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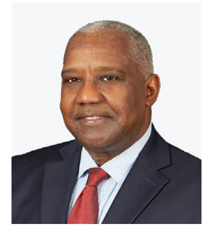
Major Country Risk Developments
May 2022



By Byron Shoulton

Overview

Global uncertainty previously associated with the Covid-19 pandemic has been replaced by uncertainty associated with Russia's invasion of Ukraine. The uncertainty shifted from the pandemic to war- and is affecting the global economy in different ways from one country to the next. The war, sanctions, export controls and natural disasters all threaten commodity supply chains, challenging the current timing of central banks' inflation fighting strategies. The IMF forecasts that the global economy will suffer a hit to growth (GDP at 3.6% compared to 6.1% in 2021) and higher inflation this year. The Fund also warned that an immediate oil and gas embargo against Russia would raise inflation further, hit European and emerging economies hard and require higher interest rates, including in the U.S.

Russia's invasion of Ukraine has triggered widespread shortages of commodities, in particular food and energy. Heightened uncertainty and marked divergences across countries will require a tailored and agile fiscal policy response that can adjust as the outlook becomes clearer. Fiscal policy will need to shift focus away from exceptional pandemic-related measures as central banks increase interest rates to fight inflation. Weaker than expected European growth, a stalling U.S., and concerns about the Chinese economy have raised the prospect of a global downturn driven by surging inflation and the Ukraine war.

Emerging and developing economies that are net importers of energy and food will be hit the hardest by surging international prices. Many countries already experienced scarring from the pandemic and have little fiscal space to tackle new spending pressures. Governments will need to focus more on those most affected by the crisis and set priority areas. Ensuring greater resiliency through investment in health, food and energy security from cleaner sources has become even more urgent. Global cooperation to achieve these objectives is regarded as more important now than even before. However, there are no clear signs that the stage is set for such cooperation. Consider: sharp rise in uncertainty caused by the war in Ukraine, rising inflation and interest rates, slower economic growth, and increasing debt vulnerabilities.

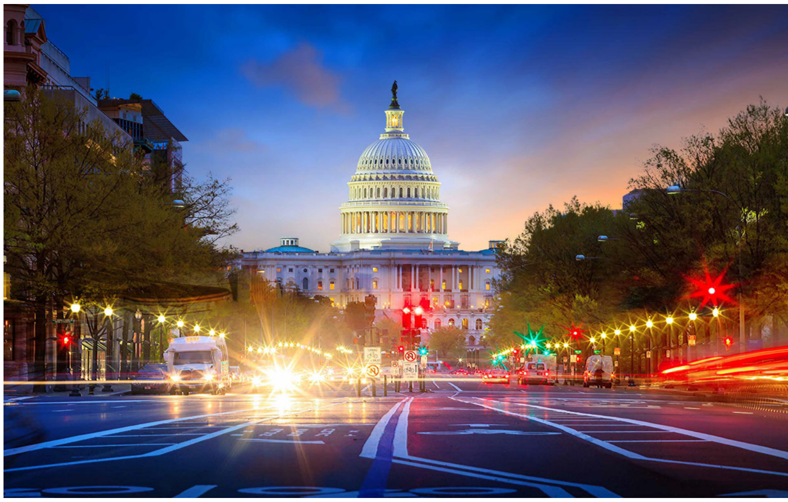
The combination of weak global growth, soaring commodity prices and a series of expected interest rate rises by western central banks- including an unusually large announced 0.5% point hike by U.S. Federal Reserve, will likely spell trouble for the global economy.

USA

The U.S. economy unexpectedly shrunk during the first quarter of 2022 by 1.4% (on an annualized basis), as trade imbalances masked strong spending by U.S. consumers and businesses. GDP growth fell dramatically from the 6.9% recorded in the fourth quarter of 2021 – marking the first contraction of the economy since mid-2020, when Covid-19 lockdowns curtailed activity. The new data translates to a 0.4% fall in economic activity compared with the previous quarter. The U.S. trade deficit hit a record high in March as import volumes and prices surged. Ongoing robust import demand, and a larger U.S. trade deficit, detracted from GDP growth.

The Commerce Department's report shows that net exports of goods and services declined in the first quarter by 3.2%. The headline figure belied the ongoing strength in U.S. household incomes and spending. Personal consumption grew 2.7% in the quarter, up from 2.5% at the end of 2021. That was nevertheless weaker than the forecast 3.5%. The data comes as fears mount that high inflation and aggressive tightening by the Federal Reserve could trigger an economic recession. U.S. growth is being threatened by the highest inflation in 40 years as the Russian invasion of Ukraine has driven up commodity prices further, and current lockdowns in China exacerbate existing supply chain disruptions. A widely used indicator of recession – the inversion of the yield curve- briefly flashed red in April.

There was further evidence of price pressures in the Commerce Department's report: so-called core PCE, the Fed's preferred measure of inflation which strips



out the volatile food and energy sectors, rose by 5.2% compared to 5% in Q4 2021. The Fed has responded forcefully to inflation, by agreeing to a half a percentage point interest rate increase at its May 2022 FOMC meeting. Investors in the futures market now expect the central bank to lift its key interest rate to 2.7% by year-end 2022. The full effects of inflation and tighter monetary policy have not yet translated into GDP indicators.

Inflation is the result of demand growing faster than supply. The decades preceding the pandemic were characterized by chronically weak demand and a seemingly limitless supply of capital, labor and raw materials, resulting in low inflation and interest rates. Those conditions have since flipped. Demand is robust, especially in the U.S., where fiscal and monetary support was especially generous during the pandemic. Advanced economies continue reporting shortages of labor, while Covid-19 continues to snarl supply chains, most recently in China.

U.S. consumer spending remained brisk in March, suggesting that U.S. households could still propel the economy in the quarters ahead. Consumers stepped up spending on services like travel and dining, as well as on gasoline and food. Spending on durable goods declined for a second month in a row, led by lower spending on vehicles. Personal income, which includes wages and government assistance, climbed 0.5% from the prior month. That was a slower rise than overall inflation, which increased 0.9% on the month in March. The national average price for gasoline recently climbed above $4, hitting its highest point since 2008. Electricity bills climbed more than 4% in 2021 and continue the upward trend this year.

The average cost of a one-bedroom apartment in the U.S. is up nearly 25% year-over-year. Home-lending costs are rising -the average rate for 30-year mortgages topped 4% for the first time since May 2019. Consumers expect their purchasing power to weaken further according to a University of Michigan measure of consumer confidence that fell to its lowest in a decade in February.

However, some of the weaknesses spotted may be short-lived. Consumers are paying down credit card debt and confidence remains mixed. With unemployment at 3.6% and wages rising, there are reasons to believe the willingness to spend and travel (pent-up demand) over the spring and summer remains sufficiently strong to prevent a marked slowdown.

Overall inflation, as measured by the Commerce Department, rose 6.6% in March from a year earlier, an acceleration from February, but when volatile food and energy costs are excluded, annual inflation cooled slightly, rising 5.2% in March from a year earlier. The consensus is that U.S. consumers will rotate toward spending more on services, but there are clear headwinds like high inflation and supply-chain disruptions that won't disappear overnight, keeping supplies scarce and prices elevated in the months ahead. We believe consumers will spend but with prices up so high, people have become more selective. Rather than buying two items, the choice will be to buy one. Rather than eating out twice it could become once per week and so on. In other words, households will be forced to tighten their spending habits due to higher prices.

U.S. exports of natural gas had been rising before the Ukraine war started in February. Last year marked the first time American tanker exports of liquefied natural gas exceeded pipeline exports to Canada and Mexico. U.S. natural gas prices are currently the same for near-term deliveries as for longer-term deliveries.

Amazon reported its first quarterly loss since 2015 – after sales growth slowed significantly in the first three months of this year and the company continued to deal with higher costs and stalled online shopping. It was impossible not to see Amazon's results as mirroring the state of the U.S. economy, while reflecting a shift in consumers' consumption patterns away from online shopping (during the pandemic), and back to instore presence once again.

Eurozone

New data shows that the Russian invasion is weighing on Europe's economy, pushing up energy and food prices, worsening supply bottlenecks for manufacturers as well as sapping business and consumer confidence. Economic growth in the Eurozone weakened during the first quarter, while inflation hit a new record in April, raising the specter of stagflation. Germany was the only one of the four largest EU economies to beat expectations but showed just 0.2% growth from the previous quarter – as inflation hit a new 40-year high of 7.8%. Soaring consumer prices, continued pandemic restrictions and the fallout from the Ukraine war all took their toll on economic activity in the first three months of this year. The strongest performers were Portugal and Austria, where output expanded by 2.6% and 2.5%, respectively.

The European Central Bank admitted it had persistently underestimated inflation, blaming soaring energy prices, supply chain problems and a faster recovery from the pandemic. Energy prices rose 38%, while unprocessed food prices jumped 9.2%. As the European energy crisis continues, Brussels said European buyers of Russian gas would be in "breach" of sanctions if they accepted Kremlin demands for payment in rubles. This, after it appears that some

companies were preparing to accept Russia's demands. The EU has imported $47 billion of fossil fuels from Russia since the invasion of Ukraine.

Natural gas prices swung higher on both sides of the Atlantic after Russia stopped exports to Poland and Bulgaria. The move portends deeper strains in global supply-chains lie ahead. Gas prices climbed as traders in Europe pondered whether Russia's action against its two neighbors in Eastern Europe foreshadows trouble in bigger markets like Germany. In the U.S. trading is being driven by the prospect that producers could continue to ship abroad as much natural gas as infrastructure allows in response to tighter supplies abroad. As European prices rise, more U.S. natural gas has been loaded onto tankers and sent to European ports – a new trend that could become a pattern.

Durable goods spending is still 25% above its pre-pandemic trend; on nondurable goods it is roughly 10% higher. Services spending remains depressed. While the pandemic did not cause a dramatic reallocation of spending in Europe, the war on Ukraine may. The prospect of a sharp fall in fossil fuel supplies from Russia- a coal embargo to be followed by oil and gas- will force a significant upward shift in prices over the coming months.

Russia's Gazprom cut off exports to Poland and Bulgaria after the two countries refused to pay for gas shipments in rubles. Gas buyers have traditionally paid in dollars or euros, but Russia decided in March that countries it deemed hostile settle contracts in Russian currency. Russia's move will have a limited impact on European supplies – especially to Poland, which already was planning to end reliance on Russian exports by the end of 2022. However, bigger European economies, such as Germany and Italy, could experience shortages if Russia turns off supplies. The growing possibility of this occurring has sent prices higher. Most European countries have rejected Russia's demand for rubles, but some countries seem prepared to pay in rubles. They need the gas supplies.

Meanwhile EU countries seem likely to approve a phased embargo on Russian oil, sealing a long-postponed measure that has divided the bloc's members and highlighted their dependence on Russian energy sources. Germany in a surprise turn is now supportive of Europe's curbing Russian gas imports. It seems German markets have secured more alternative gas supplies that could replace imports of Russian gas ahead of the year-end 2022 deadline set previously.

France's economy stagnated in the first quarter, while Italian output contracted. The Spanish economy also lost pace.

Official data show four in ten UK households are having problems paying gas and electricity bills and are buying less food after the big jump in the government's energy cap.

According to estimates, for Russia to reroute oil that it now ships to Europe through the Baltic Sea to customers in China or India would take an additional four months and require 80 more large crude carriers, 10% more than the global fleet now has. The work around would entail much longer transit routes, more expensive ships, more expensive cargo and more expensive transit fees. This would also mean higher insurance rates, more margin calls, and need for more term-bank credit.

Russia appeared on the brink of averting a widely anticipated debt default at the end of April. Even after claiming it had made two overdue bond payments in dollars, Russia's central bank confirmed that currently there is a 'zone of colossal uncertainty' in the economy. In a late twist the saga over whether Russia will renege on its debts for the first time since 1998, the country's finance ministry claimed two payments - totaling $649 million and originally due on April 4, 2022 – had been paid in dollars, but admitted that it "had witnessed difficulties with payment." This was after U.S. authorities stopped U.S. banks from processing the payments. Russia then said it would instead use rubles, which are not permitted by the terms of the bonds. Moscow claimed it had fulfilled its obligations and threatened to take legal action if sanctions forced it into default. Even if the late payments arrive before the grace period, it is still unclear how Russia will go on servicing its foreign debt beyond May 25, 2022, when an exemption in U.S. sanctions that allows U.S. investors to receive interest payments is due to expire.

One other source of worry portends possible setbacks for the electric vehicle sector. Much of the battery supply chain for electric vehicles isn't yet built, challenging the industry which aims to sell tens of millions of EV's over the coming years.

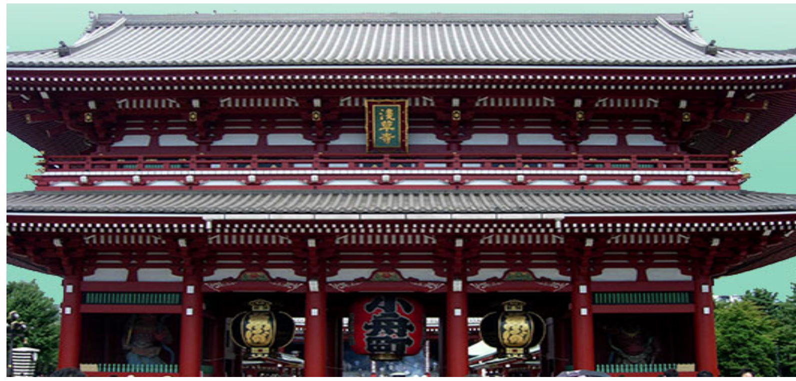
Meanwhile, Europe's efforts to wean itself off Russian energy since the start of the Ukraine war have been surprisingly swift. EU officials have been consulting with the U.S. on the possibility of using the threat of U.S. secondary sanctions on countries that might be tempted to buy Russian oil-the next target of EU sanctions being prepared and likely to be adopted soon. Those discussions are continuing on how to best design the restrictions so as not to create a rise in the global oil price and help rather than hurt, Russia's financing of its war against Ukraine. It may not be easy for Russia to find alternative buyers of its energy. China is unlikely to be a great option anytime soon, just because the infrastructure does not yet exist for Russia to easily get its gas to China. Russia relies on the sale of its energy for revenue so there are limits to how far Russia can go without making this hurt them more than it hurts the Europeans. Before Russia's invasion, 97% of Europe's purchases of Russian gas were made in euros or dollars.

Economists are concerned that an escalation of western sanctions on Moscow risks leading to shortages of oil and gas that would hit industry hard and send energy prices even higher. This would erode household income and further dent global consumer and business confidence.

China

Foreign and domestic businesses have warned that prolonged lockdowns could put China's economic growth at risk and deal a huge blow to the automobile and tech industries. The Chinese authorities have taken note. The government acknowledged in April that it would work to stabilize industrial development and supply- chains, and instructed local governments not to block transportation for key logistics. The Chinese currency fell 4.2% in April to around 6.6:US$1, the biggest drop since the end of its U.S. dollar peg, which was in place from 1994-2005. The month's fall is greater than a one-off devaluation by the Chinese central bank in 2015 that rattled global markets and a tumble by the yuan in 2018 during the U.S.-China trade war.

Local governments in Shanghai and Suzhou have put hundreds of key electronics, automotive and medical suppliers on a so-called "white list" with assurances that those on the list will be able to [gradually] resume some manufacturing and logistics activities. Nonetheless, China is officially committed to a zero-Covid policy, and many suppliers with production facilities in the region fear it will take months for normal operations to resume. Not good for countries around the globe that have become dependent on Chinese supplies of consumer electronics, household products, auto parts, tools, computers and smartphones, clothing and furniture, to name a few. Not good for Chinese factories, workers and companies that grew spectacularly over three decades via an explosion of manufactured exports to the world.



The Chinese government is preparing to pause its monthslong campaign against technology companies -as officials try to arrest a rapid decline in China's economic outlook. China's top internet regulator recently met with the country's embattled technology giants to discuss the regulatory campaign. The new engagement by the government toward tech companies -is seen as a sign that the economic slowdown may be reflecting sensitivities that the toll the new regulations are having on the technology sector – needs to be addressed. It could be an acknowledgement by officials that at this time it may have to hold-off implementation of some of the new rules that limit the time that young people spend on mobile apps, and other intrusions on personal habits.

Scheduled meetings between China's Cyberspace Administration and various tech giants including Tencent Holdings Ltd., China's most valuable company and Meituan, which runs one of China's largest food-delivery services - comes after a year in which regulatory uncertainty has triggered a wave of stock selloffs and job layoffs across the industry. There is a definite need for technology entrepreneurs to feel and know that they are wanted and needed as Chinese society matures and transforms itself, alongside a changing and evolving global economy.

Any loosening of new regulations for the Chinese tech sector would underscore the sector's importance to future economic stability for the Chinese leadership - in a key political year when the country's leader, Xi Jinping is expected to break with recent tradition and seek a third term in power.

Supporting the tech sector may help invigorate the economy at a time when forecasters are rapidly downgrading expectations for growth this year with the spread of the Omicron variant, which has caused monthslong lockdowns in Shanghai (the country's biggest and wealthiest city) and which now threatens to paralyze Beijing, the capital.

Chinese tech stocks popular among U.S. investors have tumbled amidst China's regulatory crackdown on technology firms. While the government reaffirmed that it will carry on its campaign against tech firms to its conclusion, it was careful not to give a definite timetable and stressed that any oversight would be more "standardized" to "support the healthy development" of the firms. This dovish language help fuel double-digit percentage jumps in share prices of companies such as Alibaba Group Holdings Ltd and other Chinese tech stocks.

Chinese companies supplying HP, Dell, Asus, Tesla among others, with facilities in Kunshan and Suzhou admit that it could take another quarter before normal factory, mining and farming production is resumed in China. Some basic materials such as carton boxes are in serious shortage as are raw input materials, including fertilizer, minerals and grain. Truck drivers who must deliver all materials and components remain in great shortage. Even companies placed on Suzhou's white- list for priority access to materials, are expecting to see their production dented by 20% during April. Japanese electronics component suppliers operating in Suzhou and elsewhere admitted to halting operations owing to severe logistics issues. Their own materials and component suppliers had also suspended production.

Ports and airports in Shanghai are operating under stringent Covid-related controls and traffic restrictions, creating huge challenges for businesses, according to multiple service providers and suppliers. Some are already warning that the current chaos could affect this year's holiday shopping season. The months of May and June are regarded as crucial for many consumer electronics brand vendors. If production does not ramp up in time for goods to be shipped via ocean cargo, there is a chance they could miss the Christmas holiday sales season in Europe and the U.S. due to congestion at ports- unless they ship by air, which is much more expensive.

More broadly, China's leadership has recently affirmed that it will step-up policy support to meet its target of expanding GDP by about 5.5% this year – a target that most economists think China will miss as the world's second largest economy faces rising risks from Covid-19 outbreaks and the war in Ukraine. The Chinese cabinet has confirmed that it intends to ensure that the country's economic growth outpaces that of the U.S. this year; a mandate that government agencies plan to fulfill by accelerating large scale construction projects in the manufacturing, technology, energy and the food sectors.

Analysts point to lockdowns affecting not only supplies and production but also demand. The authorities will likely continue its zero-Covid policies, as the vaccination rate among the elderly remains quite low. On the demand side we see a substantial slowdown in China's consumer spending since the lockdown in Shenzhen earlier this year. It's likely that we could see further downward revisions for the market's expectation of demand for new smartphones this year, as one example of falling demand.

Meanwhile, China is restricting exports of fertilizer and steel, driving up prices for consumers in other countries. It has also lowered then raised tariffs on pork in response to domestic conditions, whipsawing global markets.

Even if some short-term disruptions should eventually recede, there are ample opportunities for more difficulties to surface in the coming years. As a new cold war sets in between Russia, China and the West, tariffs, sanctions and export controls will likely become more frequent. Climate presents another set of ongoing risks: Extreme weather can disrupt supply chains and electric grids, while net-zero mandates can cut the capacity of legacy power systems and spur bidding wars for minerals needed in renewable energy systems.

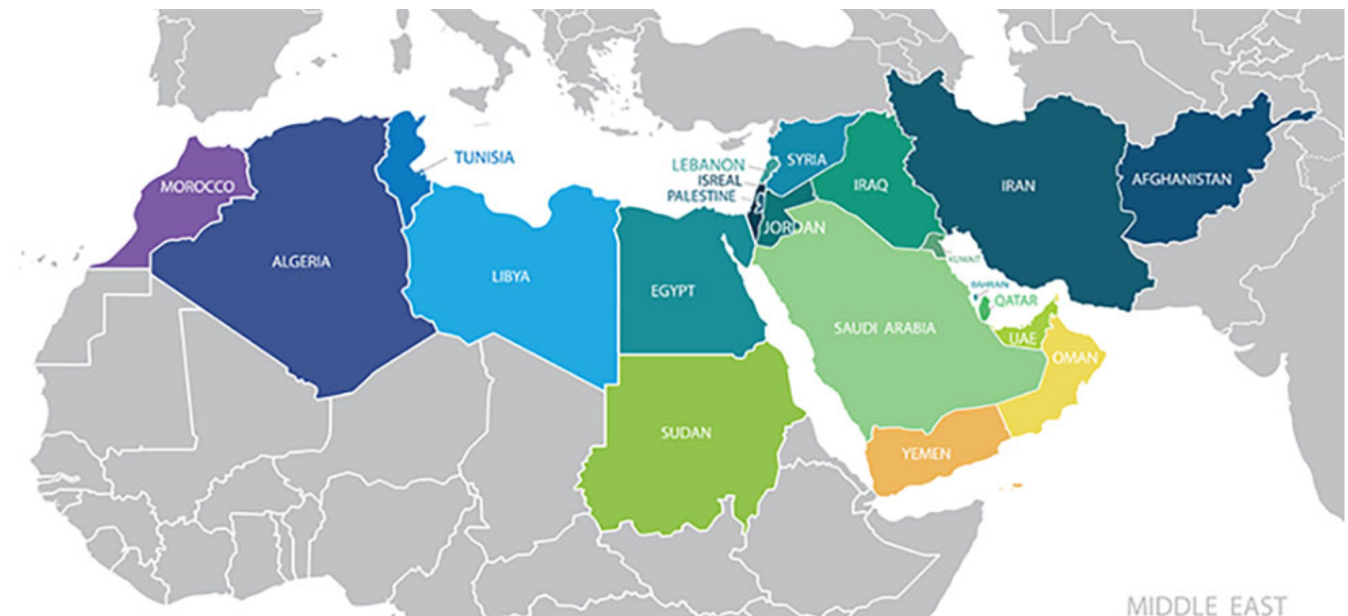
Egypt

As Egypt experiences a spike in inflationary pressures driven by key commodity prices such as wheat and fuel, owing to the war in Ukraine, concerns rise about the likelihood of a balance-of-payments crisis in Egypt. Annual inflation rose to 10.5% in March. Food prices in particular have surged, rising 20% year-on-year in the month. Headline inflation has now breached the 7% target range set by the central bank with no likelihood of an early retreat from inflationary pressures.

Recognizing the risks, Egypt's allies in the Gulf including the UAE, Qatar and Saudi Arabia pledged $22 billion in financial support and foreign direct investment to aid Egypt at this critical time. Qatar pledged $5 billion in investment to restart Qatari investment projects in Egypt. Meanwhile, state-owned Qatari Energy Co. (QE), signed an exploration deal for an Egyptian offshore exploration area. This will see QE acquiring a 40% stake in the North Marakia Block and reflects wider Qatari interest in the Eastern Mediterranean following a series of agreements in December 2021, including a QE-ExxonMobil's Egyptian exploration deal, as well as QE acquiring a 17% working interest in two blocks off Egypt's Red Sea coast.

Saudi Arabia's Public Investment Fund has pledged to invest $10 billion in Egypt's health, education and financial services. ADQ, an Abu Dhabi investment fund, is planning $2 billion in Egyptian acquisitions, targeting banks and fertilizer companies.

The countries are pursuing a reconciliation in relations to help fortify improvements in Egyptian cooperation and stabilize regional security. Recent meetings marked high-level engagement between the countries following the signing of the Al Ula agreement in January 2021, which restored trade, travel and diplomatic ties between Qatar and the Arab Quartet. The support from the Gulf countries is regarded as a backstop for balance-of-payments stress and the latest pledges should help Egypt to secure a new deal with the IMF. As Egypt has already used up its quota for borrowing from the IMF, any deal would be according to exceptional criteria, which would be likely to include a condition for co-financing. Assuming this explains the timing of the pledges, then by extension they are a reminder that Egypt's partners in the Middle East remain



willing to step up quickly when needed. The forecast is that the IMF process is being revised to incorporate the recent pledges, which should help shore up confidence and, in tandem with interest rate hikes in Egypt, avert further capital flight.

Meanwhile, Egypt and Israel are seeking to deepen energy cooperation further to sell gas to Europe.

The Central Bank of Egypt has succumbed to pressure on the exchange rate, triggering a devaluation of 16% on March 21, 2022. The central bank used its relative strong foreign exchange reserve position and its influence over state-owned banks to guide the exchange rate against the U.S. dollar for the past several years. It has now abandoned that stance. The Egyptian pound had been one of the most overvalued currencies in the Middle East and African region over the past five years.

The March depreciation puts the pound on a much more stable footing over the medium term. The currency is forecast to stabilize at about EP18:US$1 over the course of 2022. Inflationary pressures so far in 2022, stemming from the Russia-Ukraine war, have been intense enough for the CBE to raise its policy rate by 100 basis points in March. The consensus is that the CBE will act to keep expectations grounded by raising interest rates even further this year. Nonetheless, inflation will probably average the upper ranges in 2022 before easing slightly in 2023.

Egypt has borrowed $20 billion (about 5% of GDP) from the IMF since 2016, making it the fund's second-largest recipient after Argentina. It is negotiating a fresh IMF loan after the war in Ukraine pressured nervous investors to flee, which caused a hard-currency crunch. The IMF has praised Egypt for swiftly taking painful (and unpopular) austerity measures. But the Fund also complained that Egypt's government is stifling the private sector. One survey shows the private sector shrunk in all but nine months since 2016.

New ongoing talks with the IMF include a program of economic support to help Egypt with the adverse economic consequences of the war in Ukraine. It would be the third such program since 2016. The main causes of the current crisis are external, as was the case in 2020 when Egypt secured a one-year standby credit early in the Covid-19 pandemic. However, structural issues are also in important factor, in particular low rates of saving and investment, which hamper productivity advances and render Egypt heavily dependent on external borrowing. Despite some important reform efforts over the past five years, the experience since the most recent IMF program has not been smooth. It has become increasingly clear that Egypt would benefit from a continued policy anchor, as deeper structural reforms are needed, including the prevalence of the state sector.

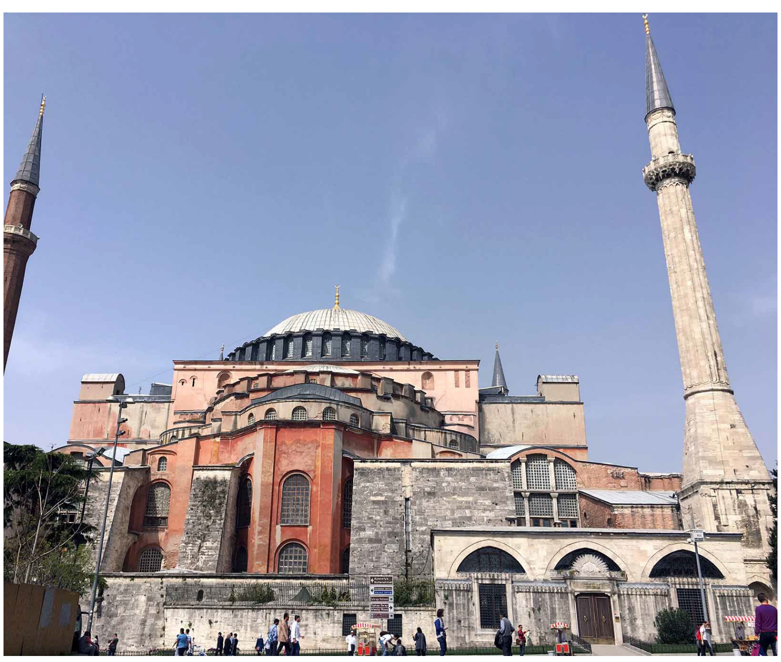
While President Sisi's government says it supports private entrepreneurism Mr. Sisi's generals, who dominate chunks of the economy have made a mockery of the free market. The government is notorious for not paying its debts to private construction companies who have undertaken construction of several roads and bridge projects under government issued contracts. Meanwhile, the army and companies it controls receive special tax breaks and customs exemptions and are lauded by government for saving the public from greedy merchants and speculators. Soldiers hand out meat at subsidized prices after a new state firm entered the lucrative market for certifying meat, but they then moved to ban all private competitors. The price for certifying meat soon shot up. Few private businesses dare stand up to the influence of the army (aka the Egyptian government).

While GDP has grown since the IMF's 2016 bailout, the economy remains in poor shape. Egypt has failed to build up its manufacturing base [while jailing one of the founding members of a leading & highly successful manufacturing company]. Egyptian exports are sluggish. The country's current account deficit has widened to $18.4 billion, and the poverty rate has risen. Since the central bank's 14% devaluation of the currency in March, President Sisi managed to persuade friendly Gulf states to deposit billions in the central bank and pledge investment. But the government will need to show by its actions -not just words- that it really welcomes and encourages private investment in Egypt (domestic and foreign).

The government considers ties with powers such as the U.S. as important for Egypt's economic prospects and the credibility of the regime itself. The government has made assurances in recent months to Western critics of its human rights record that it is taking serious steps to make improvements, and the U.S. administration has made the disbursement of a military aid package conditional on progress with human rights.

Turkey

According to the Central Bank of Turkey, the country's current-account showed a deficit of $5.2 billion end of February 2022, compared with $2.7 billion a year earlier. The cumulated deficit [January-February] widened to $12.1 billion from $4.3 billion a year earlier. In 2021 the deficit was relatively small at just 1.8% of GDP, largely reflecting strong export growth. Turkey usually records large merchandise trade deficits, which exceed its net travel and tourism revenue. The resulting current-account deficit, combined with substantial foreign debt-servicing costs, leaves the economy dependent on capital inflows for growth and currency-market stability and vulnerable to shifts in international investor sentiment.



As in January, the current-account deficit in February was the result of a large goods trade deficit, driven by higher energy prices. Goods imports increased by 45.3% year-on-year, and exports by 26.8%. Net capital inflows were positive owing to net international bond issuance by the government and the completion of a portion of January's $4.7 billion currency-swap deal between the CBT and the Central Bank of the UAE. However, inflows were insufficient to cover the current-account deficit, leading to a fall of $2.2 billion in official foreign exchange reserves.

Turkey's unorthodox, low interest rate monetary policy, low foreign exchange reserves and the prospect of global monetary tightening, continue to constrain its ability to attract adequate investment and lending. From March 2022 onwards the balance of payments will start to reflect the impact of Russia's invasion of Ukraine, which pushed prices of energy, food and other imported commodities even higher, disrupted regional trade, increased global risk perceptions and further weakened the Turkish lira.

The Ukraine war has increased uncertainty surrounding the forecasts for Turkey, given the economy's heavy dependence on imported energy, including gas from Russia; its large external financing needs; and the importance of the Russian market for Turkish tourism.

Turkey is an emerging, largely free-market economy and a leading producer of agricultural goods, textiles and construction materials. Political tensions, lack of reform and the politization of institutions continue to undermine the country's business environment.

President Erdogan continues to dominate Turkish politics, despite signs of declining popularity, through a mixture of authoritarianism and control of state resources. He is expected to rule with little restraint until 2023 parliamentary and presidential elections (which he is expected to win) and beyond.

A new governor of the central bank was appointed in March 2021 and eased monetary policy in September-December, despite accelerating inflation, causing a sharp depreciation of the Turkish lira. The central bank's independence is limited, and its stance reflects President Erdogan's preference for inflationary policies (low interest rates). Soaring inflation and the unorthodox economic policies will lead to slowdown in real GDP growth this year. Low investor and consumer confidence is also curtailing economic activity. In addition, Russia's invasion of Ukraine leaves Turkey exposed to adverse trade, energy and financial spillovers.

External and internal imbalances, policy unpredictability, poor international relations, concerns regarding the central bank's independence, and a reliance on short-term capital inflows will continue to contribute to a depreciation of the lira against the dollar in 2022-26.

Poor policy choices have put Turkey at a disadvantage relative to other emerging markets, with high external financing needs. Financing costs will, as a result, remain high. Given a revised exchange rate and global energy forecast, Turkey's annual inflation rate for 2022 in now forecast to average 50.5% (inflation in March hit 61.1%).The lira's weakness and higher inflation will dent private consumption, which is now expected to be flat in 2022. Following the outbreak of the war in Ukraine the lira has depreciated further, averaging 14.60:US$1 in March compared with 13.6:US$1 in January-February. The lira is forecast to average 14.75:US$1 this year.

The impact on 2022 real GDP growth (revised down to 3%) will be partially offset by a fall in imports of goods and services. Attracting foreign direct investment has been a government priority, but macroeconomic instability, increased nationalism, and concerns about security, corruption and politization of the judicial system have continued to curb inflows.

Under the ruling AKP party and President Erdogan, Turkey has been seeking to bolster its standing as a regional power in the Middle East and extend its influence in the South Caucasus without upsetting Russia, with which it has developed closer ties since 2016. President Erdogan's assertive foreign policy resonates with the Turkish population, but has led to strained relations with the West. Given the economy's fragility, Turkey can ill afford deeper rows with the U.S. and the EU, but the risk of further sanctions against Turkey remains. Recently, the fragility of the Turkish economy and the vulnerability of the lira have pushed Turkey to make efforts to build bridges with some countries, such as Saudi Arabia, Egypt and Israel, with which its relations had previously deteriorated sharply. The conflict in Ukraine, combined with the prospect of global monetary tightening, could prove to be highly destabilizing for Turkey's already fragile economy, which is still dealing with the aftermath of the collapse of the lira in late 2021.

One anecdotal piece of information relates to Russians moving large sums of cash into Turkey since the Ukraine war. Russians are reportedly not just storing money in Turkey but buying property, working and some are even investing in businesses in Turkey. Since there are no existing Turkish embargos on Russian funds or its citizens travelling to Turkey, it may be one avenue for Russian funds to get placed in a "friendly" country outside of Russia. Turkish reserves may benefit from these capital inflows from Russian interests.

By Byron Shoulton, FCIA's International Economist
For questions / comments please contact Byron at
bshoulton@fcia.com