



ALLIANZ RESEARCH

# DUAL CIRCULATION: CHINA'S WAY OF RESHORING?

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# EXECUTIVE SUMMARY



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- **Over the long run, the Chinese economy is facing two key challenges: declining potential growth and a deteriorating external environment.** Our growth potential model suggests China's GDP growth is likely to average between +3.8% and +4.9% over the coming decade (after +7.6% in the 2010s), due to declining labor supply and slowing productivity and capital investment. Meanwhile, China is also bracing for a long-term standoff with the U.S., which is currently its top export destination and the most innovative country at the global level. Looser economic ties with the U.S. will thus pose additional risks to China's slowing economy.
- **In this context, the "dual circulation" strategy is likely to take center stage in China's 14th five-year plan as a way towards more sustainable growth, making the country less reliant on factors outside of its control.** First introduced by President Xi Jinping in May 2020, this strategy prioritizes "domestic circulation" (increasing domestic demand and lowering dependence on foreign inputs), while "international circulation" (maintaining export market shares and liberalizing capital flows) works as a complement. While rebalancing towards domestic demand is not a new principle in China's economic planning, China will aim in the long run to use domestic production to provide for increasing domestic demand, rather than imports.
- **Taiwan, Malaysia, Singapore, Thailand and Chile are set to incur the most potential losses in the medium run as China moves towards industrial autonomy.** Conversely, goods from the U.S., Japan and Germany are exposed to very limited risk of being substituted by Chinese goods in the medium term, thanks to their technological advancement. Losses for the Eurozone overall could amount to up to 0.9% of GDP in the medium run, with machinery & equipment, construction, agrifood and electronics the most exposed sectors.
- **China is likely to increase direct investment into innovating emerging economies,** such as the electronics sector in Indonesia, India, Thailand, Mexico and Chile. Chinese outward investment has slowed but not stopped in the past years, and the Belt and Road Initiative remains part of Chinese authorities' long term vision. Implementation challenges (e.g. related to financial risks) mean that Chinese policymakers are likely to aim for outward direct investment to be more disciplined around national economic targets (e.g. industrial autonomy).
- **Long-term risks include rising debt, zombification and slow technological advancement.** China's R&D spending relies far more on government funding compared to the U.S., Japan and Germany. Strong government intervention could risk leading to overcapacity issues and resource misallocation towards the overall less profitable and less innovative state-owned enterprises.

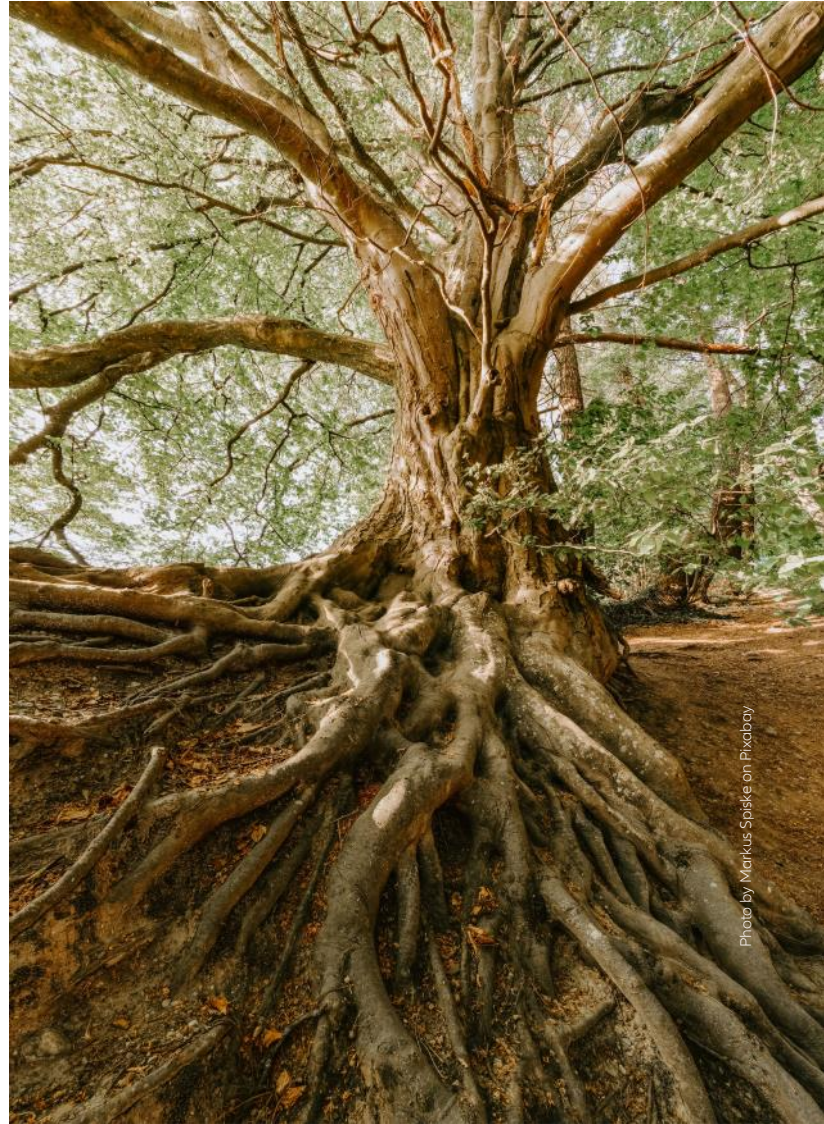


Photo by Markus Spiske on Pixabay

# 3.8%-4.9%

**China's average growth over the coming decade,  
compared to 7.6% in the 2010s.**

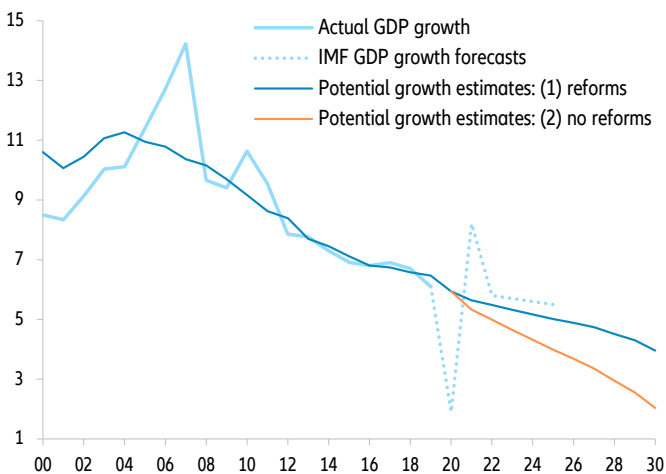
# DECLINING GROWTH AND EXTERNAL HARDSHIPS

The fifth plenum of China's Communist Party Central Committee draws to a close on 29 October 2020 after four days of discussions partly focused on the 14th five-year plan, which will define the economic policies and targets for 2021-2025. The details will be finalized and made public in March 2021 but we expect the "dual circulation" strategy, first introduced by President Xi Jinping in May 2020, to take center stage. This strategy aims to respond to two key challenges that China is facing in the long term: declining potential growth and a deteriorating external environment.

The Chinese economy has been on a declining trend over the past decade, with GDP growth averaging +7.6% in the 2010s, compared to +10.3% in the 2000s. The downward trend is likely to continue in the coming years as China deals with structural issues, including capital misallocation, overcapacity and an aging population. However, policy measures such as reducing debt levels (of firms and local governments), boosting labor mobility and human capital and upgrading the manufacturing base should help cushion the decline in China's capital and productivity growth. As such, using our proprietary

model for potential growth, we have devised two scenarios, with (1) successful structural reforms and (2) no or unsuccessful structural reforms (see Figure 1). In both scenarios, the negative contribution of the labor supply will deepen as a result of the aging population and expected low fertility rates. Capital growth and productivity growth are set to decline less in scenario (1). Overall, potential growth over 2021-2030 should average +4.9% in scenario (1) and +3.8% in scenario (2) (see Figure 2).

**Figure 1:** China GDP – actual growth, forecasts and potential growth estimates



Sources: : China National Bureau of Statistics, IMF, Euler Hermes, Allianz Research

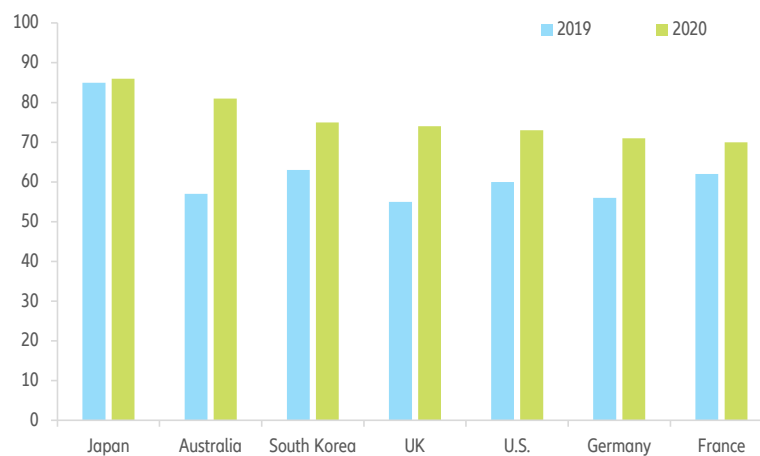
**Figure 2:** China potential growth estimates and breakdown

	2001-2007	2008-2014	2015-2020	2021-2030 (1) reforms	2021-2030 (2) no reforms
<b>GDP growth (average p.a. %)</b>	<b>10.7</b>	<b>8.7</b>	<b>6.6</b>	<b>4.9</b>	<b>3.8</b>
<b>Average contributions:</b>					
Labour supply	0.6	0.2	-0.1	-0.3	-0.3
GDP per labour	10.1	8.5	6.7	5.2	4.0
Long-term productivity	2.6	2.1	1.8	1.3	0.6
Capital per labour unit	7.6	6.4	4.9	3.9	3.4

Sources: : China National Bureau of Statistics, IMF, Euler Hermes, Allianz Research



**Figure 3:** Share (%) of surveyed who have an unfavorable view of China



Sources: Summer 2020 Global Attitudes survey (Q8b)

Meanwhile, China is also facing a deteriorating external environment, which began with trade tensions with the U.S. in 2017. Since then, these tensions have spread into technology, financial, media and geopolitical areas. Surveys conducted by the American Chamber of Commerce in China show that 37% of respondents were planning no further investment or declining investment in their China operations in 2020, com-

pared with just 16% in 2013. This likely protracted standoff could result in looser economic ties in the coming years with the U.S., which is currently China's top export destination and the most innovative country at the global level (considering R&D spending and patent applications). The Chinese leadership aims to prepare a sustainable response to this long-lasting change, as the Politburo meeting in August used the ex-

pression of "protracted war" to describe the problems the country is facing. Beyond the U.S., China's external environment overall is also turning less favorable, with a survey conducted in summer 2020 showing that the public perception of China has starkly deteriorated in developed countries (see Figure 3).

# THE DUAL CIRCULATION STRATEGY: A MORE INWARD-LOOKING GROWTH MODEL

The domestic and international context, coupled with vulnerabilities uncovered by the ongoing Covid-19 pandemic, has prompted the Chinese leadership to rethink the country's economic growth strategy. The dual circulation strategy hinges on a model where "domestic circulation" is the focus and "international circulation" works as a complement. The rationale is to establish more sustainable growth in the long run, making China less reliant on factors outside of its control.

More precisely, domestic circulation implies targets and reforms on both the demand and supply sides of the Chinese economy. On the demand side, the aim is to capture consumer spending domestically and to increase investment in specific types of infrastructure (e.g. related to environmental protection, digitalization, internet of things, etc.). On the supply side, the aim is to encourage Chinese industrial firms to become less dependent on foreign supplies and inputs.

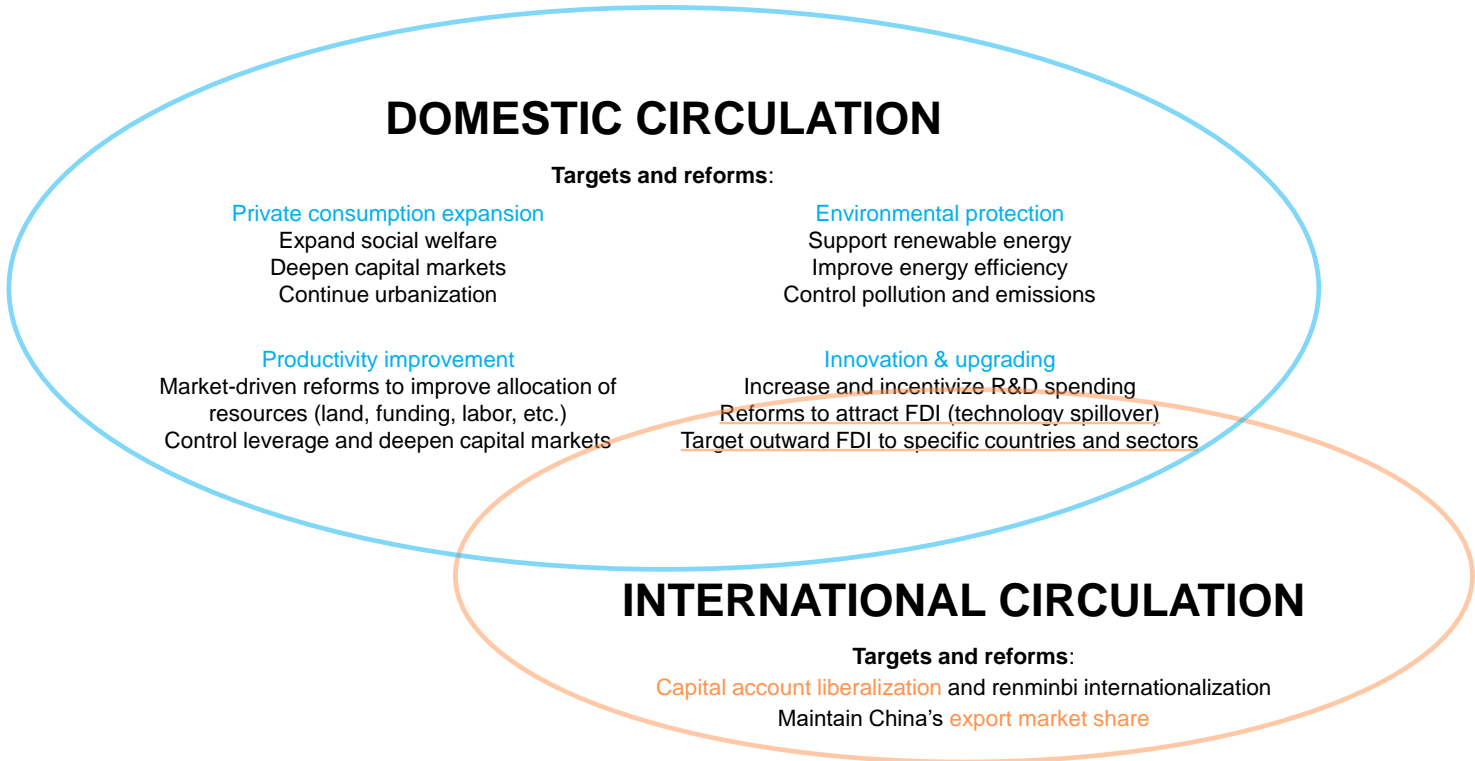
Meanwhile, international circulation means that China will continue to promote external flows of goods and capital. Exports should remain an additional driver of growth (and China has been winning export market share this year). Reforms to liberalize the capital

account will keep going as China aims to attract foreign investment and deepen its capital markets.

It is important to point out that the principles behind the dual circulation strategy are not entirely new for China. The country has been aiming to rebalance its economy towards the domestic market for well over a decade – the Global Financial Crisis (GFC) having been the trigger for such a change. As investment and consumption grew faster (+8.7% and +12.0%, respectively, in real terms on average over 2009-2019), the share of exports in total GDP declined from 35% in 2008 to 24% in 2019. In the meantime, the share of imports in total GDP has been relatively stable over the past decade, hovering between 22% and 25% over 2009-2019. This means that the rest of the world has benefited from China's economic rebalancing and comparatively higher regime of growth.

What is now different compared to the post-GFC rebalancing is that China will aim in the long run to use domestic production to provide for increasing domestic demand, rather than imports. Such a strategy change has actually been in the works since 2015, when authorities introduced the Made in China 2025 program. Its aim was to upgrade China's manufacturing base and allow some key sectors to become more autonomous, i.e. less reliant on foreign inputs. While Made in China 2025 in its exact form is not mentioned by Chinese authorities anymore (being a point of tension with the U.S.), the principles of indigenous technology and industrial autonomy live on with the dual circulation strategy. This new thrust towards self-sufficiency will happen at the expense of China's current trading partners.

Figure 4: China's dual circulation strategy



Sources: Euler Hermes, Allianz Research

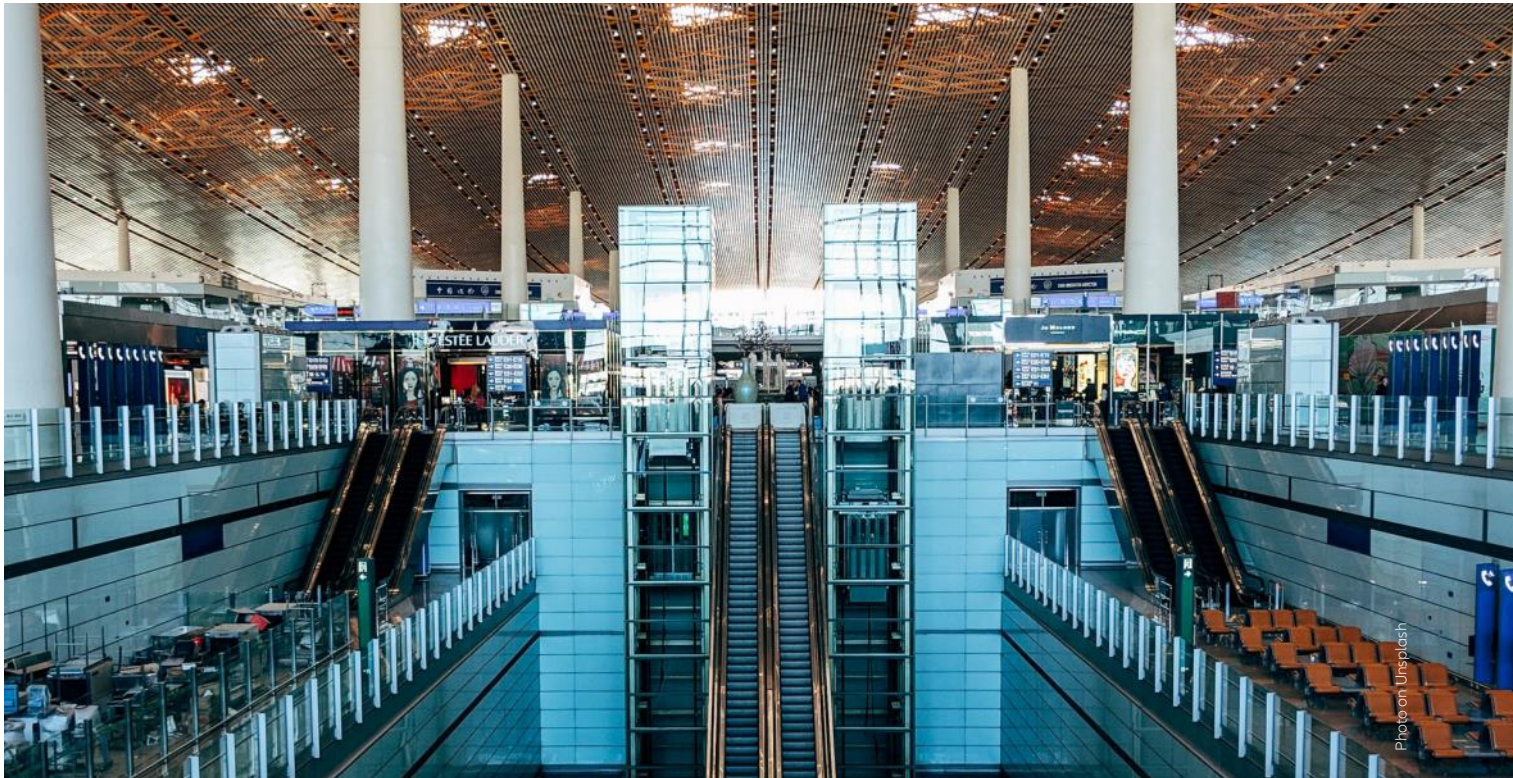


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# TAIWAN, MALAYSIA, SINGAPORE, THAILAND AND CHILE ARE SET TO INCUR THE MOST POTENTIAL LOSSES IN THE MEDIUM RUN

Which economies would particularly suffer as China moves toward autonomy? To gauge this we start by looking at countries' exposure to China not simply in terms of trade, but in terms of value-added actually contributed into China's domestic final demand (i.e. final goods or services purchased by domestic households, government and business investment). We find that foreign value-added contributes to 14% of China's total final demand, out of which the U.S. (2.1%), Japan (1.3%), South Korea (1.0%), Germany (0.9%) and Taiwan (0.7%) are the top five contributors. These numbers may suggest a relatively small exposure of China to foreign value-added and technology, but they are aggregates that mask strong disparities across sectors. For example, 44.8% of domestic final demand in China's electronics sector consists of foreign value-added, in which South Korea, Taiwan and Japan are the top contributors (see Figure 5).

To estimate China's trading partners' substitution vulnerability in each sector, we analyze the innovation potential and distance to technology frontier of each economy. More precisely, we look at the number of patent applications and we assume that a country's market share in a sector in China is vulnerable when it has filed consistently fewer patents than China over the past ten years. While such a measure for innovation potential has some drawbacks, we consciously chose the data on patent applications filed under the Patent Cooperation Treaty<sup>1</sup> to partly correct for patent quality issues. Furthermore, the number of patents filed also reflects China's sectoral priorities in terms of a technology catch-up. Figure 6 shows that the U.S., Japan and Germany are featured among the top three countries with the most patent applications filed in almost all sectors.

As a result, according to our methodology, the U.S., Japan and Germany are exposed to very limited risk of being substituted by Chinese technology and goods in the medium term (see Figure 7). Conversely, Taiwan, Malaysia, Singapore, Thailand and Chile are the five economies most at risk of losing market share in China as it moves towards industrial autonomy, with losses in the medium run of up to 10.3%, 6.5%, 5.6%, 5.1% and 5.0% of GDP<sup>2</sup> respectively. Losses for the Eurozone could amount to up to 0.9% of GDP in the medium run, with machinery & equipment, construction, agrifood and electronics the most exposed sectors. The most exposed countries in the area are Slovakia (1.9% of GDP at risk in the medium run), Ireland (1.8%), Malta (1.6%), Finland (1.4%) and Austria (1.4%).

<sup>1</sup> The treaty makes it possible to seek patent protection for an invention simultaneously in a large number of countries (more than 145 contracting states) by filing a single "international" patent application.

<sup>2</sup> These numbers can be seen as the maximum share of GDP lost in the medium run as a result of China's industrial autonomy. More precisely, we calculate them for each sector by assuming that an economy's value-added contributed into China's final demand in a given sector falls to 0 when it has persistently filed fewer patents in that sector than China over the past ten years.



**Figure 5: Contributors to China's domestic final demand, by sector**

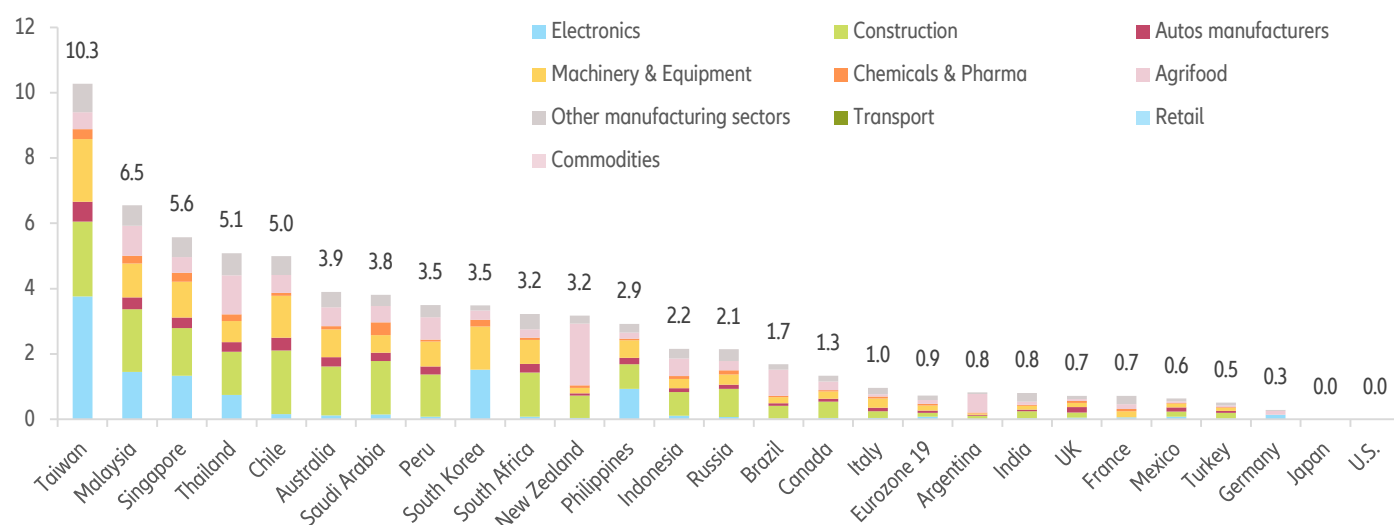
% of China's final demand	Share of domestic value-added	#1 foreign value-added contributor	#2 foreign value-added contributor	#3 foreign value-added contributor
Electronics	55.2	South Korea 9.2	Taiwan 8.3	Japan 5.1
Transport Equipment	67.6	U.S. 12.9	France 3.6	Germany 2.5
Paper	72.1	U.S. 5.2	Canada 1.8	Japan 1.7
Automotive manufacturers	75.4	Germany 4.1	Japan 3.5	U.S. 3.5
Machinery & Equipment	76.5	Japan 3.5	U.S. 2.6	Germany 2.4
Chemicals & Pharmaceuticals	78.4	U.S. 3.0	Japan 1.7	Germany 1.3
Transport	80.2	U.S. 3.2	Japan 1.4	Hong Kong 1.0
Household Equipment	80.8	U.S. 2.3	Japan 1.7	India 1.3
Metals	80.8	U.S. 2.1	Australia 2.0	Japan 1.5
Energy	81.1	Saudi Arabia 2.0	Russia 1.5	U.S. 1.1
Software & IT services	83.9	U.S. 2.4	India 2.2	South Korea 1.3
Retail	84.5	U.S. 3.3	Japan 1.7	Germany 1.0
Textile	85.9	U.S. 1.3	South Korea 1.0	Japan 0.9
Commodities	87.5	U.S. 1.3	Australia 0.9	Saudi Arabia 0.8
Agrifood	89.3	U.S. 1.8	Brazil 1.1	Australia 0.5
Construction	90.0	U.S. 1.1	Japan 0.8	South Korea 0.7
Computers & Telecom	90.5	U.S. 1.4	South Korea 0.7	Taiwan 0.7

Sources: OECD, Euler Hermes, Allianz Research

**Figure 6: Patent applications filed under the Patent Cooperation Treaty, by sector**

% of world total	#1 patent applications filed		#2 patent applications filed		#3 patent applications filed		#4 patent applications filed		#5 patent applications filed	
Electronics	U.S.	26.7	Japan	19.7	China	19.6	South Korea	7.0	Germany	5.7
Transport Equipment	U.S.	18.0	China	11.9	Japan	11.2	Germany	11.2	France	7.9
Paper	U.S.	21.1	Japan	18.4	Germany	14.6	France	5.2	Finland	5.0
Automotive manufacturers	Japan	31.0	Germany	23.2	U.S.	13.4	France	7.1	China	4.6
Machinery & Equipment	Japan	23.1	U.S.	19.5	Germany	12.9	China	10.8	South Korea	5.6
Chemicals & Pharmaceuticals	U.S.	29.1	Japan	19.4	Germany	9.8	China	6.8	South Korea	5.1
Household Equipment	U.S.	33.5	Japan	15.8	Germany	7.2	China	6.3	South Korea	5.3
Metals	Japan	23.0	U.S.	17.5	Germany	13.9	China	7.3	South Korea	5.9
Energy	U.S.	39.7	Japan	7.2	Germany	6.3	China	4.9	France	4.9
Software & IT services	U.S.	40.2	Japan	12.1	China	11.2	South Korea	10.2	UK	2.9
Textile	U.S.	31.6	Japan	16.0	South Korea	8.1	China	7.3	Germany	6.1
Agrifood	U.S.	22.0	Japan	15.6	China	10.8	South Korea	5.5	Switzerland	5.4
Construction	U.S.	32.7	Japan	13.6	Germany	7.4	China	6.3	South Korea	5.8

Sources: OECD, Euler Hermes, Allianz Research

**Figure 7: Share of GDP (%) at risk in the medium term due to China's industrial autonomy drive (G20 countries and large emerging economies)**

Sources: OECD, Euler Hermes, Allianz Research

# INNOVATING EMERGING ECONOMIES TO ATTRACT CHINESE INVESTMENT

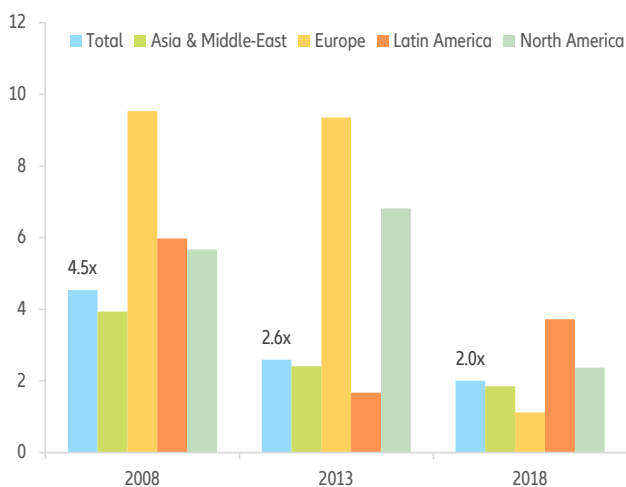
While China's ultimate industrial autonomy will be detrimental to the rest of the world, the dual circulation strategy could have positive implications before China reaches that target. Indeed, as China aims to upgrade its manufacturing base and improve productivity, firms may look abroad in order to acquire technology. This is in part the reason why China's outward direct investment has increased so much in recent years, in particular in Europe and North America (see Figure 8), where innovation-leading countries at the global level are located. However, as the U.S. and the EU aim to protect local technology, scrutiny over foreign acquisitions

has increased in recent years. Along with domestic regulation in order to control capital outflows in the wake of the currency scares in 2015-16, this is why China's outward foreign direct investment has slowed overall in the past few years.

However, it has not stopped, and the Belt and Road Initiative remains part of Chinese authorities' long term vision. Indeed, it has been discussed at the fifth plenum of China's Communist Party Central Committee. That said, given implementation challenges since it was first introduced in late 2013 (related to financial, legal and political risks), Chinese policymakers are likely to aim

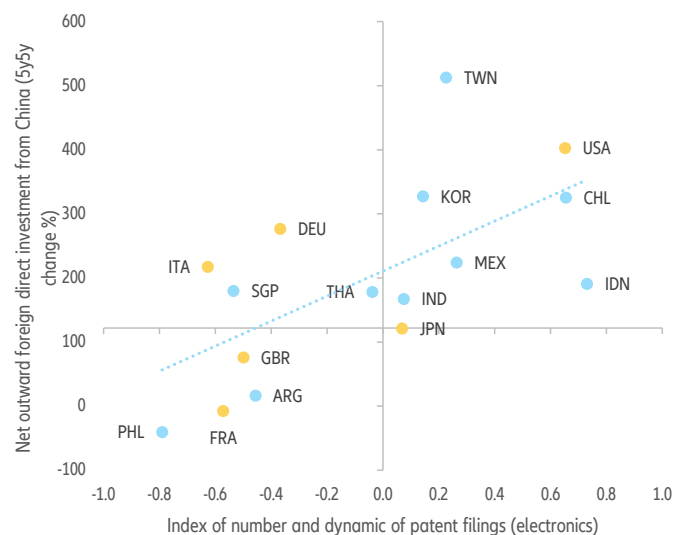
for outward direct investment to be more disciplined around national economic targets. In particular, investment that helps advance the country's industrial autonomy is likely to be encouraged. As such, we looked into which economies have exhibited the most dynamism in terms of innovation (patent filings) in the electronics sector, which is currently the sector in which China relies the most on foreign value-added. Outside G7 countries, which are likely to scrutinize more investment from China, Figure 9 suggests that China could increase direct investment into Indonesia, India, Thailand, Mexico and Chile.

**Figure 8:** Outstanding outward foreign direct investment from China, 5-year change



Sources: Ministry of Commerce of China, Euler Hermes, Allianz Research

**Figure 9:** Innovation (index of number and dynamic of patent filings, electronics sector) vs. direct investment from China (total)

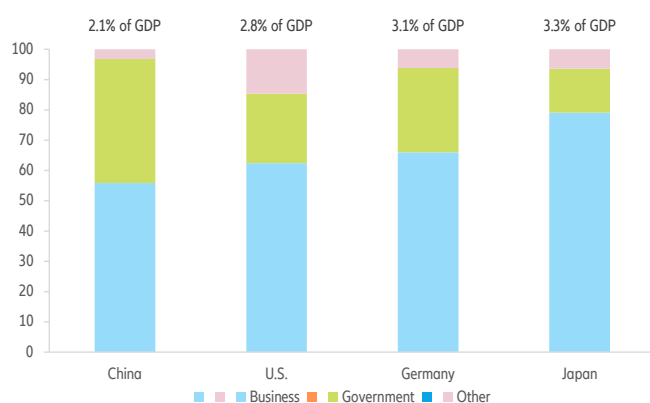


Note: orange dots are G7 countries, which are likely to scrutinize more investment from China

Sources: OECD, Ministry of Commerce of China, Euler Hermes, Allianz Research

# RISKS: RISING DEBT, ZOMBIFICATION, SLOW TECHNOLOGICAL ADVANCEMENT

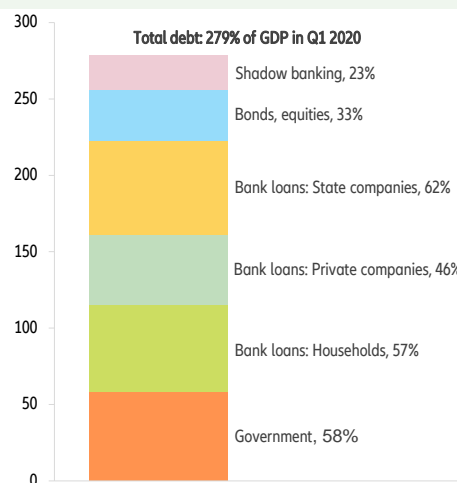
**Figure 10: R&D spending breakdown in 2018**



*Note: China breakdown is based on national sources, in an aim to better capture R&D public spending*

*Sources: OECD, National Bureau of Statistics of China, Ministry of Finance of China, Euler Hermes, Allianz Research*

**Figure 11: China total debt breakdown (% of GDP)**



*Sources: BIS, PBOC, National Bureau of Statistics of China, Ministry of Finance of China, Euler Hermes, Allianz Research*

China's R&D spending has been growing very rapidly, reaching 2.2% of GDP in 2019 compared with 1.4% in 2008. This is also already slightly higher than the level in the EU, although still falling short compared with the global innovation leaders (the U.S., Japan and Germany). Another important difference is that a larger share of R&D is carried out through public spending in China, amounting to 41% of the total in 2018, compared with 23%, 15% and 28% in the U.S., Japan and Germany, respectively (see Figure 10).

This structure of R&D spending in China means that policy mistakes could create long-term risks of accelerating debt, zombification in some sectors, and slow technological advancements.

First, R&D financing could become increasingly difficult, as public debt is already high. As of Q1 2020, we estimate that government and state-owned enterprises' debt amounted in total to 120% of GDP (see Figure 11). This ratio is only set to increase in the coming years (particularly for government debt) as fiscal support is still necessary to help the economy sustainably emerge from the Covid-19 induced economic crisis, and the government needs resources to implement other long-term reforms (infrastructure investment, urbanization, social welfare system expansion, etc.).

Second, a strong involvement of the government in the development of a sector could risk leading to resource

misallocation, overcapacity and zombification issues. This is a problem that China had encountered in the early 2010s in the solar panel industry. Heavy subsidies and tax incentives could lead to artificially maintaining an unprofitable company alive for longer than would be advised.

Finally, government funding of R&D could be biased towards state-owned enterprises (SOEs). This could be a hurdle against China's technological advancement as SOEs tend to be less productive and profitable than private firms<sup>3</sup>, and there is also evidence that they produce research of lower quality compared with private firms<sup>4</sup>.

<sup>3</sup> In 2016, return on asset of private industrial firms stood at 10.6%, compared with just 3% for SOEs according to "The state strikes back: the end of economic reform in China?", N. Lardy (2019).

<sup>4</sup> For example, "Analysis on the enterprises' innovation quality based on the patent value: a comparison between public and private enterprises in China", D. Huang, H. Duan and G. Zhang (2020).

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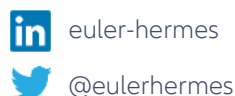
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## FORWARD-LOOKING STATEMENTS

The statements contained herein may include prospects, statements of future expectations and other forward-looking statements that are based on management's current views and assumptions and involve known and unknown risks and uncertainties. Actual results, performance or events may differ materially from those expressed or implied in such forward-looking statements.

Such deviations may arise due to, without limitation, (i) changes of the general economic conditions and competitive situation, particularly in the Allianz Group's core business and core markets, (ii) performance of financial markets (particularly market volatility, liquidity and credit events), (iii) frequency and severity of insured loss events, including from natural catastrophes, and the development of loss expenses, (iv) mortality and morbidity levels and trends, (v) persistency levels, (vi) particularly in the banking business, the extent of credit defaults, (vii) interest rate levels, (viii) currency exchange rates including the EUR/USD exchange rate, (ix) changes in laws and regulations, including tax regulations, (x) the impact of acquisitions, including related integration issues, and reorganization measures, and (xi) general competitive factors, in each case on a local, regional, national and/or global basis. Many of these factors may be more likely to occur, or more pronounced, as a result of terrorist activities and their consequences.

## NO DUTY TO UPDATE

The company assumes no obligation to update any information or forward-looking statement contained herein, save for any information required to be disclosed by law.