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# PANORAMA

JANUARY 2017

## An economic upturn in the face of uncertainty

COFACE ECONOMIC PUBLICATIONS

By Coface Group economists



**S**tarting with falling oil prices and financial markets in the winter, the *Brexit* referendum in the summer and the election of Donald Trump in the autumn, 2016 was punctuated by a series of upsets. Can we hope for more calm – or even improvements in 2017?

Although the end of 2016 was marked by the upsets in the US, with the unexpected outcome of the US presidential elections and the Fed's long-awaited raising of key lending rates, neither of these events triggered a collapse in the financial markets. In emerging economies, there has even been a detectable uplift in recent months – but can this last?

The fog of uncertainty dominating the economic sphere is unlikely to lift in 2017. The forecasts on the repercussions of the events of 2016 remain unclear.

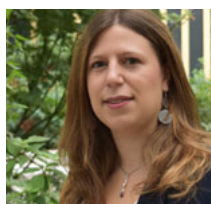
Among these uncertainties are (i) the as yet unknown and unpredictable policies of Donald Trump, both internally and in terms of *spillovers* (such as the impact on Mexico, where activity is already slowing, with a lowering of Coface's assessment to B); (ii) the lack of visibility on the future of the United Kingdom, where the terms of its exit from the European Union are yet to be defined; and (iii) the dominance of political risks linked to upcoming elections<sup>1</sup> (namely in the Netherlands, France and Germany). In addition to these undetermined risks, are “conventional” hazards, such as concerns over the slowing and rebalancing of economic activity in China and questions on how quickly the prices of raw material will rise. One new factor, however, will be the expected return of inflation, if only as a mechanical reaction from the reaching of the lowest point for raw materials prices in 2016, and even though domestic demand remains relatively restrained.

Despite these risks a number of countries (such as Spain which has been upgraded to A3) are back on track. In Central Europe, Estonia, Bulgaria, Serbia and Hungary are continuing to see their risk assessments improving. In Africa, Ghana (upgraded to B) and Kenya (to A4) are looking more positive, while there are continuing rays of hope for Brazil and Russia. Other countries have adopted good resolutions for the new year. Clearly, voluntary and often painful adjustments will need to be made, but the outlook for the medium term looks much sunnier. Following a difficult year, Argentina, looks likely to start harvesting the fruits of its labours (hence the raising of its assessment to B). Subsequent to a devaluation of its currency and the receipt of an IMF loan, Egyptian companies are expected to see an easing of payment problems, even though a slowdown in growth is anticipated. Turkey, however, remains on watch, as does South Africa, (which has been downgraded to C). Finally, this is the first time since June 2015 that Coface has upgraded more assessments than downgraded.

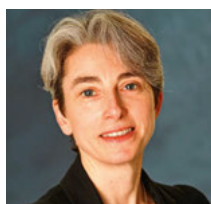
<sup>1</sup> Coface study: “Will political risk “spoil the party” in 2017?”, October 2016

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## 1 WORLD ECONOMY: AFTER A TUMULTUOUS 2016, A SLIGHT IMPROVEMENT IN 2017

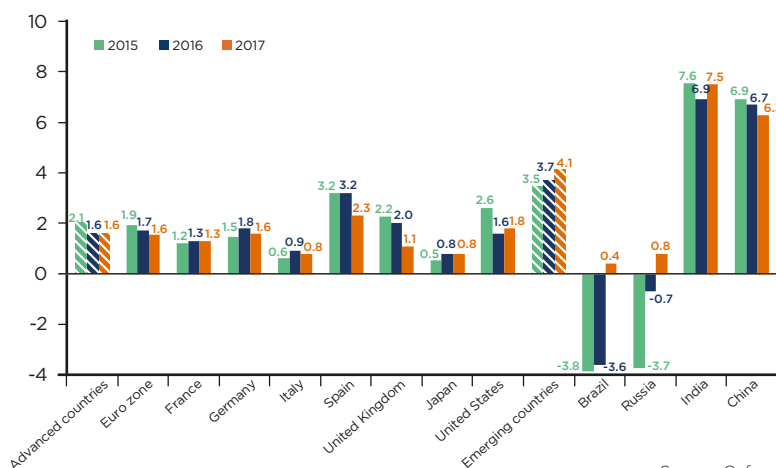
According to our estimates, global growth weakened for the second consecutive year in 2016, to reach 2.5%. A slight improvement (+2.7%) is expected for 2017, especially with the upturn in activity for emerging economies (+4.1%, up from +3.7%) and the economic recoveries in Brazil and Russia which will offset China's gradual economic deceleration. Activity in advanced economies will hold steady (+1.6%), with the slowdown in the United Kingdom being compensated for by the resilience of the Eurozone and the slight improvement in US economic activity (*cf. graph 1*).

The factors that have sustained the developed economies through recent years, such as low oil prices, relaxed monetary policies and low levels of inflation, are set to become less favourable this year. Raw material prices, which started falling in mid-2014 to reach a low point in 2016, and helped boost activity<sup>2</sup>, are slightly higher. The IMF global raw materials index will increase by 11% in 2017, following a 10% drop in 2016. The recent agreement reached by OPEC at the end of November was undoubtedly responsible for the upwards surge of 10 dollars in the price of Brent, seen in December 2016. Nevertheless, prices are unlikely to increase greatly this year, due to a number of factors, such as: (i) there is no guarantee of compliance with the production targets for the 1<sup>st</sup> half of 2017; (ii) the long-term commitments by OPEC countries are still to be honoured, while Russia has only made a relatively limited effort; (iii) the risk of the release

onto the market of US shale oil, if prices rise further and reach the marginal cost of shale oil of around 60 dollars. Any potential rebalancing of the market is thus only likely to happen slowly. Macroeconomic uncertainties remain significant, as in 2016. There were peaks of volatility during the year, following the UK referendum and the US elections, with increases in the VIX volatility indicator (*cf. graph 2*). The reigning environment of uncertainty could thus, once again, be accentuated by peaks of volatility in raw material prices - although, according to an analysis by the Banque de France, this does not seem to be automatic. Price uncertainties appear to be more closely linked to the issue of predictability than that of volatility<sup>3</sup>. Among the other global factors is the current performance of world trade, which is at an historical low point and is not expected to rebound quickly, given the depressed state of economic growth. The relationship between trade and economic activity has weakened (reduced elasticity). This new "normality" (the reasons for which lie in structural factors, such as the slower growth in the world value chain<sup>4</sup>) will lead to continuing disappointing performances in international trade in the coming years, even if there is an upsurge in activity<sup>5</sup>. This lack of vitality in trade is an even greater concern given the mounting fears of a resurgence of protectionism, heightened with the victory of Donald Trump in the US elections.

The outcome of the elections did not, however, prevent the Fed from raising its rates, as expected. There were limited reactions from the financial markets to this first (and long awaited) sign of a reduction in the abundant levels of liquidity in the markets. The US Federal Reserve is concerned about the re-emergence of inflation and is expected, at the very least, to raise its rates once again in 2017 (following the rises of December 2015 and 2016). In this context, the dollar should continue strengthening against other currencies during the first half of 2017. The euro reached its low point in December 2016, at USD 1.054. Capital flows to emerging economies are also likely to be limited by the reduction in the relative gap between national key lending rates and US rates - at least unless countries decide to align with this rate increase (as Mexico has done, with +250 bp in 2016). In addition, the growing levels of uncertainty in developed economies are likely to inhibit the flow of investments into the emerging economies, as this triggers a "flight to quality" (as shown in an analysis by the Banque de France<sup>6</sup>). Shocks originating in Europe normally tend to have a more limited impact on flows than those from the United States.

**Graph n° 1**  
Growth rate forecasts (%)



Source: Coface

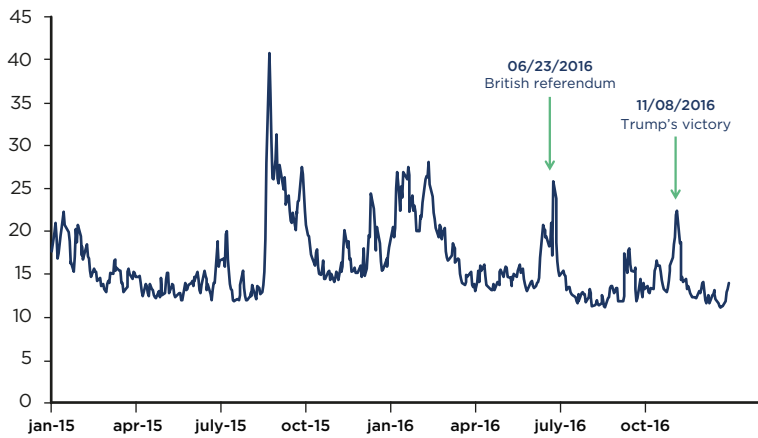
2/ IMF, WP/16/210, "Oil price and the global economy: is it different this time around?", November 2016

3/ Banque de France, Working Document 607 "Does the volatility of commodity prices reflect macroeconomic uncertainty?", November 2016

4/ Coface Country Risk Assessment 3<sup>rd</sup> quarter 2016 "The price of oil, the emerging economy thermometer, once again a key concern", October 2016

5/ VoxEu Article "The great normalisation of global trade", October 2016

Graph n° 2  
VIX volatility index



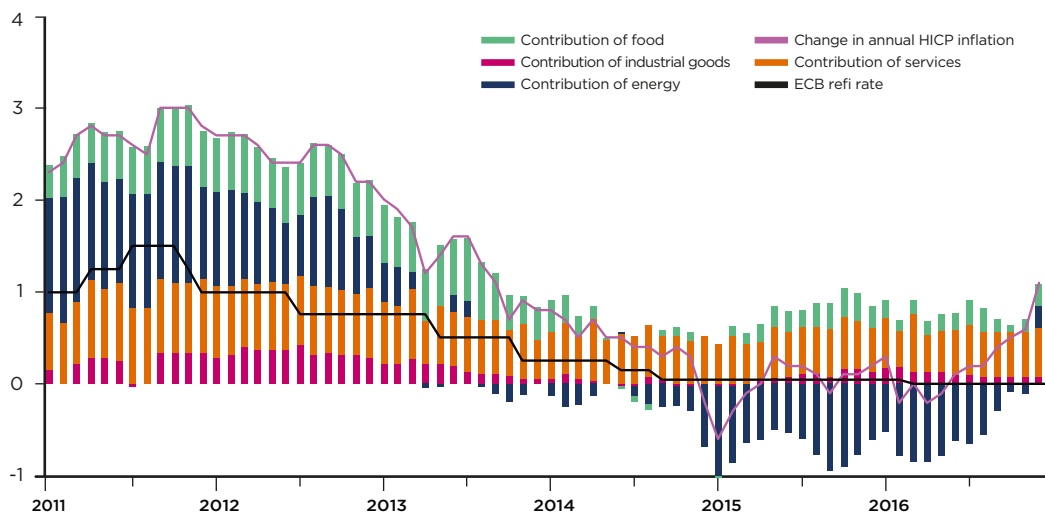
Source: Thomson Reuters - Last available data: 30 December 2016

China will remain subject to the same issues this year. As the Chinese government is not yet ready to trim its level of support for the economy, it would seem that reducing the country's imbalances is not a priority. This has been amply demonstrated by the increase in the private non-financial debt/GDP ratio of +20 GDP pts between June 2015 and June 2016 (according to the Bank of International Settlements). Moreover, the restrictive measures aimed at investors<sup>7</sup> are not indicative of financial deregulation, despite

the gradual changes in exchange rate policy (recent changes to the basket of currencies aimed at achieving a better representation of the relative weights of the various trading partners).

Should a change in the paradigm be expected in terms of inflation? Inflation in developed countries remained particularly low last year (with, for example, below 1% in the Eurozone). Compounding the relatively poor level of domestic demand, the fall in raw material prices from mid-2014 to 2016 has accentuated the downwards trend, leading to negative inflation rates in some cases (such as in Spain during the first-half of the year). Inflation is expected to begin rising again in 2017, if only as a basic mechanical reaction to raw material prices having reached their low point in 2016. A sudden leap in inflation is unlikely, due to weak internal demand, in the context of a still-widening output gap (particularly in the Eurozone). According to the latest Eurostat flash estimates, Eurozone inflation rose by 1.1% in December (against +0.6% in November), due to sharp rises in energy and food prices. One noteworthy factor, is that energy will be making an upwards contribution to inflation for the first time since July 2014 (*cf. graph 3*). Inflation in the United States is not expected to increase rapidly either, with the core index remaining below the 2% threshold (according to an IMF analysis), provided that the dollar does not depreciate and the unemployment rate does not fall below its structural level<sup>8</sup>. Growing political uncertainties in the US are also likely to limit the rise in inflation, due to their negative impact on short and medium-term inflation expectations<sup>9</sup>.

Graph n° 3  
Eurozone: Contributors to changes in inflation (% and pts of %)



Source: Eurostat, BCE - Last data: December 2016

6/ Banque de France, Rue de la Banque n°34, "Economic policy uncertainties in industrialised countries and shift of portfolio investments towards emerging economies", November 2016

7/ Adopted at the end of November, these measures are intended to limit outgoing capital movements (namely by means of increased controls on acquisitions abroad by companies based in China and increased controls on financial flows in yuan or currencies leaving the country) and implementing greater controls on investments made in other countries.

8/ IMF, WP/16/124, "What is keeping US inflation low: insights from a bottom-up approach", July 2016

9/ Banque de France, Rue de la Banque n°33, "Uncertainty in economic policy and inflation expectations", November 2016

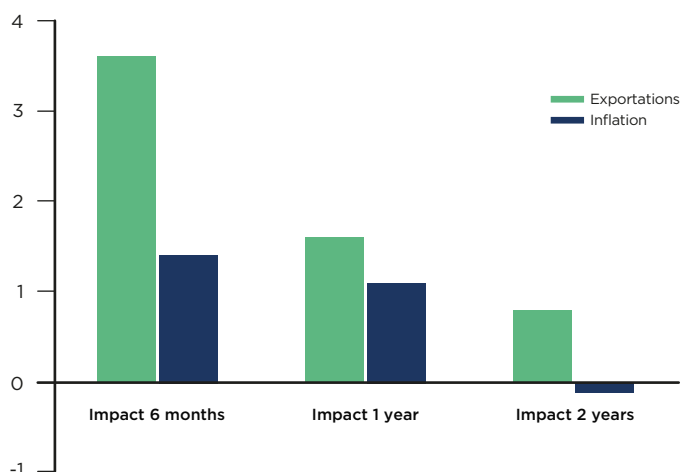
## 2 PERSISTENT CLOUDS ON THE HORIZON FOR 2017: DETAILS OF BREXIT AND US POLICIES

Headlining the uncertainties are the repercussions of *Brexit* and Donald Trump's victory. These decisions highlight the intentions of the United Kingdom and the United States to focus their policies on their own very specific interests - even if this works against the interests of the rest of the world. Other countries could also opt to follow a similar path. In terms of the United Kingdom, the details of its exit from the EU have yet to be defined and the earliest date would not be before April 2019. The country could also see early elections. In the event that the UK's exit from the EU does take place in April 2019, the trading regime would be less open than before and immigration policies would be more restrictive. Sectors that are closely integrated within the EU, such as pharmaceuticals and automobiles, would be the hardest hit. Europe is likely to adopt a tough stance if the United Kingdom ends the free movement of European citizens, hindering access to the single market. This would be aimed at discouraging other European countries from following suit, which would further destabilise the Union - which is already politically shaken due to the rise in populism. Within this environment, investments are likely to fall off, as investors adopt a "wait and see" approach, while defaults are expected to rise (+8% anticipated for 2017). Exports could feel the benefits of the sharp fall in sterling against the dollar (more than 15% recorded in the second half of 2016).

According to Coface's estimates, a 15% depreciation of the real effective exchange rate (REER) will lead to a 1.6% increase in exports by the end of the year (cf. graph 4). Although this is not an insignificant figure, exchange rate movements play a relatively minor role in comparison to the level of external demand. There should therefore be a slightly positive contribution from foreign trade, especially as imports are expected to decline as a result of slowing household consumption. The employment market is likely to weaken, while increases in real wages will slow. Inflation is expected to increase significantly, up to 2.5% in 2017, after reaching 1.2% in November 2016. On the basis of our estimates, inflation is likely to rise by up to 1.1 percentage points after a year, due to the depreciation of REER (all other things being equal). Even if the economy is unlikely to enter into recession in 2017, the country still has budgetary room for manoeuvre, should there be an extremely negative impact on growth. The Chancellor of the Exchequer thus decided, last November, not to launch a large-scale recovery plan (+0.1 pt impact on growth in 2017) and chose to ease back on the speed of budgetary consolidation (abandoning the 2020 balanced budget target).

Looking at the US, the surprise victory of Donald Trump has only led to minor changes in the evolution of the US and global economies. This is mainly because the underlying dynamic of the economy is not on a positive trajectory, as consumption and investment are showing signs of waning. Moreover upwards pressures on the dollar will have negative implications for foreign trade. Details on potential economic policy decisions are unknown. However, statements made by the incoming President since his election have helped ease certain worries, as they appear to be less extreme than those given while he was a candidate (particularly on the subjects of immigration and Obamacare). It seems unlikely that the Republican Party will readily agree to his wish to raise the minimum wage by 38%. There is also uncertainty over the implementation of a huge public infrastructure investment plan, which could only be partially achieved. Increases in customs duties of 45% for China and 35% for Mexico also seem relatively unlikely - but there has undoubtedly been a marked shift towards greater protectionism. Agreements under negotiation - such as the Transpacific Partnership - are no longer expected to be ratified. The reduction in corporation tax from 35% to 15% and on taxes on wealthier households seem much more likely. A compromise would only leave enough spending to provide modest support for growth (of around 0.3 GDP points over the next two years), and the effects of expansionist budgetary policy will be partially neutralised by the tightening of monetary policy. Corporate profitability, which was already struggling in 2016, could also suffer further (especially if taxes are not cut). Companies in the construction and automobile sectors could lose momentum, as they have reached a high point in their business cycles. There is only expected to be

Graph n° 4  
The United Kingdom: Impact of a 15% REER depreciation (in pts of %)



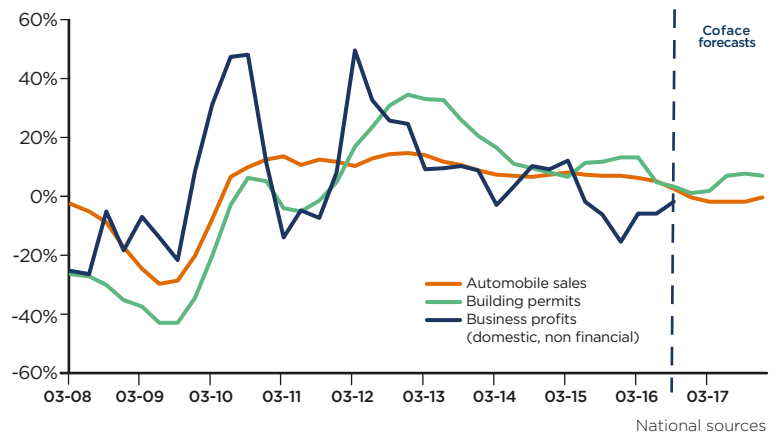
Source: Coface calculations



a 5.6% increase in building permits in 2017 (compared with an average of 14.1% a year, during the 5 previous years). Automobile sales are expected to decline by 1.6% (compared with annual average growth of +6.6% during the 5 previous years, as illustrated in *graph 5*). There could therefore be a slight increase, of 1%, in insolvencies in 2017 (compared to -3% in 2016). Finally, the “Trump” impact on the US economy is only expected to provide a slight boost to US growth, to reach +1.8% next year. In terms of spillovers, the most serious negative impacts could potentially be felt by Central American countries such as Mexico, Honduras and El Salvador, which earn the equivalent of 25 to 30% of their GDP from exports to the United States. Asian countries, such as Vietnam and Thailand, will also suffer on a similar basis (*cf. graph 6*). In the event of fiscal, trade and immigration measures being implemented and a more restrictive monetary policy, world growth would be reduced by 0.2 pt a year between now and 2020<sup>10</sup>.

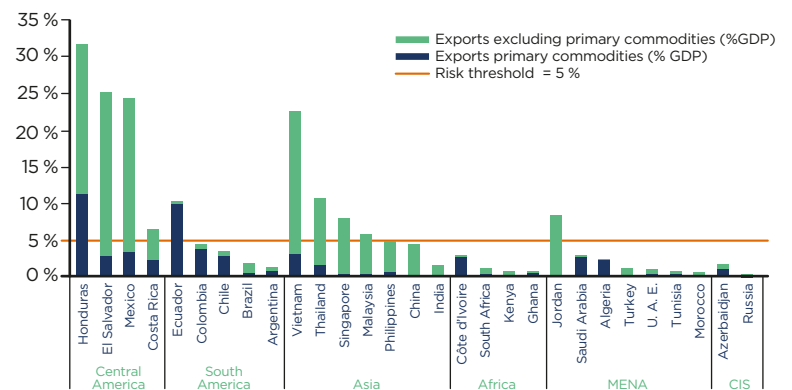
Graph n° 5

United States: Reduced vitality in the automobile and construction sectors



Graph n° 6

Exports from the leading emerging economies to the United States



Sources: CNUCED, IMF

### 3

## POLITICAL RISKS IN 2017: POSSIBILITY OF STORMS

Political risks will continue to be a core concern throughout 2017. The financial markets have demonstrated remarkable calm and limited volatility since the surprise election of Donald Trump, the lengthy time of one year taken to form a government in Spain and the referendum failure experienced by Italy's Matteo Renzi. Could this trend continue in 2017, with the upcoming elections in France and Germany?

Some countries are able to withstand the impact of political risks better than others<sup>11</sup>. Spain, for example, does not seem to have suffered significantly, despite not having had a government for almost a year. Moreover, Spain's level of economic growth and decline in insolvencies has led Coface to upgrade the country to A3 - although the rate of growth will somewhat slow in 2017. The closing of the output gap is likely to result in less dynamic growth rates compared to the past. Further improvements are expected in the labour market, albeit at a slower rate, while external factors are less favourable. In Italy, on

the other hand, the political situation has become increasingly unstable. The referendum's “No” result triggered the resignation of Prime Minister Matteo Renzi. The President of the Republic called on Paolo Gentiloni, from the ruling Democratic Party (PD), to head the government until the parliamentary elections in February 2018. He will have to deal with the banking crisis, a major source of worry, and harmonise electoral laws relating to the Chamber and the Senate. The government's survival will be subject to a motion of non-confidence. Given the current nature of these laws, if there were to be early elections, Beppe Grillo's 5 Star Movement (currently neck and neck with the PD in polls) could gain a majority in the Chamber. The Italian economy does not seem to be overly sensitive to these regular changes in government but growth remains flat, at less than 1%, and private consumption continues to suffer from these uncertainties and declining household confidence. In France, the presidential and parliamentary elections in April and May 2017 will determine the direction of the country's economic policy.

10/ GS “Global economic implications of the Trump agenda”, November 2016.  
11/ Coface analysis - “Will political risk “spoil the party” in 2017?”, October 2016



■ ■ ■ In Germany, the situation is less of a concern, even though parliamentary elections in the autumn will be a major milestone. The December attack on a Berlin market has fuelled tensions, while the openness of Angela Merkel towards refugees (approximately 900,000 refugees processed in 2015) is subject to criticism by her allies on the right, as well as by some of the population. Nevertheless, the Chancellor remains popular. According to Coface, in France a sudden increase in political uncertainty (such as a “Brexit” type shock) could reduce growth by 0.7 points over a year, compared to just under 0.5 points in Germany. In economic terms, our central scenario does not foresee any uplift in French growth in 2017 and the level of investment will remain weak. The most recent survey by INSEE on investment in industry, showed that executives expected their levels of investment, by value, to remain unchanged in 2017 (and these

surveys usually turn out to be more optimistic than the reality – which is not very encouraging). Companies have, however, rebuilt their margins and in the draft Finance Bill, corporation tax for the SME sector is due to be cut to 28%. The outlook in terms of employment will be stronger, despite the continuing relatively high level of unemployment. Meanwhile, the German economy with its low unemployment rate of around 4%, will remain particularly resilient, despite the slight slowing expected for this year. Real wages should also increase, even with a slight rise in inflation. The construction sector should strengthen. Finally, there will be a slight falling-off in insolvencies in 2017 in France (1%, following -3.8% in 2016) and in Germany (-6%, down from -5%). In France, however, certain sectors will be excluded from this decline in insolvencies, such as textiles & clothing, hotels & catering and transport.

## Insert

## 2016 Business climate assessment

**Every year, Coface assesses the business climate in 160 countries, ranking them on an 8 level scale:** A1, A2, A3, A4, B, C, D, E, from the most favourable situation to the least favourable situation. This assessment takes into account the availability and reliability of financial information on companies, the level of legal protection for creditors and the quality of institutions. The data is obtained from international bodies and the experiences of Coface entities from around the world.

**The most developed countries** have the best business environments, with 80% of these having A1 level ratings. Even the lowest performer among these, Greece, is rated at A3.

**In emerging and developing economies,** business climate rating levels are normally between B and D. However, in Central and Eastern Europe (which has A4 average rating), 40% of countries are in the A1 to A3 categories. In Sub-Saharan Africa, which has an average ranking of C, 15% of countries fall into the newly introduced E category. The Middle-East, which has an average ranking of B, has 21% of its countries in the E category. The average assessment for emerging countries in the Asia zone is B (cf. graph 7).

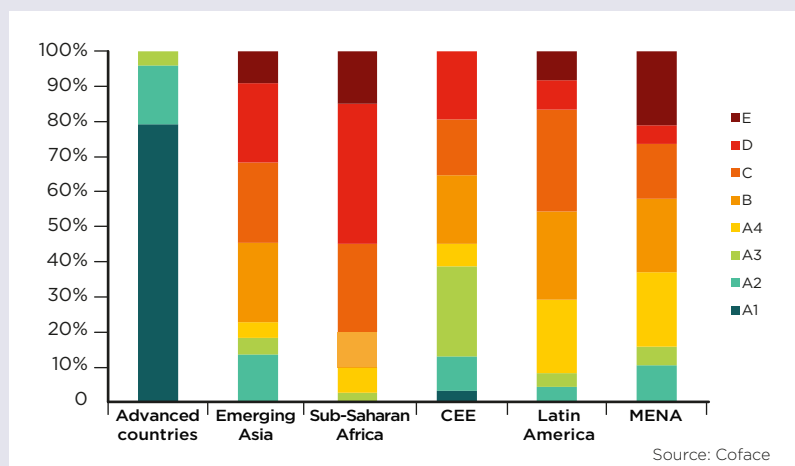
**Changes in the business climate, because of its structural nature, are slow. There have, however, been some noteworthy events since 2015.**

**Among the improvements,** are six Central and Eastern European countries. Estonia (A1) and Serbia (B) have been upgraded, thanks to improvements in the “institutional” and “financial information” indicators. Romania (A3), Bosnia (B) and Georgia (B) have been awarded higher rankings because of better protection for creditors, and Montenegro (B) for improvements in its institutions. The United Arab Emirates (A2) benefited from a new law on insolvencies. Pakistan and Bangladesh (both now at C) benefited from improvements in financial information, as did Kenya (B). Argentina (B) was also upgraded, thanks to the reforms implemented by pro-business President Macri.

**The deteriorations,** particularly reflect the impact of lengthy legal processes in Singapore (A2), Slovakia and Slovenia (A3) and Thailand (A4). Hungary (A3) saw increased state interventionism, the Dominican Republic (C) suffered from weaknesses in protections for creditors, while Lebanon (C) and Mozambique (D) experienced deteriorations in their institutional environments.

Graph n° 7

The business climate by region in 2016



## 4 EMERGING COUNTRIES: DUOS TO MONITOR

### Brazil and South Africa: same symptoms, same problems

Brazil's growth has long been driven by household consumption, which accounts for more than 63% of its GDP. South Africa has the same model (60% of GDP) and is increasingly reliant on credit. The economic model shared by these two countries is starting to run out of breath (*cf. graph 8*). Household demand, although not collapsing, is weakening, under the weight of rising inflation and high unemployment. Brazil's unemployment rate has risen rapidly over the last two years (by more than 5 pt). According to Tendencias, Brazilian household purchasing power declined by around 9% during the two crisis years, to return to its 2011 level. In South Africa, the unemployment rate has been rising at a faster rate in the last 12 months than previously, even though the level is much higher than that of Brazil. The investment rates in both countries are poor (below 20%), held back by weak demand and high interest rates (13.75% in Brazil and 7% in South Africa).

The downwards trend in prices of raw materials, the leading sources of export earnings and thus of foreign currencies, has undermined South Africa's current account (platinum and gold). This has also been the case for Brazil (oil, iron ore). This deterioration in the current accounts began to moderate in 2016 and could even be halted (particularly in Brazil), thanks to the fall in imports. Nevertheless, current account deficits will continue to weigh on the two national currencies, even though the exchange rates for the South African rand and the Brazilian real firmed up against the US dollar in 2016. In South Africa, a

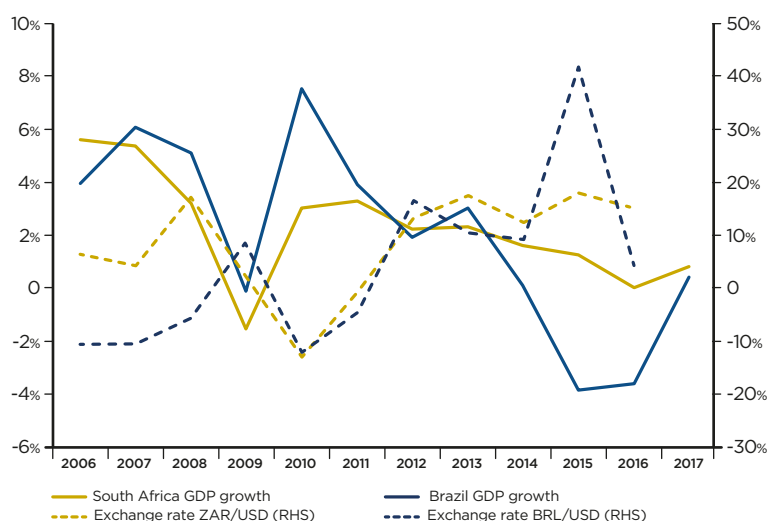
country with a sophisticated financial market which is valued by investors, capital inflows are likely to remain extremely uneven, thus increasing the volatility of the rand's exchange rate. Even though credit rating agencies retained South Africa at "investment" grade in 2016, the risk of a downgrade and its classification as "junk" cannot be ruled out during 2017. The agencies' decisions will be strongly influenced by whether there are improvements in the budget situation and in the level of public debt, which is likely to exceed 50% of GDP (and over 70% in Brazil). South Africa could thus follow in the wake of Brazil, which is already rated as "speculative" (first rated in this category by S&P, in September 2015). Exchange rates for the South African and Brazilian currencies, which fell strongly against the dollar last year, could also suffer if there is an increase in US interest rates. The exchange rates will also be influenced by uncertainties surrounding political developments in the two countries.

Brazil's President, Dilma Rouseff was impeached in 2016. In South Africa, the authority of President Jacob Zuma is being increasingly challenged, especially since allegations of embezzlement of public funds and collusion with business interests. As the ANC 2017 Convention approaches, Zuma's future, as head of the party, looks increasingly uncertain. Finally, social tensions, aggravated by failings in governance and the widening of income inequalities, have been exacerbated by the deterioration of the economic situation - which has led to rising prices and unemployment. The general discontent surrounding the corruption scandal is crystallising, with increasingly frequent popular demonstrations (as is also the case in Brazil). These demonstrations reflect the populations' high levels of expectations in terms of their rulers, who will be facing significant economic and political challenges in 2017.

### Turkey and the Russian model?

Turkey and Russia share a major common feature, as both are headed by strong leaders. Recep Erdogan and Vladimir Putin both have high levels of popular support, whilst their international reputations are low. Both are also characterised by a lack of a credible political opposition and the desire to consolidate their power. In Turkey, the presidential referendum on granting greater powers to Recep Erdogan is infringing on the rule of law. The opposition's weakness can be partly explained by its repression, as demonstrated in the scale of arrests of opponents following the attempted *coup d'état* in Turkey on 15 July 2016 (and in Russia by the imprisonment of Navalny and the undermining of freedom of expression). The media has also come under greater threat. In 2016, Reporters Sans Frontières rated Russia at 151<sup>st</sup> place out of 181 and Turkey at 148<sup>th</sup> in its freedom of the press rankings. This ranking is in line with the governance index compiled by the World Bank for 2015, where Turkey and Russia were respectively in 132<sup>nd</sup> and 165<sup>th</sup> place out of 215 countries in terms

Graph n° 8  
South Africa/Brazil: Growth rates and exchange rates



Sources: IMF Coface

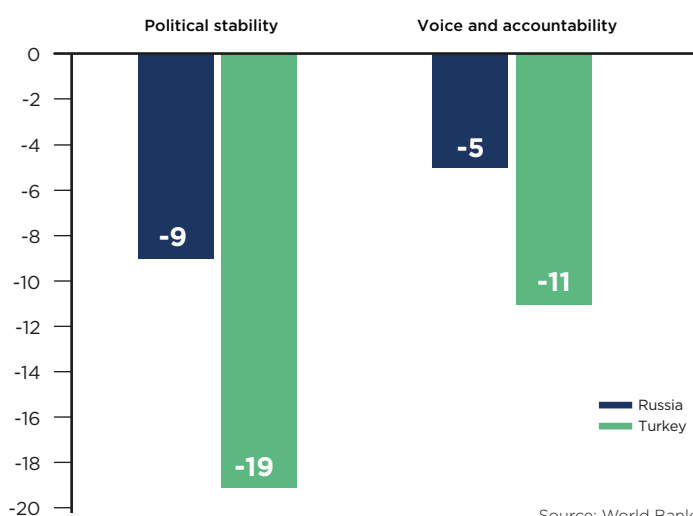


- ■ ■ of political freedom, and 191<sup>st</sup> and 184<sup>th</sup> in terms of political stability. Both countries have seen a rapid deterioration in their rankings since 2011 (cf. graph 9). In addition, the two countries have difficult relations with Europe.

Political risks began to have impacts on Russia, following the introduction of sanctions by Europe in 2014. These measures hit consumption and investment, against a background of falling oil prices. More recently, Turkey's political and security risks have also increased and its tourism industry has suffered significantly. According to the Central Bank, the estimated fall of 31% in tourist revenues could lead to a 1.1 pp loss in growth for 2016. The Turkish pound is depreciating and, according to the Bank, a 10% devaluation would boost inflation by 1.8 pp over the next two years. The 21% depreciation registered between mid-October 2016 and mid-January 2017 could thus result in a 3.8% pp inflation surplus. This is therefore a major concern in terms of the strength of private consumption – the driving force for growth. Fluctuations in exchange rates are also critical economic factors for Russia. Nevertheless the rouble previously suffered from a sharp fall, even though these pressures have now somewhat relaxed. Both economies are thus having to deal with significant inflationary pressures (average inflation in 2016 was between 7 and 8%). Nevertheless, the two countries are not following the same growth models, or the same trajectories. In Russia, growth is slowly recovering, largely bolstered by higher oil prices, whilst growth in Turkey is weakening, in line with sluggish domestic demand.

Graph n° 9

Turkey/Russia : Deteriorating governance indicators  
(number of ranks lost between 2011 and 2015, out of 209 countries)



Source: World Bank

## Mexico and Argentina: at a crossroads

The economic trajectories of these two Latin American countries, which both have a degree of dependence on raw materials for budget income, are divergent. Mexico's economy is in a landing phase. The country has achieved strong performances in the past and has implemented reforms in tax collection, the labour market and in terms of opening up to competition of its energy and telecommunications sectors ("*Pacto por Mexico*"). These reforms have been welcomed by the international community. The country is now on slower growth path, with the weakening of investments and manufacturing exports, the negative consequences of raising of the key lending rate and the 30% depreciation in the exchange rate against the dollar over the last 2 years (which has undermined household purchasing power<sup>12</sup>). Argentina on the other hand is expected to see accelerated growth, thanks to recent reforms to improve the business climate. The country has consequently been upgraded to B for its business climate and country risk levels. The measures implemented include the deregulation of exchange controls, the removal of restrictions on access to foreign currencies, the streamlining of administrative procedures for imports and exports and the relaunch of dialogue with the ICSID<sup>13</sup> (as part of country's policy

to normalise its external financial situation). There has undeniably been a serious negative short term impact (GDP again declined by 3.8% in the third quarter y-on-y), but the economy should pick up in 2017 (+2%, up from -2%). This will be particularly due to reduced inflation, which should allow consumption to increase in Argentina (in contrary to Mexico, cf. graph 10). The relaxation of Argentina's monetary policy is likely to be continued (again unlike Mexico, which has to follow US monetary policy in order to remain attractive, even while its exchange rate slips).

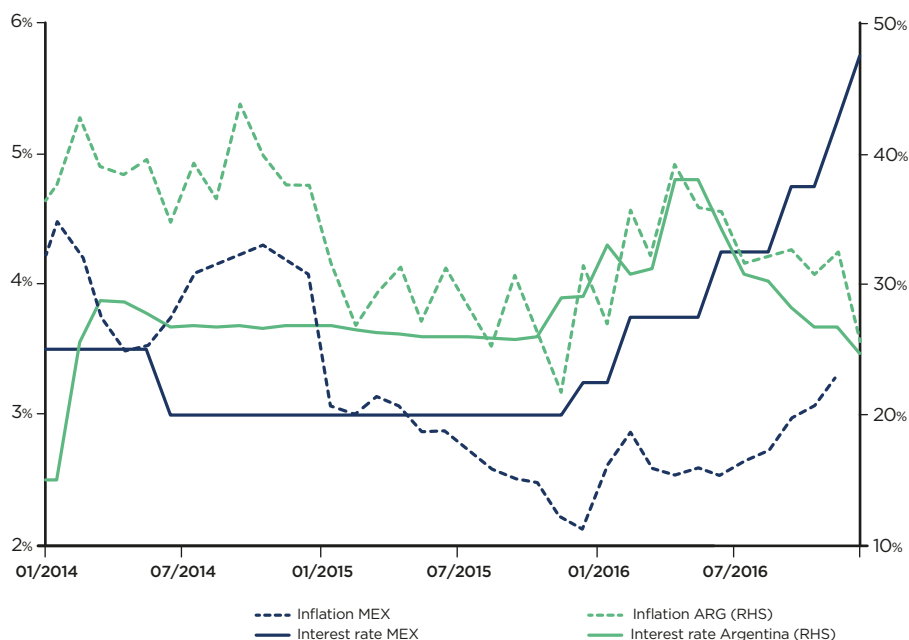
The unknowns facing Argentina should be mainly positive ones. The country has regained access to capital markets and the return of foreign investors bodes well. Mexico, however, is reliant on the United States as the destination for 80% of its exports. The election of Trump has resulted in a wait-and-see attitude from investors, because of potential protectionist (a 35% increase in customs tariffs has been mentioned) and anti-immigration legislation. Remittances from Mexican workers living in the United States account for 2.4% of Mexico's GDP. These unknown factors, in addition to the weakening in Mexico's fundamentals, have led Coface to downgrade the country from A4 to B.

12/ Even if the pass-through between the exchange rate and inflation is weak, according to an analysis by Banxico, a 1% change in the nominal exchange rate leads to a 0.073 pp increase in inflation. The 30% depreciation against the dollar will thus result in a 2 pt impact on inflation.

13/ International Centre for Settlement of Investment Disputes.



Graph n° 10  
Mexico/Argentina: Inflation and monetary policy



Sources: Central banks and Torcuato di Tella University  
Last available data : December 2016 except inflation MEX : November 2016.

## India and Egypt: reforms are continuing haphazardly

India has decided to carry out reforms. In November there was a “*demonetisation shock*”, when Prime Minister Modi announced the withdrawal of 500 and 1,000 rupee banknotes (which accounted for 86% of cash in circulation). Egypt did not have any choice, as the Egyptian pound was hugely overvalued, with official and unofficial exchange rates respectively at 9 and 18 pounds against the US dollar. The long overdue relaxation of the exchange regime took place in November 2016, following a 14% devaluation in March. This decision was welcomed by the markets.

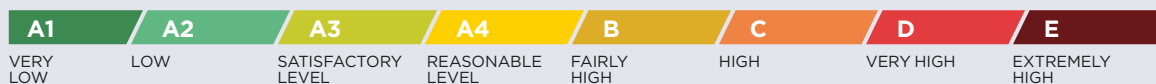
India’s decision to carry out the “*demonetisation*” was based on its needs to (i) control the black market, counterfeiting, tax evasion, corruption and terrorism; (ii) improve the liquidity of the domestic banking system, particularly by encouraging deposits (to boost dematerialised transactions in a country where 90% of transactions are made in cash); (iii) help the implementation of monetary policy, with reduced borrowing rates (a benefit for companies), thanks to the aforementioned increase in deposits; (iv) increase tax receipts and reduce tax evasion; (v) shift from the informal economy (23% of GDP) to a more formalised model. In Egypt, the decision to devalue was accompanied by the removal of the list of import restrictions and the raising of the key lending rate by 300 bp. In global terms this decision will make it possible for companies to at least partly overcome payment problems and shortages of currencies.

In both countries, these shocks have had negative short term repercussions on activity but will enable a more sustainable growth trajectory in the long term. In India the problem was that the decision caused panic, as it came as a surprise (banks were closed, with a ceiling on withdrawals). The measures taken will seriously impact the sectors which are the most closely linked with the black market (such as retail sales and construction). Despite the short term negative shock, India’s economy is proving resilient (growing by +7.5%, following +6.9%). Egypt’s economic situation, in contrast, is far less positive. Activity is continuing to suffer from the after-effects of terrorist attacks (with reduced tourism), the decline in revenues from the Suez Canal and falling support from the Gulf Countries (due to reduced remittances from overseas workers). However, the country is now in receipt of a USD12 billion IMF loan and is expected to continue with the implementation of its reforms. There are a considerable number of risks for the economy. Inflation is increasing and reached 19.4% in November (from 13.6%). An increase in key lending rates is thus on the cards. There is also the impact of the IMF’s austerity measures - particularly reductions in subsidies. The increased risk of social tensions also needs to be monitored and President Sissi’s popularity is declining. The country’s growth forecast is moderate, with +3.5% for 2017, following +3.6% in 2016. This is far removed from the nearly 6% growth the country was enjoying before the Arab Spring.

### COUNTRY RISK ASSESSEMENTS CHANGES

COUNTRY		CURRENT		NEW
<b>UPGRADES</b>				
ESTONIA		A3	▶	A2
ICELAND		A3	▶	A2
SPAIN		A4	▶	A3
BULGARIA		B	▶	A4
KENYA		B	▶	A4
ARGENTINA		C	▶	B
CYPRUS		C	▶	B
GHANA		C	▶	B
SERBIA		C	▶	B
BOSNIA		D	▶	C
PAKISTAN		D	▶	C
<b>DOWNGRADES</b>				
MEXICO		A4	▶	B
JORDAN		B	▶	C
SOUTH AFRICA		B	▶	C
MAURITANIA		C	▶	D

Probability of companies default



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