **The improvement in current account balances has declined but does not remove the FX risk.**

The outlook for GCC countries has improved thanks to the partial recovery in oil prices. The rebound in revenues from hydrocarbon exports makes the need for budget adjustments less urgent than when oil prices collapsed in 2015-2016. Domestic demand is currently benefiting from the relaxation of fiscal consolidation and driving the growth of non-oil sectors. Non-oil GDP is expected to accelerate in 2018 but will remain well below the average of 7.5% for the period 2003-2014.

The OPEC+ agreement has helped support higher oil prices: $73/b in May 2018, or 35% above the 2017 average (and +70% vs. 2016). However, Saudi Arabia and Russia would be prepared to gradually raise their production ceilings as soon as 2H18. An oil price above $80/b has obvious advantages for producers, but it could also encourage US companies to inject additional resources into shale oil development and cause the oil monarchies to again lose control of prices.

Value of monthly exports in USD



Source: Thomson Reuters Datastream

Thanks to the increase in revenues, the budget deficit of Gulf states looks set to gradually reduce from 9% of GDP on average in 2017 to 5% of GDP between now and 2020. However, sovereign bond issuance in the international markets remains very high: USD 37 billion in 2016, USD 37 billion in 2017 and USD 29 billion between January and May 2018.

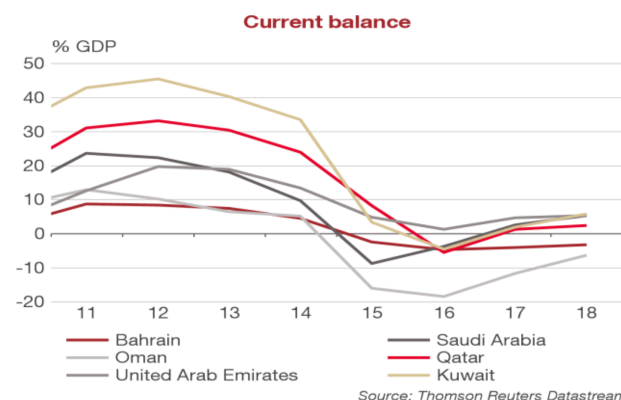
Investors still want to increase their GCC exposure because of low debt to GDP ratios and substantial financial buffers (sovereign funds) which provide visibility. Even non-investment grade issuers with fragile fundamentals, such as Bahrain have been successful with their sovereign eurobond placements, but the yields on this debt (7.1% at end-May for Bahrain) are very high within the group of emerging countries. The risk is that ultimately this debt would have to be refinanced at less favourable international market conditions.

The general improvement in current accounts would support the fixed exchange rate regimes against the dollar of GCC. However, Bahrain still faces considerable vulnerability and its monetary stability will depend on the financial support of allies, Saudi Arabia and the United Arab Emirates. In Oman, the government is involved in infrastructure projects and projects to support the employment of nationals, which will maintain considerable budget and external imbalances. In the event of liquidity pressures, Oman could initially mobilise its sovereign funds but its situation could become fragile.

To prepare for the post-oil era and diversify its economy, Saudi Arabia has launched a vast reform programme (opening to foreign investors, privatisations, introduction of 5% VAT) in order to improve the business environment and promote more job-creative growth. However, success is not assured.

Qatar continues to resist the blockade by other States in the region with the aid of new trade routes. The financial wealth of the country and its solid fundamentals (large current account surpluses) have created conditions that are conducive to sustained expansion. However, the regional political crisis is not over and remains an uncertainty factor.

Current balance



Source: Thomson Reuters Datastream

CENTRAL AND EASTERN EUROPE

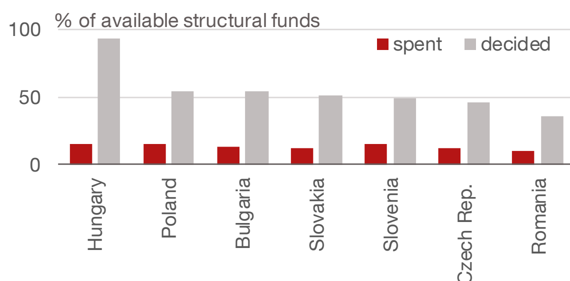
- **CEE countries should post strong growth supported by dynamic domestic and external demand.**
- **Wages have significantly accelerated and should lead to a pick-up in inflation.**
- **FX pressures led to a monetary tightening in Turkey that will cool down activity.**

After the 2017 acceleration, activity remained dynamic in the region in 1Q18. For the entire 2018, GDP growth should remain strong supported by dynamic exports to the Euro area and domestic demand. We expect a softer expansion in 2019 against the backdrop of a less supportive external environment and more restrictive domestic monetary policies.

Investment has accelerated in 2017 and should rise further in 2018 thanks to the utilization of EU structural funds, which could lead to a specific boost in the construction sector. So far, absorption of EU structural funds has however been very uneven in the region.

Private consumption is expected to slightly decelerate as inflation erodes households' purchasing power in 2018-2019. It will however remain a key driver of growth, backed by employment gains and wage increases.

Absorption of EU structural funds as of Q1-2018



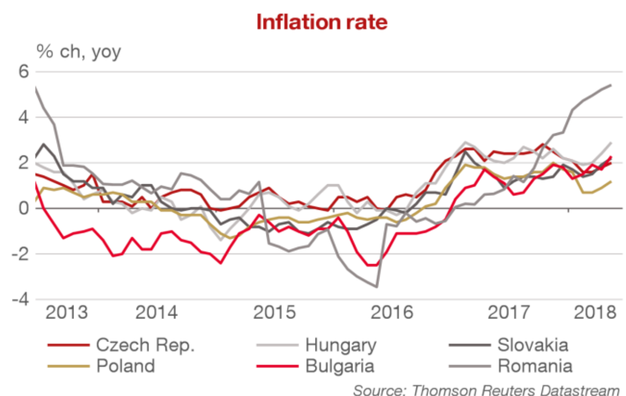
Source: European Commission

Regarding the labour market, there are signs of growing supply-side constraints. The share of employers citing labour shortages as an issue has risen to an all-time high in the region. In addition, the rise in real wages has not been accompanied by a corresponding pick-up in productivity and unit labour costs have thus increased.

However, this rapid wage growth has not fed into a meaningful pick-up in inflation, except in Romania, where inflation reached a five-year high of 5.2% yoy in April. In most countries, core inflation still sits beneath the central bank's inflation targets. Low inflation in the Euro Area and currency strength (CZK and PLN appreciated by about 9% last year in trade weighted terms) are behind this relative price stability. Firms may also have absorbed higher wage costs by reducing profit margins rather than raising prices, as suggested by the decline in gross operating surplus as a share of GDP.

Looking forward, growth above potential will eventually pass onto inflation. The Czech National Bank and the Romanian National Bank should continue to increase policy rates in 2018-2019 while the Polish and Hungarian central bank could prompt the first interest hikes since the 2011/2012 Euro area debt crisis.

Inflation rate



Source: Thomson Reuters Datastream

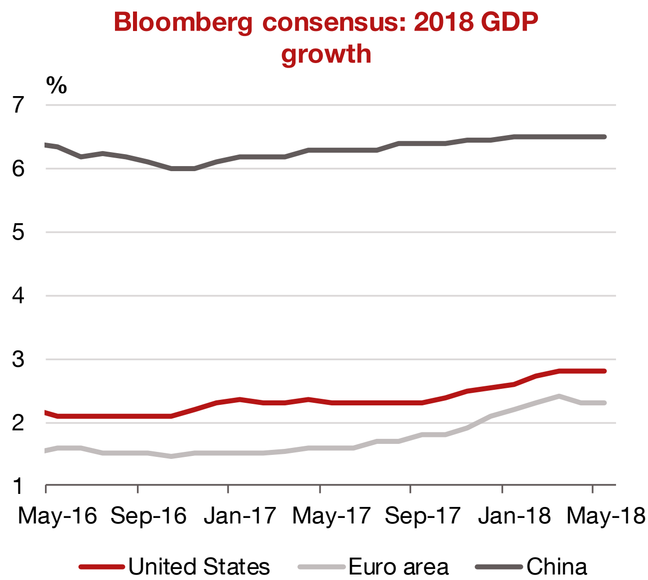
This strong growth momentum in CEE is overall well-balanced with decreasing debt levels and sounder external financial situations except in Turkey and Romania.

In Turkey, fears over macroeconomic sustainability (double-digit inflation, growing current account deficit) have led to a plunge in the Turkish lira. The Central Bank took steps to restore stability by increasing interest rate, but this would likely cool down the economy.

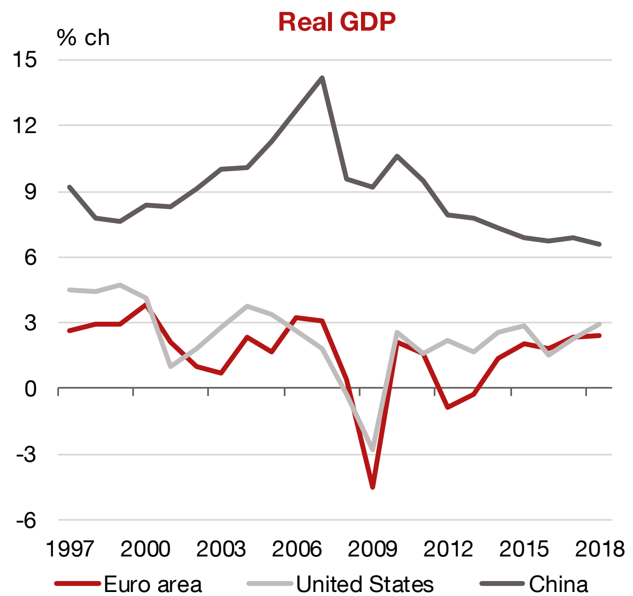
In Romania, inflation acceleration and the widening of twin deficits increases the risks of currency volatility.

On the longer term, a major risk for CEE would be a cut in European structural funds. The EU draft budget for 2021-2027 published in May announced a reduction in European Structural Funds by 7% and a change in the allocation criterions. The EU will have the power to suspend or reduce access to the Structural Funds if a member country does not respect the rule of law. These decisions could have a significant impact on investment in the region and on long term growth potential.

Economic Data



Source : Bloomberg

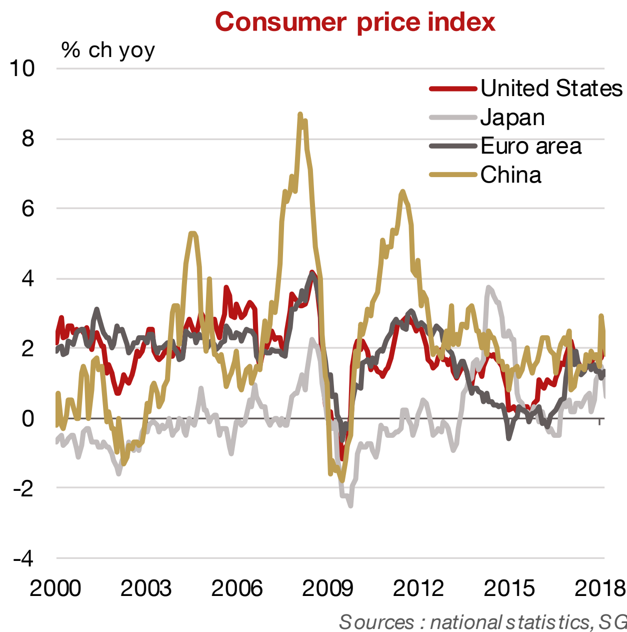


Sources: national statistics, SG

	2012	2013	2014	2015	2016	2017	2018(f)	2019(f)	2020 (f)	2021(f)	2022(f)
Real GDP, % ch											
World	**2.5**	**2.7**	**2.9**	**2.9**	**2.6**	**3.3**	**3.3**	**3.1**	**2.8**	**2.7**	**2.7**
United States	2.2	1.7	2.6	2.9	1.5	2.3	2.8	2.4	1.5	1.0	1.0
Japan	1.5	2.0	0.3	1.4	1.0	1.7	1.2	0.9	0.8	0.8	0.7
United Kingdom	1.5	2.1	3.1	2.3	1.9	1.8	1.5	1.3	1.3	1.5	1.6
Euro area	-0.8	-0.2	1.4	2.0	1.8	2.5	2.1	1.8	1.5	1.3	1.3
Germany	0.7	0.6	1.9	1.5	1.9	2.5	2.0	1.9	1.5	1.3	1.3
France	0.4	0.6	1.0	1.0	1.1	2.3	1.8	1.7	1.5	1.5	1.5
Italy	-2.9	-1.7	0.2	0.8	1.0	1.6	1.4	1.5	1.4	1.0	0.9
Spain	-2.9	-1.7	1.4	3.4	3.3	3.1	2.6	2.1	1.7	1.5	1.4
China	7.9	7.8	7.3	6.9	6.7	6.9	6.6	6.2	5.8	5.6	5.6
India	5.5	6.4	7.4	8.2	7.1	6.7	7.2	7.1	7.2	7.3	7.4
Brazil	1.9	3.0	0.5	-3.5	-3.5	1.0	2.0	2.5	2.5	2.5	2.5
Russia	3.7	1.8	0.7	-2.8	-0.1	1.5	1.2	1.2	1.5	1.5	1.5
Real investment, % ch											
World*	**2.8**	**2.6**	**3.3**	**2.7**	**3.3**	**3.4**	**3.5**	**2.8**	**2.4**	**2.2**	**2.2**
United States	2.6	1.8	3.5	3.4	2.2	3.1	3.3	2.8	1.6	1.0	1.0
Japan	3.5	5.0	2.9	1.8	1.1	3.8	2.1	1.0	0.2	0.6	0.4
United Kingdom	2.1	3.4	7.1	2.8	1.8	4.0	2.3	0.5	2.1	2.8	1.7
Euro area	-3.3	-2.4	1.9	3.0	4.5	3.1	2.7	2.4	2.0	1.7	1.6
Germany	-0.1	-1.2	3.7	1.0	2.9	4.0	3.2	2.1	1.9	1.4	1.2
France	0.4	-0.7	0.0	0.9	2.7	4.7	2.7	2.2	1.8	1.7	1.7
Italy	-9.4	-6.6	-2.2	1.9	3.3	3.9	2.7	2.4	1.9	1.4	1.2
Spain	-8.6	-3.4	4.7	6.5	3.3	5.0	3.5	3.3	2.2	1.8	1.7
China	7.2	6.2	6.4	6.1	6.2	4.8	4.6	4.0	3.9	3.7	3.8
India	2.4	2.5	1.9	5.2	10.1	7.6	12.3	8.1	7.4	7.5	7.6
Brazil	0.8	5.8	-4.2	-13.9	-10.3	-1.8	4.7	6.0	3.5	4.0	4.0
Russia	5.9	1.3	-2.7	-13.4	-0.8	4.0	2.5	2.0	2.0	2.0	2.0

Sources: IMF, OECD, National statistics, SG computations and forecasts
** Weighted average of the 11 countries shown here*

Economic Data

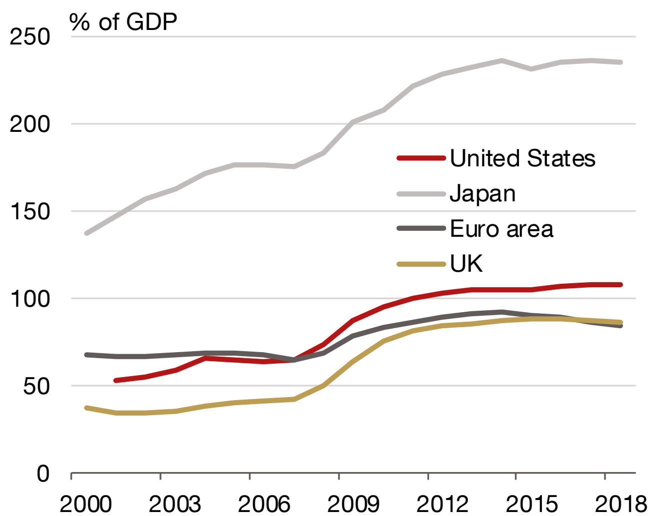


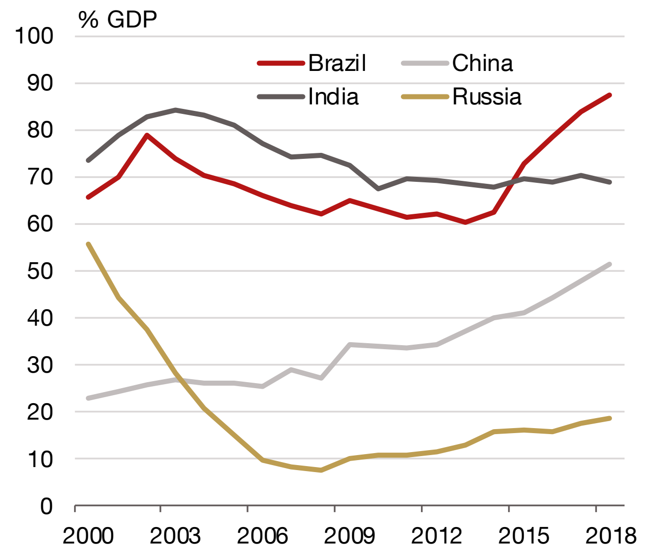
	2012	2013	2014	2015	2016	2017	2018(f)	2019(f)	2020 (f)	2021(f)	2022(f)
Inflation, %											
World*	**2.7**	**2.4**	**2.2**	**1.4**	**1.6**	**2.0**	**2.3**	**2.4**	**2.2**	**2.0**	**2.0**
United States	2.1	1.5	1.6	0.1	1.3	2.1	2.4	2.2	1.9	1.3	1.2
Japan	-0.1	0.3	2.8	0.8	-0.1	0.5	1.4	1.7	2.1	1.1	0.9
United Kingdom	2.8	2.6	1.5	0.0	0.7	2.6	2.4	2.3	1.8	2.0	1.8
Euro area	2.5	1.4	0.4	0.0	0.2	1.5	1.4	1.6	1.7	1.7	1.6
Germany	2.0	1.5	0.9	0.2	0.5	1.7	2.0	1.9	1.7	1.7	1.7
France	2.0	0.9	0.5	0.0	0.2	1.0	1.8	1.5	1.8	1.9	1.9
Italy	3.3	1.2	0.2	0.1	-0.1	1.3	1.0	0.9	1.5	1.6	1.5
Spain	2.5	0.4	-0.5	-0.6	1.4	1.4	1.4	1.3	1.8	1.7	1.7
China	2.6	2.6	2.0	1.4	2.0	1.5	2.1	2.1	1.8	2.0	2.3
India	10.0	9.4	5.8	4.9	4.5	3.8	4.9	4.8	4.9	5.0	5.0
Brazil	5.4	6.2	6.3	9.5	8.0	3.7	4.0	4.5	4.5	4.5	4.5
Russia	5.1	6.8	7.8	15.5	7.0	3.7	2.5	3.5	4.0	4.0	4.0
Current account balance, % of GDP											
United States	-2.6	-2.1	-2.1	-2.4	-2.4	-2.4	-2.7	-3.5	-4.2	-3.9	-3.4
Japan	1.0	0.9	0.8	3.1	3.8	4.0	3.1	3.0	2.9	2.9	2.8
United Kingdom	-4.3	-5.6	-5.4	-5.2	-5.7	-4.1	-4.1	-3.8	-4.2	-4.0	-4.2
Euro area	1.4	2.2	2.4	3.2	3.4	3.5	2.9	2.9	2.9	2.9	3.0
Germany	7.1	6.8	7.5	9.0	8.5	8.1	8.0	7.9	7.7	7.7	7.6
France	-1.0	-0.5	-1.0	-0.4	-0.8	-0.6	-1.2	-1.0	-1.1	-1.2	-1.3
Italy	-0.3	1.0	1.9	1.5	2.6	2.8	2.5	2.3	2.1	2.0	1.9
Spain	-0.2	1.5	1.1	1.1	1.9	1.9	1.8	1.9	2.0	2.0	2.1
China	2.5	1.5	2.2	2.8	1.8	1.3	1.0	0.9	1.2	1.1	1.0
India	-4.8	-1.7	-1.3	-1.1	-0.7	-1.4	-1.5	-1.6	-1.8	-2.0	-2.4
Brazil	-3.0	-3.0	-4.2	-3.3	-1.3	-0.5	-1.0	-1.5	-2.0	-2.0	-2.0
Russia	3.2	1.5	2.8	5.0	2.0	2.8	3.2	3.6	3.8	3.9	4.0

Sources: IMF, National statistics, SG computations and forecasts

** Weighted average of the 11 countries shown here*

Economic Data

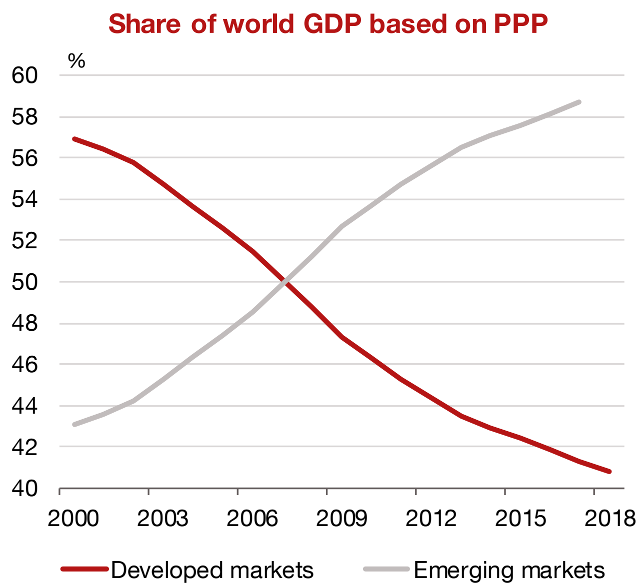


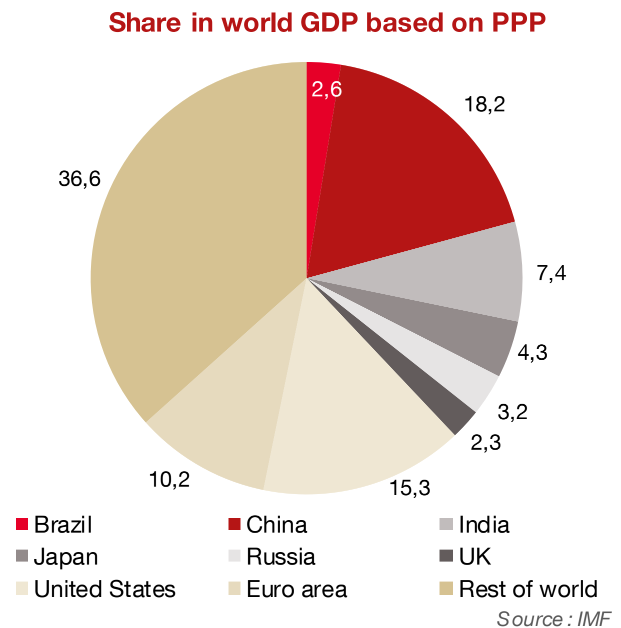


	2012	2013	2014	2015	2016	2017	2018(f)	2019(f)	2020 (f)	2021(f)	2022(f)
Fiscal balance, % GDP											
United States	-9.0	-5.5	-4.9	-4.3	-5.0	-3.5	-5.9	-6.6	-6.5	-6.3	-5.9
Japan	-8.3	-7.6	-5.4	-3.5	-4.2	-4.1	-3.8	-3.0	-2.8	-2.8	-2.8
United Kingdom	-8.2	-5.4	-5.4	-4.3	-3.0	-1.9	-1.9	-2.1	-2.3	-2.1	-1.9
Euro area	-3.6	-3.0	-2.6	-2.1	-1.5	-1.2	-0.9	-1.2	-1.0	-0.9	-0.8
Germany	0.0	-0.2	0.3	0.7	0.8	0.9	1.0	1.0	1.0	1.0	1.0
France	-5.0	-4.1	-3.9	-3.6	-3.4	-2.6	-2.4	-2.9	-2.0	-1.8	-1.6
Italy	-2.9	-2.9	-3.0	-2.6	-2.5	-2.3	-2.0	-3.7	-3.5	-3.4	-3.4
Spain	-10.5	-7.0	-6.0	-5.3	-4.5	-3.1	-2.4	-1.9	-1.7	-1.5	-1.4
China	-0.3	-0.8	-0.9	-2.4	-3.0	-3.0	-2.6	-3.1	-3.3	-3.3	-3.0
India	-7.6	-7.0	-7.2	-7.1	-6.6	-6.4	-6.2	-5.9	-5.8	-5.6	-5.4
Brazil	-2.5	-3.0	-5.4	-10.3	-9.2	-7.9	-7.0	-6.0	-5.5	-5.0	-4.8
Russia	0.4	-1.2	-1.1	-3.4	-3.7	-2.1	-1.5	-1.0	-0.5	0.3	0.5
Public debt, % GDP											
United States	99	101	102	101	105	104	106	108	110	114	117
Japan	206	210	215	215	218	221	223	224	223	222	222
United Kingdom	85	86	87	88	88	88	87	87	88	88	87
Euro area	90	92	92	90	89	87	85	83	82	80	78
Germany	80	78	75	71	68	65	61	58	55	53	50
France	91	93	95	96	97	97	97	96	95	94	93
Italy	123	129	132	132	132	131	130	130	130	130	131
Spain	86	96	100	99	99	98	97	96	94	93	92
China	34	37	40	41	44	48	51	54	57	60	62
India	69	69	68	70	70	69	67	65	63	61	60
Brazil	62	60	62	66	70	74	75	77	79	79	78
Russia	12	13	16	16	16	17	18	18	18	18	18

Sources : IMF, National statistics (Maastricht methodology for EU countries), SG computations and forecasts

Structural Data

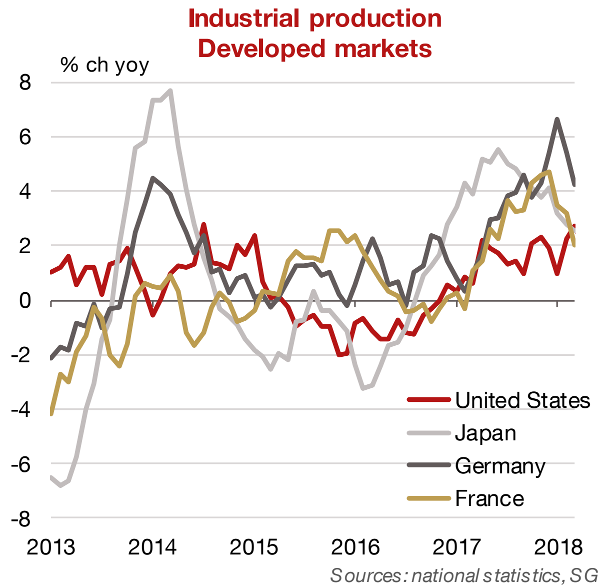


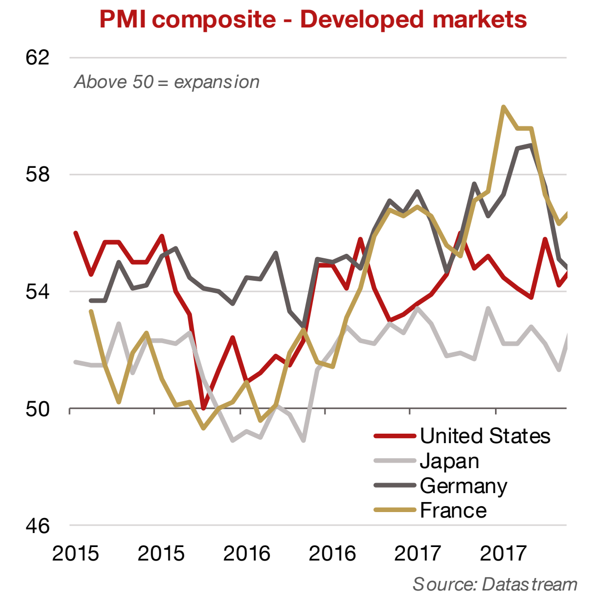


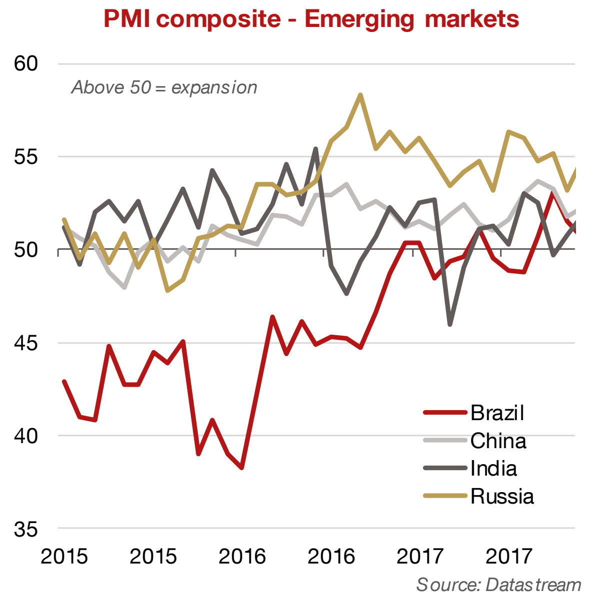
As of 2016	GDP in $ (USDbn)	GDP p. capita ($, at PPP)	Population (Millions)	Credit (% GDP)*	International investment position, net** (% GDP)	Openness ratio***
United States	18 624	57 559	324	152	-42	20
Euro area	11 940	37 071	341	160	-2	67
Germany	3 479	48 532	82	107	66	69
France	2 466	42 367	65	192	-22	44
Italy	1 860	36 877	61	112	-7	47
Spain	1 238	36 444	46	158	-91	49
Netherlands	778	51 249	17	221	79	139
China	11 222	15 397	1 383	209	16	33
Japan	4 949	41 297	127	161	59	25
United Kingdom	2 661	42 839	66	171	-13	39
India	2 274	6 697	1 300	56	-19	28
Brazil	1 793	15 295	206	69	-38	18
Canada	1 536	46 606	36	214	21	53
South Korea	1 411	37 730	51	193	18	64
Russia	1 281	26 930	144	66	21	37
Australia	1 265	49 096	24	197	-61	32
Mexico	1 077	19 356	122	43	-49	74
Indonesia	932	11 719	259	39	-37	30
Turkey	863	24 986	80	85	-53	40
Switzerland	669	60 365	8	241	130	86
Saudi Arabia	645	55 292	32	60	93	49

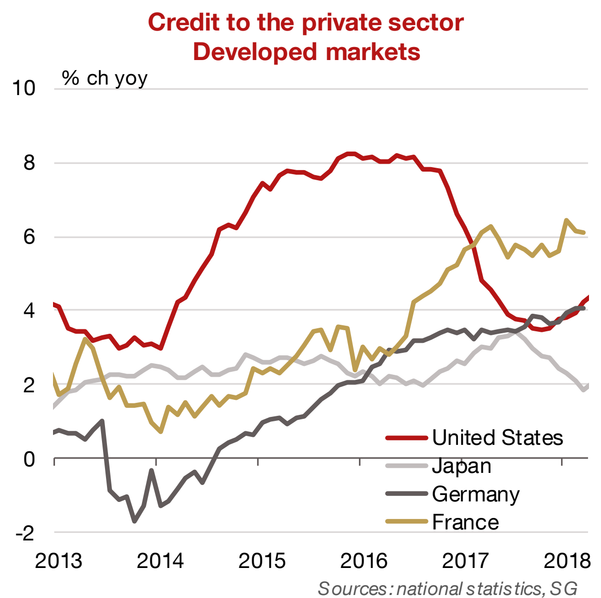
Sources: World Bank, BIS, IMF
**Bank loans and debt securities of the non financial private sector*
*** Total external financial assets minus total external liabilities*
**** Sum of imports and exports, divided by GDP*

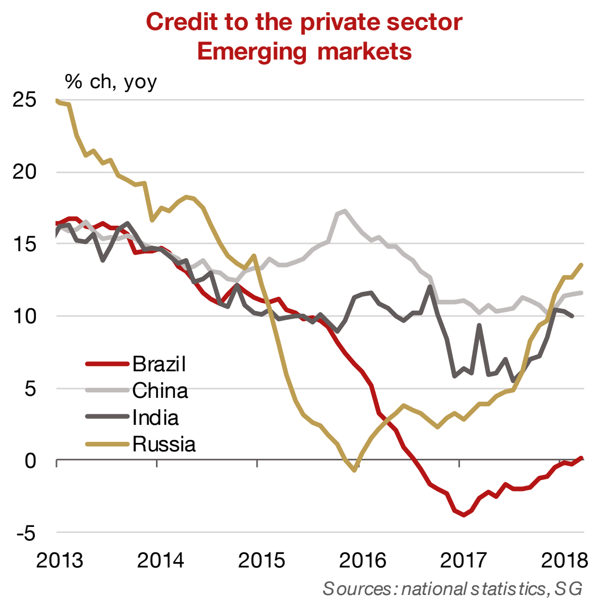
Cyclical Data





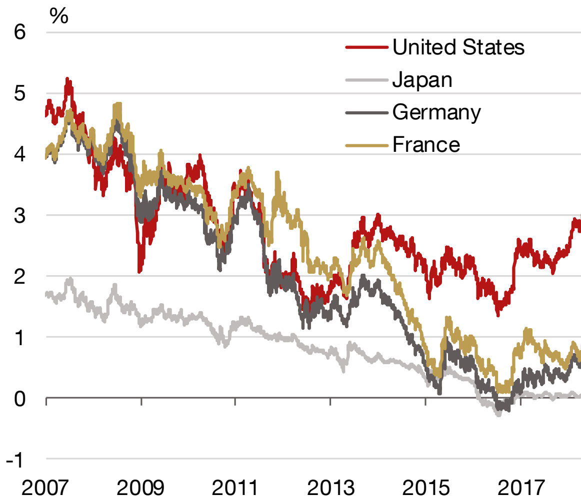






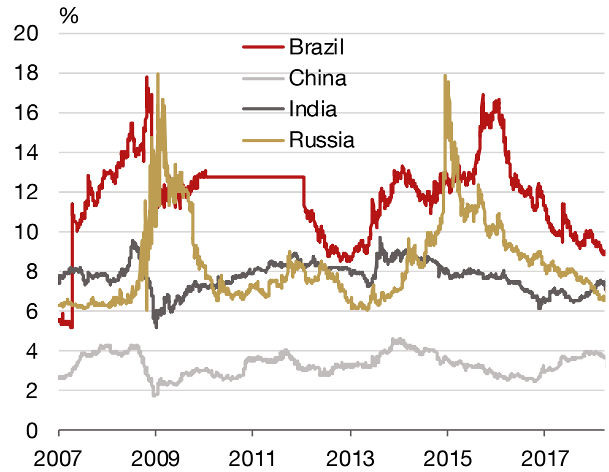
Financial Data

10Y sovereign bond yield



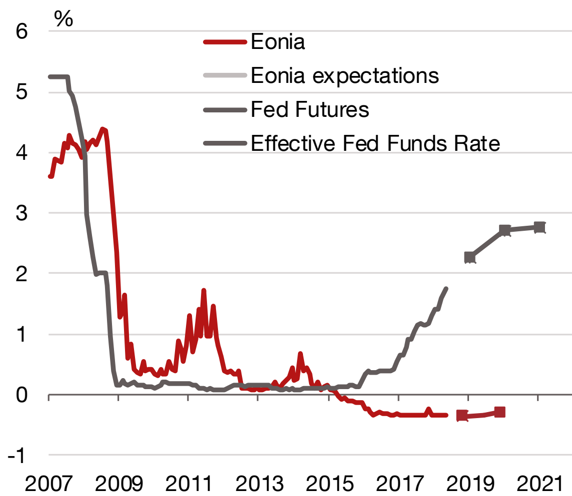
Source : Datastream

5Y sovereign bond yield in local currency



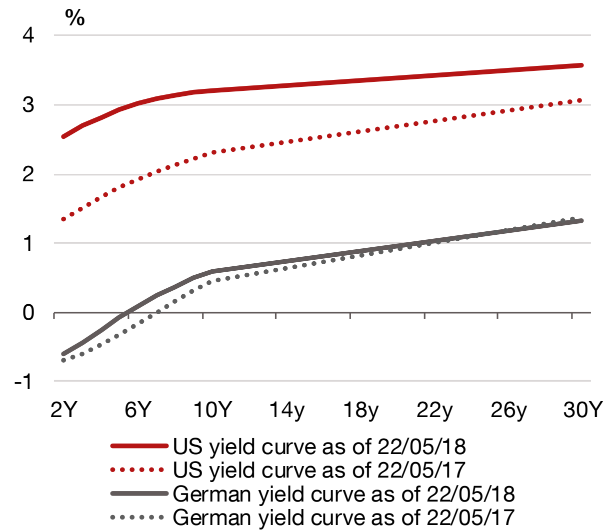
Source : Datastream

Overnight interest rates



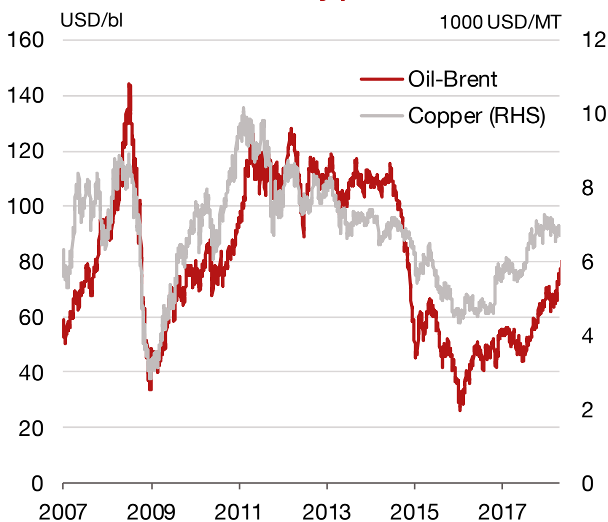
Source : Bloomberg

Yield curves



Source: Datastream

Commodity prices



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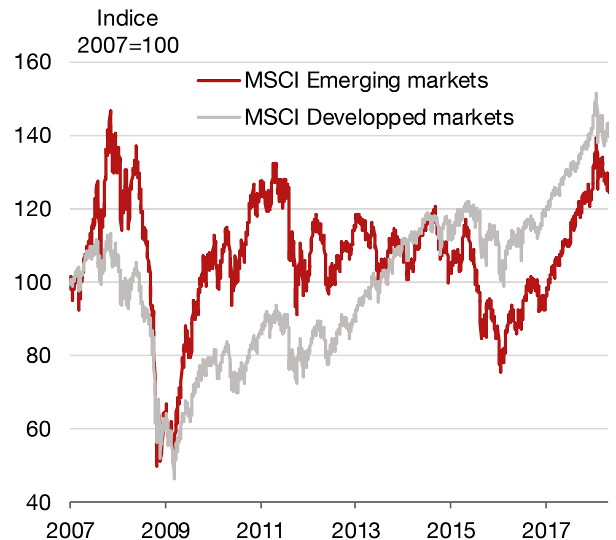
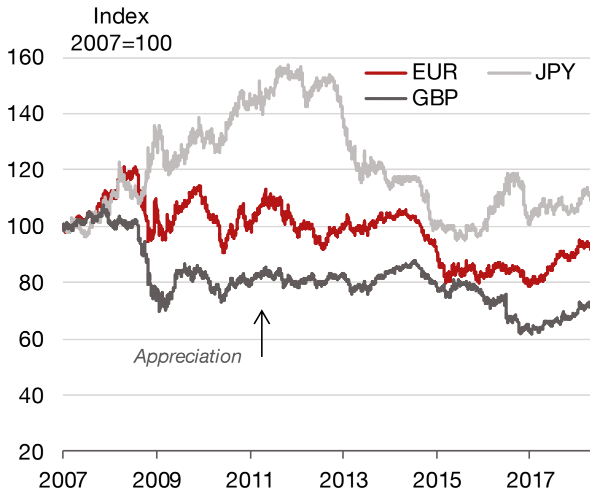
STOCK INDICES



Source: Datastream

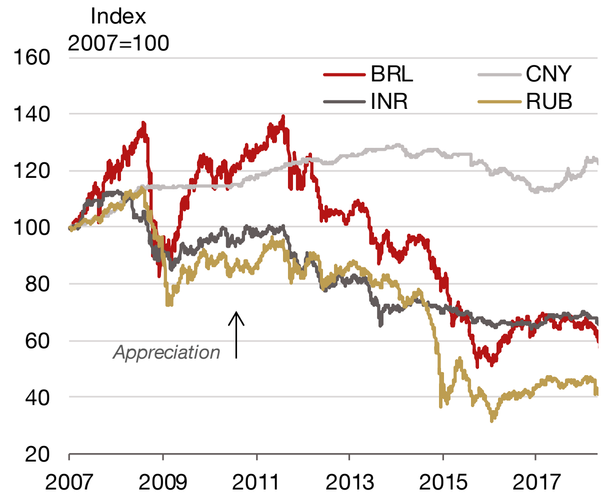
Financial Data

Exchange rates against USD



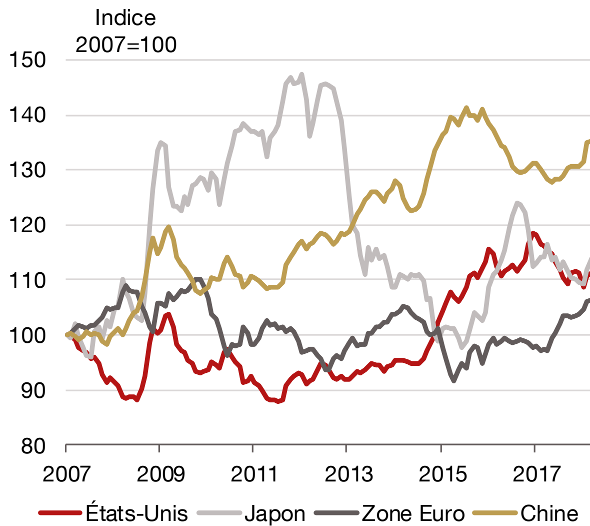
Source: Datastream

Exchange rates against USD



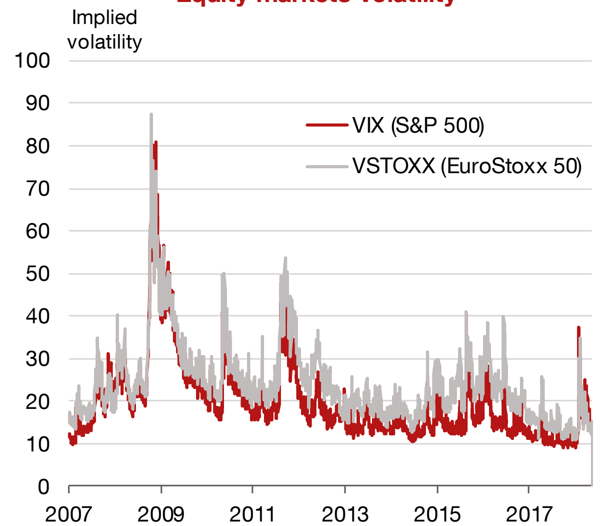
Source : Datastream

Taux de change effectif nominal



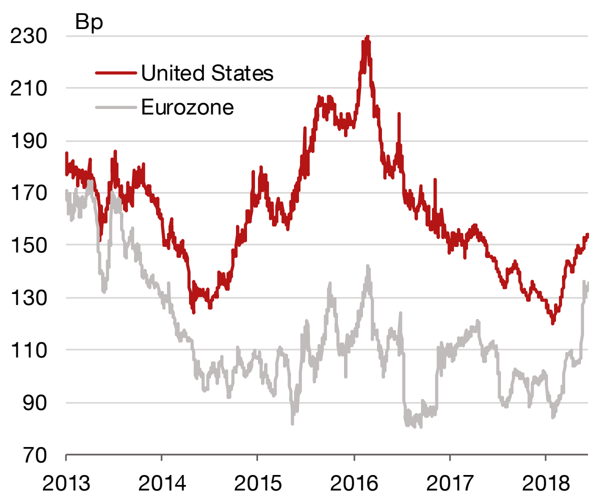
Sources : BRI, SG

Equity markets volatility



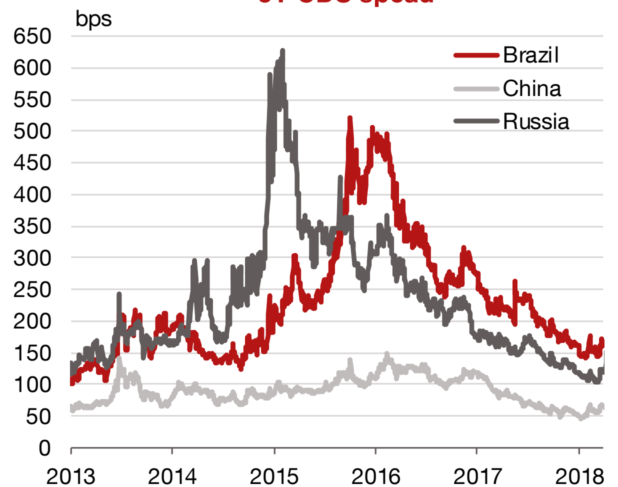
Source: Datastream

High yield corporate spread



Sources : Bloomberg, SG

5Y CDS spead



Sources: Datastream, SG

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