Trade Credit & Political Risk

Major Country Risk Developments
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Overview

The IMF recently revised downwards its outlook for global growth in 2022-23 and is not ruling out a possible global recession.

U.S. GDP growth is down at 0.9% in 2022. This reflects weaker than expected growth in the first two quarters of 2022, with significantly less momentum in private consumption, in part caused by the erosion of household purchasing power and the expected impact of a steeper tightening in monetary policy by the Federal Reserve.

Labor market tightness is currently at historical highs in several countries, and workers could increasingly demand compensation for increases in the cost of living. Policymakers could underestimate the degree of labor market tightness and its impact on inflation; or tighten policies insufficiently, thereby failing to prevent un-anchoring of long-term inflation expectations. Similarly, prices may become more sensitive to changes in demand as more of the economy's productive resources are employed. In that case, a rapid increase in inflation may be followed by an equally sudden decline if policy tightens too much.

Major central banks have responded to high inflation by raising interest rates. But the exact amount of policy tightening required to lower inflation without inducing a recession remains difficult to ascertain.

Still, U.S. inflation pressures eased in July 2022 as commodity prices fell, including lower gasoline prices at the pump. Furthermore, the Institute of Supply Management's (ISM) index of manufacturing activity was 52.8 in July, as a decline in new orders signaled weaker demand for factory products. That marked the lowest reading since June 2020 and down from 53 in June. A reading above 50 indicatesthat U.S. factory activity is expanding - while a reading below 50 signals contraction.

The ISM index, based on a poll of manufacturers across the U.S., observed that businesses are expressing concerns about a softening economy, as new orders contracted for a second month, amid anxiety over excess inventory in the supply chain. Warehouses across the country reportedly contains too many supplies that consumers are no longer buying. The trend is hitting retailers, forcing pricing markdowns to help clear space for incoming shipments for the next shopping season.

Meanwhile, U.S. consumers have adjusted their purchasing habits over recent months, mindful of higher costs across the board, and the need to cut-back on unnecessary spending amidst growing economic uncertainty.

A separate measure of U.S. manufacturing produced by S&P Global also pointed to slower growth due to weakened demand. It's purchasing managers' index was 52.2 in July, down from 52.7 in June. S&P reported that a growth spurt which occurred in the spring - has quickly reversed itself. A gloomier outlook means companies are taking an increasingly cautious approach to purchasing decisions and inventory management.

The consensus is that there are signs of easing supply constraints and a slower pace of cost inflation- providing fresh signs that inflation may have peaked. A recent ease in the pace of price increases -is a positive for companies struggling with high input costs. That includes companies in transportation, fuel, commodities and manufacturing sectors, among others.

After more than a year of record run-ups in apartment rents, growth is starting to cool off, a trend that could help U.S. housing affordability and ease the rise in overall inflation. Nationally, average apartment rents rose 9.4% in the second quarter of 2022 compared with the same quarter in 2021. While that is high by historical standards, it is down from the more than 11% annual increases seen in the previous two quarters. U.S. construction spending fell in June as outlays on single-family homes posted their biggest drop since early in the pandemic. Overall spending on new structures slid 1.1%. The pullback was broad-based across private and public projects. The drop in private single family home construction, 3.1%, was especially sharp, suggesting that rising mortgage rates, higher costs and falling demand from buyers are leading builders to at least pause some new construction.

Manufacturing prices fell in July, its steepest decline since June 2010, as prices of raw materials rose more slowly. Backlogs eased as well -in a sign that supply-chain disruptions are lessening. Meanwhile, the U.S. economy shrank in the latest quarter, for the second quarter in a row.

Growth in the labor market is slowing, with only a few companies report laying off workers; more people filing for unemployment insurance and some labor data pointing to cracks forming in demand for workers. Yet employers so far have continued to hire. The U.S. added 372,000 jobs in June, and 328,000 in July.

Payrolls have grown faster during the first half of this year than during any other post-World War II period when the economy began contracting. Regardless of whether a recession is eventually declared, the latest economic figures show that output is weakening much faster than the U.S. job market.

Asia

Purchasing Managers' Index (PMI) figures for global economies point to weak manufacturing elsewhere. Chinese manufacturing activity contracted in July, as Beijing's stringent Covid-19 restrictions and weak demand undercut hopes of a more dynamic economic revival.

While Chinese factories and housing markets stumble (after a brief respite in the wake of Shanghai's cautious reopening in June), China's economy now seems to be back in the wringer. Property sales from China's top 100 developers fell 28.6% from June, completely erasing and early-summer sales bump. Meanwhile, cash-strapped Chinese property developers are struggling to build apartments, while condo owners with mortgages are threatening to stop making payments. So far, the Chinese government has declined to announce a bailout fund for the housing sector and instead emphasized that local governments retain primary responsibility for completing unfinished housing projects. Rather than seeming intent on shoring up confidence in China's currently heavily over-leveraged housing market – the key driver in past economic recoveries, including the global financial crisis- Beijing appears to be doubling down on more infrastructure spending as the way tostimulate renewed growth. However, this time the entire stimulus is being funneled through the formal government bond market – which is essentially controlled by higher level provincial governments and ultimately Beijing.

Meanwhile, the Chinese property sector (viewed as the linchpin of household savings and local government finances), desperately awaits a bailout. Local governments appear less engaged in the process of an expected restructuring, playing a significantly diminished role – compared with previous financial crises. If the new approach works, it will represent a radical reordering of China's economy, with an even tighter grip by the central authorities in Beijing.

Further Covid driven economic shocks in China could have negative economic effects on regional companies as China is the biggest export market for most countries in the region. It is also an important supplier of intermediate products whose availability could be interrupted, affecting regional exports. Many Asian economies have a high degree of trade exposure to China, amplifying the effect of China's weakening on other economies in the region.

A significant slowdown in China would also represent the third major external shock in the last few years for regional companies - following the Covid pandemic and fallout from Russia-Ukraine war. Successive shocks could further erode fiscal space and exacerbate credit risks in developing countries, potentially eroding their political and institutional stability. Post-pandemic fiscal consolidation could be setback or reversed due to weaker growth or the use of fiscal stimulus to offset the external shock.

Increased investor risk-aversion linked to a China slowdown may also intensify capital flow volatility across most of Asia. This could add to financing strains for some sovereigns, although many have substantial external buffers that could cushion the effect, at least for one or two years.

Eurozone

Eurozone manufacturing also contracted in July, as factories grappled with high inflation, the war in Ukraine; and expensive, yet unreliable energy supply sources. The uncertainty over energy supplies is bad for businesses, hurts household confidence and hence spending. It is bad for the economy. Retail sales volumes fell by 1.3% for the month and 2.8% year-on -year. German sales volumes were down by 8.8% - the steepest annual fall in 28 years. Companies are struggling in the face of slowing demand. July eurozone output contracted for the first time since February 2021. Activity in France and Italy are at 15 and 18 month lows – and in Germany at the lowest for over two years. German GDP didn't grow at all during the second quarter, even though exports surged in June. Early signs are that regional third quarter growth won't show much improvement.

The UK's PMI fell to a 25-month low of 52.1 in July from 52.8 in June.

Improved prospects for tourism and industrial activity in Italy is more than offset by significant downward trends in France, Germany, and Spain. Eurozone economies are now feeling the effects of war in Ukraine which sent energy and food costs surging. The effects are shattered consumer and business confidence. The spillovers from the war in Ukraine and tightening

financial conditions- with the European Central Bank ending asset purchases and raising interest rates in July – for the first time since 2011- help to set the stage for a slowdown. In several European economies, NextGeneration EU [emergency] funds are what's supporting economic activity.

Soaring energy prices have sharply increased living costs for Europeans. Since early 2021, oil prices doubled, coal prices nearly quadrupled and European natural gas prices increased almost seven-fold. With energy prices likely to remain above pre-crisis levels for some time, Europe must adapt to higher import bills for fossil fuels. Governments cannot prevent the loss in real national income arising from the terms-of-trade shock. Many countries are being urged to allow the full increase in fuel costs to pass to end-users to encourage energy savings and switching out of fossil fuels. Policy should shift from broad-based support such as price controls to targeted relief such as transfers to lower-income households who suffer the most from higher energy bills.

The negative data comes amidst growing concerns about a global economic slowdown. The balance of risks is squarely on the downside, driven by a range of factors that could adversely affect global economic performance.

Global trade growth in 2022 and 2023 will likely slow by more than previously expected, according to new data from the IMF. This reflects decline in global demand and supply chain problems. The dollar's appreciation this year by about 5% as of June- is likely to have slowed world trade growth, considering the dollar's dominant role. Invoicing in dollars has a negative effect on companies' balance sheets located in countries with weakened currencies. Still, demand for imports in countries with already high dollar-denominated debts have increased, aided by price increases. We expect more country debt negotiations over the next 12-18 months, as well as requests for corporate debt reschedulings – driven by slower growth, high foreign debt loads, and weakened emerging market currencies.

Projections for global inflation will trend more pessimistic, having been recently revised upwards. The upside inflation revisions are larger for advanced economies: 8.5% in U.S., 10.5% in UK; and 8.2% in eurozone. Inflation growth in emerging markets is forecast to average 10% this year.

Inflation is generally expected to return to near pre-pandemic levels by the end of 2024, according to the latest IMF outlook. However, several factors could cause it to maintain momentum and raise longer-term expectations. Further supply-related shocks to food and energy prices from the war in Ukraine could sharply increase headline inflation and pass through to the wider economy.

Russian pipeline gas supplied to Europe has fallen sharply, to about 40% of last year's level. There is much uncertainty surrounding what levels of Russian gas supplies will be delivered to Europe over the rest of 2022 and in 2023. The latest forecasts expect that volumes will decline to "low levels" by mid-2024, in line with major European economies energy independence goals.

A complete cessation of exports of Russian gas to Europe in 2022 would significantly increase inflation worldwide through higher energy prices. In Europe it would force energy rationing, affecting major industrial sectors, and could sharply reduce growth in the euro area over two years, with negative cross-border spillovers.

In emerging markets and developing countries the negative revisions to growth in 2022-23 reflect mainly China's slowdown; and moderation in India's economic growth. The revision in growth projections in emerging and developing Asia includes downgrade in growth to 3.3%- due primarily to China's weakening demand - it's slowest growth trend in more than four decades.

The growth outlook for India has been revised down 0.8% for 2022 due to less favorable external conditions and more rapid policy tightening.

Latin America

Growth expectations are on the upside for a few countries in Latin America. Regional private sector credit has recovered and is now growing; wage growth remains positive in many countries; and job growth has gathered pace.

In the first quarter of 2022 there was dramatic increase in FDI into the region, with several countries posting their highest inflows in more than a decade. The reasons were twofold: high commodity prices; and moves by U.S. companies to bring some of their

Taxco city at sunset, Mexico

production closer home. Commodity prices were high even before the spike caused by the war in Ukraine, and this will certainly have been a factor in the first quarter FDI boom. For example, Colombia a major oil producer received its highest inflows since 2005.

However, the perception of increased political risks in the region in recent months – suggest that investor interest toward the region will likely wane in the months ahead. FDI flows will likely taper off over the coming quarters as the supply of funds dries up, commodity prices ease from their recent peaks and concerns about political risk in Latin America are once again at center stage.

Colombia

Gustavo Petro takes office as Colombia's new president on August 7th, 2022. The Petro campaign espoused more interventionist economic policies, especially for the oil and mining sectors, making it likely that regulatory changes are coming. Petro has pledged to halt new oil exploration. The incoming administration includes a mix of hardline left-wing idealogues and moderate pragmatists. Managing this mix of views in the cabinet and in Congress – will be one of President Petro's biggest challenges – as he pursues reforms in areas including taxes, pensions, healthcare and security. Mr. Petro is himself is a former senator and former guerrilla fighter.

Fear of changes to the legal and regulatory environment will likely subdue new investment inflows over the coming months – as markets assess the new government's policies. The consensus is that government expropriations will be unlikely. While Mr. Petro will review current bilateral investment treaties and free trade agreements (FTA), significant changes are unlikely for now. After a year in office however, we would expect the government to seek some renegotiation of trade agreements.

Mr. Petro advocates a more interventionist approach to foreign trade in order to protect local industry andagriculture from foreign competition. This is expected to hinder further trade liberalization in Colombia under the new government. How traders and market participants in Colombia respond, will determine how much radical government intervention will be tolerated. The next few months will set the stage.

Policy unpredictability will be high under President Petro, despite the moderate tone he has adopted after the election. Mr. Petro will have to bring together members of a cabinet that includes representatives from his own and other parties. Several moderate politicians who joined Mr. Petro's campaign in its later stages have been given positions in the new government. Clashes with leftist members of his cabinet and moderates are on the cards. For example, the incoming environmental minister insists that Ecopetrol (the state-owned oil company) must concentrate on clean energies and begin to move away from hydrocarbon. Her stance will need to be aligned with that of the incoming energy minister. The new agricultural minister is convinced of the need for land reform and for taxing unproductive land in the countryside, with the intention of discouraging cattle-raising. The new health minister is a well-known critic of the present system. While it faces financial difficulties, the current structure is credited with providing almost universal health coverage, with the lowest out-of-pocket expenses in Latin America.

Taxes on companies' dividends are likely to increase.

Markets have responded with skepticism to the contradictions facing the new administration. Although most emerging-economy currencies have weakened against the dollar recently, the Colombian peso broke records – and has been one of the weakest currencies globally since mid-June 2022. High oil prices will have played a significant role in this, but markets remain unconvinced about Mr. Petro and his policy intentions, despite some signs of policy moderation. Colombia's prospects for governability and stability in the near-term remains uncertain.

Many believe that Mr. Petro has a chance of making early progress on tax reform, if he continues to moderate his stance. However, conflict between moderates and leftists ultimately seems likely to emerge in the coming months.

The normalization of relations between Colombia and Venezuela could play well with the political bases of both Presidents Petro and Maduro, but it will not deliver significant economic benefits to either country. Some suspect that Mr. Petro will probably be cautious in his relations with the Maduro government (which he has described as "dictatorial"), in part so as not to antagonize centrist allies in the Colombian Congress whom he will need to keep on his side in order to govern in the next four years.

The country's legal framework remains strong, but distortions lead to continued wide differentials between deposit and lending interest rates, and limit long-term financing for small firms.

The new government is expected to seek to boost work and training for vulnerable groups, and to implement labor reforms to curb high unemployment.

Research and development spending will increase in the coming years but remains low by OECD and Latin American standards. Government efforts to promote university-to-business linkages have had limited effect in boosting Colombia's technological readiness.

Many expect the orientation of Colombia's international relations will change under the incoming government. Mr. Petro's foreign relations agenda is likely to complicate (and possible sour) the historically close military and economic relationship between Colombia and the U.S.

The outlook is for the economy's terms of trade to remain favorable, higher export volumes will be partly offset by rising inflation. While the central bank is expected to increase the pace of monetary tightening, the effects will only become apparent early in 2023. In the meantime, consistently firm consumer spending, still-rising inflation expectations and currency depreciation - on the back of political/policy uncertainty – year-end 2022 inflation forecast is now up at 12%. The assumption is that 2023 inflation pressures will recede on the back of monetary tightening, and moderating domestic consumption.

The immediate currency depreciation pressures that Mr. Petro's election triggered, is likely to linger over the remainder of 2022 -owing to uncertainty as to how far the government will go to implement its radical economic policy agenda. Combined with brisk monetary tightening in the U.S., this will continue to weigh on the peso. Capital flight is likely to remain elevated.

Brazil

Although the Brazilian central bank suggests some softness in the economy, sectoral data indicate a recovery in most activities, supported in part by the continued reopening of the economy. Data published by the national statistics office show month-on-month upticks in the headline figures for industrial production (0.3%), retail sales (0.1%) and services (0.9%). Notably, the only services categories to contract were air transport services and other household services; all others expanded, probably because the services sector was the most severely affected by pandemic-related restrictions and therefore benefited the most from the lifting of most of these since March.

On balance, we believe that upside risks outweigh downside risks as regards short-term GDP growth. The latest stimulus package, together with tax cuts on fuel and cooking gas, will likely boost consumption, which will in turn support growth in services and retail sales in the coming months. However, continued headwinds from elevated inflation and interest rates will curtail growth later in the year, despite the government's fiscal measures.

The Brazilian central bank has indicated a continuing deterioration in credit conditions, with a contraction in total loans, rising lending rates and growing levels of household delinquencies. These trends will remain amid monetary tightening and slowing economic activity, partly offsetting the positive impact on GDP growth of measures recently adopted to boost private consumption.

Part of the increase in household income from recent measures such as the boost in the cash-transfer program for the poor and new benefits for taxi and truck drivers will be diverted to improve families balance sheets.

The stock of household debt as a share of their 12-month accumulated incomes remained at the same record level of 53% achieved since January this year. This trend in growing high debt has contributed to a continuing increase in households' delinquency rates, which reached 3.5%, up from 3% at the beginning of the year. During the same period the share of corporate non-performing loans grew more modestly, from 1.3% to 1.5%.

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The combination of growing delinquency levels and monetary tightening has prompted banks to increase lending interest rates and reduce the pace of new credit concessions. Average annual interest rates for households increased for the ninth consecutive month to 32%, while those for corporates grew for the fourth consecutive month to 20%. Total loans contracted by 0.2% in month-on-month terms, as a result of a modest 1.8% expansion in new credit concessions to families and a 0.1% decline in the case of companies. These results would have been even more disappointing were it not for the introduction of higher borrowing limits for payroll loans starting in March. The banks are forecast to maintain a cautious approach toward new lending, and households that benefit from recent measures to boost social benefits and reduce fuel prices - to use at least part of their increased incomes to paydown debt.

These trends support the view that the impact of the government's package to boost private consumption will have a moderate impact on real GDP growth. At the same time, high interest rates and persistent inflation will contribute to slower growth in 2023. Forecasters indicate the likelihood that Brazil's GDP growth forecast for 2022 [currently at 1.5%] will rise in the coming weeks. While growth may soften towards year-end, leading indicators, as well as stronger job creation and a new fiscal stimulus package, will lift overall growth higher than previously projected.

President Bolsonaro has again attacked the reliability of Brazil's voting system, which uses electronic machines. This is part of a long-running campaign to discredit upcoming October general election results, which most opinion polls indicate that he will lose to former president Luiz Inacio Lula da Silva.

There have been no meaningful cases of electoral fraud in Brazil in 26 years of electronic voting, and the system is considered safe by virtually all local and international specialists. Nevertheless, President Bolsonaro insists that there must be a paper trail so that the voting can be audited. The main concern is that, by calling a meeting with the foreign diplomatic corps to express these misgivings, Mr. Bolsonaro could be preparing international public opinion to justify a possible rejection of the result should he lose.

The election race is heating up, and the political landscape is likely to remain tense until the first-round vote, on October 2nd (the second round is on October 30th). There have already been instances of political violence, including the killing of a Lula supporter by a "bolsonarista" in the city of Foz do Iguaçu, on July 9th.

Bolsonaro will continue attacking the voting system despite calls for restraint, even from some of his allies. If he loses the election-especially narrowly-he will probably discredit the result and whip up protesters, many of whom now carry guns after his government relaxed gun laws. However, he would need much more support to stage a coup; and it is unlikely that the armed forces and political actors would support such an effort.

The Russia-Ukraine conflict could affect Brazil's foreign relations dynamics. Over recent decades Brazilian foreign policy has sought to consolidate the country's profile as an emerging-market leader while maintaining its long-standing tradition of neutrality on controversial international power disputes. Whoever wins the presidential election will try to keep a foot in both camps, but this will become increasingly tricky, and Brazil may be forced to commit more overtly to one side. However, neutral emerging markets could also benefit from the new geopolitical order.

As expected, policymaking is becoming more unpredictable and populist as the election approaches. Given that President Bolsonaro is trailing in the polls and voters are growing increasingly dissatisfied with the state of the economy, there is a growing risk that fiscal policy will become even looser this year. In this regard, the government has recently been trying to cushion the effects of high fuel prices on consumers; Congress recently approved a 17-18% cap on rates for a key state tax (ICMS), effectively reducing rates. The government wants to go even further and is negotiating a bill with Congress that would increase transfers to states that cut taxes on diesel, cooking gas and natural gas to zero until end-2022.

Meanwhile, President Bolsonaro is continuing his attempts to meddle with Petrobras's market-based pricing policy. We believe that this policy will be maintained, although risks of a change have increased.

Following recent downward revisions to U.S. and global GDP forecasts, the expectation is that Brazil's economy will grow by just 0.5% in 2023. This also partly reflects the likely reversal of fuel tax cuts at end-2022, which will push prices up in 2023, keeping interest rates and inflation higher for longer. At the same time, this year's GDP growth forecast was revised up to 1.5% (from 1.3% previously), as recent economic performance has been stronger than expected.

It is worth noting, however, that activity will weaken over the rest of the year, mainly because high interest rates and inflation will hit credit demand and sap purchasing power respectively, but also because some investment decisions will be postponed until the outcome of the presidential election is clear.

On the supply side, agriculture and mining exports will rise as global demand recovers. Manufacturing has already rebounded, owing to stimulus for consumers and a weaker currency, which could keep goods more competitive against imports. The services sector will recover more fully over the coming year.

The commodity price spike and looser fiscal policy will keep domestic inflationary pressures high over the next few quarters; 12-month consumer price inflation was 11.7%, substantially above the 3.5% mid-point target for 2022, despite tight monetary policy and measures such as temporary fuel tax cuts introduced to tame inflation. It is believed that inflation will ease and start to converge towards the declining medium-term targets, owing to aggressive monetary policy tightening and a persistent output gap, but this is likely to occur later in 2023. The main threat to the forecast is that inflation expectations remain unanchored.

Given uncertainty surrounding the duration of the Russia-Ukraine conflict, and the government's weakening commitment to fiscal consolidation (along with a price spike when temporary tax cuts end), the risk of this happening--and potentially leading to a more persistent inflationary problem--has increased.

Notwithstanding some volatility in recent months resulting from global economic developments--notably aggressive tightening by the Federal Reserve, the Brazilian Real has recovered some of the losses that it sustained in the second half of 2021 amid fiscal concerns. This recovery has been turbocharged by the commodity price surge following the outbreak of the Russia-Ukraine war, as well as by rising local interest rates. In mid-June the Real was trading at R5.1:US$1, but by most measures it is still undervalued, and there is room for some slight Real appreciation later in 2023-26. In the near term, however, U.S. monetary tightening and election-related volatility will weaken the Real, especially as the vote approaches.

The main domestic downside risk is a market sell-off should confidence in debt sustainability evaporate (for example if the new administration's fiscal policy is looser than expected). Faster advances in productivity-enhancing reforms are an upside risk that could strengthen the Real more than anticipated.

The commodity price surge caused by the conflict in Ukraine has benefited Brazil, as an exporter of iron ore, crude oil, and soybean. This will lift the trade surplus, taking the current account to balance in 2022. Looking ahead, risks to Brazil's external position (including from a sudden fall in commodity prices should global demand collapse) will be assuaged by its structural trade surplus, modest external debt ratio, comfortable reserves cushion and a weaker Real than in the past.

Public external debt is low, and most companies have some sort of currency hedge, despite moderate private external debt. Exports of Agri-goods and iron ore to China and other countries will keep the trade account in surplus in 2022-26, but the surplus will decline gradually as imports rise following recession-related compression in 2020. As a result, the current-account position will deteriorate, with the deficit eventually widening to 2.7% of GDP by 2026. However, inflows of foreign direct investment (FDI) will cover the shortfall, reflecting sizeable market opportunities.

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